Hedge Accounting Can Bite You!

By John Nardozzi, CPA
Nardozzi Consulting, LLC

While we are still several weeks away from the heart of the heating season, it appears that several of the more dire pre-season predictions are not coming true. The combination of a warmer-than-average fall, relatively calm hurricane season and plentiful oil supply has driven prices down appreciably. At least for now.

That's good news for consumers. But what about dealers who, anticipating another season of skyrocketing prices, committed significant portions of their pre-buy to fixed price programs? Or invested in hedging programs to protect themselves against unexpected movement in the market?

In some cases, customers who were clamoring for price protection this summer have turned their backs and abandoned the programs for lower "street" prices. As a dealer, what can you do about it? Unless you have a strong contract in place with your customers, or enforce a monetary penalty for early withdrawal from the program, you may be looking at hefty losses.

What about the hedge positions that many dealers have taken to protect themselves? If you guessed right, you may actually see the value of your hedge increase as oil prices fall. On the other hand, you may take a "hit" on the value of your hedge position if you applied last years lessons to this year.

To make matters worse (or at least more complex), you must account for these gains or losses. Many retail oil companies have a calendar year-end, which falls in the middle of the heating season, which further complicates matters.

While space prevents me from getting into too much detail, you should be aware of the following issues regarding financial reporting for price protection or hedging programs.

If you have hedging programs in place at the end of the year, and the value of those options is less than you paid for them (a likely scenario if oil prices remain low) you must show the loss as a reduction of equity on your year-end financial statement. On the other hand, you cannot take a tax deduction for this loss until the contract is fulfilled, which would push the deduction into the next tax year.

If, on the other hand, your hedging options increase in value, you must show the gain as an increase in equity. The good news is that this is also not a taxable event.

Each of these events represents a change in equity because the increase or decrease in the value of your pricing program is not regular income, thus does not go through your profit & loss statement. Instead, it is “suspended” and treated as a pending adjustment to the equity of the company. Remember this is a financial statement loss (or gain), not a tax deduction or a taxable gain.

Accounting for losses of hedging options for the oilheat dealer falls into two categories, unrealized and realized.

UnRealized: If the hedge option has not yet expired as of year-end, you must "mark to market" and record any unrealized gain or loss as comprehensive income/loss. This is called hedge accounting, For tax purposes, the unrealized gains or losses should not be recorded.

Realized: If, as of year-end, the option has expired and there is a realized gain or loss, and your company is not utilizing the hedges in a speculative way, you may be able to treat this as a “cost of goods sold.” If you are using the hedges in a speculative way, they should be treated as investment gains or losses.

As you can see, the accounting required for hedge and price protection programs is complex and convoluted. You should consult with a your CPA or other knowledgable professional who is familiar with the process before making any decision. Make sure you have an understanding of its impact prior to your year-end to avoid surprises.

Hope you all have a successful season!

John Nardozzi of Nardozzi Consulting, LLC provides valuation, transaction advice and business management services for fuel oil retailers and distributors. He can be reached at (617) 487-4752, or jnardozzi@nardozziconsulting.com.