Futures And options –Accounting Treatment,Taxability and Levy of STT

(1) Accounting for futures

The Institute of Chartered Accountants of India (ICAI) has issued guidance note on accounting for index futures and stock futures contracts from the view point of the parties who enter into such futures contracts as buyers or sellers. For other parties involved in the trading process, like brokers, trading members, clearing members and clearing corporations, a trade in equity index futures is similar to a trade in, say shares, and does not pose any peculiar accounting problems. Hence in this section we shall largely focus on the accounting treatment of equity index futures in the books of the client. But before we do so, a quick re-look at some of the terms used.

1. 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. All the clearing and settlement for trades that happen on the NSE's market is done through NSCCL.
2. 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.
3. 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.
4. Contract month: Contract month means the month in which the exchange/clearing corporation rules require a contract to be finally settled.
5. Daily settlement price: Daily settlement price is the closing price of the equity index futures contract for the day or such other price as may be decided by the clearing house from time to time.
6. Derivative exchange/segment: Derivative exchange means an exchange approved by SEBI as a derivative exchange. Derivative segment means segment of an existing exchange approved by SEBI as derivatives segment.
7. Final settlement price: The final settlement price is the closing price of the equity index futures 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.
8. Long position: Long position in an equity index futures contract means outstanding purchase obligations in respect of the equity index futures contract at any point of time.
9. Open position: Open position means the total number of equity index futures contracts that have not yet been offset and closed.
10. Settlement date: Settlement date means the date on which the settlement of outstanding obligations in an equity index futures contract are required

to be settled as provided in the Bye-Laws of the Derivatives exchange/segment.

11. Short position: Short position in an equity index futures contract means outstanding sell obligations in respect of an equity index futures contract at any point of time.
12. Trading member: Trading member means a Member of the Derivatives exchange/segment and registered with SEBI.

(i) <u>Accounting at the inception of a contract :</u>

Every client is required to pay to the trading member/clearing member, the initial margin determined by the clearing corporation as per the byelaws/regulations of the exchange for entering into equity index futures contracts. Such initial margin paid/payable should be debited to “Initial margin - Equity index futures account”. Additional margins, if any, should also be accounted for in the same manner. It may be mentioned that at the time when the contract is entered into for purchase/sale of equity index futures, no entry is passed for recording the contract because no payment is made at that time except for the initial margin. At the balance sheet date, the balance in the ‘Initial margin -Equity index futures account’ should be shown separately under the head ‘current assets’. In those cases where any amount has been paid in excess of the initial/additional margin, the excess should be disclosed separately as a deposit under the head ‘current assets’. In cases where instead of paying initial margin in cash, the client provides bank guarantees or lodges securities with the member, a disclosure should be made in the notes to the financial statements of the client.

(ii) <u>Accounting at the time of daily settlement</u>

This involves the accounting of payment/receipt of mark-to-market margin money. Payments made or received on account of daily settlement 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 account titled as “Mark-to-market margin -Equity index futures account”.

Some times the client may deposit a lump sum amount with the broker/trading member in respect of mark-to-market margin money instead of receiving/paying mark-to-market 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 mark-to-market margin account”. The amount of “mark-to-market margin” received/paid from such account should be credited/debited to “Mark-to-market margin - Equity index futures account” with a corresponding debit/credit to “Deposit for mark-to-market margin account”. At the year-end, any balance in the “Deposit for mark-to-market margin account” should be shown as a deposit under the head “current assets”.

(iii) <u>Accounting for open positions</u>

Position left open on the balance sheet date must be accounted for. Debit/credit balance in the “mark-to-market margin -Equity index futures account”, maintained on global basis, represents the net amount paid/received on the basis of movement in the prices of index futures till the balance sheet date. Keeping in view ‘prudence’ as a consideration for preparation of financial statements, provision for anticipated loss, which may be equivalent to the net payment made to the broker (represented by the debit balance in the “mark-to-market margin -Equity index futures account”) should be created by debiting the profit and loss account. Net amount received (represented by credit balance in the “mark-to-market margin -Equity index futures account”) being anticipated profit should be ignored and no credit for the same should be taken in the profit and loss account. The debit balance in the said “mark-to-market margin -Equity index futures account”, i.e., net payment made to the broker, may be shown under the head “current assets, loans and advances” in the balance sheet and the provision created there against should be shown as a deduction therefrom. On the other hand, the credit balance in the said account, i.e., the net amount received from the broker, should be shown as a current liability under the head “current liabilities and provisions in the balance sheet”.

