ACCT-GB 6317 C1, Accounting for Financial Instruments
Summer 2024
Stern School of Business, New York University
Classes are in UC21 on Tu/Th from Th 5/23-Tu 7/2, 9:30 AM-12:25 PM
There will be a 15-minute break at a convenient time around 11:00 AM

Professor Stephen Ryan
***E-mail*: sr1@stern.nyu.edu**
***Office*: 5-129 KMC (this is essentially a closet, not an office, as the accounting suite is being renovated over the summer)**
***Office hours*: After classes in UC21 until questions cease or we are kicked out, F 1-3 by Zoom (except for June 21, when I am traveling), and by appointment**
***Teaching Assistant*: Qishen Fu, qf2071@stern.nyu.edu, office hours to be determined**

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 assets or to exchange financial instruments on favorable terms. A financial liability is the obligation to pay cash or other financial assets or to exchange financial instruments on unfavorable terms.
- A simple financial transaction involves an exchange of financial instruments or financial services.
- Structured financial transactions typically involve multiple financial instruments, services, or transactions. Securitizations and repurchase agreements are examples of structured financial transactions.
- Structured financial transactions generally unbundle and repackage the risk and value of the financial instruments and services involved in the transactions, thereby enabling the counterparties to obtain desired economic, financial reporting, regulatory capital, and tax outcomes.
    - Frequently desired financial reporting outcomes include income management through realization of gains or losses on sale; off-balance sheet accounting for financing transactions; hedge accounting (which reduces the volatility of reported income for the hedging relationship); preferred financial statement classification and/or 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, the average half-life of financial reporting rules for complex financial instruments and structured finance transactions historically has been fairly short, perhaps 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.

A second and related primary goal of the course is for students to learn how to conduct GAAP research on complex accounting issues. This task involves identifying and reading the GAAP rules relevant to the specific facts and circumstances involved, spending the considerable amount of time often necessary to determine how those rules apply to those 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. The simplest and often best way to do so is for auditors to encourage their clients to make transparent disclosures.

To give you a sense for the speed of change in the accounting for financial instruments and the importance of this accounting particularly for financial institutions, consider the following sets of recent events.

- Post-financial crisis, in response to political pressure to remove burdens on financial institutions, the FASB reduced the scope of several projects on financial instruments and transactions on which it had begun working in 2008. Moreover, the FASB became much slower to issue these standards and much more generous with their effective dates, particular for smaller public reporting companies and private companies. Beginning in 2016, the FASB finally issued standards for the following projects with the effective dates for large public reporting companies indicated: measurement and financial statement classification/presentation of financial instruments (ASU 2016-01, effective as of FY 2018);[1] measurement of current expected credit losses and elimination of other-than-temporary impairments (ASU 2016-13, effective as of FY 2020 for large public reporting companies and in 2023 for small public reporting companies and private firms); derivatives and hedge accounting simplification (ASU 2017-12, effective as of FY 2019); leases (ASU 2016-02, effective as of FY 2019); and long-duration insurance contracts (ASU 2018-12, effective for FY 2023).

- Due to the COVID-19 pandemic, several important accounting rules (1) were temporarily softened by one or more of bank regulators, the FASB, and the SEC; or (2) had their effective dates delayed by the FASB. The most notable instance of this was the delay and regulatory phase-in of the requirements of ASU 2016-13's current expected credit loss model.

- Leading up to the banking turmoil in March 2023 (i.e., the FDIC resolutions of three large regional banks: Silicon Valley, Signature, and First Republic), the amortized cost

[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.

> accounting for held-to-maturity securities, the exclusion of accumulated other comprehensive income (i.e., cumulative unrealized gains and losses) on available-for-sale securities from regulatory capital, and transfers of securities across classifications allowed problems to fester, largely unmanaged and regulated, at banks.

Be aware that, due to the numerous changes in the GAAP for financial instruments and transactions over time, particularly in recent years, along with the fact that I teach current GAAP, many prior exam questions and some other course materials (those that I deem overall useful to keep as part of the course) no longer reflect current GAAP. As discussed below, my class presentation slides reflect (my understanding of) current GAAP.

<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; (2) fair value; and (3) amortized cost less current expected credit losses (CECL). We will discuss the distinct features of these measurement bases, how different measurement bases apply to different 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.

Unfortunately, due to time constraints, we will not cover the (highly detailed) accounting for derivatives and hedging in this course. However, the fair value accounting principles underlying much of this accounting are covered in the course. I will occasionally allude to derivatives and hedge accounting.

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 were 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>No Textbook</u>: Unfortunately, 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 have posted or will post those slides, as well as problems, cases, and other materials, on Brightspace. To conserve class time, I will skip over certain slides that contain background material in class; if you have questions about any of these slides, please ask in class or afterwards.

