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230 *Compendium of Guidance Notes - Accounting*

GN(A) 17 (Issued 2003)

Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options

Foreword

In recent years, efforts have been made towards providing impetus for the development of Indian financial markets. As a part of these efforts, trading in derivative instruments has been introduced in the markets, in a phased manner, under the overall supervision of the Securities and Exchange Board of India. Equity index futures, equity stock futures, equity index options and equity stock options are derivative instruments in which trading has already been introduced by The National Stock Exchange (NSE) and The Stock Exchange, Mumbai (BSE).

With the introduction of trading in equity index futures, and equity index options and equity stock options in two phases, it was necessary to lay down accounting treatment for the same, based on sound accounting principles. Consequently, the Institute of Chartered Accountants of India, issued the 'Guidance Note on Accounting for Equity Index Futures' and the 'Guidance Note on Accounting for Equity Index Options and Equity Stock Options' which recommended accounting treatment for the respective instruments. With the introduction of trading in equity stock futures in the NSE and the BSE, it was imperative to provide guidance on the accounting treatment for the same. I am glad that keeping in view the similarity in the nature of these four derivative instruments, the Research Committee formulated this 'Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options' which contains comprehensive recommendations for accounting for these four derivative instruments.

I trust, this Guidance Note would be useful not only to the members but also to others concerned.

New Delhi
September 25, 2003

R. Bupathy
President

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Preface

Subsequent to the experience of successful trading in Equity Index Futures, Equity Index Options and Equity Stock Options, trading in Equity Stock Futures has also been introduced in the National Stock Exchange (NSE) and The Stock Exchange, Mumbai (BSE). Presently, all the above four instruments are being traded in a separate segment of the Stock Exchanges. Since these are similar instruments, a need was being felt for a Guidance Note that contains the recommendations in respect of all the above four instruments in a comprehensive manner. Accordingly, the Research Committee has formulated this 'Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options'.

Prior to the issuance of this Guidance Note, the Council of the Institute of Chartered Accountants of India had issued the 'Guidance Note on Accounting for Equity Index Futures' and the 'Guidance Note on Accounting for Equity Index Options and Equity Stock Options'. The new Guidance Note, besides including the recommendations of these existing Guidance Notes, recommends accounting for Equity Stock Futures. Apart from the above, modifications have been made in the light of the subsequent developments and to make the recommendations consistent in respect of accounting treatment of the instruments dealt with in the Guidance Note.

This Guidance Note discusses the nature of the four instruments (collectively referred to as 'Equity Derivative Instruments' in the Guidance Note) and trading mechanism thereof in a comprehensive manner. This Guidance Note recommends accounting treatment in the books of buyers and sellers of Equity Derivative Instruments which are settled in cash as well as of those which are settled by delivery of the concerned security. The Guidance Note also has an appendix to illustrate the application of the recommendations contained in the Guidance Note.

I would like to thank Shri Kamlesh S. Vikamsey, a member of the Central Council of the Institute, under whose convenorship the basic draft of the 'Guidance Note on Accounting for Equity Index Options and Equity Stock Options' was prepared and invaluable inputs were provided in respect of accounting for Equity Stock Futures. I am also thankful to Shri Ketan S. Vikamsey, Shri Deval A. Joshi and Shri Pankaj J. Thakur, the other members of the study group involved in the above endeavour. I also place on record my appreciation of the representatives of the National Stock Exchange, The Stock Exchange, Mumbai and the Securities and Exchange Board of India

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for giving their invaluable comments and suggestions during the preparation of the Guidance Notes on Accounting for 'Equity Index Futures' and 'Equity Index Options and Equity Stock Options'.

I take this opportunity to also thank all the members of the Research Committee, namely, Shri Vinod Jain (Vice-Chairman), Shri R. Bupathy (President), Shri Sunil Goyal (Vice-President), Shri Ashok Chandak, Smt. Bhavna G. Doshi, Shri Niranjan Saha, Shri P.P. Pareek, Shri S. Gopalakrishnan, Shri N.V. Iyer (special invitee), Shri G.C. Srivastava, Shri Chandrakant A. Sureka, Shri Cherian K. Baby, Shri Gobind Prasad Agrawal, Shri Pawan Kumar Sharma and Shri Sanjeev D. Lalan. My thanks are also due to all the members of the earlier Committees for their contribution in the preparation of the earlier Guidance Notes.

I would especially like to thank Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary to the Research Committee, and Shri Vishal Bansal, Technical Officer, for their invaluable contribution in the preparation and finalisation of the earlier Guidance Notes as also in the preparation and finalisation of this Guidance Note.

I sincerely hope that this Guidance Note will go a long way in the establishment of best accounting practices in respect of accounting for Equity Derivative Instruments and will be useful to the members and others concerned.

New Delhi
September 25, 2003

Rajkumar S. Adukia
Chairman
Research Committee

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Guidance Note on Accounting for
Equity Index and Equity Stock
Futures and Options

(The following is the text of the Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options, issued by the Council of the Institute of Chartered Accountants of India. With the issuance of this Guidance Note, Guidance Note on Accounting for Equity Index Futures and Guidance Note on Accounting for Equity Index Options and Equity Stock Options, issued by the Council of the Institute of Chartered Accountants of India, stand withdrawn.)

INTRODUCTION

1. During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are a kind of financial instruments whose values change in response to the change in specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts.
2. Equity index futures, equity stock futures, equity index options and equity stock options are traded on some major stock exchanges. For instance, in case of equity index futures and equity index options, The National Stock Exchange of India Limited (NSE) and The Stock Exchange, Mumbai (BSE) have introduced trading in S&P CNX NIFTY index and BSE SENSEX, respectively. In case of equity stock futures and equity stock options, NSE and BSE have introduced trading in certain securities specified by the Securities and Exchange Board of India (SEBI).
3. This Guidance Note deals with accounting treatment of equity index futures, equity stock futures, equity index options and equity stock options (hereinafter collectively referred to as 'Equity Derivative Instruments') from the viewpoint of the parties who enter into such contracts as buyers or sellers.
4. Equity Derivative Instruments are a type of financial instruments, which are bought or sold with specific motives, e.g., speculation, hedging and

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arbitrage. The accounting treatment recommended in this Guidance Note is applicable to all contracts entered into for Equity Derivative Instruments irrespective of the motive.

NATURE OF EQUITY DERIVATIVE INSTRUMENTS

5. In order to understand the nature of various Equity Derivative Instruments, it is essential to first understand the meaning of the terms 'forward contract', 'futures contract' and 'options contract'.

6. A forward contract is an agreement between two parties whereby one party agrees to buy from, or sell to, the other party an asset at a future time for an agreed price (usually referred to as the 'contract price'). The parties to forward contracts may be individuals, corporates or financial institutions. At maturity, a forward contract is settled by delivery of the asset by the seller to the buyer in return for payment of the contract price. For example, a person (X) may enter into a forward contract with another person (Y) on June 15, 20x3 to buy 10 kgs. of silver at the end of 90 days at a price of Rs. 8,200 per kg. At the end of the 90 days, Y will deliver 10 kgs. of silver to X against payment of Rs. 82,000. If the price of silver, at the end of the 90 days, is Rs. 8,300 per kg., X would make a profit of Rs. 1,000 and Y would lose Rs. 1,000, as X could sell silver bought at Rs. 82,000 for Rs. 83,000, whereas Y would have to buy silver for Rs. 83,000 and sell for Rs. 82,000. On the other hand, if the price of silver at the end of the 90 days is Rs. 7,800 per kg., X would lose Rs. 4,000, whereas Y would make a profit of Rs. 4,000, as X would have to sell silver bought at Rs. 82,000 for Rs. 78,000, whereas Y would buy silver for Rs. 78,000, which he would sell to X at Rs. 82,000.

7. A futures contract, like a forward contract, is an agreement between two parties to buy or sell an asset at a certain time in future for an agreed price. Futures contracts are normally traded on an exchange. To make trading possible, the exchange specifies certain standardised features of the contract. The exchange may also provide for guarantee mechanism to ensure that each party to the contract meets its obligations and, consequently, risk from default by parties is minimised.

