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

(The following is the text of the Guidance Note on Accounting for Equity Index Options and Equity Stock Options, issued by the Institute of Chartered Accountants of India.)

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. Some major stock exchanges have already begun trading in equity index futures, equity index options and equity stock options. For instance, the National Stock Exchange has introduced trading in S&P CNX NIFTY index, and the Bombay Stock Exchange has introduced trading in BSE SENSEX.

3. This Guidance Note deals with accounting treatment of equity index options and equity stock options from the viewpoint of the parties who enter into such option contracts as buyers or sellers.

4. Equity index options and equity stock options are financial instruments, which are bought or sold with specific motives, e.g., speculation, hedging and arbitrage. The accounting treatment recommended in this Guidance Note is applicable to all equity index option and equity stock option contracts entered into irrespective of the motive.

NATURE OF EQUITY INDEX OPTIONS AND EQUITY STOCK OPTIONS

5. In order to understand the nature of equity index options and equity stock options, it would be useful to understand first the meaning of two terms, viz., forward contracts and futures contracts.

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 'delivery 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 delivery price. For example, a person (X) may enter into a forward contract with another person (Y) on September 15, 20x1 to buy 10 kg. 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 kg. 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 date 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 ‘Buyer’ or ‘Holder’. The person against whom the buyer/holder can exercise his right is called ‘Seller’ or ‘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. 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. A buyer/holder of a 'call option' gets the right to purchase the underlying asset whereas a buyer/holder of a 'put option' gets the right to sell the underlying asset. A person buying a call option is considered to have made a 'long call' in terms of market terminology. Similarly, a person buying a put option is considered to have made a 'long put'.

10. Similarly, a person can sell either a call option or a put option. In market terminology, such a person 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.

11. 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.

12. 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.

13. 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 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.

14. There can be options on commodities, currencies, securities, stock index, individual stock, etc. In India, SEBI has permitted trading in options in certain equity indexes and certain equity stocks. Currently, The Stock Exchange, Mumbai (hereinafter referred to as **BSE**) and The National Stock Exchange of India Limited (hereinafter referred to as **NSE**) are authorised to trade in these options.

15. Equity index options are a type of derivative instruments whereby a person gets the right to buy or sell an agreed amount of equity index on the specified future date. Equity stock options are a type of derivative instruments whereby a person gets the right to buy or sell an agreed amount of equity stock on or before the 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 31 securities listed on the stock exchanges.

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

    a. *The underlying assets*
    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 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.

    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 option contract takes the form of payment of the difference between the strike/exercise price and the value of the index on the maturity date, in cash. In contrast, equity stock option can be settled through delivery of shares for which an option contract was entered into or by payment of the difference between strike/exercise price and the value of the share for which the option contract was entered into, in cash, just like equity index option.

Examples of Equity index options

Call Options

In August, a person (buyer/holder) buys a call option of 200 units of S&P CNX NIFTY of October series with strike price of Rs. 1,100 per unit. As a result, the buyer/holder 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, the buyer/holder 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, the buyer/holder will exercise his right to call. By exercising the right to call, he will receive the difference between the price on expiry date and the strike price. If the price is below Rs. 1,100, then he will not exercise his call option.

Put Options

In August, a person (buyer/holder) buys a put option of 100 units of BSE SENSEX of October series with strike price of Rs. 3,500 per unit. As a result, the buyer/holder obtains a right to sell 100 units of BSE SENSEX on the expiry date at Rs. 3,500 per unit. For this right, the buyer/holder 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. 3,500, the buyer/holder will exercise his right to put. By exercising the right to put, he will receive the difference between strike price and the price on expiry date. If the price is above Rs. 3,500 then he will not exercise his put option.

Examples of Equity stock options

Call Options

In August, a person (buyer/holder) buys an October call option contract of 100 equity shares of XYZ Ltd., at a strike price of Rs. 250 per share. As a result, the buyer/holder obtains a right to buy 100 equity shares of XYZ Ltd. on or before the expiry date at the rate of Rs. 250 per share. For this right, the buyer/holder 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, the buyer/holder may exercise his right to call. By exercising the right to call, he acquires equity shares of XYZ Ltd. at Rs. 250 per share and since the prevailing market price is higher, the buyer/holder can make profit by selling these shares in the market. If the market price is below Rs. 250 per equity share, the buyer/holder will not exercise his call option.

