

# 5 BUCK CLUCK

A SOLUTION TO ONE OF COSTCO'S MOST IMPORTANT PRODUCT LINES

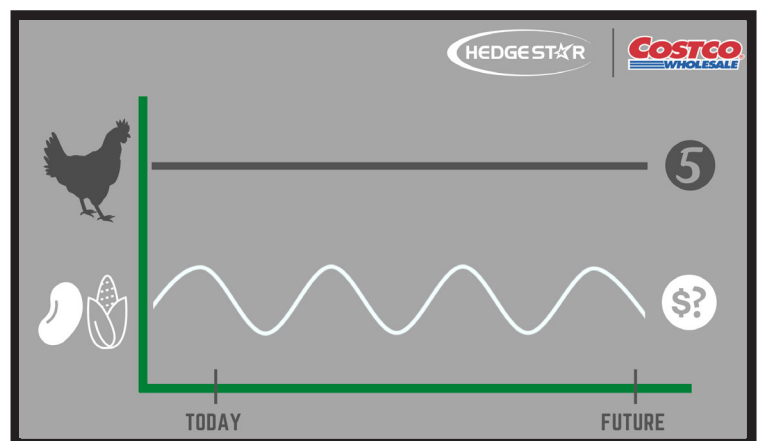


## BACKGROUND

Costco Wholesale Corporation (the “Company” or “Costco”) had a clear goal in mind. The Company wanted to sustain the price of their massively popular rotisserie chickens, or “broilers,” at a flat \$4.99 per chicken and deliver it with a reasonable operating margin. Costco has offered broilers since the chain first opened in 1985 and has not changed its price since 2009. Just how popular are these chickens? Costco sold 91 million of them in 2018. The Company supplies almost 10% of the chicken consumed in the USA.

Poultry is a \$65 billion industry – more than 60% of which is supplied by Tyson, Pilgrim’s Pride, Sanderson Farms, Perdue and Koch foods. Demand by consumers for chicken has only increased during the last decade, putting these major suppliers in the driver’s seat for retail pricing. Costco had seen fluctuating chicken prices from competitors who were, understandably, seeking to achieve healthier margins to accommodate changes in supply chain and manage their own increasing input costs.

Maintaining a flat price for their poultry product has been challenging for the retail giant. Costco was becoming increasingly sensitive to changes in market prices. More importantly, rising grain prices inherent in chicken feed were causing poultry costs to increase. This was exposing the Company to commodity price risk. It was apparent that changes in grain prices, such as corn and soybean meal, were having significant impacts on the profitability of their broiler chicken product. For these reasons (and many more), Costco wanted to reduce reliance on the major poultry market suppliers, proactively reduce price risk and take control of their operating margin.



The answer? Build a \$450 million poultry production facility equipped with feed mill and hatchery in the heart of the Midwest grain belt – Fremont, Nebraska.

91 million chickens sold by Costco in 2018

10 % of chicken consumed in USA is supplied by Costco

## THE PROJECT SCOPE

Costco was already adept at managing vendor relationships within the supply chain and merchandising products for mass consumption. They were also familiar with vertical integration after bringing beef hot dogs “in-house” back in 2009. But this would be the first time the Company was expected to hedge their commodity input prices.

For all their experience, Costco needed help. The Company was new to creating a full-scale risk management program (the “Program”) and new to addressing price risk with hedging instruments. This is where HedgeStar entered the scene.

HedgeStar’s key contact at Costco was Tom Sherman, Assistant General Merchandising Manager for the Poultry business, who was candid about the significance of the project and its importance to senior leadership. Mr. Sherman relayed to HedgeStar their primary concerns.

The Company was concerned about clarity of roles and responsibilities for key stakeholders and groups across the organization that were expected to contribute to the Program. They were also concerned about what the policy would look like and whether it would be well-defined and useful for its users. “How will my leadership team be able to tell whether the Program is doing what it’s supposed to be doing,” said Mr. Sherman.

From an operational perspective, the Company was worried about its systems. Before HedgeStar had joined the project team, software vendors had already been selected. Costco was concerned about the software operating consistent with expectations, especially with risk management and financial reporting. Their final concern related to the use of derivatives as hedging instruments and it was a message that resounded like the rumble of an earthquake: no mark-to-market accounting under any circumstances. It was clear that the Company wanted to reduce volatility in earnings. In other words, hedge accounting would be the only acceptable means of record keeping for its hedging instruments.

