

APPENDIX-I

The students are advised to refer the latest Accounting Standards from the Chartered Accountant Journal or Students' Newsletter

		<i>Chartered Accountant Journal</i>	<i>Students Newsletter</i>
AS 11(Revised)	The Effects of Changes in Foreign Exchange Rates	March, 2003	January, 2004
AS 29	Provisions, Contingent Liabilities and Contingent Assets	November, 2003	January, 2004
AS 15 (Revised)	Employee Benefits	March, 2006	

Note: AS 1 to AS 29 [including AS 15 (Revised 2005)] are applicable for Nov. 2006 Examinations.

APPENDIX-II

Announcements and Limited Revisions to Standards

Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction*

1. The revised Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates, was published in the March 2003 issue of the Institute's Journal, 'The Chartered Accountant', (pp. 916 to 922). AS 11 (revised 2003) has come into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.
2. AS 11 (revised 2003) deals, inter alia, with forward exchange contracts. Paragraphs 36 and 37 of AS 11 (revised 2003) deal with accounting for a forward exchange contract or any other financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, i.e., it is for hedging purposes. Paragraphs 38 and 39 of AS 11 (revised 2003) deal with forward exchange contracts intended for trading or speculation purposes.
3. An issue has been raised regarding the applicability of AS 11 (revised 2003) to the exchange difference arising on a forward exchange contract or any other financial instrument that is in substance a forward exchange contract (hereinafter the term 'forward exchange contract' is used to include such other financial instruments also), entered into by an enterprise to hedge the foreign currency risk of a firm commitment¹ or a highly probable forecast transaction.²
4. In this regard, it may be noted that paragraphs 36 and 37 of AS 11 (revised 2003) are not intended to deal with forward exchange contracts which are entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. Further, paragraphs 38 and 39 are also not applicable in respect of such forward exchange contracts since these

* Issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.

¹ A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

² A forecast transaction is an uncommitted but anticipated future transaction.

Note: Clarification on Applicability of AS 11 to Forward Exchange Contracts

Some persons have expressed a view that the Announcement amounts to withdrawal of AS 11 with regard to forward exchange contracts. It is hereby clarified that AS 11 continues to be applicable to exchange differences in respect of all forward exchange contracts other than those entered into, to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction.

contracts are not for trading or speculation purposes. Accordingly, it is clarified that AS 11 (revised 2003) does not deal with the accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction.

5. It may be noted that the hedge accounting, in its entirety, including hedge of a firm commitment or a highly probable forecast transaction, is proposed to be dealt with in the accounting standard on Financial Instruments: Recognition and Measurement, which is presently under formulation.

Limited Revision to AS 25

The Council of the Institute of Chartered Accountants of India has decided to make the following limited revision to Accounting Standard (AS) 25, Interim Financial Reporting:

Paragraph 29(c) of AS 25 has been decided to be revised as under. The revisions made are shown in strike-through form.

"29. To illustrate:

- (a)(no change)
- (b)(no change)
- (c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

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As a consequence to the above, the following revisions are made in the relevant paragraphs of Appendix 3 to AS 25 (the revisions made are shown in strike-through form).

"Measuring Income Tax Expense for Interim Period

8. (no change)
9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual income-tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.
10.(no change)
11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

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(Amount in Rs. lakhs)

	1 st	2 nd	3 rd	4 th	
	Quarter	Quarter	Quarter	Quarter	Annual
Tax					
Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. (no change)
13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

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(Amount in Rs. lakhs)

	Quarter	Quarter	Quarter	Quarter	Year
	Ending	Ending	Ending	Ending	Ending
	31 Dec.	31 Mar.	30 June	30 Sep.	30 Sep.
	Year 1	Year 1	Year 2	Year 2	Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14.(no change)
- Tax Loss Carry forwards
15.(no change)
16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs $\{(Rs. 400 \text{ lakhs} - Rs. 100 \text{ lakhs}) \times 40\%\}$. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% $\{(Rs. 120 \text{ lakhs}/Rs. 400 \text{ lakhs}) \times 100\}$. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

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(Amount in Rs. lakhs)

	1 st	2 nd	3 rd	4 th	
	Quarter	Quarter	Quarter	Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00"

The limited revision comes into effect in respect of accounting periods commencing on or after 1-4-2004. It may be noted that the limited revision has been made to align the drafting of AS 25 with the corresponding International Accounting Standard (IAS) 34.

Deferment of the Applicability of AS 22 to Non-Corporate Enterprises

Non-corporate enterprises, such as sole proprietors, partnership firms, trusts, Hindu Undivided Families, association of persons and co-operative societies will now be required to follow Accounting Standards (AS) 22, Accounting for Taxes on Income, in respect of accounting periods commencing on or after 1-4-2006. The decision to this effect has been taken by the Council of the Institute of Chartered Accountants of India (ICAI), at its meeting, held on June 24-26, 2004. The applicability of AS 22 has been deferred for those non-corporate enterprises which were required to follow AS 22 in respect of

accounting periods commencing on or after 1-4-2003.

It may be noted that the applicability paragraphs of AS 22 provided as below:

" Accounting Standards (AS) 22, 'Accounting for Taxes on Income', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001. It is mandatory in nature for:

- a. All the accounting periods commencing on or after 01.04.2001, in respect of the following:
 - (i) Enterprises whose equity or debt securities are listed on a recognized stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors' resolution in this regard.
 - (ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.
- b. All the accounting periods commencing on or after 01.04.2002, in respect of companies not covered by (a) above.
- c. All the accounting periods commencing on or after 01.04.2003, in respect of all other enterprises."

The decision to defer the applicability of AS 22 to enterprises covered by (c) above so as to make it mandatory in respect of accounting periods commencing on or after 1-4-2006 instead of 1-4-2003 has been taken by the Council on a consideration of certain representations and views expressed at various forums. The decision has been taken with a view to provide some more time to such enterprises for effective implementation of AS 22.

Announcement

Elimination of unrealized profits and losses under AS 21, AS 23 and AS 27

Accounting Standard (AS) 21, Consolidated Financial Statements, came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory from that date if an enterprise presents consolidated financial statements. Paragraph 16 of AS 21 requires that intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. It further provides that unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

There may be transactions between a parent and its subsidiary(ies) entered into during accounting periods commencing on or before 31-3-2001. While preparing consolidated financial statements, in respect of some of the transactions entered into during accounting periods commencing on or before 31-3-2001, it may not be practicable to eliminate resulting unrealised profits and losses. It has, therefore, been decided that elimination of unrealised profits and losses in respect of transactions entered into during accounting periods commencing on or before 31-3-2001, is encouraged, but not required on practical grounds.

The above position also applies in respect of AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures while applying the 'equity method' and 'proportionate consolidation method' respectively.

Announcement

Treatment of Inter-Divisional Transfers

Attention of the members is invited to the definition of the term 'revenue' in Accounting Standard (AS) 9, Revenue Recognition, issued by the Institute of Chartered Accountants of India, which is reproduced below:

"Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration." (emphasis supplied)

The use of the word 'enterprise' in the definition of the term 'revenue' clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term 'revenue'. Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard (AS) 9, Revenue Recognition. This aspect is further strengthened by considering the recognition criteria laid down in AS 9. Paragraphs 10 and 11 of AS 9, reproduced below, provide as to when revenue from the sale of goods should be recognised:

"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and*
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."*

Since in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

Announcement

Disclosures in cases where a Court/ Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard

Paragraph 4.2 of the 'Preface to the Statements of Accounting Standards' (revised 2004) provides as under:

"4.2 The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements."

