This course focuses on the:

1) financial analysis of firms in the financial services industries (thrifts, mortgage banks, commercial banks, and lessors); and the

2) accounting and disclosure rules for financial instruments (interest rate risk disclosures, loan loss disclosures, fair value accounting for financial instruments, securitization accounting, derivatives and hedge accounting, market risk disclosures, and lease accounting).

The main goal of the course is to provide students with an in-depth understanding of how financial reports provide unusually accurate and detailed (but not perfect) information about the risks and performance of firms in the financial services industries. These firms’ financial statements increasingly are based on fair value accounting and their financial reports typically include extensive risk and estimation sensitivity disclosures. Both fair value accounting and risk and estimation sensitivity disclosures are necessary ingredients for financial reports to convey the risk and performance of financial services firms in today’s world of complex, structured, and value and risk-partitioning financial instruments and transactions. While financial services firms often report imperfect (or worse) fair value measurements and risk and estimation sensitivity disclosures, careful joint analysis of the information they do provide invariably yields important clues about their risks and performance.

While this course is most relevant to students interested in the financial services industries, much of the accounting material also pertains to varying extents to other types of firms. For example, many firms securitize their accounts receivable or hedge their commodity, interest rate, or foreign exchange risk using derivatives.

Notice from the attached course schedule that I interweave the financial analysis of financial services industries with the accounting and disclosure rules that most directly affect these industries. This sequence of sessions reflects my belief that a good understanding of a financial services firm’s economics is a prerequisite for evaluating its accounting and disclosures and thus analyzing its financial reports. Throughout the course, I emphasize the use of financial reports for financial analysis purposes rather than technical accounting issues. I note, however, that some of the accounting and disclosure rules that we will cover (in particular, derivatives and hedging) are inherently complex, and that I do not avoid complexity when it is necessary for a
good understanding of the topic.

Prerequisites: B09.2301 (Financial Accounting: A User Perspective) and either B10.2303 (An Integrated Approach to Financial Statement Analysis) or B10.2302 (Financial Reporting and Analysis), or the equivalent. I assume the student has a working knowledge of basic finance, especially net present valuation and the operation of securities markets.

Requirements and Grading: There will be three take-home problems (usually cases based on public financial report information) with the following weight in determining your grade.

1. interest rate risk, credit risk, and fair value accounting  35%
2. securitizations  25%
3. derivatives, hedging, and market risk  40%

Each take-home problem will be handed out when I finish the relevant topic, regardless of whether I am on schedule or not. Class participation of the productive sort is encouraged and will be rewarded by one-quarter of a letter grade increase. I emphasize that productive participation does not require being either an expert or correct; for example, asking good questions is sufficient.

Required Text and Other Materials: The required text is Stephen Ryan, Financial Instruments and Institutions: Accounting and Disclosure Rules, John Wiley & Sons, 2002 (hereafter Ryan). I will also hand out various other readings, most importantly, the financial reports of representative financial services firms. While somewhat tedious, I highly recommend reading these reports carefully from cover to cover as they provide considerable insight into the firms and their financial services industries. In contrast, readings from the popular press can usually be skimmed. I will also hand out exercises and problems (usually with answers) for the financial analysis and technical accounting topics. While I only go over a subset of these exercises and problems in class, I highly recommend working through them all, looking at the answers only after you have made your own attempt.

Web Access to Materials/Blackboard: While I will hand out all materials needed for the course in class, the materials that are in electronic form will be available on Blackboard. I do not use Blackboard for any other purpose.

Course Schedule: The tentative sequence of class sessions is attached. Some of the readings and assignments will change over the course of the term.
Course Schedule (Tentative)

1/25-1/27 Course Overview and Background on Depository Institutions

Read: Ryan, Preface and Chapters 1 and 2
“Fair Value Accounting”, Speech by Federal Reserve Board Governor Susan Schmidt Bies

Note: I will not cover all of this material in class, but it is all worthwhile background reading.