8. An Option is a type of derivative instrument whereby a person gets the right to buy or sell at an agreed amount an underlying asset on or before the specified future date. He is not under any obligation to do so. The person who gets such right is called 'Option Buyer' or 'Option Holder'. The person against whom the buyer/holder can exercise his right is called 'Option Seller'

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or 'Option Writer'. Unlike a buyer/holder, the seller/writer of an option has no right but has an obligation to sell or buy the underlying asset as and when the buyer/holder exercises his right. In order to acquire the right of Option, the buyer/holder pays to the seller/writer an Option Premium, which is the price, paid for the right. Every option contract is for a specific period of time. On the expiry of the specified period, the contract also expires. On the basis of the rights of the buyer with regard to the time of settlement, the Options can be classified into two broad categories, viz., American style options and European style options. In case of American style options, the buyer/holder can exercise his right at any time before the contract expires or on the Expiry Date, whereas in case of European style options, the buyer/holder can exercise his right only on the Expiry Date.

9. An Option can either be a 'Call Option' or a 'Put Option'. In case of Call Option, buyer/holder of the Option gets the right to purchase the underlying asset whereas in case of Put Option buyer/holder gets the right to sell the underlying asset. In market terminology, a person buying a Call Option is considered to have made a 'long call' and a person buying a Put Option is considered to have made a 'long put'. Similarly, a person selling a Call Option or a Put Option is considered to have made a 'short call' or a 'short put', respectively. In a Call Option the seller/writer of the Option has an obligation to sell the underlying asset, whereas in a Put Option the seller/writer has an obligation to buy the underlying asset. The rights and the obligations of the parties involved in an option contract can be summarised in a tabular form as under:

Option Type	Buyer/Holder	Seller/Writer
Call	Right but not an obligation to buy the underlying asset.	Obligation but no right to sell the underlying asset.
Put	Right but not an obligation to sell the underlying asset.	Obligation but no right to buy the underlying asset.

10. The price at which the buyer/holder has the right to buy or sell and the seller/writer has an obligation to sell or buy is known as the 'Strike' or 'Exercise' price.

11. It may be noted that the buyer/holder of an option can make a loss of no more than the Option Premium paid to the seller/writer but the possible

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gain is unlimited. On the other hand, the Option Seller/Writer's maximum gain is limited to the Option Premium charged by him from the buyer/holder but can make unlimited loss.

12. In market terminology, an option contract can be 'at the money', 'in the money' or 'out of the money'. 'At the money' means that the current market value of the underlying asset is the same as the Exercise Price of the Option. A Call Option is said to be 'in the money' if the current market value of the underlying asset is above the Exercise Price of the Option. A Put Option is said to be 'in the money' if the current market value of the underlying asset is below the Exercise Price of the Option. A Call Option is said to be 'out of the money' if the current market value of the underlying asset is below the Exercise Price of the Option. A Put Option is said to be 'out of the money' if the current market value of the underlying asset is above the Exercise Price of the Option.

13. Futures and options are both standardised derivative instruments traded on a stock exchange. The difference between these two types of derivative instruments is in respect of the rights and obligations of the parties involved in such contracts. In case of a futures contract, both the parties are under obligation to complete the contract on the specified date. However, in case of options contract, the buyer/holder has a right, but no obligation to exercise the Option, whereas the seller/writer has an obligation but no right to complete the contract.

14. There can be futures and options on commodities, currencies, securities, stock index, individual stock, etc. In India, SEBI has permitted trading in futures and options in two equity indexes, viz., BSE SENSEX and S&P CNX NIFTY and certain specified securities listed on the stock exchanges. Currently, these futures and options contracts are traded on The Stock Exchange, Mumbai and The National Stock Exchange of India Limited.

Equity Index Futures and Equity Stock Futures

15. An equity index futures contract is a futures contract in which the underlying asset is an equity index, e.g., S&P CNX NIFTY or BSE SENSEX. In other words, it is a contract to buy or sell equity index at an agreed amount on a specified future date.

16. An equity stock futures contract is a futures contract in which the underlying asset is a security, e.g., equity shares of ABC Limited, equity

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shares of PQR Limited, etc. In other words, it is a contract to buy or sell a security at an agreed amount on a specified future date.

17. The following are the basic differences between these two types of equity futures:

(a) The underlying asset

In case of equity index futures, the underlying asset is equity index itself (e.g., BSE SENSEX, S&P CNX NIFTY), whereas in case of equity stock futures, the underlying asset is a security (e.g., equity shares of a company).

(b) The mode of settlement

By its very nature, the index cannot be delivered on maturity of the contract. As such, the settlement of an equity index futures contract takes the form of payment of the difference between the price as agreed in the contract (contract price) and the value of the index on the maturity date (Settlement Date), in cash. In contrast, an equity stock futures contract can be settled either through delivery of security for which the contract was entered into or by receipt/payment of the difference between contract price and the value of the security for which the contract was entered into, in cash, just like equity index futures. At present, in India, equity stock futures contracts are settled through cash. However, in near future equity stock futures may be settled through physical delivery of shares.

18. Examples of Equity Index Futures

- (i) In July, Mr. A enters into an equity index futures contract to buy 100 units of BSE SENSEX of September 20x3 series at a price of, say, Rs. 3,650 per unit. As a result, Mr. A is under obligation to buy 100 units of BSE SENSEX on the Settlement Date at the rate of Rs. 3,650 per unit. On the Settlement Date, if the price of BSE SENSEX is higher than Rs. 3,650, say, Rs. 3,680 per unit, Mr. A will receive Rs. 30 per unit (the difference between the price on the Settlement Date and the contract price). On the other hand, if, on the Settlement Date, the price of BSE SENSEX is lower than Rs. 3,650, say, Rs. 3,610 per unit, Mr. A will pay Rs. 40 per unit.

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- (ii) In July, Mr. B enters into an equity index futures contract to sell 200 units of S&P CNX NIFTY of September 20x3 series at a price of, say, Rs. 1,100 per unit. As a result, Mr. B is under obligation to sell 200 units of S&P CNX NIFTY on the Settlement Date at the rate of Rs. 1,100 per unit. On the Settlement Date, if the price of the S&P CNX NIFTY is higher than Rs. 1,100, say, Rs. 1,125 per unit, Mr. B will pay Rs. 25 per unit (the difference between the price on the Settlement Date and the contract price). On the other hand, if, on the Settlement Date, the price of S&P CNX NIFTY is lower than Rs. 1,100, say, Rs. 1,050 per unit, Mr. B will receive Rs. 50 per unit.

19. Examples of Equity Stock Futures

- (i) In July, Mr. A enters into an equity stock futures contract to buy 1,000 equity shares of XYZ Limited of September 20x3 series at a price of, say, Rs. 250 per share. As a result, Mr. A is under obligation to buy 1,000 equity shares of XYZ Limited on the Settlement Date at the rate of Rs. 250 per share. On the Settlement Date, Mr. A will have to settle the contract either through purchase of shares or by payment/receipt of the difference between the contract price of Rs. 250 per share and the price of the shares of XYZ Limited on that date, depending upon whether the contract is delivery-settled or cash-settled. If the contract is delivery-settled, on the Settlement Date, Mr. A will buy 1,000 equity shares of XYZ Limited at a price of Rs. 250 per share. On the other hand, if the contract is cash-settled, on the Settlement Date, if the price of the shares of XYZ Limited is higher than Rs. 250, say, Rs. 280 per share, Mr. A will receive Rs. 30 per share (the difference between the price on the Settlement Date and the contract price). However, if, on the Settlement Date, the price of the shares of XYZ Limited is quoted lower than Rs. 250, say, Rs. 210 per share, Mr. A will pay Rs. 40 per share.
- (ii) In July, Mr. B enters into an equity stock futures contract to sell 500 equity shares of PQR Limited of September 20x3 series at a price of, say, Rs. 500 per share. As a result, Mr. B is under obligation to sell 500 equity shares of PQR Limited on the Settlement Date at the rate of Rs. 500 per share. On the Settlement Date, Mr. B will have to settle the contract either through sale of shares or by payment/receipt of the difference between the contract

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price of Rs. 500 per share and the price of the shares of PQR Limited on that date, depending upon whether the contract is delivery-settled or cash-settled. If the contract is delivery-settled, on the Settlement Date, Mr. B will sell 500 equity shares of PQR Limited at a price of Rs. 500 per share. On the other hand, if the contract is cash-settled, on the Settlement Date, if the price of the shares of PQR Limited is higher than Rs. 500, say, Rs. 525 per share, Mr. B will pay Rs. 25 per share (the difference between the price on the Settlement Date and the contract price). However, if, on the Settlement Date, the price of the shares of PQR Limited is lower than Rs. 500, say, Rs. 450 per share, Mr. B will receive Rs. 50 per share.