As they expounded on poultry production and risk management needs, the full project scope for Costco started coming into focus:



Articulating oversight roles and responsibilities of the risk management program



Creating a new risk management policy



Onboarding a new risk management and procurement system



Implementing a new hedge accounting regimen

## THE HEDGESTAR SOLUTION

HedgeStar assembled its team of internal experts. Employees with backgrounds in enterprise risk management, audit, SEC financial reporting, accounting, tax and quantitative analytics were deployed to the project.



### Oversight Roles and Responsibilities

Costco owns and operates 782 warehouses in 13 countries with the help of 254,000 employees. It's a sizable operation with many moving pieces. As such, it was crucial to have appropriate oversight measures in place to properly administer the program. HedgeStar began by evaluating the governance structure to determine if there were existing committees that could oversee the new program. Based on HedgeStar's recommendation, the Company identified and refined its new Program team comprised of key employees from the Fresh Foods business, Treasury and Accounting departments. This Program team has direct reporting responsibilities up through Costco's head of merchandising and up to the CFO and CEO. Internal Audit was also elevated to oversee the Program, commensurate with its role as a 'third-line of defense' within the Company.

HedgeStar created a process flow to convey the workflow from initial hedge approval and execution, to system entry, accounting at the subsidiary and consolidation at the parent level. The process flow was a living, breathing document showing the data interchange as hedge processing moved from group-to-group, and entity-to-entity. The process flow helped give key stakeholders a sense of clarity around how the risk management activities would be managed.

### Risk Management Policy

As the Program was new to the Company, it needed assistance with the risk management policy. There were plenty of other policies to use for comparison, but this required careful tailoring. The Company's legal team provided the foundation and from there HedgeStar built up the document.

HedgeStar began by refining roles and responsibilities within the governance structure. This was accomplished by defining the scope of the program, risk exposures across the different asset classes, hedge strategies, and allowable hedging instruments.

Senior management and the Board of Directors needed an efficient tool to hold the execution team accountable to the Company's risk appetite and to establish "guardrails" surrounding the program.

HedgeStar provided the Company with examples of risk limits and metrics to which the Program team would adhere. Thus, the Risk Scorecard was born. It served as a weekly update for senior leaders to follow and ensure that risk management outcomes were consistent with expectation.



## Risk Management and Procurement System



Implementing an enterprise resource planning and procurement system from scratch is no small feat. Add a risk management platform on top and an already difficult task becomes monumental. Fortunately, the chosen vendor for the risk management platform (the “Platform”) already had strong infrastructure in place. The Platform needed to be customized for Costco’s preferences and enhanced to accommodate accounting treatment under Financial Accounting Standards Board (“FASB”) topic 815, also known as “hedge accounting.”

HedgeStar set out to collaborate with Costco’s overseas vendor to cover three core topics: 1) hedge entry process and control, 2) internal management reporting and 3) accounting and financial reporting. HedgeStar worked closely with the vendor’s consultants to make hedge approvals quick and easy, and to allow for ease of reporting in the event Internal Audit or their external auditors needed a catalogue of trades and approvals for control testing. Additionally, after having set risk limits and metrics with senior management, the commodity risk and procurement teams needed a better, automated way to comply with those limits/metrics. To address this, HedgeStar assisted in the Platform build out of automated checks so that, for example, the Company could not hedge more than XYZ total bushels of corn over a specified time horizon.

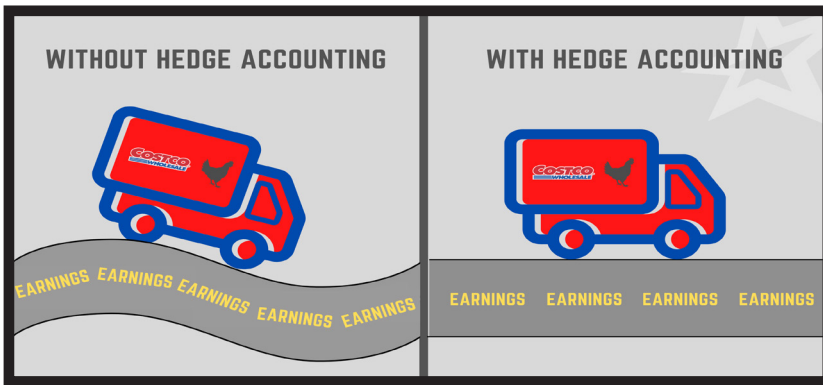
Costco required greater flexibility to accommodate its internal reporting needs including the weekly risk scorecard. The Platform needed a Business Intelligence (“BI”) tool to seamlessly create and make changes to reports as necessary. The BI tool was used to report on the valuation of the Company’s portfolio of hedges and help summarize hedge accounting results. This led to the final phase of the solution.

