B10. 6317, Accounting for Financial Instruments
Summer 2017
Stern School of Business, New York University
Professor Stephen Ryan (10-73 KMC, 998-0020, fax 995-4004, sryan@stern.nyu.edu, office hours M/W 4-5:15 and by appointment)
Classes MW from 5/22-6/28 (except 5/29 M class is replaced by 6/2 F class)
Morning class/Section 60 9-11:55 AM, Afternoon class/Section 61 1-3:55 PM
Tisch UC-24

Description of Course: This course provides a conceptually sound and comprehensive treatment of the complex and imperfectly consistent financial reporting rules for financial instruments and structured financial transactions. The following terminology clarifies what this means.

- Financial reporting rules include both accounting and disclosure requirements.
- A financial instrument may be a financial asset or a financial liability. A financial asset is the right to receive cash or other financial instruments or to exchange financial instruments on favorable terms. A financial liability is the obligation to pay cash or other financial instruments or to exchange financial instruments on unfavorable terms.
- Structured financial transactions typically involve multiple financial instruments or transactions. Securitizations, repurchase agreements, and hedging relationships are examples of structured financial transactions.
- Structured financial transactions generally unbundle and repackage the risk and value of the financial instruments involved in the transactions, thereby enabling the counterparties to obtain desired economic, financial reporting, regulatory capital, and tax outcomes.
    - Frequently (but not universally) desired financial reporting outcomes include: income management through realization of gains or losses on sale; off-balance sheet accounting (i.e., reduced reported debt and thus leverage) for collateralized financing transactions; hedge accounting (which reduces reported income volatility for the hedging relationship); particular financial statement classification/presentation; and reduced disclosure.

Two related facts provide the context for this course. First, market participants continually design new financial instruments and structured financial transactions. These new financial products often stress existing financial reporting rules. Second, because the FASB tries to remedy these stresses over time, historically the average half-life of financial reporting rules for financial instruments and transactions has been fairly short, perhaps about five years.

Reflecting these facts, a primary goal of this course is to provide students with the intellectual tools to understand new financial reporting rules for financial instruments and structured financial transactions as they are written. Such understanding requires an awareness of the economically important features of the instruments and transactions and how these features generally are only partly captured by financial reporting rules. This understanding is particularly important for auditors, who increasingly are expected to be able to understand complex accounting issues and to explain them to non-accountants.

Relatedly, a second primary goal of the course is for students to learn how to conduct GAAP research on complex accounting issues. This task involves reading the relevant GAAP rules, spending the often considerable time necessary to determine how those rules apply to specific facts and circumstances, and addressing the ambiguity that sometimes remains regarding GAAP compliance and appropriate financial report disclosures. We will discuss problems and cases to help you learn how to conduct this research and the issues you should consider when faced with ambiguity. Auditors' career progress, legal exposures, reputations, and sense of self-worth can depend on how they (induce their clients to) resolve this ambiguity. Often, the simplest and best way to do so is for auditors to encourage their clients to make transparent disclosures.

Post-financial crisis, in response to political pressure not to stress financial institutions, the FASB reduced the scope of projects for financial instruments and transactions that it had begun working on in 2008. Moreover, it became much slower to issue these standards and much more generous with their effective dates. In 2016, the FASB finally began to issue standards for the following projects: measurement and financial statement classification/presentation (ASU 2016-01, effective for FY 2018);[1] measurement of credit losses (ASU 2016-13, effective for FY 2020); and leases (ASU 2016-02, effective for FY 2019). Two projects are in fairly advanced stages but no standards have yet been issued: hedge accounting and insurance.

The lengthy delays in the effective dates of issued standards yields the practical question of whether to cover existing accounting requirements or those that will become effective in a few years. Primarily to enable the use of current financial reports, in most cases I focus on existing accounting requirements and briefly describe how they will change.

<u>Topical Coverage</u>: The course begins with the three main measurement bases used in the current "mixed-attribute" accounting model for financial instruments: (1) amortized cost accounting, typically subject to impairment write-downs for financial assets; (2) fair value accounting; and (2) FAS 5's incurred loss model for loss contingencies (this basis will be eliminated by the new credit loss measurement standard when becomes effective for FY 2020). We will discuss the distinct features of these measurement bases, how different measurement bases apply to specific financial instruments, the problems caused by mixed-attribute accounting for portfolios of financial instruments, and how these problems are mitigated in part through disclosure.