Equity Index Options and Equity Stock Options

20. Equity index options are a type of derivative instruments whereby a person gets the right to buy or sell an agreed number of units of equity index on a specified future date. Equity stock options are a type of derivative instruments whereby a person gets the right to buy or sell an agreed number of units of a security on or before a specified future date. At present, in India, trading in equity index options is allowed in two indexes, viz., BSE SENSEX and S&P CNX NIFTY and equity stock options are allowed in certain specified securities listed on the stock exchanges.

21. The following are the basic differences between these two types of equity options:

(a) The underlying asset

In case of equity index options, the underlying asset is equity index itself (e.g., BSE SENSEX, S&P CNX NIFTY), whereas in case of equity stock options, the underlying asset is a security (e.g., equity shares of a company).

(b) The time of settlement

Equity index options are of European style, i.e., buyer/holder can exercise his option only on the day on which the option expires, whereas equity stock options are of American style, i.e., the buyer/holder can exercise his option at any time before the Expiry Date or on the date of expiry itself.

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(c) The mode of settlement

By its very nature, the index cannot be delivered on maturity of the contract. As such, the settlement of an equity index options contract takes the form of payment of the difference between the Strike/Exercise Price and the value of the index on the Expiry Date, in cash. In contrast, equity stock options contract can be settled either through delivery of security for which an options contract was entered into or by payment of the difference between the Strike/Exercise Price and the value of the security for which the options contract was entered into, in cash, just like equity index option. At present, in India, equity stock options are settled through cash. However, in near future equity stock options may be settled through physical delivery of shares.

22. Examples of Equity Index Options

Call Options

In July, Mr. A (buyer/holder) enters into an equity index options contract to buy a Call Option for 200 units of S&P CNX NIFTY of September 20x3 series at a price of Rs. 1,100 per unit. As a result, Mr. A obtains the right to buy 200 units of S&P CNX NIFTY on the Expiry Date at Rs. 1,100 per unit. For this right, Mr. A pays a premium of Rs. 10 per unit of index to the seller/writer of the option. If, on the Expiry Date, the price of S&P CNX NIFTY is higher than Rs. 1,100, Mr. A will exercise his right to call. By exercising the right to call, he will receive the difference between the price on the Expiry Date and the Strike Price. On the other hand, if the price is below Rs. 1,100, he will not exercise his Call Option.

Put Options

In July, Mr. B (buyer/holder) enters into an equity index options contract to buy a Put Option for 100 units of BSE SENSEX of September 20x3 series at a price of Rs. 3,650 per unit. As a result, Mr. B obtains a right to sell 100 units of BSE SENSEX on the Expiry Date at Rs. 3,650 per unit. For this right, Mr. B pays a premium of Rs. 25 per unit of index to the seller/writer of the option. If, on the Expiry Date, the price of BSE SENSEX is lower than Rs. 3,650, Mr. B will exercise his right to put. By exercising the right to put, he will receive the difference between the Strike Price and the price on the Expiry Date. On the other hand, if the price is above Rs. 3,650, he will not exercise his Put Option.

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23. Examples of Equity Stock Options

Call Options

In July, Mr. A (buyer/holder) enters into an equity stock options contract to buy a Call Option for 1,000 equity shares of XYZ Limited of September 20x3 series at a price of Rs. 250 per share. As a result, Mr. A obtains a right to buy 1,000 equity shares of XYZ Limited at the rate of Rs. 250 per share on or before the Expiry Date. For this right, Mr. A pays a premium of Rs. 5 per equity share to the seller/writer of the option. If, at any time on or before the Expiry Date, the price of the equity shares is quoted higher than Rs. 250, Mr. A may exercise his right to call. In case the contract is delivery-settled, by exercising the right to call, Mr. A will acquire 1,000 equity shares of XYZ Limited at Rs. 250 per share and since the prevailing market price is higher, he can make a profit by selling these shares in the market. In case the contract is cash-settled, by exercising the right to call, Mr. A will receive the difference between the prevailing market price and the Strike Price. On the other hand, if the market price is below Rs. 250 per share, he will not exercise his Call Option.

Put Options

In July, Mr. B (buyer/holder) enters into an equity stock options contract to buy a Put Option for 500 equity shares of PQR Limited of September 20x3 series at a price of Rs. 500 per share. As a result, Mr. B obtains a right to sell 500 equity shares of PQR Limited on or before the Expiry Date at the rate of Rs. 500 per share. For this right, Mr. B pays a premium of Rs. 15 per equity share to the seller/writer of the Option. If, at any time on or before the Expiry Date, the price of the equity shares is quoted lower than Rs. 500, Mr. B may exercise the right to put. In case the contract is delivery-settled, by exercising his right to put, Mr. B will sell equity shares of PQR Limited at Rs. 500 per share and since the prevailing market price is lower, he can make a profit by buying these shares in the market. In case the contract is cash-settled, by exercising the right to put, Mr. B will receive the difference between the Strike Price, i.e., Rs. 500 per share and the prevailing market price. On the other hand, if the market price is above Rs. 500 per share, Mr. B will not exercise his Put Option.

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DEFINITIONS

24. For the purpose of this Guidance Note, the following terms are used with the meanings specified:

Call Option: A Call Option is an Option to buy the specified underlying asset on or before the Expiry Date.

Clearing Corporation/House: Clearing Corporation/House means the Clearing Corporation/House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/Segment. (The terms 'Clearing Corporation' and 'Clearing House' have been used interchangeably in this Guidance Note)

Clearing Member: Clearing Member means a member of the Clearing Corporation and includes all categories of Clearing Members as may be admitted as such by the Clearing Corporation to the Derivatives Segment.

Client: A Client means a person, on whose instructions and, on whose account, the Trading Member enters into any contract for the purchase or sale of any contract or does any act in relation thereto.

Contract Month: Contract Month, in relation to a futures contract, means the month in which the exchange/Clearing Corporation rules require a contract to be finally settled, and in relation to an options contract, means the month in which the Expiry Date falls.

Daily Settlement Price: Daily Settlement Price is the closing price of the equity index/stock futures contract for the day or such other price as may be decided by the Clearing House from time to time.

Derivatives: Derivatives include,

- (a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- (b) a contract which derives its value from the prices, or index of prices, of underlying securities.

Derivative Exchange/Segment: Derivative Exchange means an Exchange approved by SEBI as a Derivative Exchange. Derivative

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Segment means Segment of an existing Exchange approved by SEBI as Derivative Segment.

Exercise Date: Exercise Date is the date on which the buying/selling right in the Option is actually exercised by the Option Buyer/Holder.

Exercise of an Option: Exercise of an Option means enforcing the right by the Option Buyer/Holder available under the option contract of buying or selling the underlying asset at the Strike Price.

Expiry Date: Expiry Date is the last date on or upto which the Option can be exercised.

Final Settlement Price: Final Settlement Price is the closing price of the Equity Derivative Instruments contract on the last trading day of the contract or such other price as may be specified by the Clearing Corporation, from time to time.

Long Position: Long Position means outstanding purchase obligations in respect of equity index/stock futures contracts at any point of time.

Open Interest: Open Interest means the total number of Equity Derivative Instruments contracts that have not yet been offset and closed by an opposite contract nor fulfilled either by delivery of cash or by actual delivery of underlying security.

Option: Option is a contract, which gives the buyer/holder the right, but not the obligation, to buy or sell a specified underlying asset at a predetermined price.

Option Buyer/Holder: Option Buyer/Holder is the person who buys a Call or a Put Option.

Option Premium: Option Premium is the price paid by the Option Buyer/Holder to the Option Seller/Writer to acquire the right in the Option.

Option Seller/Writer: Option Seller/Writer is the person who sells a Call or a Put Option.

Put Option: Put Option is an Option to sell the specified underlying asset on or before the Expiry Date.