In the case of Companies, Section 211 (3B) of the Companies Act, 1956, provides that "Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:-

- a. the deviation from the accounting standards;
- b. the reasons for such deviation; and

- c. the financial effect, if any, arising due to such deviation.”

In view of the above, if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/Tribunal Order.
2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.
3. The financial impact, if any, arising due to such a difference.

It is recommended that the above disclosures should be made by enterprises other than companies also in similar situations.

Applicability of AS 4 to impairment of assets not covered by present Indian Accounting Standard

1. Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute in November 2003, comes into effect in respect of accounting periods commencing on or after 1-4-2004. As per AS 29, from the date of this Accounting Standard becoming mandatory, all paragraphs of Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1 (a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16), stand withdrawn.

2. Paragraph 7 of AS 29 provides that this Statement defines provisions as liabilities which can be measured only by using a substantial degree of estimation. It further provides that the term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement. In view of this, impairment of assets and doubtful debts are not covered by AS 29.

3. It may be noted that the paragraphs of AS 4 dealing with contingencies also cover provision for contingent loss in case of impairment of assets, not covered by other Accounting Standards, such as, AS 2, Valuation of Inventories, AS 10, Accounting for Fixed Assets, AS 13, Accounting for Investments and AS 28, Impairment of Assets (coming into effect from 1-4-2004). Accordingly, AS 4 deals with impairment of certain assets, for example, the impairment of financial assets like receivables (commonly referred to as the provision for bad and doubtful debts).

4. As may be noted from paragraph 1 above, pursuant to AS 29 coming into effect, the paragraphs of AS 4 that deal with contingencies stand withdrawn. It may further be noted that while impairment of certain assets is covered by some existing Accounting Standards referred to in paragraph 3 above, impairment of financial assets such as receivables, which are not covered by AS 29, is expected to be covered in an Accounting Standard on Financial Instruments: Recognition and Measurement, which is under preparation.

5. In view of the above, it is brought to the notice of the members and others that till the issuance of the proposed Accounting Standard on financial instruments, the paragraphs of AS 4 which deal with contingencies would remain operational to the extent they cover the impairment of assets not covered by other Indian Accounting Standards. Thus, for instance, impairment of receivables (commonly referred to as the provision for bad and doubtful debts) would continue to be covered by AS 4.

Announcement

Applicability of Accounting Standard (AS) 28, Impairment of Assets, to Small and Medium Sized Enterprises (SMEs)

1. Accounting Standard (AS) 28, Impairment of Assets, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004. The Standard is mandatory in nature from different dates for different levels

of enterprises as below:

- (i) To Level I enterprises- from accounting periods commencing on or after 1.4.2004.
- (ii) To Level II enterprises- from accounting periods commencing on or after 1.4.2006.
- (iii) To Level III enterprises- from accounting periods commencing on or after 1.4.2008.

The criteria for different levels are given in Annexure I.

2. Considering the feedback received from various interest-groups and the concerns expressed at various forums, it is felt that relaxation should be given to Level II and Level III enterprises (referred to as 'Small and Medium Sized Enterprises' (SMEs)), from the measurement principles contained in AS 28, Impairment of Assets.

3. AS 28 defines, inter alia, the following terms:

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recoverable amount is the higher of an asset's net selling price and its value in use.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

4. The relaxations for SMEs in respect of AS 28 have been decided as below:

- (i) Considering that detailed cash flow projections of SMEs are often not readily available, SMEs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Therefore, the definition of the term 'value in use' in the context of the SMEs would read as follows:

"Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life, or a reasonable estimate thereof".

- (ii) The above change in the definition of 'value in use' implies that instead of using the present value technique, a reasonable estimate of the 'value in use' can be made. Consequently, if an SME chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SME. Further, such an SME need not disclose the information required by paragraph 121(g) of the Standard. Subject to this, the other provisions of AS 28 would be applicable to SMEs.

5. An enterprise, which, pursuant to the above provisions, does not use the present value technique for measuring value in use, should disclose, the fact that it has measured its 'value in use' on the basis of the reasonable estimate thereof and the manner in which the estimate has been arrived at including assumptions that govern the estimate.
6. Where an enterprise has been covered in Level I and subsequently, ceases to be so covered, the enterprise will not qualify for relaxation/exemption from the applicability of this Standard, until the enterprise ceases to be covered in Level I for two consecutive years.
7. Where an enterprise has previously qualified for the above relaxations (being not covered in Level 1) but no longer qualifies for relaxation in the current accounting period, this Standard becomes applicable from the current period without the above relaxations. However, the corresponding previous period figures in respect of the relevant disclosures need not be provided.

The above provisions are applicable in respect of the accounting periods commencing on or after 1-4-2006 (for Level II enterprises) and 1-4-2008 (for Level III enterprises). However, if an enterprise being a Level II enterprise starts applying AS 28 from accounting periods beginning on or after 1-4-2006, it will continue to apply this Standard even if it ceases to be covered in Level II and becomes a Level III enterprise.

Annexure I

Criteria for classification of enterprises

Level I Enterprises

Enterprises which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

- (i) Enterprises whose equity or debt securities are listed whether in India or outside India.
- (ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.
- (iii) Banks including co-operative banks.
- (iv) Financial institutions.
- (v) Enterprises carrying on insurance business.
- (vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.
- (vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.
- (viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level II Enterprises

Enterprises which are not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises:

- (i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.
- (ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.
- (iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level III Enterprises

Enterprises which are not covered under Level I and Level II are considered as Level III enterprises.

ANNOUNCEMENT

Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account

1. It has been noticed that some companies are charging certain expenses, which are otherwise required to be charged to the profit and loss account, directly against reserves and/or Securities Premium Account pursuant to the court orders. In such a case, while the expenses are charged to reserves and/or Securities Premium Account, the tax benefit arising from admissibility of such expenses for tax purposes is not recognised in the reserves and/or Securities Premium Account. Such a situation may also arise where an enterprise adjusts its reserves to give effect

to a change, if any, in accounting policy consequent upon adoption of an Accounting Standard, in accordance with the transitional provisions contained in the standard. Further, a company may adjust an expense against the Securities Premium Account as allowed under the provisions of section 78 of the Companies Act, 1956. A similar situation may arise where, pursuant to a court order or under transitional provisions prescribed in an accounting standard, an income, which should have otherwise been credited to the profit and loss account in accordance with the requirements of generally accepted accounting principles, may have been directly credited to a reserve account or a similar account and the tax effect thereof is not recognised in the reserve account or a similar account.

2. Not recognising the tax benefit, arising from admissibility of expense charged to the reserves and/or Securities Premium Account, in the reserves and/or Securities Premium Account is contrary to the generally accepted accounting principles because it results in recognition and presentation of tax effect of an expense in a manner which is different from the manner in which the expense itself has been recognised and presented. Similarly, recognising and presenting the tax effect of an income in a manner which is different from the manner in which income itself has been recognised and presented is contrary to the generally accepted accounting principles. Accordingly, any expense charged directly to reserves and/or Securities Premium Account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.
3. In view of the above, any item of income or expense adjusted directly to reserves and/or Securities Premium Account should be net of its tax effect.