The course then proceeds to the accounting for structured financial transactions. Some of these transactions, such as securitizations and repurchase agreements, raise the issue of sale versus secured borrowing accounting. Some transactions employ special purpose/variable interest entities, which raise the issue of consolidation of the entities.

The course finishes with the accounting for derivatives and hedging.

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[1] ASU 2016-01's two most significant changes are: (1) to require full fair value accounting for non-controlling equity investments and (1) to present unrealized gains and losses associated with the reporting firm's own credit risk on liabilities for which the firm elects the fair value option in (accumulated) other comprehensive income.

While this course focuses on U.S. GAAP for financial instruments and transactions, there is considerable overlap with IFRS. Post-financial crisis, however, the FASB and IASB have been largely unable to come to consensus on what started out as joint projects related to financial instruments and structured financial transactions. I will occasionally mention significant differences between U.S. GAAP and IFRS.

<u>Textbook?</u>: No good, up-to-date textbook exists that covers the course material. I summarize the most relevant aspects of accounting standards in my detailed, up-to-date class presentation slides. I will hand out those slides, as well as problems, cases, and other materials in class. To conserve class time I may skip over slides that contain background material in class; if you have questions about a slide that I skip over, please ask in class or afterwards.

If you find the class slides are inadequate, you can consult the following two optional references, both of which I wrote and are available on NYUClasses: (1) a research-oriented monograph, Stephen G. Ryan, "Financial Reporting for Financial Instruments," *Foundations and Trends in Accounting*, 2011; and (2) an out-of-date book, Stephen G. Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, 2007, John Wiley & Sons. Although out of date, the book contains considerable discussion of accounting and financial analysis beyond that in the monograph. In the course outline, I indicate the portions of the monograph and book that are relevant to the each session of the course.

<u>The Accounting Standards Codification</u>: To conduct GAAP research, we will also directly identify and read the relevant GAAP. It is essential for auditors to be able to read and understand GAAP at the source.

As of September 2009, the FASB organizes pre-existing accounting standards (from all primary sources) and issues new standards according to the Accounting Standards Codification (ASC). New standards are issued as Accounting Standards Updates (ASUs). ASUs are prefaced by brief summaries describing their purposes and effects. Significant ASUs also contain basis for conclusions sections.

The ASC has strengths and weaknesses relative to the prior system. On the plus side, putting all of GAAP into a single, searchable database, with hyperlinks to implementation guidance and examples, significantly facilitates the conduct of GAAP research. On the minus side, the ASC does not reliably exposit material in a coherent fashion, in part because it forces each standard into the same schema. It also does not contain the basis for conclusions sections of pre-existing standards or ASUs that explain what the FASB had in mind in setting financial reporting requirements. Lastly, even after using the ASC for eight years, I find it very difficult to remember the relevant section numbers in the ASC's five-level-deep schema.

Standards issued by the FASB and it predecessors prior to the adoption of the ASC in September 2009 are available online on the ASC website.

Full access to the ASC is available to Stern accounting students at http://www2.aaahq.org/ascLogin.cfm, with the username AAA51820 and password B65cRfY.

Prerequisites: This course is only open to students that have completed the Stern undergraduate degree in the accounting CPA track.

Grading: Your grade will be determined as follows.

1. 40% 3-hour in-class "mid-term" on June 21 testing the course material covered in class up to that time
2. 40% group accounting research project. I will hand out the projects and group assignments on June 7, the groups will present the projects in class on June 28, and the written projects are due on July 10 at 5 pm. I am on vacation from July 1 to July 8, so your group should ask me any questions you have about the case write-up by June 30.
3. 20% class participation that evidences preparation for class and considered thought about the material. Volume is far less important than quality of thought.

Group Accounting Research Project: On June 7, I will divide the class randomly into groups of 5-7 students each and assign each group a case. Depending on the number of groups, two groups may receive the same case. Groups should attempt to resolve the case questions and any related questions that arise through GAAP research, judgment, and discussion among the members. The groups will present their transactions and findings on the last day of class (June 28). Each group will have 20 minutes to present followed by 10 minutes of questions from me and the remainder of the class. Each group will hand in a written report by July 10 at 5 pm; this report should attempt to summarize and address any issues raised in group presentation. The reports should not exceed 20 pages, double-spaced, 12 point font, 1 inch margins. Shorter reports are fine as long as they adequately cover the material; 12 pages has been the typical length in prior years. You may add appendices with the relevant GAAP, diagrams of the transactions, and similar supporting material.

