Policy 2.85
Hedge Accounting

Responsible Official: VP for Finance
Administering Division/Department: Controller’s Office
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I. Overview

To provide guidelines for constant maturity swap accounting. It is the responsibility of the Controller’s Office to accurately reflect the validity of securities and other financial instruments classified as derivatives on the financial books.

II. Applicability

All finance employees.

III. Policy Details

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2.85.1 Hedge Accounting Overview

The advantage of hedge accounting in “for-profit” accounting relates to the ability of the reporting company to defer recognition of qualifying hedge related activities by reporting changes in other comprehensive income (OCI) instead of through net income. Since the University is a not-for-profit organization, it is not allowed to report other comprehensive income and all activity must be reported as a change in net assets. Historically, the University has closely aligned its operating expense categories with the NACUBO functional area classifications and has reflected swap-related gains/losses as non-operating.
An example of a hedge transaction is the exchange of one indexed interest rate for a rate based on a different published index.

As governed by not-for-profit accounting rules disallowing OCI, the University is reporting hedge transaction unrealized and realized gains/losses as a non-operating activity for Emory’s consolidated financial reporting and the University’s stand-alone financial reporting.

These guidelines are based on the following applicable accounting pronouncements and guidance:

- FAS133
- FAS138
- NACUBO Financial Accounting Reporting Manual (FARM)

2.85.2 Guidelines for Accounting for Covered calls

Covered calls do not fall under the special hedging rules of FAS 133. Therefore University accounting should follow the same rules as other call options, with resulting gains or losses recognized in the Statement of Activities when realized or unrealized. As a non-profit entity subject to FAS 116 and FAS 117, Emory University does not report comprehensive income. This strengthens the case that deferrals under the hedging provisions of FAS 133 cannot be used.

2.85.3 Supporting research for Covered Call Guidelines

FAS 133 applies to all entities and requires all derivative instruments (“DI’) be recognized as either assets or liabilities on the balance sheet, at their respective fair values. Gains and losses on DI which are not designated as hedges are recognized currently in earnings (or as a change in net assets for nonprofit entities). Special accounting (effectively, the deferral of gains or losses) for derivatives is permissible only when the instrument has been designated as a hedge. [Source:Wiley GAAP Guide]

The written call option is a short position exposing the call option writer to upside risk. A covered call transfers upside potential of the long position to the buyer of the call and, thereby, may create more upside price risk than downside price expected benefit. FAS 133 Paragraph 399 on Page 180 does not allow hedge accounting for covered calls, because the upside potential must be equal to or greater than the downside potential. In the case of a covered call, the upside risk may exceed the downside potential.

FAS 133, Paragraph 399: This Statement does not permit hedge accounting for “covered call” strategies – strategies in which an entity writes an option on an asset it owns (unless that asset is a call option embedded in another instrument). In this strategy, any loss on the written option will be covered by the gain on the owned asset. However, a covered call strategy will not qualify for hedge accounting because the risk profile of the combined position is asymmetrical (the exposure to losses is greater than the potential for gains). In contrast, the risk profile of the asset alone is “symmetrical or better” (the potential for gains is at least as great as the exposure to losses).

Paragraph 399 on Page 180 of FAS 133 does not allow covered call strategies permitting an entity to write an option on an asset owned. In a covered call the combined position of the hedged item and the derivative option is asymmetrical in exposure to losses is always greater than potential gains. The option premium, however, is set so the option writer certainly does not expect those "remotely possible" losses to occur. Only when the potential gains are at least equal to potential cash flow losses will Paragraph 28c on Page 19 of FAS 133 kick in to allow a cash flow hedge under FAS 133. Also see Paragraph 20c on Page 12.

FAS 133, Paragraph 28c: If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. Testing is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c) (1).)
FAS 133, Paragraph 20 (c): If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. Testing is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss incurred from an unfavorable change in the underlying of the same percentage. [The reference to combined instruments refers to the written option and the hedged item, such as an embedded purchased option.]

A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate of other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.) Furthermore, a derivative instrument resulting from combining a written option and any other non-option derivative shall be considered a written option.

2.85.4 Guidelines for Financial Statement Disclosures

Due to the total assets of Emory University exceeding $100 million, the requirements of FAS 107 to disclose the fair market value of financial instruments would apply. If the total option calls included in the total investment portfolio for the University are immaterial, the University takes the position they do not intend to footnote the fair value of the call options.

In the Summary of Accounting Policies, the University may be required to disclose involvement with derivatives and state that the involvement is not material, assuming the year-end evaluation supports this statement. If the derivative amount is considered to be material, disclosure on a separate line in the current Investments footnote may be required.

2.85.5 Supporting Research for Financial Statement Disclosures

FAS 107 “Disclosures about Fair Value of Financial Instruments” defines the term “financial instrument” as cash, evidence of an ownership interest in an entity, or a contract that both:

(FAS 107, Paragraph 3(a)) Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity and (b) Conveys to the second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

The Black-Sholes model is often used for estimating the fair value of call options. (FAS 107, paragraph 25)

FAS 126 – “Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities” requires the entity to have less than $100 million of total assets on the date of the financial statements in order to be exempt from the requirements of FAS 107 (FAS 126, paragraph 2 and FAS 133, paragraph 537).

V. Definitions

NACUBO: The National Association of College and University Business Officers; a professional organization providing business support to higher education institutions.

Other Comprehensive Income (OCI): OCI is the sum of net income and other items required by for-profit entities to defer recognition on the income statement because they have not been realized. These items are not a component of realized net income, but are considered significant enough to warrant representation to the reader of the financial statement.

Covered Call: Term used to describe the situation when an option writer already owns shares and can therefore turn them over to the option buyer without having to go to the market to purchase them first.
**Derivative:** A financial instrument deriving its value from changes in benchmark-based stock prices, interest rates, mortgage rates, currency rates, commodity prices or some other agreed-upon reference. Option contracts and forward contracts are the two basic forms of derivatives; they can be either publicly or privately traded.

V. **Related Links and Resources**

- Current Version of this Policy: [http://policies.emory.edu/2.85](http://policies.emory.edu/2.85)

VI. **Contact Information**

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<thead>
<tr>
<th>Subject</th>
<th>Contact</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Accounting</td>
<td>Controller’s Office</td>
<td>404.727.6080</td>
<td><a href="mailto:ctrl@emory.edu">ctrl@emory.edu</a></td>
</tr>
</tbody>
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VII. **Revision History**

No previous versions of this policy were found.

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