ANNOUNCEMENT

Applicability of Accounting Standards to an Unlisted Indian Company,
which is a Subsidiary of a Foreign Company Listed Outside India

1. The Council of the Institute of Chartered Accountants of India has issued an Announcement (see 'The Chartered Accountant', November 2003 (pp. 480-489)) on 'Applicability of Accounting Standards' with a view to lay down the scheme of applicability of Accounting Standards to Small and Medium Sized Enterprises (SMEs). As per the said scheme, all accounting standards are applicable to Level I enterprises. Level I enterprises, *inter alia*, include (i) enterprises whose equity or debt securities are listed whether in India or outside India, and (ii) holding or a subsidiary of a Level I enterprise.
2. With regard to above, an issue has been raised as to whether, as per the above scheme, a foreign company which is incorporated and listed outside India would also be considered as a Level I enterprise and consequent to this, whether an unlisted Indian company, which is a subsidiary of this foreign company, would become a Level I enterprise merely because of it being a subsidiary of the said foreign company.
3. It is clarified that, in the above-stated scheme, the term 'enterprise' includes all entities that are required to prepare their financial statements as per the Indian GAAPs. Accordingly, all Indian entities, i.e., the entities which are incorporated in India, are covered in the said scheme. The scheme also covers those foreign entities which are required to prepare their financial statements as per the Indian GAAPs. Thus, in case a foreign company, which is incorporated and listed outside India, is required to prepare its financial statements as per the Indian GAAPs, it will be considered as a Level I enterprise. In such a case, the Indian company, which is a subsidiary of the aforesaid foreign company, would also be considered as a Level I enterprise for the reason that it is a subsidiary of another Level I enterprise. In case the parent foreign company is not required to prepare its financial statements as per the Indian GAAPs, its Indian subsidiary would not be considered to be a Level I enterprise provided it does not meet any other criteria for becoming Level I enterprise as per the said scheme. Thus, in such a situation, the status of the Indian company under the above scheme will be determined independent of the status of its parent foreign company.

APPENDIX-III

ACCOUNTING STANDARDS INTERPRETATIONS

The authority of the Accounting Standards Interpretations (ASI) is the same as that of the Accounting Standard to which it relates. The contents of the ASI are intended for the limited purpose of the Accounting Standard to which it relates. ASI is intended to apply only to material items. The Institute of Chartered Accountants of India has, so far, issued 30 ASIs. These interpretations are available at the institute's website www.icaai.org. The students are advised to refer PE-II Course Study Material (June, 2004 edition) for the text of ASI 1 to ASI 28. The further interpretations - ASI 29 including revised ASI 3, ASI 4 and ASI 20 are given below:

Accounting Standards Interpretation (ASI) 29

Turnover in case of Contractors

Accounting Standard (AS) 7, Construction Contracts (revised 2002)

ISSUE

1. AS 7, Construction Contracts (revised 2002) deals, inter alia, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting period in which the work is performed.

The issue is whether the revenue so recognised in the financial statements of contractors as per the requirements of AS 7 can be considered as 'turnover'.

CONSENSUS

2. The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 should be considered as 'turnover'.

BASIS FOR CONCLUSIONS

3. The paragraph dealing with the 'Objective' of AS 7 provides as follows:

"Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."

From the above, it may be noted that AS 7 deals, inter alia, with the allocation of contract revenue to the accounting periods in which construction work is performed.

4. Paragraphs 21 and 31 of AS 7 provide as follows:

"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

“31. When the outcome of a construction contract cannot be estimated reliably:

- a. revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and*
- b. contract costs should be recognised as an expense in the period in which they are incurred.*

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”

From the above, it may be noted that the recognition of revenue as per AS 7 may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognised inclusive of profit and when the same cannot be estimated reliably, it is recognised exclusive of profit. However, in either case it is considered as revenue as per AS 7.

5. ‘Revenue’ is a wider term. For example, within the meaning of AS 9, Revenue Recognition, the term ‘revenue’ includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term ‘turnover’ is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7, by whatever nomenclature described in the financial statements, is considered as ‘turnover’.

Accounting Standards Interpretation (ASI) 3 (Revised)

Accounting for Taxes on Income in the situations of Tax Holiday under

Section 80-IAQ and 80-IB of the Income-tax Act, 1961

Accounting Standard (AS) 22, Accounting for Taxes on Income

ISSUE

1. Sections 80-IA and 80-IB of the Income-tax Act, 1961 (hereinafter referred to as the ‘Act’) provide certain deductions, for certain years, in determining the taxable income of an enterprise. These deductions are commonly described as ‘tax holiday’ and the period during which these deductions are available is commonly described as ‘tax holiday period’
2. The issue is how AS 22 should be applied in the situations of tax-holiday under sections 80-IA and 80-IB of the Act.

CONSENSUS

3. The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise’s gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act.
4. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in paragraphs 15 to 18 of AS 22.
5. For the above purposes, the timing differences which originate first should be considered to reverse first.

The Appendix to this Interpretation illustrates the application of the above requirements.

BASIS FOR CONCLUSIONS

6. Section 80A (1) of the Act provides that in computing the total income of an assessee, there shall be allowed from his gross total income, in accordance with and subject to the provisions of this Chapter, the deductions specified in sections 80C to 80U. Therefore, the deductions under sections 80-IA and 80-IB are the deductions from the gross total income of an assessee determined in accordance with the provisions of the Act. For example, depreciation under section 32 of the Act is provided for arriving at the amount of gross total income even if it is not claimed in view of Explanation 5 to clause (ii) of sub-section (1) of section 32 of the Act.

7. In view of the above, the amount of the deduction under sections 80-IA and 80-IB of the Act, is based on the gross total income which is determined in accordance with the provisions of the Act. In respect of the situations covered under sections 80-IA and 80-IB, the difference in the relevant accounting income and taxable income (relevant gross total income minus deduction allowed under sections 80-IA and 80-IB) of an enterprise during a tax holiday period is classified into permanent differences and timing differences. The amount of deduction in respect of sections 80-IA and 80-IB is a permanent difference whereas the differences which arise because of different treatment of items of income and expenses for determination of relevant accounting income and relevant gross total income such as depreciation are timing differences.

8. The Framework for the Preparation and Presentation of Financial Statements provides that "An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably". The Framework also provides that "A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably". In the situation of tax holiday under Sections 80-IA and 80-IB of the Act, it is probable that deferred tax assets and liabilities in respect of timing differences which reverse during the tax holiday period, whether originated in the tax holiday period or before that (refer provisions of section 80-IA(2) of the Act), will not be realised or settled. Accordingly, a deferred tax asset or a liability for timing differences which reverse during the tax holiday period does not meet the above criteria for recognition of asset or liability, as the case may be, and therefore is not recognised to the extent the gross total income of the enterprise is subject to the deduction during the tax holiday period.

9. Deferred tax assets/liabilities for timing differences which reverse after the tax holiday period, whether originated in the tax holiday period or before that, are recognised in the period in which these differences originate because these can be realised/paid after the expiry of the tax holiday period by payment of lesser or higher amount of tax after the tax holiday period because of reversal of timing differences.