NYUClasses/Access to Class Materials and Streaming Videos: While I will hand out all materials needed for the course in class, I will post the materials that are in electronic form on NYUClasses. These materials include files for streaming videos of each class. They also include the exams from 2010-2016 with answers. I will not use NYUClasses for other purposes. Please let me know if I have forgotten to post something on NYUClasses.

Course Schedule: The tentative sequence of class sessions is attached. Some of the readings and assignments may change over the course of the term. **NOTE THAT THERE IS NO CLASS ON MEMORIAL DAY (MONDAY MAY 29), AND THERE IS A REPLACEMENT CLASS ON FRIDAY JUNE 2.**

Course Schedule (Tentative)

THERE IS NO CLASS ON MEMORIAL DAY (MONDAY MAY 29). THERE IS A REPLACEMENT CLASS ON FRIDAY JUNE 2.

READ THE RELEVANT CLASS PRESENTATION SLIDES BEFORE EACH CLASS

5/22 Course Overview and Introduction to Financial Instruments, Interest Rate and Credit Risks, and Motivations for Structured Financial Transactions

Optional reading in Ryan Monograph: Chapters 1 and 2

Optional reading in Ryan Book: Preface, Chapter 1, Chapter 4, pp. 63-78, Chapter 5, pp. 93-97. Don't sweat the duration-related equations in Chapter 4, but try to follow the gist of the discussion.

5/24-5/31 (half) Amortized Cost and/versus Fair Value Accounting

Relevant Standards: APB 21 (amortized cost accounting) [ASC 835-30]
FAS 91 (deferral of certain fees and costs and related yield adjustments) [ASC 310-20]
FAS 157 (fair value measurement guidance) [ASC 820-10]
FAS 107 (fair value disclosures) [ASC 825-10]
FAS 159 (fair value option) [ASC 825-10]
ASU 2016-01 (gains on losses on fair valued liabilities associated with the reporting firm's own credit risk) [ASC 825-10-45]

Optional reading in Ryan Monograph: Chapter 4, pp. 65-88. The portion of Section 4.1.1 that pertains to impairment write-downs is related to the next session of the course.

Optional reading in Ryan Book: Chapter 6, pp. 131-149. This chapter is somewhat out of date, because it does not discuss FAS 159 and ASU 2016-01

Prepare: Amortized cost accounting versus fair value accounting spreadsheet exercise. (Similar questions on past exams: 2010 Exam, questions 3 and 4 (partly); 2011 Exam, questions 2 and 3 (partly); 2012 Exam, question 3)
Citigroup's Super-Senior CDO Write-downs during 2007 thought questions
Recast Well Fargo's 2016 income statement to fair value. (Similar questions on past exams: 2012 exam, question 3; 2013 exam, question 2; 2014 exam, question 2; 2015 exam, question 2; 2016 exam, question 2)

5/31 (half)-6/2 Investment Securities, Gains Trading, and the Various Impairment Accounting Models for Financial Assets

Relevant Standards: FAS 115 (investment securities) [ASC 320-10]
FSP FAS 115-2 and FAS 124-2 (2009 change in other-than-temporary impairment guidance) [ASC 320-10]
EITF 99-20 (retained securities from securitizations)
FAS 114 and 118 (loan impairment) [ASC 310-10 and -40]
FAS 65 (mortgage impairment) [ASC 948]
SOP 03-3 (acquired impaired loans) [ASC 310-30]
ASU 2016-01 (the new accounting for non-controlling equity investments effective for FY 2018) [ASC 321]
ASU 2016-13 (the new credit loss standard effective for FY 2020) [ASC 326]

Optional reading in Ryan Monograph: Section 4.1.1.

Optional reading in Ryan Book: Chapter 6, pp. 149-160. This chapter is significantly out of date because it does not discuss FSP FAS 115-2 and FAS 124-2 and ASU 2016-13.