If you find the class slides to be inadequate, you can consult the following two optional but *increasingly out-of-date* references, both of which I wrote and are available without charge on Brightspace: (1) a research-oriented monograph, Stephen G. Ryan, "Financial Reporting for Financial Instruments," *Foundations and Trends in Accounting*, 2011; and (2) a book, Stephen G. Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, second edition, 2007, John Wiley & Sons. The monograph has the benefits of being shorter and somewhat less out of date, but 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 remain relevant to 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 a highly useful skill 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.

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

In a nice move, in January 2023 the FASB made full access to the ASC available free at asc.fasb.org.

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

<u>Grading</u>: Your grade will be determined as follows.

1. 60% 5 take-home assignments (problems or short cases) on each of the 5 major topics covered in class. I will make each of these assignments immediately after the corresponding topic is completed and it will be due one week later. I will aim for each of these assignments to take three hours or less to complete.
    - Assignments from the prior three years with answers are available on Brightspace.
2. 40% group accounting research project. I will hand out the projects and group assignments on June 13, the groups will present the projects in class on July 2, and the written projects are due on July 12 at 5 pm. See below for further details.

In addition, about five students with the best class participation will receive a quarter grade bump (if they would not otherwise have received an A grade). High quality class participation evidences preparation and considered thought about the material. Volume is far less important than quality of thought and timeliness in the context of the development of a class session or specific problem or case.

Group Accounting Research Project: On June 13, I will divide the class randomly into six groups of approximately eight students each and assign each group one of three cases. (That is, two groups will receive each of the cases.) 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 (July 2). Each group will have 20 minutes to present followed by 10 minutes of questions from me and the remainder of the class. Each group member should present some aspect of the case. Each group will hand in a written report by July 12 at 5 pm; this report should attempt to summarize and address any issues raised in the 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.

Brightspace/Access to Class Materials/Streaming Videos: All course materials will be in electronic form and posted on Brightspace. These materials include the assignments with answers from 2020−2023 and the exams with answers from 2010−2019, although as noted above be aware that some of the exam questions are now out of date. I will use Brightspace only for limited other purposes. Please let me know if I have forgotten to post something on Brightspace. Class sessions will be streaming videoed, with the videos available from the Mediasite section of Brightspace.

Office Hours: Because the accounting suite is being renovated this summer, I will not have access to my usual office or office computer. I am sharing 5-129 KMC with another faculty. This closet-like office will work for office hours with one or maybe two students, but with not a crowd such as a group project team. Hence, I will cobble together opportunities for you to ask me questions as follows. First, I will stay in the classroom after each class until questions cease or we get kicked out. Second, I will have office hours by Zoom on Fridays from 1-3; please let me know by 12 if you plan to attend these office hours. Third, you can make an appointment to meet by Zoom; this will be the most natural way for group project teams to meet with me.

Teaching Assistant: Qishen Fu, an accounting Ph.D. student, will serve as the teaching assistant for the course. She will have office hours and probably will run some optional problem sessions. She is not available from May 28-31. Her e-mail is qf2071@stern.nyu.edu.

Course Schedule: The tentative sequence of class sessions is attached. **THE COURSE MATERIAL IS BOTH CUMULATIVE AND MORE COMPLEX THAN MOST ACCOUNTING YOU HAVE LEARNED SO FAR, SO IT WILL BE CRITICAL TO STAY ON TOP OF IT. WORKING THROUGH THE NUMERICAL EXAMPLES IN THE SLIDES AND THE SIMILAR PROBLEMS WITH ANSWERS AVAILABLE ON BRIGHTSPACE IS PARTICULARLY IMPORTANT.**

Course Schedule (Tentative)

PLEASE READ THE RELEVANT CLASS PRESENTATION SLIDES BEFORE EACH CLASS

5/23 Th Course Overview and Introduction to Financial Instruments, Interest Rate and Credit Risks, and Motivations for Structured Financial Transactions

Optional readings: Ryan Monograph, Chapters 1 and 2; Ryan Book, Preface, Chapter 1, Chapter 4, pp. 63-78, Chapter 5, pp. 93-97. Don't sweat the duration-related equations in these readings, but try to follow the gist of the discussion.

5/28 Tu-5/30 Th (~first two-thirds) 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 107 (fair value disclosures) [ASC 825-10]
FAS 157 (fair value measurement guidance) [ASC 820-10]
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 readings: Ryan Monograph, Chapter 4, pp. 65-88; Ryan Book; Chapter 6, pp. 131-149. The book chapter is out of date, because it does not discuss FAS 159 and ASU 2016-01.