Put Options

In August, a person (buyer/holder) buys an October put option contract of 100 equity shares of PQR Ltd. at a strike price of Rs. 250 per share. As a result, the buyer/holder obtains a right to sell 100 equity shares of PQR Ltd. on or before the expiry date at the rate of Rs. 250 per share. For this right, the buyer/holder pays a premium of Rs. 5 per equity share to the seller/writer of the option. If, at any time before the expiry date, the price of the equity shares is quoted lower than Rs. 250, the buyer/holder may exercise the right to put. By exercising his right to put, he sells equity shares of PQR Ltd. at Rs. 250 per share and since the prevailing market price is lower, the buyer/holder can make profit by buying these shares in the market. If the market price is above Rs. 250 per equity share, the buyer/holder will not exercise his put option.

17. 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.

18. At present, in India, both equity index options and equity stock options are settled through cash. However, in the near future equity stock options may be settled through physical delivery of shares.

19. Trading in the options reflects the views of the parties to the contract about the movement in the index and prices of stock. For instance, when two persons enter into an equity index call option contract of one month's maturity at a strike price of Rs. 1,100 per unit, it implies that the buyer/holder expects that the price of the equity index at the time of maturity of the contract would be higher than Rs. 1,100 while the seller/writer expects it to be less than Rs. 1,100.

DEFINITIONS

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

Buyer/Holder : The person who buys a call or a put option.

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.

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 means the month in which the expiry date falls.

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

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.

Exercise Date : Exercise Date is the date on which the buying/ selling right in the option is actually exercised by the buyer/holder.

Exercise of an option: Exercise of an option means enforcing the right by the 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 up to which the option can be exercised.

Final settlement price: Final settlement price is the closing price of the equity index/stock option contract on the last trading day of the contract or such other price as may be specified by the

Clearing Corporation/House, from time to time.

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 Strike Price.

Open Options: Open Options means the total number of equity stock/index options that have not yet been offset and closed by an opposite equity stock/index options nor fulfilled either by delivery of cash or by actual delivery of equity stock.

Option Premium: Option Premium is the price paid by the buyer/holder to the option seller/writer to acquire the right in the option.

Put Option: Put Option is an option to sell the specified underlying asset on or before the expiry date.

Seller / Writer: The person who sells a call or a put option.

Strike Price/Exercise Price: 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.

Underlying Assets: Underlying Assets are Stocks and Stock Indices.

DIFFERENCE BETWEEN EQUITY INDEX FUTURES AND EQUITY INDEX OPTIONS

21. Equity index futures and equity index options are both standardised derivatives instruments traded on a stock exchange. The difference between these two types of derivative instruments is the rights and obligations of parties involved in such contracts. In case of equity index futures both the parties are under obligation to complete the contract on the expiry date. However, in case of equity index options, 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.

TRADING MECHANISM

22. Trading in equity index options and equity stock options has been recently 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 to all the deals in equity index options and equity stock options on the exchange. Thus, for all practical purposes, both the parties to equity index option and equity stock option contracts 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.

23. A Client can trade in options only through a Trading Member/Clearing Member of the Derivatives Segment. The process of trading of options is similar to screen-based trading in securities like shares on an exchange.

24. The exchanges, allowing trading in option contracts, introduce standardised contracts where the expiry day is specified by the stock exchange and the clients can enter into contracts with different strike prices and different premiums. The expiry day adopted by BSE and NSE is the last Thursday of a contract month. For example, the option contracts of May 2002 series will expire on 30th May 2002 (being the last Thursday of May 2002). In both BSE and NSE, the options contracts will have a maximum of three month trading cycle - the near month (one), the next month (two) and the far month (three). New contract will be introduced on the next trading day following the expiry of near month contract. Thus, in May 2002, one would be able to enter into option contracts for the months of May 2002, June 2002 and July 2002. On 30th May 2002 (last Thursday of May 2002) the option contracts for May 2002 series will expire and afterwards trading in August 2002 series will start.