10. According to one view, during the tax holiday period, no deferred tax should be recognised even for the timing differences which reverse after the tax holiday period, because timing differences do not originate, for example, in the situation of a 100 percent tax holiday period the taxable income is nil. This view was not accepted because in the aforesaid situation, although the current tax is nil but deferred tax, on account of the timing differences which will reverse after the tax holiday period, exists. Further, even in case of carry forward of losses which can be set-off against future taxable income, deferred tax may be recognised, as per AS 22, in respect of all timing differences irrespective of the fact that the taxable income of the enterprise is nil in the period in which the timing differences originate.

11. According to another view, the timing differences which will reverse after the tax holiday period should be recognised at the beginning of the first year after the expiry of the tax holiday period and not in the year in which the timing differences originate. Accordingly, as per this view, during the tax holiday period, deferred tax should not be recognised. This view was also not accepted because as per AS 22 deferred tax should be recognised in the period in which the relevant timing differences originate.

Appendix

Note: This appendix is illustrative only and does not form part of the Accounting Standards Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

Facts:

1. The income before depreciation and tax of an enterprise for 15 years is Rs. 1000 lakhs per year, both as per the books of account and for income-tax purposes.
2. The enterprise is subject to 100 percent tax-holiday for the first 10 years under section 80-IA. Tax rate is assumed to be 30 percent.
3. At the beginning of year 1, the enterprise has purchased one machine for Rs. 1500 lakhs. Residual value is assumed to be nil.
4. For accounting purposes, the enterprise follows an accounting policy to provide depreciation on the machine over 15 years on straight-line basis.
5. For tax purposes, the depreciation rate relevant to the machine is 25% on written down value basis.

The following computations will be made, ignoring the provisions of section 115JB (MAT), in this regard:

Table 1

Computation of depreciation on the machine for accounting purposes and tax purposes

(Amounts in Rs. lakhs)

Year	Depreciation for accounting purposes	Depreciation for tax purposes
1	100	375
2	100	281
3	100	211
4	100	158
5	100	119
6	100	89
7	100	67
8	100	50
9	100	38
10	100	28
11	100	21
12	100	16
13	100	12
14	100	9
15	100	7

At the end of the 15th year, the carrying amount of the machinery for accounting purposes would be nil whereas for tax purposes, the carrying amount is Rs. 19 lakhs which is eligible to be allowed in subsequent years.

Table 2
Computation of Timing differences

(Amounts in Rs. lakhs)

1	2	3	4	5	6	7	8	9
Year	Income before depreciation and tax (both for accounting purposes and tax purposes)	Accounting Income after depreciation	Gross Total Income (after deducting depreciation under tax laws)	Deduction under Section 80-IA	Taxable Income (4 – 5)	Total Difference between accounting income and taxable income (3 – 6)	Permanent Difference (deduction pursuant to section 80-IA)	Timing Difference (due to different amounts of depreciation for accounting purposes and tax purposes) (O = Originating and R = Reversing)
1	1000	900	625	625	Nil	900	625	275 (O)
2	1000	900	719	719	Nil	900	719	181 (O)
3	1000	900	789	789	Nil	900	789	111 (O)
4	1000	900	842	842	Nil	900	842	58 (O)
5	1000	900	881	881	Nil	900	881	19 (O)
6	1000	900	911	911	Nil	900	911	11 (R)
7	1000	900	933	933	Nil	900	933	33 (R)
8	1000	900	950	950	Nil	900	950	50 (R)
9	1000	900	962	962	Nil	900	962	62 (R)
10	1000	900	972	972	Nil	900	972	72 (R)
11	1000	900	979	Nil	979	–79	Nil	79 (R)
12	1000	900	984	Nil	984	–84	Nil	84 (R)
13	1000	900	988	Nil	988	–88	Nil	88 (R)
14	1000	900	911	Nil	911	–91	Nil	91 (R)
15	1000	900	993	Nil	993	–93	Nil	74 (R) 19 (O)

Notes:

1. Timing differences originating during the tax holiday period are Rs. 644 lakhs, out of which Rs. 228 lakhs are reversing during the tax holiday period and Rs. 416 lakhs are reversing after the tax holiday period. Timing difference of Rs. 19 lakhs is originating in the 15th year which would reverse in subsequent years when for accounting purposes depreciation would be nil but for tax purposes the written down value of the machinery of Rs. 19 lakhs would be eligible to be allowed as depreciation.

2. As per the Interpretation, deferred tax on timing differences which reverse during the tax holiday period should not be recognised. For this purpose, timing differences which originate first are considered to reverse first. Therefore, the reversal of timing difference of Rs. 228 lakhs during the tax holiday period, would be considered to be out of the timing difference which originated in year 1. The rest of the timing difference originating in year 1 and timing differences originating in years 2 to 5 would be considered to be reversing after the tax holiday period. Therefore, in year 1, deferred tax would be recognised on the timing difference of Rs. 47 lakhs (Rs. 275 lakhs - Rs. 228 lakhs) which would reverse after the tax holiday period. Similar computations would be made for the subsequent years.

The deferred tax assets/liabilities to be recognised during different years would be computed as per the following Table. Table 3

Computation of current tax and deferred tax

(Amounts in Rs. lakhs)

Year	Current tax (Taxable Income x 30%)	Deferred tax (Timing difference x 30%)	Accumulated Deferred tax (L= Liability and A= Asset)	Tax expense
1	Nil	$47 \times 30\% = 14$ (see note 2 above)	14 (L)	14
2	Nil	$181 \times 30\% = 54$	68 (L)	54
3	Nil	$111 \times 30\% = 33$	101 (L)	33
4	Nil	$58 \times 30\% = 17$	118 (L)	17
5	Nil	$19 \times 30\% = 6$	124 (L)	6
6	Nil	Nil ¹	124 (L)	Nil
7	Nil	Nil ¹	124 (L)	Nil
8	Nil	Nil ¹	124 (L)	Nil
9	Nil	Nil ¹	124 (L)	Nil
10	Nil	Nil ¹	124 (L)	Nil
11	294	$-79 \times 30\% = -24$	100 (L)	270
12	295	$-84 \times 30\% = -25$	75 (L)	270
13	296	$-88 \times 30\% = -26$	49 (L)	270
14	297	$-91 \times 30\% = -27$	22 (L)	270
15	298	$-74 \times 30\% = -22$	Nil	270
		$-19 \times 30\% = -6$	6 (A) ²	

Accounting Standards Interpretation (ASI) 4 (Revised)

Losses under the head Capital Gains

Accounting Standard (AS) 22, Accounting for Taxes on Income

[This revised Accounting Standards Interpretation replaces ASI 4 issued in December 2002.]

ISSUE

1. The issue is how AS 22 should be applied in respect of 'loss' arising under the head 'Capital gains' of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'), which can be carried forward and set-off in future years, only against the income arising under that head as per the requirements of the Act.

¹ No deferred tax is recognized since in respect of timing differences reversing during the tax holiday period, no deferred tax was recognized at their origination.

² Deferred tax asset of Rs. 6 lakhs would be recognized at the end of year 15 subject to consideration of prudence as per AS 22. If it is so recognized, the said deferred tax asset would be realized in subsequent periods when for tax purposes depreciation would be allowed but for accounting purposes no depreciation would be recognized.