Prepare for class (but not to submit):
2020−2023 first assignment problems (the 2023 problem is motivated by the March 2023 failure of SVB Financial)
Citigroup's Super-Senior CDO Write-downs during 2007 thought questions
Recast Well Fargo's 2023 income statement to fair value

Additional problems:
Questions on past exams similar to Wells Fargo problem: 2016 exam, question 2; 2017 exam, question 2; 2018 exam, question 2; 2019 exam, question 2

To submit: I will make the first assignment available when I finish this topic, which I expect will be on 5/30. This assignment will be due one week later, likely 6/6.

5/30 Th (~last third)-6/6 Th (~first two-thirds) Th Investment Securities, Gains Trading, and Impairments of Available-for-Sale Securities

Relevant Standards: ASU 2016-01 and ASU 2019-04 (non-controlling equity investment securities) [ASC 321]
FAS 115 (most aspects of debt investment securities) [ASC 320-10]
ASU 2016-13 (impairment of available-for-sale debt investment securities) [ASC 326]

Optional readings: Ryan Monograph, Section 4.1.1; Ryan Book, Chapter 6, pp. 149-160.

Prepare for class (but not to submit):
Wells Fargo gains trading in 2022 case
2020−2022 second assignment problems
ASU 2016-13 Accounting Standards Codification Research Exercise

Additional problems:
Impairment of AFS Securities under ASU 2016-13, part 1
Impairment of AFS Securities under ASU 2016-13, part 2
2016 exam, question 3; 2018 exam, question 3; 2019 exam, question 3. (These questions examine the differences between the accounting for impairments of AFS securities under ASU 2016-13 and prior GAAP.)

To submit: I will make the second assignment available when I finish this topic, which I expect will be on 6/8. This assignment will be due one week later, likely 6/15.

6/6 Th (~last third)-6/13 Th The Current Expected Credit Losses (CECL) Approach to Impairments of Financial Assets Measured at Amortized Cost, including Impairments of Held-to-Maturity Securities

Relevant Standards: ASU 2016-13 and ASU 2019-11 (recoveries) [ASC 326]

Optional readings: Ryan Monograph, Chapter 3, pp. 29-46; Ryan Book, Chapter 5. The accounting in both the monograph and book chapter are out of date as of FY 2020. Ryan, S. "The CECL Approach," *Banking Perspectives*, Quarter 1, 2019. The copy editor inserted two errors in this article in the last partial sentence on p. 6 that I did not catch in when proofing the article. This sentence should read: "Second, loss rates fall [not rise] when moving from bad times to good times (and rise [not fall] when moving from good times to bad times)…"

Prepare for class (but not to submit):
2020−2022 third assignment problems
ASU 2016-13's Current Expected Credit Loss Model Problem
Credit Loss Allowance Measurement under ASU 2016-13 versus FAS 5 Problem
Wells Fargo's Allowance for Loan Losses Adequacy in 2022

Additional problems:
Effect of Adopting ASU 2016-13 by Loan Type Problem (*warning*: This problem is difficult and not entirely well considered. It was question 4 on the 2018 exam.)
2016 exam, question 4. (This question examines the differences in the matching of interest revenue and provisions for loans under ASU 2016-13 versus FAS 5. It is strongly related to the required reading.)
2019 exam, question 4.

To submit: I will make the third assignment available when I finish this topic, which I hope will be on 6/15. This assignment will be due one week later, hopefully 6/22.

6/18 Tu-6/23 Tu (~first half) FAS 140 and 166: Sale versus Secured Borrowing Accounting

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 readings: Ryan Monograph, Chapter 5, pp. 511-512 (through middle of first paragraph) and Section 5.2.2; Ryan Book, Chapter 8. The book chapter is significantly out of date because it does not discuss FAS 166.

Prepare for class (but not to submit):
2020−2022 fourth assignment problems
Sale versus secured borrowing research exercise: Repo 105 (note ASU 2011-3 altered the critical portion of FAS 140)
Doral Financial Case

Additional problems:
Questions on past exams related to securitizations: 2016 exam, question 5; 2017 exam, question 5; 2018 exam, question 5; 2019 exam, question 5

To submit: I will make the fourth assignment available when I finish this topic, which I hope will be on 6/22. This assignment will be due one week later, hopefully 6/29.

6/25 Tu (~Second half)-6/27 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 (very 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: Ryan Book, Chapter 9, pp. 235-244. This chapter is highly significantly out of date because it does not discuss FAS 167.

Prepare for class (but not to submit): 2011 exam, question 5 (partly)
2020 and 2021 fifth assignment problems
JPMC's Support of its Credit Card Securitization Vehicles in 2009

Additional problems:
VIE consolidation research exercise
Consolidation of a Jointly Sponsored Asset-Backed Commercial Paper Conduit

To submit: I will make the fifth (and short) assignment available when I finish this topic, which will be on 6/27. This assignment will be due on 7/6.

7/2 Th Group Project Presentations