25. Each exchange, permitting options trading, would provide the contract specifications. For

	example, the NSE has decided to permit contract multiplier of 200 for the S&P CNX NIFTY option contracts, whereas the BSE has decided that the contract multiplier would be 50. Similarly, for each individual stock, option market lot has been decided. A person can trade in equity stock options only in the multiples of the market lot.
26.	In order to minimise the risk of failure of parties to a contract, the Clearing Corporation prescribes margin requirements for Clearing / Trading Members. Margins are required to be paid at the inception of the option contract ('initial margin') as well as on daily basis (daily margin). It is the option seller/writer who is required to meet the margin requirements as he carries the obligation to perform the contract. Such margins are calculated through a Software called "Standard Portfolio Analysis of Risk" (SPAN). SPAN calculates risk arrays for all products specified 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, firms, customers etc. use the data from SPAN risk file, together with their position data, to calculate SPAN margin requirements on their respective positions. SPAN calculates margin by determining the worst possible loss using 16 risk scenarios. The option buyer/holder is not required to meet any margin requirement, as he possesses a right but no obligation to exercise call or put.
27.	As mentioned above, 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, would prescribe margin requirements for Clearing/Trading Members. Clearing/Trading Members, in turn, would 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. If any margin charged by the Clearing Corporation is released then the Clearing Member will credit the account of the respective client.
28.	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).
29.	After entering into an option contract a Client can square off his position by entering 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 October 20x1 series with Strike Price of Rs. 950 can square off his position by selling/writing S&P CNX NIFTY call option of October 20x1 series with Rs. 950 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 off the position, before the Expiry Date.
30.	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 to the option seller/writer through the trading member.
31.	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.
32.	At present, in India, both the equity index options and equity stock options are settled in cash. As such, on exercise of the option, the underlying asset is not physically delivered. Instead, the difference in the strike price and the Final Settlement Price is paid or received. For example, a call option on XYZ Ltd. September 20x1 series with strike price of Rs. 290 per unit is exercised and the Final Settlement Price is Rs. 320 per unit, then the option buyer/holder will receive the difference, i.e., Rs. 30 per unit. However, the position will be slightly different for equity stock

options when they will become delivery based. In that case, on exercise of the option, the holder of a call option will be required to pay for the shares to be acquired at strike price and the writer of a call option will be required to deliver the underlying asset (shares) and will receive the strike price. Likewise, on exercise of a put option, the buyer/holder will deliver the shares and the seller/writer will pay the price at the rate of strike price. In the case of equity index options, the underlying asset is the index, which cannot be delivered, hence these options will always be cash settled.

ACCOUNTING TREATMENT IN RESPECT OF EQUITY INDEX OPTIONS AND EQUITY STOCK OPTIONS IN CASE OF CASH SETTLED OPTIONS

Accounting at the inception of the contract

33. The seller/writer of the option is required to pay initial margin for entering into the option contract. Such initial margin paid should be debited to an appropriate account, say, "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".

34. The buyer/holder of the option is not required to pay any margin. 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.

Accounting at the time of payment/receipt of Margin

35. Payments made or received by the seller/writer for the margin would be credited/debited to the bank account and the corresponding debit or credit for the same should be made to "Equity Index Option Margin Account" or to "Equity Stock Option Margin Account", as the case may be.

36. Sometimes, the client may deposit a lumpsum amount with the Trading/Clearing Member in respect of the margin instead of paying/receiving margin on daily basis. In such a case, the amount of margin paid/received from/into such account should be debited/credited to the "Deposit for margin account". At the year end, any balance in the "Deposit for margin account" should be shown as a deposit under the head "Current Assets".

Accounting for open options as on the balance sheet date

37. 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 34 above may be made in one "Equity Index Option Premium Account" or "Equity Stock Option Premium Account", in respect of options of all scrips. The balance of this composite account should be shown under the head "Current Assets" or "Current Liabilities", as the case may be.

38. 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 off the transaction. The excess of premium prevailing in the market on the balance sheet date over the premium paid is not recognised on the consideration of prudence. 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'.

39. 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. The excess of premium received over the premium prevailing on the balance sheet date is not recognised on the consideration of prudence. 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’.

40. In case of multiple open options at the year-end, a Stockwise/Indexwise provision should be made considering all the open options of any strike price and any expiry date under that stock / Index taken together as illustrated below.

For Stock Options of ABC Ltd.	**In Situations**			
	A	B	C	D
Bought	Rs.	Rs.	Rs.	Rs.
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
Sold 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 the “Provision for Loss on Equity Index Options Account” should be credited by debiting the profit and loss account.

41. 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.