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Settlement Date: Settlement Date means the date on which the outstanding obligations in an equity index/stock futures contract are required to be settled as provided in the bye-laws of the Derivatives Exchange/Segment.

Short Position: Short Position means outstanding sell obligations in respect of equity index/stock futures contracts at any point of time.

Strike Price/Exercise Price: Strike Price/Exercise Price is the price specified in the option contract at which the underlying asset may be purchased or sold by the buyer/holder.

Trading Member: Trading Member means a member of the Derivatives Exchange/Segment and registered with SEBI.

TRADING MECHANISM

25. Trading in Equity Derivative Instruments has commenced in India in a separate segment of existing stock exchanges known as 'Derivatives Segment'. The Clearing Corporation/House of the exchange may act as legal counter-party to all deals or may provide an unconditional guarantee for all the deals in Equity Derivative Instruments on the exchange. Thus, for all practical purposes, both the parties to an Equity Derivative Instruments contract would be assured that the obligations of the other party would be met – either by the party itself or, in the event of default on the part of the party, by the Clearing Corporation.

26. A Client can trade in Equity Derivative Instruments only through a Trading Member of the exchange. A Clearing Member can also act as a Trading Member. The process of trading is similar to screen-based trading in securities like shares on an exchange.

27. The exchanges, allowing trading in Equity Derivative Instruments contracts, introduce standardised contracts where the Settlement Date/Expiry Date, as the case may be, is specified by the stock exchange and the Clients can enter into contracts with different contract/Strike Prices, as the case may be, and different premiums, if relevant. The Settlement Date/Expiry Date adopted by BSE and NSE is the last Thursday of a Contract Month. For example, the Equity Derivative Instruments contracts of August 2003 series will expire on 28th August 2003 (being the last Thursday of August 2003). In both BSE and NSE, the Equity Derivative Instruments contracts will have a maximum of three month trading cycle – the near month (one),

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the next month (two) and the far month (three). Thus, in August 2003, one would be able to enter into futures contracts for the months of August 2003, September 2003 and October 2003. On 28th August, 2003 (last Thursday of August 2003) the Equity Derivative Instruments contracts for August 2003 series will be finally settled/will expire and thereafter trading in November 2003 series will start.

28. Each exchange permitting Equity Derivative Instruments trading also provides the contract specifications. For example, the NSE has decided to permit contract multiplier of 200 for the S&P CNX NIFTY futures/options contracts, whereas the BSE has decided that the contract multiplier would be 50 for trading in BSE SENSEX. Similarly, for each individual stock, market lot has been decided. A person can trade in Equity Derivative Instruments only in the multiples of the market lot.

29. In order to minimise the risk of failure of parties to a contract in fulfilling their respective obligations under the contract, the Clearing Corporation, from time to time, prescribes margin requirements for Clearing/Trading Members. Margins are required to be paid by Clearing/Trading Members, who, in turn, collect margins from their respective Clients. Margins can be paid in cash or be provided by way of a bank guarantee or by deposit receipts or securities or such other mode and would be subject to such terms and conditions as the Clearing Corporation may specify from time to time. There is a continuing obligation, during the contract period, to maintain margins at the levels specified by the Clearing Corporation, from time to time.

30. Every Client is required to pay an initial margin to the Trading Member/Clearing Member at the time of entering into an Equity Derivative Instruments contract. Such a margin is calculated by using a Software called 'Standard Portfolio Analysis of Risk' (SPAN). SPAN calculates risk arrays for all the open positions on an overall basis and gives the output in the form of a risk parameters file. This risk parameters file is made available to all the participants of Derivatives Segment. Members and Clients use the data from SPAN risk file, together with their position data, to calculate SPAN margin requirements on their respective positions on daily basis. SPAN calculates the margin by determining the worst possible loss using 16 risk scenarios. The Clients pay the deficit margin to, or receive the refund of excess margin from, the Trading Member/Clearing Member on daily basis.

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Equity Index Futures and Equity Stock Futures

31. In addition to the payment of the Initial Margin computed as per paragraph 30 above, both the parties to the equity index/stock futures contract are required to pay daily 'Mark-to-Market Margin'. For computation of 'Mark-to-Market Margin', all outstanding contracts, whether Long or Short, of a Clearing Member in an equity index/stock futures contract are deemed to have been settled at the Daily Settlement Price. Such a member would be liable to pay to, or be entitled to collect from, the Clearing House the difference between the price at which such contract was bought or sold and the Daily Settlement Price of that day, or the Settlement Price of the previous trading day and the Settlement Price of the contract at the end of the trading day, as the case may be. The Mark-to-Market Margin would be paid only in cash. After such settlement with the Clearing House, the member would be deemed to be Long or Short, as the case may be, in contracts at the Daily Settlement Price. Supposing 'X' buys one unit of an equity index future of one month maturity (say, April) on March 29 for Rs. 1,420. If at the end of the day (i.e., March 29) the Daily Settlement Price of the equity index futures has fallen to Rs. 1,400, he would pay Rs. 20 to the Clearing House. The position for the subsequent days upto March 31 would be as follows:

	Assumed Daily Settlement Price (Rs.)	
March 30	1,435	Receive Rs. 35
March 31	1,430	Pay Rs. 5

Such differences would be directly debited/credited to the separate bank account required to be maintained by the Clearing Member with the Clearing Corporation. The Clearing Member would, in turn, debit/credit the bank account of the Trading Member, who, in turn, would debit/credit the account of the Client.

32. Each party to an equity index/stock futures contract is under an obligation to meet its commitment at the maturity of the contract. However, either party can, at any time during the currency of the contract, square-up its future obligations under the contract by entering into a reverse contract. For example, a person who is a buyer of 300 units of Stock of LMN Co. Limited September 2003 series can enter into another contract of September 2003 series for sale of 300 units of Stock of LMN Co. Limited. Any gain or loss

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on the original contract arising after the date of entering into the second contract would be offset by an equivalent loss or gain on the second contract. On entering into a reverse contract, the purchase and sales contracts offset each other automatically.

33. In case of non-payment of daily settlement dues by the Client, before the next trading day, the Clearing Member would be at liberty to close out transactions by selling or buying the futures contracts, as the case may be. The loss incurred in this regard would be met from the margin money of the Client and the gains, if any, would accrue to the Client. In case of shortfall caused by loss being in excess of the margin money, the amount would be recovered from the Client.

Equity Index Options and Equity Stock Options

34. In case of equity index options and equity stock options contracts, Option Buyer/Holder is required to pay Option Premium to the Option Seller/Writer to acquire the right in the Options. When a person buys or sells Options, the premium amount will be debited or credited to the separate bank account of the Clearing Member with the Clearing Corporation. At the BSE and the NSE, this premium is normally debited or credited on the next trading day (T+1 Basis).

35. After entering into an option contract, a Client can square-up his position by entering into a reverse contract of the same series with the same Strike Price. For example, a buyer/holder having bought S&P CNX NIFTY Call Option of September 20x3 series with Strike Price of Rs. 1,150 can square-up his position by selling/writing S&P CNX NIFTY Call Option of September 20x3 series with Rs. 1,150 as Strike Price. In such a case, the gain or loss of the Client will be the difference between Option Premium received and paid after reducing/adding the brokerage charged by the Clearing Member. Thus, profit can be earned by or loss can be reduced to the difference in the premium amounts by squaring-up the position, before the Expiry Date.

36. On the expiry of a Call Option, if the market price of the underlying asset is lower than the Strike Price, the call would expire unexercised. Likewise, if on the expiry of a Put Option, the market price of the underlying asset is higher than the Strike Price, the Put Option would expire unexercised. When an Option Buyer/Holder decides to exercise his Option, he gives the exercise notice through the trading network during the time specified by the Clearing Corporation. The Clearing Corporation assigns the exercise notice

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to the Option Seller/Writer through the Trading Member.

37. Practically, all those Options, which are favourable to the buyer/holder on Expiry Date, are deemed to be exercised. No special notice is required to be sent by the buyer/holder. However, the buyer/holder can let a favourable Option expire unexercised, if he so desires, upon intimation to the stock exchange.

ACCOUNTING TREATMENT IN THE BOOKS OF THE CLIENT

38. Accounting for payments/receipts in respect of initial margin is common for all types of Equity Derivative Instruments contracts. Paragraphs 39 to 41 hereinafter deal with the same. Accounting for aspects peculiar to different Equity Derivative Instruments is dealt with thereafter.