## Hedge Accounting Regimen

From many perspectives, hedge accounting is a complex and nuanced discipline. Not only does it represent one of the largest topics in the FASB codification, but it was new territory for Costco and its accounting and financial reporting teams. Costco needed to understand how to execute hedge accounting until their own software was ready for production. HedgeStar’s outsourced services would be the bridge solution to support the Company’s needs in interim.

In an effort to demystify hedge accounting, we decided the best place to start was training. HedgeStar’s training program included higher-level risk management framework concepts, hedging strategy, derivative instruments and their economics, financial reporting requirements, and lastly, hedge accounting. The training structure served its purpose of educating key Costco employees, flattening the learning curve and bringing relevant parties up to speed as quickly as possible.

Next, HedgeStar created draft hedge designation memorandums (“Hedge Memos”) for the accounting departments to evaluate. These Hedge Memos were placed in front of Costco’s external auditors for review and approval, which occurred well in advance of the initial hedge execution. HedgeStar also created ‘mock’ reports and stress testing examples so that the Company could get familiar with our reports and understand how significant changes in commodity prices would impact the fair value of their hedge positions.









When the time came to execute their first hedges, everyone was ready. HedgeStar finalized the Hedge Memos with initial effectiveness tests and delivered the first set of hedge accounting reports – Total Position, Hedge Position Summary, Hedge Position Detail and General Ledger reports – to the Costco teams. The teams were happy and relieved. Costco had successfully avoided mark-to-market accounting and adopted hedge accounting to reduce earnings volatility.

Our key contact – Mr. Sherman – was responsible for reporting results to senior leaders on a weekly basis. To address his urgent needs, HedgeStar created management reports that included information such as the risk scorecard, five-year corn and soybean meal price history, current USDA report summaries, hedge ratios and exposure ratios. He was satisfied with our services when saying “HedgeStar was extremely thorough in every aspect of our project. The team was sure to explain each facet of our risk management policy, hedge accounting treatment, and the software systems implementation so that we could be sure the finished product would both meet our needs and efficiently answer any questions posed by both Costco management and potential auditors.”

## Summary

HedgeStar delivered an end-to-end solution beginning with risk management and ending with hedge accounting. We were able to meet their needs by reducing volatility in earnings and mitigating commodity price risk in their supply chain. Per Mr. Sherman, “HedgeStar takes a very difficult and foreign subject matter and breaks it down into manageable, easy-to-understand pieces. The team came highly recommended and did not disappoint.” See [HedgeStar.com](http://HedgeStar.com) for more information on our services.

### FULL SERVICE HEDGE

-  Hedge Accounting Set-Up
-  Hedge Accounting Close
-  Auditor Interface
-  Audit Committee, Board, Analyst Presentations
-  Hedge Accounting Preview
-  Pre-Post Hedge Accounting

### ABOUT HEDGESTAR

Founded in 2004, HedgeStar delivers risk management consulting, derivative valuation and hedge accounting services, with a focus on providing transparency for financial reporting and hedge performance optimization software. We are experts in FASB, GASB and IFRS standards related to accounting for derivatives and fair value measurements. Our global clients include public and private corporations, real estate trusts, accounting firms, law firms, healthcare organizations, educational institutions, and governmental entities.

The HedgeStar team is comprised of valuation experts, Certified Public Accountants (CPAs), and hedging program professionals. We deliver our services with a personal touch. We understand our clients and their portfolios and are an extension of their risk, finance and accounting departments. We strive to live by our core values everyday. For more **information** visit [www.hedgestar.com](http://www.hedgestar.com)

Learn how HedgeStar’s solution can help you manage your financial risk. [Schedule a free, 30-minute assessment with a hedge accounting expert today: 866-200-9012](#)

**HedgeStar**