42. 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 Option Premium Account” and the “Equity Index Option Premium Account” respectively, if these have a debit balance and are disclosed under the head “Current Assets”. In case the “Equity Stock Option Premium Account” and the “Equity Index Option 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

In the books of the buyer / holder

43. On exercise of the option, the buyer/holder will recognise 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 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.

In the books of the seller/writer

44. On exercise of the option, the seller/writer will recognise 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 recognised as a loss.

45. As soon as an option gets exercised, margin paid towards such an option will 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.

Accounting at the time of squaring off of an option contract

46. The difference between the premium paid and received on the squared off transactions should be transferred to the profit and loss account. Accounting treatment is the same as in paragraph 45 above in the books of the seller/writer for margin money released on the squaring off of an option contract.

Method for determination of profit/loss in multiple options situation

47. 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 off 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.

ACCOUNTING TREATMENT IN RESPECT OF EQUITY STOCK OPTIONS IN CASE OF DELIVERY SETTLED OPTIONS

48. 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 unexercised 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. In such a case, the accounting treatment will be as recommended in the following paragraphs.

In case of buyer/holder

49. 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 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.

In case of Seller/writer

50 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.

Disclosure

The following disclosures should be made in the financial statements

51. The enterprise should disclose the accounting policies and the methods adopted, including criteria for recognition and the basis of measurement applied for equity index options and equity stock options.

52. Where initial margin is paid by way of bank guarantee and/ or lodging of securities, the amount of such bank guarantee/book value and market value of securities in respect of outstanding options at the year-end.

53. The buyer/holder and the seller/writer of the option should give the following details 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
XYZ Ltd.	2,00,000
PQR Ltd.	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.

Illustrations

54. Examples illustrating the accounting treatment of important aspects of equity index options and equity stock options are given in the Appendix to this Guidance Note.

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.)

Accounting for Equity Index Options

ACCOUNTING FOR EQUITY INDEX OPTIONS WHICH ARE ENTERED AND SETTLED WITHIN THE SAME ACCOUNTING PERIOD

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

Date of Purchase	Type of Option	Expiry date	Premium per unit (Rs.)	Contract Multiplier (No. of units)	Margin per unit (Rs.)	Strike price (Rs.)
29th March, 20x1	S & P CNX NIFTY - Call	May 31, 20x1	15	200	150	880
29th March, 20x1	S & P CNX NIFTY - Put	May 31, 20x1	20	200	160	885

Mr. A. and Mr. B follow the calendar year as the accounting year.

SUGGESTED ACCOUNTING TREATMENT

1.1 In the books of the buyer/holder

1.1.1 Accounting at the time of inception

29/3/x1	Equity Index Option Premium A/c	Dr.	Rs.7,000	
	To Bank A/c			Rs.7,000

(Being premium paid on equity Index options)

1.1.2 Accounting at the time of final settlement

Situation 1 Call Option May 20x1 strike price Rs. 880 and price on expiry is Rs. 875

31/5/x1	Profit and Loss A/c	Dr.	Rs.3,000	
	To Equity Index Option Premium A/c			Rs.3,000

(Being premium on option written off on expiry of option)

Option will not be exercised in this situation.

Situation 2 Call Option May 20x1 strike price Rs. 880 and price on expiry is Rs. 890