CONSENSUS

2. Where an enterprise's statement of profit and loss includes an item of 'loss' which can be set-off in future for taxation purposes, only against the income arising under the head 'Capital gains' as per the requirements of the Act, that item is a timing difference to the extent it is not set-off in the current year and is allowed to be set-off against the income arising under the head 'Capital gains' in subsequent years subject to the provisions of the Act. In respect of such 'loss', deferred tax asset should be recognised and carried forward subject to the consideration of prudence. Accordingly, in respect of such 'loss', deferred tax asset should be recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act. Whether the test of virtual certainty is fulfilled or not would depend on the facts and circumstances of each case. The examples of situations in which the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head 'Capital gains' is normally fulfilled, are sale of an asset giving rise to capital gain (eligible to setoff the capital loss as per the provisions of the Act) after the balance sheet date but before the financial statements are approved, and binding sale agreement which will give rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act).

3. In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, the deferred tax asset should be recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act.

Transitional Provision

4. Where an enterprise first applies this revised ASI, the deferred tax asset recognized previously considering the reasonable level of certainty, as per the pre-revised ASI 4, and no longer meets the recognition criteria laid down in the revised ASI, should be written-off with a corresponding charge to the revenue reserves.

BASIS FOR CONCLUSIONS

5. Section 71 (3) of the Act provides that "Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss and the assessee has income assessable under any other head of income, the assessee shall not be entitled to have such loss set off against income under the other head".

6. Section 74 (1) of the Act provides that "Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss to the assessee, the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

- (a) in so far as such loss relates to a short-term capital asset, it shall be set off against income, if any, under the head "Capital gains" assessable for that assessment year in respect of any other capital asset;
- (b) in so far as such loss relates to a long-term capital asset, it shall be set off against income, if any, under the head "Capital gains" assessable for that assessment year in respect of any other capital asset not being a short-term capital asset;
- (c) if the loss cannot be wholly so set-off, the amount of loss not so set off shall be carried forward to the following assessment year and so on." Section 74 (2) of the Act provides that "No loss shall be carried forward under this section for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed".

7. AS 22 defines 'timing differences' as "the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods".

8. Where an enterprise's statement of profit and loss includes an item of loss, which is considered a

'loss' under the head 'Capital gains' as per the provisions of the Act, the loss is a timing difference, to the extent the same is not set-off in the current year, because this loss can be allowed to be set-off against income arising under the head 'Capital gains' in future, subject to the provisions of the Act, and to that extent the amount of income under that head will not be taxable in the future year even though the said income would be included in the determination of the accounting income of that year.

9. AS 22 provides that *"Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18"*. Paragraph 15 of AS 22 provides that *"Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised."*

Paragraphs 17 and 18 of AS 22 provide as follows:

"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised."

18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

The income under the head 'Capital gains' does not arise in the course of the operating activities of an enterprise. Thus, for the purpose of recognition of a deferred tax asset, the degree of certainty of such an income arising in future should be higher. Accordingly, in case of 'loss' under the head 'Capital gains', deferred tax asset should be recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act.

In this regard, virtual certainty of the availability of sufficient future taxable income against which deferred tax assets can be realised, will be construed to mean virtual certainty of the availability of taxable income under the head "Capital gains" in future in accordance with the provisions of the Act.

10. In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, deferred tax asset is recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act since that is the amount which will be available for set-off in future years as per the provisions of the Act.

11. As per the requirements of the pre-revised ASI 4, deferred tax asset in respect of a loss arising under the head 'Capital Gains', in certain situations, was recognised on the consideration of the reasonable certainty. The revised ASI 4, however, requires that in all cases, deferred tax asset in respect of such loss is recognised only to the extent there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act. As a result, a deferred tax asset, recognised as per the pre-revised ASI 4, may not meet the recognition criteria laid down in the revised ASI and consequently, would be required to be written-off. A deferred tax asset, which is required to be written-off in this manner, is charged to the revenue reserves.

Accounting Standards Interpretation (ASI) 20 (Revised)

Disclosure of Segment Information

Accounting Standard (AS) 17, Segment Reporting

ISSUE

1. Whether an enterprise, which has neither more than one business segment nor more than one geographical segment, is required to disclose segment information as per AS 17.

CONSENSUS

2. In case by applying the definitions of 'business segment' and 'geographical segment', contained in AS 17, it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information as per AS 17 is not required to be disclosed. However, the fact that there is only one 'business segment' and 'geographical segment' should be disclosed by way of a note.

BASIS FOR CONCLUSIONS

3. The paragraph of AS 17 dealing with 'Objective' provides as under:

"The objective of this Statement is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

- a. better understand the performance of the enterprise;
- b. better assess the risks and returns of the enterprise; and
- c. make more informed judgements about the enterprise as a whole.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas - often called segment information - is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements."

In case of an enterprise, which has neither more than one business segment nor more than one geographical segment, the relevant information is available from the balance sheet and statement of profit and loss itself and, therefore, keeping in view the objective of segment reporting, such an enterprise is not required to disclose segment information as per AS 17. The disclosure of the fact that there is only one 'business segment' and 'geographical segment' and, therefore, the segment information is not provided by the concerned enterprise is useful for the users of the financial statements while making a comparison among various enterprises.

APPENDIX –IV

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 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' 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 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 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.
- (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 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.

(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.

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.

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 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.

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), 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.

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 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 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 – 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 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.

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.

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

For Stock Options of ABC Limited		In Situations			
	A	B	C	D	
	Rs.	Rs.	Rs.	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 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.

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.

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.

ILLUSTRATION

70. Examples illustrating the accounting treatment of important aspects of Equity Derivative Instruments 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.)

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)			

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

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.	2,000	
	To Bank A/c			2,000
	<u>(Being net MTM Margin Money paid for day)</u>			

29	Bank A/c	Dr.	7,000	
	To Mark-to-Market Margin – EIF A/c			7,000
	(Being net MTM Margin Money received)			
30	Bank A/c	Dr.	1,300	
	To Mark-to-Market Margin – EIF A/c			1,300
	(Being net MTM Margin Money received)			
31	Mark-to-Market Margin – EIF A/c	Dr.	10,200	
	To Bank A/c			10,200
	(Being net MTM Margin Money paid for day)			
	Total		20,500	20,500

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

				Balance	
Date	Particulars	Debit (Rs.)	Credit (Rs.)	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	<u> </u>	<u>3,900</u>		
	Total	<u>12,200</u>	<u>12,200</u>		

(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)

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		Mark-to-Market Margin – EIF A/c	3,900
Loss – EIF A/c over		Less: Provision for Loss – EIF A/c	<u>4,400</u>
MTM – EIF A/c	500	Excess amount to be shown as Provision	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:

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

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	EF2	EF1	EF1
Series	June 20x3	May 20x3	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	<u>50</u>	<u>200</u>	<u>200</u>
Total Profit (+) / Loss (-) (in Rs.)	<u>(-) 1,500</u>	<u>(+) 2,400</u>	<u>(+) 4,800</u>

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>		<u>18,300</u>	<u>18,300</u>

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

4. In this case, '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.)	Dr./Cr.	Balance 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	<u>4,800</u>			Nil
	<i>Total</i>	<u>11,100</u>	<u>11,100</u>		

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.