2/1-2/3 Thrifts

Read: Ryan, Chapter 3
Excerpts from Golden West’s 2003 Annual Report and Form 10-K filing

2/8-2/15 Interest Rate Risk and Net Interest Earnings

a) repricing gap
b) analysis of net interest income
c) rate/volume analysis

Read: Ryan, Chapter 4
Exercises for Chapter 4
Yield curves from 2003
Interest rate disclosures from various financial institutions
“Historical Yield Curve”, fixedincome.fidelity.com
“As Interest Rates Climb, Must Bank Stocks Fall?”, New York Times, September 21, 2003
Bring Golden West’s financial report to class
Credit Risk and Losses

a) Accounting for loss contingencies (SFAS No. 5)
b) Accounting for loan impairments (SFAS Nos. 114 and 118)
c) Recent FASB decisions regarding loan commitments and guarantees

Read: Ryan, Chapter 5
Exercises for Chapter 5
“Bank Loans in America: Shell Game”, The Economist, March 24, 2001
“Banks’ Contingent Liabilities: Holding the Bag?” The Economist, March 2, 2002
“Survey Finds Loan Losses Rose Sharply”, New York Times, October 9, 2002
Loan loss disclosures from various financial institutions
Bring Golden West’s financial report to class

Prepare for class discussion: “SunTrust Banks – After the Restatement” case in Appendix 5A of Ryan
2/24-3/1 Fair Value Accounting for Financial Instruments: Disclosures and Investment Securities

a) fair value disclosures for all financial instruments (SFAS No. 107)
b) fair values of investment securities (SFAS No. 115)

Read: Ryan, Chapter 6
Thought question for Chapter 6
Bring Golden West’s financial report to class


The first take-home problem (interest rate risk and net interest earnings, credit risk and losses, and fair value accounting for financial instruments) will be handed out in class at the end of the session in which the material above is completed (which may not be 3/1), and it will be due by the end of class two weeks later.

3/3-3/8 Mortgage Banks

Read: Ryan, Chapter 7
Countrywide Financial Corporation’s 2003 annual report
“How Freddie Mac’s House Stands”, Wall Street Journal, October 1, 2002
“Can Fannie Mae Make Necessary Repairs?”, Wall Street Journal, October 1, 2002
“In a Shaky Economic Climate, Mortgage Refinancings Have Helped One Segment of Business: Online Lenders”, New York Times, October 22, 2001
3/10-3/24 Securitizations

a) main rules (SFAS No. 140)
b) recent FASB decisions regarding consolidation of non-qualified special purpose entities and guarantees

Read: Ryan, Chapter 8
“High Risk Lenders Land with a Thud”, Business Week, February 16, 1998
Press release regarding SEC’s cease-and-desist order against PNC
“CDO – Not Cash on Delivery”, The Economist, July 28, 2001
“Steal Industry”, The Economist, February 3, 2001
“Fannie Mae Eases Credit To Aid Mortgage Lending”, New York Times, September 30, 1999
Bring Countrywide’s financial report to class

Prepare for class discussion: “Aames Financial in the Hedge Fund Crisis Case” in Appendix 8A of Ryan

There are no classes on March 15 and 17 (spring break).

The second take-home problem (securitizations) will be handed out at the end of the end of the session in which the material above is completed (which may not be 3/24), and it will be due by the end of class one week later.

3/29 Commercial Banks

Read: Ryan, Chapter 9
Excerpts from J P Morgan Chase’s 2003 Annual Report
3/31-4/12 Derivatives and Hedging

a) Main rules (SFAS No. 133 and 138)
b) Recent FASB proposals regarding the definition of derivative

Read: Ryan, Chapter 10
Derivatives and hedging questions, problems, and cases
“Freddie Mac, Fannie Mae Seem More Volatile As Accounting Rule Highlights Hedging Risks”, *Wall Street Journal*, February 7, 2002
“Credit Derivatives: Rites of Passage”, January 12, 2002
“Enron Hid Big Loans, Data Indicate”, *New York Times*, February 27, 2002
Bring J P Morgan Chase’s financial report to class

The third take-home problem (derivatives, hedging, and market risk) will be handed out at the end of the session in which the material above is completed (which may not be 4/12), and it will be due two weeks later.

4/14-4/19 Market Risk Disclosures

Read: Ryan, Chapter 11
Alternative SEC Market Risk Disclosures Problem
Bring J P Morgan Chase’s financial report to class

Prepare for class discussion: “Bank One’s Offsetting Swaps?” case in Appendix 11A of Ryan
Lessors and Lease Accounting

a) main lease accounting rules (SFAS No. 13 and its amendments)

*Read:* Ryan, Chapter 12
Leasing exercises and problems
Examples from GAAP guide
“Favorable Lease Deals may be Fading Fast”, *New York Times*, December 15, 2000
Excerpts from Leasing Solutions’ 1998 Form 10-K filing
GATX’s 2003 Form 10-K filing