Accounting for Initial Margin

39. Every Client is required to pay to the Trading Member/Clearing Member, initial margin, computed as per SPAN, for entering into an Equity Derivative Instruments contract. Such initial margin paid/payable should be debited to an appropriate account, say, 'Initial Margin – Equity Derivative Instruments Account'. Any amount paid/received subsequently on account of initial margin is also debited/credited to the account.

40. At the balance sheet date, the balance in the 'Initial Margin – Equity Derivative Instruments Account' should be shown separately under the head 'Current Assets'. Where any amount has been paid in excess of the initial margin, the excess should be disclosed separately as a deposit under the head 'Current Assets'. Where instead of paying initial margin in cash, the Client provides bank guarantees or lodges securities with the member, a disclosure in respect of outstanding Equity Derivative Instruments contracts at the year-end should be made separately for each type of instrument in the notes to the financial statements of the Client.

41. Sometimes, the Client may deposit a lumpsum amount with the Clearing/Trading Member in respect of margin money instead of paying/receiving margin money on daily basis. The amount so paid is in the nature of a deposit and should be debited to an appropriate account, say, 'Deposit for Margin Money Account'. The amount of initial margin received into/paid from such account should be debited/credited to the 'Deposit for Margin Money Account' with a corresponding credit/debit to the 'Initial Margin –

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Equity Derivative Instruments Account'. At the year-end, any balance in the 'Deposit for Margin Money Account' should be shown as a deposit under the head 'Current Assets'.

Accounting for Equity Index Futures and Equity Stock Futures

Accounting for payment/receipt of Mark-to-Market Margin

42. Payments made or received on account of Mark-to-Market Margin by the Client would be credited/debited to the bank account and the corresponding debit or credit for the same should be made to an appropriate account, say, 'Mark-to-Market Margin – Equity Index Futures Account' or 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

43. The amount of Mark-to-Market Margin received into/paid from lumpsum deposit with the Clearing/Trading Member should be debited/credited to the 'Deposit for Margin Money Account' with a corresponding credit/debit to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

Accounting for Open Interests in Futures Contracts as on the balance sheet date

44. The debit/credit balance in the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be, represents the net amount paid to/received from the Clearing/Trading Member on the basis of movement in the prices of equity index futures or equity stock futures till the balance sheet date in respect of open futures contracts. In case the said account(s) has a debit balance on the balance sheet date, the same should be shown as a current asset. On the other hand, in case the said account(s) has a credit balance on the balance sheet date, the same should be shown as a current liability.

45. Keeping in view 'prudence' as a consideration for the preparation of financial statements, a provision for the anticipated loss in respect of open futures contracts should be made. For this purpose, the net amount paid/received on account of Mark-to-Market Margin on open futures contracts on the balance sheet date should be determined Index-wise/Scrip-wise. Where the Index-wise/Scrip-wise balance is a debit balance representing the net amount paid, provision should be made for the said amount. However, where the Index-wise/Scrip-wise balance is a credit balance representing

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the net amount received, the same should be ignored keeping in view the consideration of 'prudence'. To facilitate these computations, the Mark-to-Market Margin account(s) may be maintained Index-wise/Scrip-wise.

46. The provision as created above should be credited to an appropriate account, say, 'Provision for Loss on Equity Index Futures Account' or to 'Provision for Loss on Equity Stock Futures Account', as the case may be. In case of any opening balance in the 'Provision for Loss on Equity Index Futures Account' or the 'Provision for Loss on Equity Stock Futures Account', the same should be adjusted against the provision required in the current year and the profit and loss account should be debited/credited with the balance provision required to be made/excess provision written back.

47. The 'Provision for Loss on Equity Index Futures Account' or the 'Provision for Loss on Equity Stock Futures Account' should be shown as a deduction from the balance of the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', if disclosed as a current asset. On the other hand, if the above-stated Margin account(s) is disclosed as a current liability, the aforesaid provision account(s) should be shown as a provision on the liabilities side of the balance sheet.

Accounting at the time of final settlement or squaring-up

Index futures and cash-settled stock futures contracts

48. At the expiry of a series of equity index futures/equity stock futures, the profit/loss, on final settlement of the contracts in the series, should be calculated as the difference between the Final Settlement Price and the contract prices of all the contracts in the series. The profit/loss, so computed, should be recognised in the profit and loss account by corresponding debit/credit to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

49. The same accounting treatment as recommended in paragraph 48 should be made when a contract is squared-up by entering into a reverse contract. If more than one contract in respect of the relevant series of equity index futures/equity stock futures contract to which the squared-up contract pertains is outstanding at the time of the squaring-up of the contract, the contract price of the contract so squared-up should be determined using Weighted Average Method for calculating profit/loss on squaring-up.

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Delivery-settled stock futures contracts

50. Under the delivery-settled stock futures contracts, at the time of final settlement, securities will be transferred in consideration for cash at the contract price. In such a case, irrespective of the price of the security on the Settlement Date, the same will be reflected in the books at its original contract price. Thus, the relevant securities account is debited or credited for Long and Short futures contract, respectively, by the contract price, by a corresponding credit/debit to 'Mark-to-Market Margin – Equity Stock Futures Account', and cash/bank account.

Accounting in case of default

51. When a Client defaults in making payment in respect of Mark-to-Market Margin, the contract is closed out. The amount not paid by the Client is adjusted against the initial margin already paid by him. In the books of the Client, the amount of Mark-to-Market Margin so adjusted should be debited to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be, with a corresponding credit to the 'Initial Margin – Equity Derivative Instruments Account'. In case, the amount to be paid on account of Mark-to-Market Margin exceeds the initial margin, the excess is a liability and should be shown as such under the head 'Current Liabilities and Provisions', if it continues to exist on the balance sheet date. The amount of profit or loss on the contract so closed out should be calculated and recognised in the profit and loss account in the manner described in paragraphs 48 and 49.

Accounting for Equity Index Options and Equity Stock Options

Accounting for payment/receipt of the premium

52. At the time of entering into an options contract, the buyer/holder of the Option is required to pay the premium. In the books of the buyer/holder, such premium should be debited to an appropriate account, say, 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account', as the case may be. In the books of the seller/writer, such premium received should be credited to an appropriate account, say, 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account', as the case may be.

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Accounting for Open Interests in Options Contracts as on the balance sheet date

53. The 'Equity Index Option Premium Account' and the 'Equity Stock Option Premium Account' should be shown under the head 'Current Assets' or 'Current Liabilities', as the case may be. In case of multiple Options, entries recommended in paragraph 52 above may be made in one 'Equity Index Options Premium Account' or 'Equity Stock Options Premium Account', in respect of Options of all indexes/scrips. The balance of this composite account should be shown under the head 'Current Assets' or 'Current Liabilities', as the case may be.

54. In the books of the buyer/holder, a provision should be made for the amount by which the premium paid for the Option exceeds the premium prevailing on the balance sheet date since the buyer/holder can reduce his loss to the extent of the premium prevailing in the market, by squaring-up the transaction. The provision so created should be credited to an appropriate account, say, 'Provision for Loss on Equity Index Option Account' or to 'Provision for Loss on Equity Stock Option Account', as the case may be. The provision made as above should be shown as a deduction from the balance of the 'Equity Index Option Premium Account' or the 'Equity Stock Option Premium Account' which is shown under the head 'Current Assets'. The excess of premium prevailing in the market on the balance sheet date over the premium paid is not recognised keeping in view the consideration of prudence.

55. In the books of the seller/writer, a provision should be made for the amount by which premium prevailing on the balance sheet date exceeds the premium received for that Option. This provision should be credited to 'Provision for Loss on Equity Index Option Account' or to 'Provision for Loss on Equity Stock Option Account', as the case may be, with a corresponding debit to profit and loss account. 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account' and 'Provision for Loss on Equity Index Option Account' or 'Provision for Loss on Equity Stock Option Account' should be shown under the head 'Current Liabilities and Provisions'. The excess of premium received over the premium prevailing on the balance sheet date is not recognised keeping in view the consideration of prudence.