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:

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

4: ACCOUNTING FOR EQUITY INDEX OPTIONS

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

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

Date of Purchase	Type of Options contract	Expiry date	Premium per unit (Rs.)	Contract Multiplier (No. of units)	Strike price (Rs.)
28 th March, 20x3	S&P CNX NIFTY – Call	May 29, 20x3	15	200	880
28 th March, 20x3	S&P CNX NIFTY – Put	May 29, 20x3	20	200	885

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

Suggested Accounting Treatment

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

- The following entry may be passed to record the amount of premium paid:

28/3/x3	Equity Index Option Premium A/c Dr.	Rs. 7,000	
	To Bank A/c		Rs. 7,000
	(Being premium paid on equity Index options)		

- 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	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 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	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.			

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

- 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)			

- 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)			
 <i>Situation 3</i>				
	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)			
 <i>Situation 4</i>				
	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>
Provision required	<u>Rs. -1,600</u>
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.

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

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

ILLUSTRATION 5: 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 for the payment/receipt of premium and for 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 the Options contract	Expiry date	Market Lot	Premium per unit	Strike Price (Rs.)
27 th June, 20x3	XYZ Co. Limited – Call	August 28, 20x3	100	15	230
30 th June, 20x3	ABC Co. Limited – Put	August 28, 20x3	200	20	275

Suggested Accounting Treatment

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

1. The following entries may be passed at the time of exercise of the Call Option:

Equity Shares of XYZ Limited 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 the premium on the options contract written off on exercise of the option)			

2. The following entries may be passed at the time of exercise of the Put Option:

Bank A/c	Dr.	Rs. 55,000	
To Equity Shares of ABC Limited 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 the premium on the options contract written off on exercise of the option)			

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

1. The following entries may be passed at the time of exercise of the Call Option by the buyer:

Bank A/c	Dr.	Rs. 23,000	
To Equity Shares of XYZ Limited 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 the premium on the options contract recognised as income on exercise of the option)			

2. The following entries may be passed at the time of exercise of the Put Option by the buyer:

Equity Shares of ABC Limited 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 the premium on the options contract recognised as income on exercise of the option)			

Guidance Note on Accounting for Employee Share-based Payments

(The following is the text of the Guidance Note on Accounting for Employee Share-based Payments, issued by the Council of the Institute of Chartered Accountants of India.)

INTRODUCTION

1. Some employers use share-based payments as a part of remuneration package for their employees. Such payments generally take the forms of Employee Stock Option Plans (ESOPs), Employee Stock Purchase Plans (ESPPs) and stock appreciation rights. ESOPs are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. ESPPs are plans under which the enterprise grants rights to its employees to purchase its shares at a stated price at the time of public issue or otherwise. Stock appreciation rights is a form of employee share-based payments whereby the employees become entitled to a future cash payment or shares based on the increase in the price of the shares from a specified level over a specified period. Apart from using share-based payments to compensate employees for their services, such payments are also used by an employer as an incentive to the employees to remain in its employment or to reward them for their efforts in improving its performance.

2. Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute of Chartered Accountants of India is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. The Guidance Note recognises that there are two methods of accounting for employee share-based payments, viz., the fair value method and the intrinsic value method and permits as an alternative the intrinsic value method with fair value disclosures. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

SCOPE

3. This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., ESOPs, ESPPs and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

4. For the purposes of this Guidance Note, a transfer of shares or stock options of an enterprise by its shareholders to its employees is also an employee share-based payment, unless the transfer is clearly for a purpose other than payment for services rendered to the enterprise. This also applies to transfers of shares or stock options of the parent of the enterprise, or shares or stock options of another enterprise in the same group as the enterprise, to the employees of the enterprise.

5. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee share-based payment. For example, if an enterprise grants all holders of a particular class of its shares the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock options, and an employee receives such a right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.

6. For the purposes of this Guidance Note, a grant of shares to the employees at the time of public issue is not an employee share-based payment if the price and other terms at which the shares are offered to employees are the same or similar to those at which the shares have been offered to general investors, for example, in a public issue an enterprise grants shares to its employees as a preferential allotment while the price and other terms remain the same as those to other investors.

DEFINITIONS

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

Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.

Employee Stock Option Plan is a plan under which the enterprise grants Employee Stock Options.

Employee Stock Purchase Plan is a plan under which the enterprise offers shares to its employees as part of a public issue or otherwise.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Exercise means making of an application by the employee to the enterprise for issue of shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Exercise Period is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised.

Exercise Price is the price payable by the employee for exercising the option granted to him in pursuance of the Employee Stock Option Plan.

Fair Value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Grant Date is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic Value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying share determined by an independent valuer in case of an unlisted enterprise, exceeds the exercise price of an option.

Market Condition is a condition upon which the exercise price, vesting or exercisability of a share or a stock option depends that is related to the market price of the shares of the enterprise, such as attaining a specified share price or a specified amount of intrinsic value of a stock option, or achieving a specified target that is based on the market price of the shares of the enterprise relative to an index of market prices of shares of other enterprises.

Reload Feature is a feature that provides for an automatic grant of additional stock options whenever the option holder exercises previously granted options using the shares of the enterprise, rather than cash, to satisfy the exercise price.

Reload Option is a new stock option granted when a share of the enterprise is used to satisfy the exercise price of a previous stock option.

Repricing of an employee stock option means changing the existing exercise price of the option to a different price.

Stock Appreciation Rights are the rights that entitle the employees to receive cash or shares for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price. The form of payment may be specified when the rights are granted or may be determined when they are exercised; in some plans, the employee may choose the form of payment.

Vest is to become entitled to receive cash or shares on satisfaction of any specified vesting conditions under an employee share-based payment plan.

Vesting Period is the period between the grant date and the date on which all the specified vesting conditions of an employee share-based payment plan are to be satisfied.

Vesting Conditions are the conditions that must be satisfied for the employee to become entitled to receive cash, or shares of the enterprise, pursuant to an employee share-based payment plan. Vesting conditions include service conditions, which require the employee to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the enterprise's share price over a specified period of time).

Volatility is a measure of the amount by which a price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period.

ACCOUNTING

8. For accounting purposes, employee share-based payment plans are classified into the following categories:

- (a) *Equity-settled*: Under these plans, the employees receive shares.
- (b) *Cash-settled*: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- (c) *Employee share-based payment plans with cash alternatives*: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

9. A share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended hereinbelow is based on the fair value method. The application of the intrinsic value method is explained thereafter in paragraph 40.

EQUITY-SETTLED EMPLOYEE SHARE-BASED PAYMENT PLANS

Recognition

10. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account

and/or general reserve as recommended in the subsequent paragraphs of this Guidance Note.

11. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account.

12. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

Determination of vesting period

13. A grant of shares or stock options to an employee is typically conditional on the employee remaining in the employment of the enterprise for a specified period of time. Thus, if an employee is granted stock options conditional upon completing three years' service, then the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over that three-year vesting period.

14. There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the share price of the enterprise. Thus, if an employee is granted stock options conditional upon the achievement of a performance condition and remaining in the employment of the enterprise until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over the expected vesting period. The enterprise should estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the enterprise should revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Measurement

15. Typically, shares (under ESPPs) or stock options (under ESOPs) are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the shares or stock options granted. Furthermore, shares or stock options are sometimes granted as part of a bonus arrangement, rather than as a part of basic pay, e.g., as an incentive to the employees to remain in the employment of the enterprise or to reward them for their efforts in improving the performance of the enterprise. By granting shares or stock options, in addition to other remuneration, the enterprise is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of the services received, the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted.