31/5/x1	Bank A/c	Dr.	Rs.2,000	

	To Profit and Loss A/c			Rs.2,000
(Being the profit on exercise of option received.)				
31/5/x1	Profit and Loss A/c	Dr	Rs.3,000	
	To Equity Index Option Premium A/c			Rs.3,000
(Being the premium on option written off on exercise of option)				
Situation 3 Put Option May 20x1 strike price Rs. 885 and price on expiry is Rs. 875				
31/5/x1	Bank A/c	Dr.	Rs.2,000	
	To Profit and Loss A/c			Rs.2,000
(Being the profit on exercise of option received.)				
31/5/x1	Profit and loss A/c	Dr.	Rs.4,000	
	To Equity Index Option Premium A/c			Rs.4,000
(Being the premium on option written off on exercise of option)				
Situation 4 Put Option May 20x1 strike price Rs. 885 and price on expiry is Rs. 890				
31/5/x1	Profit and Loss A/c	Dr.	Rs.4,000	
	To Equity Index Option Premium A/c			Rs.4,000
(Being the premium on option written off on expiry of option)				
Option will not be exercised in this situation.				
1.2 In the books of the seller/writer				
1.2.1 Accounting at the time of inception				
29/3/x1	Equity Index Option Margin A/c	Dr.	Rs.62,000	
	To Bank A/c			Rs.62,000
(Being the initial margin paid on option)				
29/3/x1	Bank A/c	Dr.	Rs.7,000	
	To Equity Index Option Premium A/c			Rs.7,000
(Being the premium on option collected)				
1.2.2 Accounting at the time of receipt/payment of margin				
If extra margin paid:				
	Equity Index Option Margin A/c	Dr.	Rs. xxx	
	To Bank A/c			Rs. xxx
(Being further margin paid to the Exchange)				
If extra margin refunded by the exchange:				
	Bank A/c	Dr.		Rs. xxx
	To Equity Index Option Margin A/c			Rs. xxx
(Being margin refunded by the Exchange)				
This amount will be calculated on daily basis through SPAN. It is the extra margin collected by the Exchange or refund of margin previously collected. For further understanding please refer to the illustration on 'Accounting for daily receipt/payment of margin' given later.				
1.2.3 Accounting at the time of final settlement				
31/5/x1	Bank A/c	Dr.		Rs. xxx
	To Equity Index Option Margin A/c			Rs. xxx
(Being margin on equity option received back on exercise/expiry of option)				
(This will be the amount of original margin paid as per 1.2.1 as increased or decreased by any extra				

margin collected/repaid as per 1.2.2)

Situation 1 Call Option May 20x1 strike price Rs. 880 and price on expiry is Rs. 875

31/5/x1	Equity Index Option Premium A/c	Dr.	Rs.3,000	
	To Profit and Loss A/c			Rs.3,000

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

Option will not be exercised in this situation.

Situation 2 Call Option May 20x1 strike price Rs. 880 and price on expiry is Rs. 890

31/5/x1	Profit and Loss A/c	Dr.	Rs.2,000	
	To Bank A/c			Rs.2,000

(Being loss on exercise of option paid)

31/5/x1	Equity Index Option Premium A/c	Dr.	Rs.3,000	
	To Profit and Loss A/c			Rs.3,000

(Being premium on option recognised as income on exercise of option)

Situation 3 Put Option May 20x1 strike price Rs. 885 and price on expiry is Rs. 875

31/5/x1	Profit and Loss A/c	Dr.	Rs.2,000	
	To Bank A/c			Rs.2,000

(Being loss on exercise of option paid)

31/5/x1	Equity Index Option Premium A/c	Dr.	Rs.4,000	
	To Profit and Loss A/c			Rs.4,000

(Being premium on option recognised as income on exercise of option)

Situation 4 Put Option May 20x1 strike price Rs. 885 and price on expiry is Rs. 890

31/5/x1	Equity Index Option Premium A/c	Dr.	Rs.4,000	
	To Profit and Loss A/c			Rs.4,000

(Being premium on option recognised as income on expiry of option)

Option will not be exercised in this situation.

ACCOUNTING FOR OPEN OPTIONS AT THE END OF AN ACCOUNTING PERIOD

Facts of the earlier example are the same, except that 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.

2.1 In the books of the buyer/holder

Position as on 31st March, 20x1: Call Option May 20x1 strike price Rs. 880 and closing rate of premium for the option with same strike price is Rs. 6 per unit

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

Position as on 31st March, 20x1: Put Option May 20x1 strike price Rs. 885 and closing rate of premium for the option with same strike price is Rs. 28 per unit

Premium paid	Rs. 4,000
Less: Premium as on the balance sheet date	Rs. 5,600
Provision required	Rs.-1,600

Rs.-1,600		Rs. 200.		
31/3/x1	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 31-3-20x1)

Disclosures in the balance sheet:

Under ‘Current Assets’:

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

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

2.2 In the books of seller/writer

Position as on 31st March, 20x1: Call Option May 20x1 strike price Rs. 880 and closing rate of premium is Rs. 6 per unit

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

Position as on 31st March, 20x1: Put Option May 20x1 strike price Rs. 885 and closing rate of premium is Rs. 28 per unit

Premium as on the balance sheet date	Rs. 5,600
Less: Premium received	Rs. 4,000
Provision required	Rs. 1,600
Net provision to be made in the books of account:	Rs. NIL
	(Since the net difference is negative.)