56. In case of multiple open options at the year-end, a Index-wise/Scrip-wise provision should be made considering all the open options of any Strike

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Price and any Expiry Date under that index/scrip taken together as illustrated below:

For Stock Options of ABC Limited	In Situations			
	A Rs.	B Rs.	C Rs.	D Rs.
<i>Bought</i>				
Total premium paid on all open options bought	2,00,000	1,00,000	1,00,000	1,00,000
Less: Total premium prevailing on Balance Sheet date for all open options bought	3,00,000	50,000	80,000	1,50,000
X	-1,00,000	50,000	20,000	-50,000
<i>Sold</i>				
Total premium prevailing on the Balance Sheet date for all open options sold	2,50,000	2,00,000	1,50,000	1,30,000
Less: Total premium received on all open options sold	1,00,000	3,00,000	1,00,000	1,80,000
Y	1,50,000	-1,00,000	50,000	-50,000
Provision required = X+Y (if positive)	50,000	NIL	70,000	NIL

The amount of provision required in respect of each scrip or index as illustrated above should be aggregated and a composite 'Provision for Loss on Equity Stock Options Account' or 'Provision for Loss on Equity Index Options Account' should be credited by debiting the profit and loss account.

57. In case of any opening balance in the 'Provision for Loss on Equity Stock Options Account' or the 'Provision for Loss on Equity Index Options

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Account', the same should be adjusted against the provision required in the current year and the profit and loss account be debited/credited with the balance provision required to be made/excess provision written back.

58. In case of multiple open options at the year-end, the 'Provision for Loss on Equity Stock Options Account' or the 'Provision for Loss on Equity Index Options Account', as the case may be, should be shown as a deduction from the 'Equity Stock Options Premium Account' and the 'Equity Index Options Premium Account' respectively, if these have a debit balance and are disclosed under the head 'Current Assets'. In case the 'Equity Stock Options Premium Account' and the 'Equity Index Options Premium Account' have a credit balance and are disclosed under the head 'Current Liabilities', the respective provision account should be shown under 'Provisions' under the head 'Current Liabilities and Provisions'.

Accounting at the time of final settlement

Index options and cash-settled stock options contracts

59. *In the books of the buyer/holder:* On exercise of the Option, the buyer/holder will recognise premium as an expense and debit the profit and loss account by crediting the 'Equity Index Option Premium Account' or the 'Equity Stock Option Premium Account'. Apart from the above, the buyer/holder will receive favourable difference, if any, between the Final Settlement Price as on the Exercise/Expiry Date and the Strike Price, which will be recognised as income.

60. *In the books of the seller/writer:* On exercise of the Option, the seller/writer will recognise premium as an income and credit the profit and loss account by debiting the 'Equity Index Option Premium Account' or the 'Equity Stock Option Premium Account'. Apart from the above, the seller/writer will pay the adverse difference, if any, between the Final Settlement Price as on the Exercise/Expiry Date and the Strike Price. Such payment will be recognised as a loss.

Delivery-settled stock options contracts

61. If an Option expires unexercised, the accounting entries will be the same as those in case of cash-settled options. If the Option is exercised, securities will be transferred in consideration for cash at the Strike Price. In such a case, the accounting treatment should be as recommended in the following paragraphs.

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62. *In case of buyer/holder:* For a Call Option, the buyer/holder will receive the security for which the Call Option was entered into. The buyer/holder should debit the relevant security account and credit cash/bank. For a Put Option, the buyer/holder will deliver the security for which the Put Option was entered into. The buyer/holder should credit the relevant security account and debit cash/bank. In addition to this entry, the premium paid should be transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

63. *In case of seller/writer:* For a Call Option, the seller/writer will deliver the security for which the Call Option was entered into. The seller/writer should credit the relevant security account and debit cash/bank. For a Put Option, the seller/writer will receive the security for which the Put Option was entered into. The seller/writer should debit the relevant security account and credit cash/bank. In addition to this entry, the premium received should be transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

Accounting at the time of squaring-up of an option contract

64. When an Options contract is squared-up by entering into a reverse contract, the difference between the premium paid and received, after adjusting the brokerage charged, on the squared-up transactions should be transferred to the profit and loss account.

Method for determination of profit/loss in multiple options situation

65. For working out profit or loss in case of outstanding multiple options of the same scrip/index with the same Strike Price and the same Expiry Date, weighted average method should be followed on squaring-up of transactions. Similarly, for working out profit or loss in case of outstanding multiple equity stock options of the same scrip with the same Strike Price and the same Expiry Date, weighted average method should be followed where such Option(s) is/are exercised before the Expiry Date.

DISCLOSURE

66. The enterprise should disclose the accounting policies and the methods adopted, including criteria for recognition and the basis of measurement applied for various Equity Derivative Instruments.

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67. Where initial margin is paid by way of a bank guarantee and/or lodging of securities, the amount of such bank guarantee/book value and market value of the securities in respect of outstanding Equity Derivative Instruments contracts at the year-end, should be disclosed separately for each type of instrument.

68. The enterprise should give the details as illustrated below in respect of futures contracts outstanding at the year-end (Open Interests) for each Equity Index/Stock Futures:

Name of Equity Index/Stock Futures	No. of contracts	No. of Units	
		Long	Short
XYZ Limited			
PQR Limited			

Note: All open index/stock futures interests should be added together, irrespective of the contract price and series for each equity index/stock for the purpose of disclosure.

69. The buyer/holder and the seller/writer of the option should give the details as illustrated below in respect of option contracts outstanding as at the year-end for each Equity Index/Stock Option:

Name of the Equity Option index/stock	Total premium carried forward as at the year end net of provisions made (Rs.)
XYZ Limited	2,00,000
PQR Limited	1,50,000

Note: All open options should be added together, irrespective of the Strike Price and the Expiry Date for each equity index/stock for the purpose of disclosure.

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ILLUSTRATION

70. Examples illustrating the accounting treatment of important aspects of Equity Derivative Instruments are given in the Appendix to this Guidance Note.

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Appendix

(This appendix, which is illustrative only and does not form part of the Guidance Note, provides examples to illustrate application of the principles explained in this Guidance Note.)

ILLUSTRATION 1: ACCOUNTING FOR INITIAL MARGIN

Suppose Mr. X enters into certain Equity Derivative Instruments contracts on March 28, 20x3. The Initial Margin on these contracts, calculated as per the SPAN, is Rs. 30,000. The Margin for the subsequent days, calculated as per the SPAN, is as follows:

On 29 th March, 20x3	Rs. 35,000
On 30 th March, 20x3	Rs. 25,000
On 31 st March, 20x3	Rs. 27,000

Suggested Accounting Treatment

1. The following entries may be passed for the payment/receipt of the Initial Margin:

28/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr. Rs. 30,000	
	To Bank A/c		Rs. 30,000
	(Being initial margin paid on Equity Derivative Instruments contracts)		
29/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr. Rs. 5,000	
	To Bank A/c		Rs. 5,000
	(Being further margin paid to the exchange)		
30/3/x3	Bank A/c	Dr. Rs. 10,000	
	To Initial Margin – Equity Derivative Instruments A/c		Rs. 10,000
	(Being refund of margin from the exchange)		
31/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr. Rs. 2,000	
	To Bank A/c		Rs. 2,000
	(Being further margin paid to the exchange)		

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2. The Initial Margin paid on Equity Derivative Instruments will be disclosed in the balance sheet as follows:

Extracts from the Balance Sheet

Current Assets

Initial Margin – Equity Derivative Instruments A/c Rs. 27,000

3. In respect of initial margin, the following disclosure may be made in the notes to accounts:

‘Initial Margin on Equity Derivative Instruments contracts has been paid in cash only.’