Prepare: Impairment accounting numerical exercise
Impairment accounting research exercise
Wells Fargo 2016 gains trading case
Review Problem on Amortized Cost Accounting, Fair Value Accounting, and Other-than-Temporary Impairment
Question on past exams related to impairment accounting: 2010 Exam, questions 3 and 4 (partly); 2011 Exam, questions 2 and 3 (partly); 2012 Exam, question 2; 2013 Exam, question 2; 2014 Exam, question 3; 2015 exam, question 3; 2016 exam, question 3

6/5-6/7 The Incurred Loss Model for Loss Contingencies

Relevant Standards: The incurred loss model GAAP below is in ASC 450-20, 310-10-S99, and 942-310-25-1]
FAS 5 (the incurred loss model) [ASC 450]
FIN 14 (interpretative guidance for FAS 5's capable of reasonable estimation condition) [ASC 450-20]
ASU 2016-13 (the new credit loss standard effective for FY 2020) [ASC 326]

Optional reading in Ryan Monograph: Chapter 3, pp. 29-46.

Optional reading in Ryan Book: Chapter 5. This chapter is somewhat out of date because it does not discuss ASU 2016-13.

Prepare: Allowance for Loan Losses Numerical and Research Exercise, Including Thought Questions Regarding Loan Loss Reserving based on Historical Data in 2006
Wells Fargo's Allowance for Loan Losses Adequacy in 2016
Question on past exams related to incurred loss model: 2011 Exam, question 4; 2012 Exam, question 4; 2013 Exam, question 4; 2014 Exam, question 4; 2015 exam, question 4; 2016 exam, question 4

6/12-6/14 FAS 140 and 166: Sale versus Secured Borrowing Accounting for Securitizations and Repurchase Agreements

Relevant Standards: FAS 140 (transfers of financial instruments) [ASC 860]
FAS 166 (significant amendment) [ASC 860]
ASU 2014-11 (requires most repurchase agreements—repos to maturity in particular—to be accounted for as secured borrowings, medium important) [ASC 860]

Optional reading in Ryan Monograph: Chapter 5, pp. 511-512 (through middle of first paragraph) and Section 5.2.2. While optional, Section 5.3.3 surveys accounting research on topics related to securitizations and may be of interest.

Optional reading in Ryan Book: Chapter 8. This chapter is highly significantly out of date because it does not discuss FAS 166.

Prepare: Sale versus secured borrowing research exercise: Repo 105 (note ASU 2011-3 altered the critical portion of FAS 140)
Doral Financial Case
Questions on past exams related to securitizations: 2010 exam, question 5; 2011 exam, question 5 (partly); 2012 exam, question 5; 2013 exam, question 5 (the last part is partly related to the following session); 2014 exam, question 5; 2016 exam, question 5
Question on past exam related to repurchase agreements: 2015 exam, question 5

6/19 FIN 46(R) and FAS 167: Special Purpose/Variable Interest Entity Consolidation

Relevant Standards: FIN 46(R) (consolidation of variable interest entities) [ASC 810-10]
FAS 167 (significant amendment) [ASC 810-10]
ASU 2015-02 (technical amendment with sizable implications for certain types of VIEs such as limited partnerships) [ASC 810-10]

Optional reading in Ryan Book: Chapter 9, pp. 235-244. This chapter is highly significantly out of date because it does not discuss FAS 167.

Prepare: 2011 exam, question 5 (partly)
VIE consolidation research exercise
JPMC's Support of its Credit Card Securitization Vehicles in 2009
Consolidation of a Jointly Sponsored Asset-Backed Commercial Paper Conduit

6/21 In Class Exam

6/26 Derivatives and Hedging Overview

Relevant Standards: FAS 133 (main standard) [ASC 815]
FAS 138 (amendments) [ASC 815]
FAS 149 (more amendments) [ASC 815]
FAS 161 (disclosures) [ASC 815]
FSP FAS 133-1 and FIN45-1 (more disclosures) [ASC 815]
The FASB has a project to simplify hedge accounting (see http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176159271017)

Optional reading in Ryan Monograph: Chapter 5, pp. 111-123 (through the end of Section 5.2.1).

Optional reading in Ryan Book: Chapter 11

Prepare: Derivatives problems 1-4

6/28 Group Project Presentations