Disclosures in the balance sheet:

Under ‘Current Liabilities and Provisions’:

	Rs.
Equity Index Options Premium Account	7,000
Provision for Loss on Equity Index Options	NIL

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

ACCOUNTING TREATMENT AT FINAL SETTLEMENT OF OPTIONS, WHICH WERE OPEN AT THE END OF THE ACCOUNTING PERIOD

3.1 In the books of buyer/holder

All entries will be the same as explained in 1.1.2

3.2 In the books of writer/seller

All entries will be the same as explained in 1.2.3

Accounting for Equity Stock Options

Accounting for Equity Stock Options which are settled in cash

Accounting entries for Equity Stock Options settled in cash will be the same as that in the case of Equity Index Options. This is because in both the cases the settlement is done otherwise than by delivery of the underlying assets.

Accounting for Equity Stock Options which are settled by delivery

Accounting entries at the time of inception, daily receipt/payment margin and open options at the balance sheet date will be the same as that in the case of cash settled options. The accounting entries at the time of final settlement, presuming that options are exercised, will be as follows.

Suppose Mr. A buys the following Equity Stock Options and the seller/writer of the options is Mr. B

Date of Purchase	Type of Options	Expiry date	Market Lot	Premium per unit	Strike price (Rs.)
29th June, 20x1	XYZ Co. Ltd. Call	August 30, 20x1	100	15	230
30th June, 20x1	ABC Co. Ltd. Put	August 30, 20x1	200	20	275

4.1 In the books of the buyer/ holder

4.1.1 Call Option:

Equity Shares of XYZ Ltd. A/c	Dr.	Rs. 23,000	
To Bank A/c			Rs.23,000

(Being call option exercised and shares acquired)

Profit and Loss A/c	Dr.	Rs.1,500	
To Equity Stock Option Premium A/c			Rs.1,500

(Being premium on option written off on exercise of option)

4.1.2 Put Option:

Bank A/c	Dr.	Rs.55,000	
To Equity Shares of ABC Ltd. A/c			Rs.55,000

(Being put option exercised and shares delivered)

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

(Being premium on option written off on exercise of option)

4.2 In the books of the seller/writer

4.2.1 Call Option

Bank A/c	Dr.		Rs.23,000
To Equity Shares of XYZ Ltd. A/c			Rs.23,000

(Being shares delivered on exercise of the call option)

Equity Stock Option Premium A/c	Dr.	Rs.1,500	
To Profit and Loss A/c			Rs.1,500

(Being premium on option recognised as income on exercise of option)

4.2.2 Put Option

	Equity Shares of ABC Ltd. A/c	Dr.	Rs.55,000	
	To Bank A/c			Rs.55,000

(Being shares acquired on exercise of the put option)

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

(Being premium on option recognised as income on exercise of option)

Accounting for daily receipt/payment of margin

Suppose Mr. A buys the following Equity Index Option and the seller/writer of this option is Mr. B

Date of Purchase	Type of Options	Expiry date	Premium per unit (Rs.)	Contract Multiplier (No. of units)	Margin per unit (Rs.)	Strike price (Rs.)
28th March, 20x1	S & P CNX NIFTY - Call	May 31, 20x1	15	200	150	880

Margin calculated by SPAN is as follows:

On 29th March, 20x1 is Rs. 35,000

On 30th March, 20x1 is Rs. 25,000

On 31st March, 20x1 is Rs. 27,000

5.1 In the books of the buyer/holder

No accounting entries as the buyer/holder is not required to pay any margin.

5.2 In the books of the seller/writer

28/3/x1	Equity Index Option Margin A/c	Dr.	Rs.30,000	
	To Bank A/c			Rs.30,000

(Being initial margin paid on option)

29/3/x1	Equity Index Option Margin A/c	Dr.	Rs.5,000	
	To Bank A/c			Rs.5,000

(Being further margin collected by Exchange)

30/3/x1	Bank A/c	Dr.	Rs.10,000	
	To Equity Index Option Margin A/c			Rs.10,000

(Being refund of margin received from Exchange)

31/3/x1	Equity Index Option Margin A/c	Dr.	Rs.2,000	
	To Bank A/c			Rs.2,000

(Being further margin collected by Exchange)

Disclosure in the balance sheet:

Current Assets

Equity Index Option Margin	Rs. 27,000