Determining the fair value of shares or stock options granted

16. An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 18 to 21). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant

date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 18 to 21).

17. Appendix I contains further guidance on the measurement of the fair value of shares and stock options, focusing on the specific terms and conditions that are common features of a grant of shares or stock options to employees.

Treatment of vesting conditions

18. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited*), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 20.

19. To apply the requirements of paragraph 18, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest, subject to the requirements of paragraph 20.

20. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. Therefore, for grants of shares or stock options with market conditions, the enterprise should recognise the services received from an employee who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified period of service), irrespective of the fact whether that market condition is satisfied.

Treatment of a reload feature

21. For options with a reload feature, the reload feature should not be taken into account when estimating the fair value of options granted at the grant date. Instead, a reload option should be accounted for as a new option grant, if and when a reload option is subsequently granted.

After vesting date

22. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

Appendix II contains various illustrations of the accounting for equity-settled employee share-based payment plans that do not involve modifications to the terms and conditions of the grants.

Modifications to the terms and conditions on which shares or stock options were granted, including cancellations and settlements

23. An enterprise might modify the terms and conditions on which the shares or stock options were granted. For example, it might reduce the exercise price of options granted to employees (i.e., reprice

* The term 'forfeiture' is used to refer only to an employee's failure to earn a vested right to obtain shares or stock options because the specified vesting conditions are not satisfied.

the options), which increases the fair value of those options.

24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.

25. The requirements of paragraph 24 should be applied as follows:

- (a) If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, the enterprise should include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the shares or stock options granted. The incremental fair value granted is the difference between the fair value of the modified shares or stock options and that of the original shares or stock options, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified shares or stock options vest, in addition to the amount based on the grant date fair value of the original shares or stock options, which is recognised over the remainder of the original vesting period. If the modification occurs after the vesting date, the incremental fair value granted is recognised immediately, or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified shares or stock options.
- (b) Similarly, if the modification increases the number of shares or stock options granted, the enterprise should include the fair value of the additional shares or stock options granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the shares or stock options granted, consistent with the requirements in (a) above. For example, if the modification occurs during the vesting period, the fair value of the additional shares or stock options granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional shares or stock options vest, in addition to the amount based on the grant date fair value of the shares or stock options originally granted, which is recognised over the remainder of the original vesting period.
- (c) If the enterprise modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

26. Furthermore, to apply the requirements of paragraph 24, if the enterprise modifies the terms or conditions of the shares or stock options granted in a manner that reduces the total fair value of the employee share-based payment plan, or is not otherwise beneficial to the employee, the enterprise should nevertheless continue to account for the services received as consideration for the shares or stock options granted as if that modification had not occurred (other than a cancellation of some or all the shares or stock options granted, which should be accounted for in accordance with paragraph 27). For example:

- (a) if the modification reduces the fair value of the shares or stock options granted, measured immediately before and after the modification, the enterprise should not take into account that decrease in fair value and should continue to measure the amount recognised for services received as consideration for the shares or stock options based on the grant date fair value of the shares or stock options granted.
- (b) if the modification reduces the number of shares or stock options granted to an employee, that reduction should be accounted for as a cancellation of that portion of the grant, in accordance

with the requirements of paragraph 27.

- (c) if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

27. If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- (a) the enterprise should account for the cancellation or settlement as an acceleration of vesting, and should therefore recognise immediately the amount that otherwise would have been recognised for services received over the remaining vesting period.
- (b) any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognised as an expense.
- (c) if new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options, in accordance with paragraphs 24 to 26. For the purposes of the aforesaid paragraphs, the incremental fair value granted is the difference between the fair value of the replacement shares or stock options and the net fair value of the cancelled shares or stock options, at the date the replacement shares or stock options are granted. The net fair value of the cancelled shares or stock options is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the shares or stock options that is deducted from the relevant equity account in accordance with (b) above.

28. If an enterprise settles in cash vested shares or stock options, the payment made to the employee should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options, measured at the settlement date. Any such excess should be recognised as an expense.

Appendix III contains illustrations on modifications to the terms and conditions on which stock options were granted.

CASH-SETTLED EMPLOYEE SHARE-BASED PAYMENT PLANS

29. An enterprise might grant rights such as stock appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than shares), based on the increase in the share price of the enterprise from a specified level over a specified period of time. Or an enterprise might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of stock options) that are redeemable, either mandatorily (e.g., upon cessation of employment) or at the option of the employee.

Recognition

30. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in a cash-settled employee share-based payment plan when it receives the services with a corresponding increase in liability by creating a provision therefor.

31. The enterprise should recognise the services received, and the liability to pay for those services, as the employees render service. For example, some stock appreciation rights vest immediately, and the employees are therefore not required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, the enterprise should presume that the services rendered by the employees in exchange for the stock appreciation rights have been

received. Thus, the enterprise should recognise immediately the services received and a liability to pay for them. If the stock appreciation rights do not vest until the employees have completed a specified period of service, the enterprise should recognise the services received, and a liability to pay for them, as the employees render service during that period.

Measurement

32. For cash-settled employee share-based payment plan, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise should remeasure the fair value of the liability at each reporting date and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period.

33. The liability should be measured, initially and at each reporting date until settled, at the fair value of the stock appreciation rights, by applying an option pricing model taking into account the terms and conditions on which the stock appreciation rights were granted, and the extent to which the employees have rendered service to date.

Appendix IV contains an illustration of a cash-settled employee share-based payment plan.

Employee share-based payment plans with cash alternatives

Employee share-based payment plans in which the terms of the arrangement provide the employee with a choice of settlement

34. If an enterprise has granted the employees the right to choose whether a share-based payment plan is settled in cash or by issuing shares, the plan has two components, viz., (i) liability component, i.e., the employees' right to demand settlement in cash, and (ii) equity component, i.e., the employees' right to demand settlement in shares rather than in cash. The enterprise should first measure, on the grant date, fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of cash settlement. The fair value so arrived at should be considered as the fair value of the liability component. The enterprise should also measure the fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of equity settlement. In case the fair value under equity-settlement is greater than the fair value under cash-settlement, the excess should be considered as the fair value of the equity component. Otherwise, the fair value of the equity component should be considered as zero. The fair value of the equity component should be accounted for in accordance with the recommendations in respect of 'Equity-settled employee share-based payment plan'. The fair value of the liability component should be accounted for in accordance with the recommendations in respect of 'Cash-settled employee share-based payment plan'.

35. At the date of settlement, the enterprise should remeasure the liability to its fair value. If the enterprise issues shares on settlement rather than paying cash, the amount of liability should be treated as the consideration for the shares issued.

36. If the enterprise pays in cash on settlement rather than issuing shares, that payment should be applied to settle the liability in full. By electing to receive cash on settlement, the employees forgo their right to receive shares. The enterprise should transfer any balance in the relevant equity account (e.g., Stock Options Outstanding Account) to general reserve.

Appendix V contains an illustration of an employee share-based payment plan with cash alternatives.

