# Superannuation Funds and Warrants

## *What is a warrant?*

A warrant is a type of long-term put (sell) or call (buy) option which is tradable. The two most common forms of warrants used by superannuation funds are endowment and instalment warrants. At the cessation of a call warrant, the investor has acquired the underlying shares. The cost of the warrant will include interest and borrowing costs.

An **endowment warrant** does not have a specific exercise price or expiry date. These are geared share instruments. These are often a long-term investment. The investor pays a portion of the price of the underlying share, and the dividends payable on the underlying shares are used to pay the outstanding purchase amount and interest.

An **instalment warrant** is a shorter term investment. The investor pays a portion of the price of the underlying share, prepaid interest and borrowing costs and undertakes to pay the remainder of the price as at the expiry date. The holder of the warrant receives the full benefit of dividends paid on the underlying share and any attaching franking credits.

## *Can a superannuation fund invest in warrants?*

The Assistant Treasurer indicated that an endowment warrant or instalment receipt may be considered a borrowing. To address this concern the government has introduced legislation to allow an investment in warrants where the remaining instalment is not compulsory and the holder receives the value of the warrant/receipt less costs on default. Funds would therefore need to consult the contract document to ensure these requirements are met prior to entering into such an arrangement.
http://assistant.treasurer.gov.au/pcd/content/pressreleases/2006/078.asp

## *Accounting for warrants in a superannuation fund*

Warrants can be accounted for at year end in two methods. These are the market value method and the asset/liability method. There will be a variance in the value obtained by the two methods; however, this is generally an immaterial variance. Where the variance is material, the market value should be used.

The market value method is to value the warrant at the closing trading price for the year end. The change in net market value is the movement in the acquisition cost/prior year value and the market value at year end.

With the asset liability method, the asset is valued at the current market value of the underlying asset and a liability determined for the amount of the outstanding loan and any accrued interest and borrowing costs. In this case, the change in net market value is the movement in the net value of asset for the period. This method is used where the accounting package is the tool for the preparation of the tax return as well as the accounts.

The tax return requires use of the asset and liability method for tax reporting methods purposes. As a result of this, the ATO has sent a number of ‘request for information’ letters to superannuation funds with borrowings and interest paid included in the return. The ATO has indicated it will follow the approach adopted by APRA when reviewing these investments in SMSFs.

## *Auditing the balance*

The asset and liability information is available from the marketer of the warrant, which is traded on commercial terms similar to an investment in a unit trust. The market value is obtained through published listings of trading prices.

## *Compliance aspects of investing in warrants*

A warrant is a form of derivative and as such, a superannuation fund investing in these products should have a risk management statement and comply with the derivative provisions of the Superannuation Industry (Supervision) Act as contained in APRA Circular II.C.7

## *Disclosure aspects of investing in warrants*

An accounting policy note should be included, informing users of the financial report on the accounting policy applied in the fund.

Additionally for reporting entities, a warrant is a derivative product and as a result, it should be disclosed in accordance with AASB 139 where the fund prepares financial reports in accordance with the applicable accounting standards.

## *Accounting Entries using the Market Value Method*

**Purchase**
Dr Investment - warrants (No of Warrants * price)
Cr Cash
(Recognition of purchase)

**Revaluation**
Dr Investment - warrants(No of Warrants * (closing price -opening price)
Cr Change in Net Market Value
(Recognition of increase in market value at year end)

Dr Change in Net Market Value
Cr Investment - warrants(No of Warrants * (closing price -opening price)
(Recognition of decrease in market value at year end)

**Additional capital**
Dr Investment - warrants
Cr Income - dividend
(Recognition of dividend used to reduce the liability at exercise date)

**Closing out the position**
Dr Investment – warrants (Share)
Cr Cash
Cr Investment – warrants (No of Warrants * exercise price)
(Exercising the warrant)

Dr Cash
Cr Investment – warrants (No of Warrants * current price)
(Sale of warrant to issuer or on secondary market)

## *Accounting Entries using the Asset / Liability Method*

**Purchase**
Dr Investment – warrants (No of Warrants * underlying exercise price)

Dr Prepaid Interest
Dr Borrowing Expense
Cr Liability (Loan including borrowing costs)
Cr Cash (Amount paid for warrants)
(Recognition of purchase)

**Revaluation**
Dr ITE
Cr Deductible Prepaid Interest
Cr Deductible Borrowing Expense
(Recognition of tax deduction for expenses at year end)

**Closing out the position**
Dr Liability (loan amount)
Cr Cash
(Exercising the warrant)

Dr Cash
Dr Liability (loan amount)
Cr Prepaid Interest (not claimed)
Cr Borrowing Expense (not claimed)
Cr Investment – warrants (No of Warrants * underlying exercise price)
(Sale of warrant to issuer or on secondary market)