ILLUSTRATION 2: ACCOUNTING FOR EQUITY INDEX FUTURES

(A) Accounting for payment/receipt of Mark-to-Market Margin

1. Suppose Mr. A purchases the following units of Equity Index Futures:

Date of Purchase	Name of the Futures contract	Expiry Date/ Series	Contract Price per unit (Rs.)	Contract Multiplier (No. of Units)
28 th March, 20x3	EF1	May 20x3	1,420	200
29 th March, 20x3	EF2	June 20x3	4,280	50
29 th March, 20x3	EF1	May 20x3	1,416	200

2. Daily Settlement Prices of the above units of Equity Index Futures are as follows:

Date	EF1 May Series (Rs.)	EF2 June Series (Rs.)
28/03/20x3	1,410	-
29/03/20x3	1,428	4,300
30/03/20x3	1,435	4,270
31/03/20x3	1,407	4,290

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Suggested Accounting Treatment

1. The amount of Mark-to-Market Margin Money received/paid due to increase/decrease in Daily Settlement Prices is as below:

Date	EF1 May Series (Rs.)		EF2 June Series (Rs.)		Net Amount (Rs.)	
	Receive	Pay	Receive	Pay	Receive	Pay
28/03/20x3	-	2,000	-	-	-	2,000
29/03/20x3	6,000	-	1,000	-	7,000	-
30/03/20x3	2,800	-	-	1,500	1,300	-
31/03/20x3	-	11,200	1,000	-	-	10,200

2. The amount of Mark-to-Market Margin Money received/paid will be credited/debited to 'Mark-to-Market Margin – EIF A/c' by passing the following entries:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
March, 20x3				
28	Mark-to-Market Margin – EIF A/c Dr. To Bank A/c (Being net MTM Margin Money paid for day)		2,000	2,000
29	Bank A/c Dr. To Mark-to-Market Margin – EIF A/c (Being net MTM Margin Money received)		7,000	7,000
30	Bank A/c Dr. To Mark-to-Market Margin – EIF A/c (Being net MTM Margin Money received)		1,300	1,300
31	Mark-to-Market Margin – EIF A/c Dr. To Bank A/c (Being net MTM Margin Money paid for day)		10,200	10,200
	<i>Total</i>		20,500	20,500

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3. On the above basis, 'Mark-to Market Margin – EIF A/c' for the year will appear as follows in the books of Mr. A:

Mark-to-Market Margin – EIF A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance	
				Dr./Cr.	Amount(Rs.)
March					
28	To Bank	2,000		Dr.	2,000
29	By Bank		7,000	Cr.	5,000
30	By Bank		1,300	Cr.	6,300
31	To Bank	10,200		Dr.	3,900
31	By Balance c/d		3,900		
	<i>Total</i>	12,200	12,200		

(B) Accounting for Open Interests on the Balance Sheet date

Suggested Accounting Treatment

1. Continuing Illustration 2(A) above, on 31st March, 20x3, Mark-to-Market (MTM) Margin Money received/paid on all the contracts in each of the indexes is as follows:

Amount paid on the contracts in respect of EF1 Rs. 4,400

Amount received on the contracts in respect of EF2 Rs. 500

2. Keeping in view the consideration of prudence, a provision should be created for anticipated loss on open contracts in respect of EF1, equivalent to the amount paid, by passing the following entry, whereas the amount received in open contracts in respect of EF2 would be ignored:

Profit & Loss A/c Dr. Rs. 4,400

To Provision for Loss – EIF A/c Rs. 4,400

(Being provision created for the amount paid to Clearing Member/ Trading Member on account of movement in the prices of the contracts in respect of EF1)

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3. In the balance sheet, the debit balance of 'Mark-to-Market Margin – EIF A/c' and 'Provision for Loss – EIF Account' would be shown as follows:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Current Liabilities and Provisions		Current Assets, Loans and Advances	
(A) <i>Current Liabilities</i>		(A) <i>Current Assets</i>	
(B) <i>Provisions</i>		(B) <i>Loans and Advances</i>	
Excess of Provision for Loss – EIF A/c over MTM – EIF A/c	500	Mark-to-Market Margin – EIF A/c <i>Less:</i> Provision for Loss – EIF A/c Excess amount to be shown as Provision	3,900 <u>4,400</u> 500

4. In respect of open equity index futures contracts, the following disclosures should be made in the notes to accounts:

Detail of Open Interests in Equity Index Futures contracts

Name of Equity Index Future	No. of contracts	Units	
		Long	Short
EF1	2	400	
EF2	1	50	

(C) Accounting at the time of squaring-up/final settlement of the contracts

Continuing Illustration 2(A) above, the following further facts are provided:

1. Equity Index Futures contracts are squared-up at the Daily Settlement Price of the day on the following dates:

- EF2 June Series on 1st April, 20x3
- 200 Units of EF1 May Series on 2nd April, 20x3
- 200 Units of EF1 May Series on 3rd April, 20x3

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

2. Daily Settlement Prices of the units of Equity Index Futures, till squaring-up of the contracts, are as follows:

Date	EF1 May Series (Rs.)	EF2 June Series (Rs.)
01/04/20x3	1,415	4,250
02/04/20x3	1,430	-
03/04/20x3	1,442	-

Suggested Accounting Treatment

1. The amount of Mark-to-Market Margin Money received/paid due to increase/decrease in Daily Settlement Prices is as below:

Date	EF1 May Series (Rs.)		EF2 June Series (Rs.)		Net Amount (Rs.)	
	Receive	Pay	Receive	Pay	Receive	Pay
01/04/20x3	3,200	-	-	2,000	1,200	-
02/04/20x3	6,000	-	-	-	6,000	-
03/04/20x3	2,400	-	-	-	2,400	-

2. The amount of profit/loss arising on squaring-up is calculated, using Weighted Average method, as follows:

Name of the Futures contract Series	EF2 June 20x3	EF1 May 20x3	EF1 May 20x3
Date of Squaring-up	1 st April, 20x3	2 nd April, 20x3	3 rd April, 20x3
Contract Price per unit (in Rs.)	4,280	1,418 ¹	1,418 ¹
Settlement Price per unit (in Rs.)	4,250	1,430	1,442
Profit (+) / Loss (-) per unit (in Rs.)	(-) 30	(+) 12	(+) 24
Number of Units	50	200	200
Total Profit (+) / Loss (-) (in Rs.)	(-) 1,500	(+) 2,400	(+) 4,800

¹Weighted Average Price = $(1,420 * 200 + 1,416 * 200)/400$

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3. On the above basis, the following entries will be passed for the amount of Mark-to-Market Margin Money received/paid and profit/loss arising on the squaring-up:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
April, 20x3				
01	Bank A/c Dr. To Mark-to-Market Margin – EIF A/c (Being net MTM Margin Money received)		1,200	1,200
01	Profit & Loss A/c Dr. To Mark-to-Market Margin – EIF A/c (Being loss on squaring-up)		1,500	1,500
02	Bank A/c Dr. To Mark-to-Market Margin – EIF A/c (Being net MTM Margin Money received)		6,000	6,000
02	Mark-to-Market Margin – EIF A/c Dr. To Profit & Loss A/c (Being profit on squaring-up of the contract)		2,400	2,400
03	Bank A/c Dr. To Mark-to-Market Margin – EIF A/c (Being net MTM Margin Money received)		2,400	2,400
03	Mark-to-Market Margin – EIF A/c Dr. To Profit & Loss A/c (Being profit on squaring-up of the contract)		4,800	4,800
	<i>Total</i>		18,300	18,300

4. In this case, 'Mark-to-Market Margin – EIF A/c' for the year will appear as follows in the books of Mr. A:

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

Mark-to-Market Margin – EIF A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance	
				Dr./Cr.	Amount (Rs.)
April, 20x3					
01	To Balance b/d	3,900		Dr.	3,900
01	By Bank		1,200	Dr.	2,700
01	By Profit & Loss A/c		1,500	Dr.	1,200
02	By Bank		6,000	Cr.	4,800
02	To Profit & Loss A/c	2,400		Cr.	2,400
03	By Bank		2,400	Cr.	4,800
03	To Profit & Loss A/c	4,800			Nil
	<i>Total</i>	11,100	11,100		

5. In case the contracts as above are not squared-up, but are settled on the final settlement date, the same entries as have been passed on squaring-up of the contracts, will be passed at the time of final settlement.

ILLUSTRATION 3: ACCOUNTING FOR EQUITY STOCK FUTURES

Accounting for Equity Stock Futures which are settled in cash

The accounting treatment for Equity Stock Futures settled in cash would be the same as that in the case of Equity Index Futures. This is because in both the cases the settlement is done otherwise than by delivery of the underlying assets.

Accounting for Equity Stock Futures which are settled by delivery

Accounting for payment/receipt of Mark-to-Market Margin and for Open Interests on the balance sheet date will be the same as that in case of cash-settled futures. The accounting at the time of final settlement of delivery-settled Equity Stock Futures contracts might be explained with the help of example given hereunder.