(iv)<u>Accounting at the time of final settlement</u>

This involves accounting at the time of final settlement or squaring-up of the contract. At the expiry of a series of equity index futures, the profit/loss, on final settlement of the contracts in the series, should be calculated as the difference between final settlement price and contract prices of all the contracts in the series. The profit/loss, so computed, should be recognized in the profit and loss account by corresponding debit/credit to “mark-to-market margin -Equity index futures account”. However, where a balance exists in the provision account created for anticipated loss, any loss arising on such settlement should be first charged to such provision account, to the extent of the balance available in the provision account, and the balance of loss, if any, should be charged to the profit and loss account. Same accounting treatment should be made when a contract is squared-up by entering into a reverse contract. It appears that, at present, it is not feasible to identify the equity index futures contracts. Accordingly, if more than one contract in respect of the series of equity index futures contracts to which the squared-up contract pertains is outstanding at the time of the squaring of the contract, the contract price of the contract so squared-up should be determined using First-In, First-Out (FIFO) method for calculating profit/loss on squaring-up.

On the settlement of an equity index futures contract, the initial margin paid in respect of the contract is released which should be credited to “Initial margin Equity index futures account”, and a corresponding debit should be given to the bank account or the deposit account (where the amount is not received).

(v) Accounting in case of a default

When a client defaults in making payment in respect of a daily settlement, the contract is closed out. The amount not paid by the Client is adjusted against the initial margin. In the books of the Client, the amount so adjusted should be debited to “mark-to-market -Equity index futures account” with a corresponding credit to “Initial margin -Equity index futures account”. The amount of initial margin on the contract, in excess of the amount adjusted against the mark-to-market margin not paid, will be released. The accounting treatment in this regard will be the same as explained above. In case, the amount to be paid on daily settlement 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 recognized in the profit and loss account in the manner dealt with above.

(vi) Disclosure requirements

a) The amount of bank guarantee and book value as also the market value of securities lodged should be disclosed in respect of contracts having open positions at the year end, where initial margin money has been paid by way of bank guarantee and/or lodging of securities.
b) Total number of contracts entered and gross number of units of equity index futures traded (separately for buy/sell) should be disclosed in respect of each series of equity index futures. The number of equity index futures contracts having open position, number of units of equity index futures pertaining to those contracts and the daily settlement price as of the balance sheet date should be disclosed separately for long and short positions, in respect of each series of equity index futures.

Note:Same Procedure is to be followed for Equity stock Futures also.

(2) Accounting for options

The Institute of Chartered Accountants of India has issued guidance note on accounting for index options and stock options from the view point of the parties who enter into such contracts as buyers/holder or sellers/writers. Following are the guidelines for accounting treatment in case of cash settled index options and stock options:

(i) Accounting at the inception of a contract

The seller/writer of the option is required to pay initial margin for entering into the option contract. Such initial margin paid would be debited to ‘Equity Index Option Margin Account’ or to ‘Equity Stock Option Margin Account’, as the case may be. In the balance sheet, such account should be shown separately under the head

‘Current Assets’. The buyer/holder of the option is not required to pay any margin. He is required to pay the premium. In his books, such premium would be debited to ‘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 ‘Equity Index Option Premium Account’ or ‘Equity Stock Option Premium Account’ as the case may be.

(ii) Accounting at the time of payment/receipt of margin

Payments made or received by the seller/writer for the margin should be credited/debited to the bank account and the corresponding debit/credit for the same should also be made to ‘Equity Index Option Margin Account’ or to ‘Equity Stock Option Margin Account’, as the case may be. Sometimes, the client deposit a lump sum amount with the trading/clearing member in respect of the margin instead of paying/receiving margin on daily basis. In such case, the amount of margin paid/received from/into such accounts should be debited/credited to the ‘Deposit for Margin Account’. At the end of the year the balance in this account would be shown as deposit under ‘Current Assets’.

(iii) Accounting for open positions as on balance sheet dates

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 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. The provision so created should be credited to ‘Provision for Loss on Equity Index Option Account’ or to the ‘Provision for Loss on Equity Stock Options Account’, as the case may be. The provision made as above should be shown as deduction from ‘Equity Index Option Premium’ or ‘Equity Stock Option Premium’ which is shown under ‘Current Assets’.

In the books of the seller/writer, the 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 the ‘Provision for Loss on Equity Stock Option Account’, as the case may be, with a corresponding debit to profit and loss account. ‘Equity Index Options Premium Account’ or ‘Equity Stock Options Premium Account’ and ‘Provision for Loss on Equity Index Options Account’ or ’Provision for Loss on Equity Stock Options Account’ should be shown under ‘Current Liabilities and Provisions’.

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 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.