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1. Suppose Mr. A purchases the following units of Equity Stock Futures (ESF):

Date of Purchase	ESF (Name of the Company)	Settlement Date/Series	Contract Price Per Unit (Rs.)	Contract Multiplier (No. of Units)
28 th March, 20x3	XYZ Limited	May, 20x3	1,420	200
29 th March, 20x3	PQR Limited	June, 20x3	4,280	50
29 th March, 20x3	XYZ Limited	May, 20x3	1,416	200

2. The contracts are settled through physical delivery of shares on the Settlement Date, i.e., both the contracts for shares of XYZ Limited (May 20x3 Series) are settled by purchasing the shares on the Settlement Date, viz., May 29, 20x3. Similarly, the contract for shares of PQR Limited (June 20x3 Series) is settled by purchasing the shares on the Settlement Date, viz., June 26, 20x3.

3. Net Mark-to-Market Margin received in respect of the contracts for shares of XYZ Limited (May 20x3 Series) till the Settlement Date is Rs. 4,000. Net Mark-to-Market Margin paid in respect of the contract for shares of PQR Limited (June 20x3 Series) till the Settlement Date is Rs. 3,500.

Suggested Accounting Treatment

At the time of final settlement, the shares are required to be purchased/sold against the payment/receipt of the contract price. The amount paid/received earlier in the form of Mark-to-Market Margin will be adjusted against the amount payable/receivable. Accordingly, the following entries will be passed for purchase of shares on the final settlement of the contract:

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

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Date	Particulars	L. F.	Debit (Rs.)	Credit (Rs.)
May, 20x3				
29	Shares of XYZ Limited A/c Dr. Mark-to-Market Margin – ESF A/c Dr. To Cash/Bank A/c (Being shares purchased on Settlement Date by payment of the net amount due in respect of the contracts)		5,67,200 4,000	5,71,200
June, 20x3				
26	Shares of PQR Limited A/c Dr. To Cash/Bank A/c To Mark-to-Market Margin – ESF A/c (Being shares received on settlement of contract by payment of the net amount due)		2,14,000	2,10,500 3,500

**ILLUSTRATION 4: ACCOUNTING FOR EQUITY INDEX
OPTIONS**

**(A) Accounting for Payment/Receipt of Premium and for Final
Settlement of the Contracts**

1. Suppose Mr. A buys the following equity index options and the seller/
writer of these options is Mr. B:

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

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Situation 2 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 890

29/5/x3 Bank A/c Dr. Rs. 2,000
To Profit and Loss A/c Rs. 2,000
(Being the profit on exercise of the option received.)

29/5/x3 Profit and Loss A/c Dr. Rs. 3,000
To Equity Index Option Premium A/c Rs. 3,000
(Being the premium on the options contract written off on exercise of the option)

Situation 3 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 875

29/5/x3 Bank A/c Dr. Rs. 2,000
To Profit and Loss A/c Rs. 2,000
(Being the profit on exercise of the option received.)

29/5/x3 Profit and loss A/c Dr. Rs. 4,000
To Equity Index Option Premium A/c Rs. 4,000
(Being the premium on the options contract written off on exercise of the option)

Situation 4 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 890

29/5/x3 Profit and Loss A/c Dr. Rs. 4,000
To Equity Index Option Premium A/c Rs. 4,000
(Being the premium on the options contract written off on expiry of the option)

Option will not be exercised in this situation.

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In the books of the seller/writer, i.e., Mr. B

1. The following entry may be passed to record the amount of premium received:

28/3/x3	Bank A/c	Dr.	Rs. 7,000	
	To Equity Index Option Premium A/c			Rs. 7,000

(Being the premium on the option collected)

2. The following entries may be passed at the time of final settlement of the contracts:

Situation 1 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 875

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 3,000	
	To Profit and Loss A/c			Rs. 3,000

(Being the premium on the options contract recognised as income on expiry of the option)

Option will not be exercised in this situation.

Situation 2 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 890

29/5/x3	Profit and Loss A/c	Dr.	Rs. 2,000	
	To Bank A/c			Rs. 2,000

(Being loss on exercise of the option paid)

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 3,000	
	To Profit and Loss A/c			Rs. 3,000

(Being the premium on the options contract recognised as income on exercise of the option)

Situation 3 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 875

29/5/x3	Profit and Loss A/c	Dr.	Rs. 2,000	
	To Bank A/c			Rs. 2,000

(Being loss on exercise of the option paid)

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 4,000	
	To Profit and Loss A/c			Rs. 4,000

(Being the premium on the options contract recognised as income on exercise of the option)

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

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Situation 4 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 890

29/5/x3 Equity Index Option Premium A/c Dr. Rs. 4,000
To Profit and Loss A/c Rs. 4,000

(Being the premium on the options contract recognised as income on expiry of the option)

Option will not be exercised in this situation.

(B) Accounting for Open Options at the end of an Accounting Period

Continuing with Illustration 4(A) above, except the following facts:

- (a) Mr. A and Mr. B follow the financial year as the accounting year. Consequently, options entered into in one accounting period are settled in another accounting period.
- (b) On 31st March, 20x3: For Call Option May 20x3 Strike Price Rs. 880, closing rate of premium Rs. 6 per unit. For Put Option May 20x3 Strike Price Rs. 885, closing rate of premium Rs. 28 per unit.

Suggested Accounting Treatment

In the books of the buyer/holder, i.e., Mr. A

1. Net provision required to be made in the books of account would be computed as follows:

Call Option May 20x3 Strike Price Rs. 880

Premium paid	Rs. 3,000
Less: Premium on the balance sheet date	<u>Rs. 1,200</u>
Provision required	<u>Rs. 1,800</u>

Put Option May 20x3 Strike Price Rs. 885

Premium paid	Rs. 4,000
Less: Premium as on the balance sheet date	<u>Rs. 5,600</u>

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Provision required Rs. -1,600

Net provision to be made in the books of account: Rs. 200

2. The following entry may be passed to create provision for the above amount:

31/3/x3 Profit and Loss A/c Dr. Rs. 200
 To Provision for Loss on Equity Index Options A/c Rs. 200
(Being provision for loss on options as on 31-3-20x3)

3. In the balance sheet, the balance of 'Equity Index Options Premium Account' and 'Provision for Loss on Equity Index Options Account' would be shown as below:

Extracts from the Balance Sheet

Current Assets:

	Rs.
Equity Index Options Premium Account	7,000
Less: Provision for Loss on Equity Index Options	(200)
	<u>6,800</u>

4. In respect of the premium carried forward (net of provisions), the following disclosure may be made in notes to accounts:

Name of Options (Equity index/ stock)	Premium carried forward as at the year-end net of provisions
S&P CNX NIFTY	Rs. 6,800

5. At the time of final settlement of these contracts, the same entries would be passed as in the case of Illustration 4(A) above.

(Withdrawn as AS 30 became recommendatory from April 1, 2009)

In the books of seller/writer, i.e., Mr. B

1. Net provision required to be made in the books of account may be computed as follows:

Call Option May 20x3 Strike Price Rs. 880

Premium as on the balance sheet date	Rs. 1,200
Less: Premium received	<u>Rs. 3,000</u>
Provision required	<u>Rs. -1,800</u>

Put Option May 20x3 Strike Price Rs. 885

Premium as on the balance sheet date	Rs. 5,600
Less: Premium received	<u>Rs. 4,000</u>
Provision required	<u>Rs. 1,600</u>

Net provision to be made in the books of account: Rs. NIL

(Since the net difference is negative.)

2. In the balance sheet, the balance of 'Equity Index Options Premium Account' would be shown as below:

Extracts from the Balance Sheet

Current Liabilities and Provisions:

	Rs.
Equity Index Options Premium Account	7,000
Provision for Loss on Equity Index Options	<u>NIL</u>

3. In respect of the premium carried forward (including provisions), the following disclosure may be made in notes to accounts:

Name of Options (Equity index/stock)	Total premium carried forward as at the year-end including provisions made
S&P CNX NIFTY	Rs. 7,000

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Equity Stock Option Premium A/c	Dr.	Rs. 4,000	
To Profit and Loss A/c			Rs. 4,000

(Being the premium on the options contract recognised as income on exercise of the option)