(iv) <u>Accounting at the time of final settlement</u>

On exercise of the option, the buyer/holder will recognize premium as an expense and debit the profit and loss account by crediting ‘Equity Index Option Premium Account’ or ‘Equity Stock Option Premium Account’. Apart from the above, the buyer/holder will receive favorable difference, if any, between the final settlement price as on the exercise/expiry date and the strike price, which will be recognized as income. On exercise of the option, the seller/writer will recognize premium as an income and credit the profit and loss account by debiting ‘Equity Index Option Premium Account’ or ‘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 recognized as a loss.

As soon as an option gets exercised, margin paid towards such option would be released by the exchange, which should be credited to ‘Equity Index Option Margin Account’ or to ‘Equity Stock Option Margin Account’, as the case may be, and the bank account will be debited.

(v) <u>Accounting at the time of squaring off an option contract</u>

The difference between the premium paid and received on the squared off transactions should be transferred to the profit and loss account. Following are the guidelines for accounting treatment in case of delivery settled index options and stock options: The accounting entries at the time of inception, payment/receipt of margin and open options at the balance sheet date will be the same as those in case of cash settled options. At the time of final settlement, if an option expires un-exercised then the accounting entries will be the same as those in case of cash settled options. If the option is exercised then shares will be transferred in consideration for cash at the strike price. For a call option the buyer/holder will receive equity shares for which the call option was entered into. The buyer/holder should debit the relevant equity shares account and credit cash/bank. For a put option, the buyer/holder will deliver equity shares for which the put option was entered into. The buyer/holder should credit the relevant equity shares account and debit cash/bank. Similarly, for a call option the seller/writer will deliver equity shares for which the call option was entered into. The seller/writer should credit the relevant equity shares account and debit cash/bank. For a put option the seller/writer will receive equity shares for which the put option was entered into. The seller/writer should debit the relevant equity shares account and credit cash/bank. In addition to this entry, the premium paid/received will 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.

(3) TAXATION OF DERIVATIVE TRANSACTION IN SECURITIES

Taxation of Profit/Loss on derivative transaction in securities

Prior to Financial Year 2005–06, transaction in derivatives were considered as speculative transactions for the purpose of determination of tax liability under the Income-tax Act. This is in view of section 43(5) of the Income -tax Act which defined speculative transaction as a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. However, such transactions entered into by hedgers and stock exchange members in course of jobbing or arbitrage activity were specifically excluded from the purview of definition of speculative transaction.

In view of the above provisions, most of the transactions entered into in derivatives by investors and speculators were considered as speculative transactions. The tax provisions provided for differential treatment with respect to set off and carry forward of loss on such transactions. Loss on derivative transactions could be set off only against other speculative income and the same could not be set off against any other income. This resulted in payment of higher taxes by an assessee.

Finance Act, 2005 has amended section 43(5) so as to exclude transactions in derivatives carried out in a “recognized stock exchange” for this purpose. This implies that income or loss on derivative transactions which are carried out in a “recognized stock exchange” is not taxed as speculative income or loss. Thus, loss on derivative transactions can be set off against any other income during the year. In case the same cannot be set off, it can be carried forward to subsequent assessment year and set off against any other income of the subsequent year. Such losses can be carried forward for a period of 8 assessment years. It may also be noted that securities transaction tax paid on such transactions is eligible as deduction under Income-tax Act, 1961.

(4) Securities transaction tax on derivatives transactions

As per Chapter VII of the Finance (No. 2) Act, 2004, Securities Transaction Tax (STT) is levied on all transactions of sale and/or purchase of equity shares and units of equity oriented fund and sale of derivatives entered into

in a recognized stock exchange.

As per Finance Act 2008, the following STT rates are applicable w.e.f. 1st June, 2008 in relation to sale of a derivative, where the transaction of such sale in entered into in a recognized stock exchange.

S.No	Taxable Securities transaction	Rate	Payable by
(a)	Sale of an option in securities	0.017%	Seller
(b)	Sale of an option in securities, where option is exercised	0.125%	Purchaser
(c)	Sale of a futures in securities	0.017%	Seller

Consider an example. Mr. A. sells a futures contract of M/s. XYZ Ltd. (Lot Size: 1000) expiring on 29-Sep-2005 for Rs. 300. The spot price of the share is Rs. 290. The securities transaction tax thereon would be calculated as follows:

1. Total futures contract value = 1000 x 300 = Rs. 3,00,000
2. Securities transaction tax payable thereon 0.017% = 3,00,000 x 0.017% = Rs. 51

Note: No tax on such a transaction is payable by the buyer of the futures contract.