Employee share-based payment plans in which the terms of the arrangement provide the enterprise with a choice of settlement

37. For an employee share-based payment plan in which the terms of the arrangement provide the enterprise with the choice of whether to settle in cash or by issuing shares, the enterprise should determine whether it has a present obligation to settle in cash and account for the share-based payment plan accordingly. The enterprise has a present obligation to settle in cash if the choice of settlement in shares has no commercial substance (e.g., because the enterprise is legally prohibited from issuing shares), or the enterprise has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the employee asks for cash settlement.

38. If the enterprise has a present obligation to settle in cash, it should account for the transaction in

accordance with the requirements in respect of 'Cash-settled employee share-based payment plan'.

39. If no such obligation exists, the enterprise should account for the transaction in accordance with the requirements in respect of 'Equity-settled employee share-based payment plan'. Upon settlement:

- (a) If the enterprise elects to settle in cash, the cash payment should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except as noted in (c) below.
- (b) If the enterprise elects to settle by issuing shares, the balance in the relevant equity account should be treated as consideration for the shares issued except as noted in (c) below.
- (c) If the enterprise elects the settlement alternative with the higher fair value (e.g., the enterprise elects to settle in cash the amount of which is more than the fair value of the shares had the enterprise elected to settle in shares), as at the date of settlement, the enterprise should recognise an additional expense for the excess value given, i.e., the difference between the cash paid and the fair value of the shares that would otherwise have been issued, or the difference between the fair value of the shares issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Intrinsic Value Method

40. Accounting for employee share-based payment plans dealt with heretofore is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. For example, an option with an exercise price of Rs. 100 on an equity share whose current quoted market price is Rs. 125, has an intrinsic value of Rs. 25 per share on the date of its valuation. If the quoted market price is not available on the grant date then the share price nearest to that date is taken. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39.

Examples of equity-settled employee share-based payment plan and cash-settled employee share-based payment plan, using intrinsic value method, are given in Illustration 1 of Appendix II and the Illustration in Appendix IV, respectively.

Recommendation

41. It is recommended that accounting for employee share-based payment plans should be based on the fair value approach as described in paragraphs 10 to 39. However, intrinsic value method as described in paragraph 40 is also permitted.

GRADED VESTING

42. In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

An illustration of an employee share-based payment plan having graded vesting is given in Appendix VI.

EMPLOYEE SHARE-BASED PAYMENT PLAN ADMINISTERED THROUGH A TRUST

43. An enterprise may administer an employee share-based payment plan through a trust constituted for this purpose. The trust may have different kinds of arrangements, for example, the following:

- (a) The enterprise allots shares to the trust as and when the employees exercise stock options.
- (b) The enterprise provides finance to the trust for subscription to the shares issued by the enterprise

at the beginning of the plan.

- (c) The enterprise provides finance to the trust to purchase shares from the market at the beginning of the plan.

44. Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee share-based payment plan, the enterprise should recognise in its separate financial statements the expense on account of services received from the employees in accordance with the recommendations contained in this Guidance Note. Various aspects of accounting for employee share-based payment plan administered through a trust under the arrangements mentioned above, are illustrated in Appendix VII, for the purpose of preparation of separate financial statements.

45. For the purpose of preparation of consolidated financial statements as per Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Institute of Chartered Accountants of India, the trust created for the purpose of administering employee share-based compensation, should not be considered. This is because the standard requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and, accordingly, consolidation of entities, such as, gratuity trust, provident fund trust, etc., is not required. The nature of a trust established for administering employee share-based compensation plan is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment.

EARNINGS PER SHARE IMPLICATIONS

46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive.

47. For computations required under paragraph 35 of AS 20 with regard to shares or stock options granted pursuant to an employee share-based payment plan, the assumed proceeds from the issues should include the exercise price and the unamortised compensation cost which is attributable to future services.

An example to illustrate computation of Earnings Per Share in a situation where the enterprise has granted stock options to its employees is given in Appendix VIII.

DISCLOSURES

48. An enterprise should describe the method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS – both basic and diluted – for the accounting period, had the fair value method been used.

49. An enterprise should disclose information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period.

50. To give effect to the principle in paragraph 49, the enterprise should disclose at least the following:

- (a) a description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity). An enterprise with substantially similar types of plans may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 49.

- (b) the number and weighted average exercise prices of stock options for each of the following groups of options:
 - (i) outstanding at the beginning of the period;
 - (ii) granted during the period;
 - (iii) forfeited during the period;
 - (iv) exercised during the period;
 - (v) expired during the period;
 - (vi) outstanding at the end of the period; and
 - (vii) exercisable at the end of the period.
 - (c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.
 - (d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.
51. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:
- (a) for stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:
 - (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
 - (ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and
 - (iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.
 - (b) for other instruments granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the grant date, and information on how that fair value was measured, including:
 - (i) if fair value was not measured on the basis of an observable market price, how it was determined;
 - (ii) whether and how expected dividends were incorporated into the measurement of fair value; and
 - (iii) whether and how any other features of the instruments granted were incorporated into the measurement of fair value.
 - (c) for employee share-based payment plans that were modified during the period:
 - (i) an explanation of those modifications;
 - (ii) the incremental fair value granted (as a result of those modifications); and
 - (iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

52. An enterprise should disclose the following information to enable users of the financial statements to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:
- (a) the total expense recognised for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;
 - (b) for liabilities arising from employee share-based payment plans:
 - (i) the total carrying amount at the end of the period; and
 - (ii) the total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

Appendix IX contains illustrative disclosures.

EFFECTIVE DATE

53. This Guidance Note applies to employee share-based payment plans the grant date in respect of which falls on or after April 1, 2005.

Note:- For the Appendices of the Guidance Note, the students are advised to refer the booklet, 'Guidance Note on Accounting for Employee Share Based Payments' [GN (A) 18 (Issued 2005)]. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

Guidance Note on Accounting for Fringe Benefits Tax

(The following is the text of the Guidance Note on Accounting for Fringe Benefits Tax, issued by the Council of the Institute of Chartered Accountants of India)

1. The Finance Act, 2005, has introduced Chapter XII-H on 'Income-tax on Fringe Benefits' [hereinafter referred to as 'Fringe Benefits Tax']. The relevant extracts from Chapter XII-H of the Income-tax Act, 1961 (hereinafter referred to as 'the Act'), governing the Fringe Benefits Tax, have been reproduced in the Annexure to this Guidance Note. This Guidance Note is being issued to provide guidance on accounting for Fringe Benefits Tax, particularly with regard to the recognition and presentation of Fringe Benefits Tax in the financial statements. The Guidance Note does not deal with accounting for 'fringe benefits' as such.
2. The salient features of Fringe Benefits Tax are as below:
 - (a) Fringe Benefits Tax is tax payable by an employer in respect of fringe benefits provided or deemed to have been provided by the employer to his employees during the previous year.
 - (b) Fringe Benefits Tax is in addition to the income-tax charged under the Act.
 - (c) Fringe Benefits Tax is payable at the specified rate on the value of fringe benefits. The value of fringe benefits is calculated in accordance with the provisions of section 115WC of the Income-tax Act, 1961, reproduced in the Annexure to this Guidance Note.
 - (d) An employer is required to pay Fringe Benefits Tax even if no income-tax on the total income is payable.
 - (e) The term 'employer' means:
 - (i) a company;
 - (ii) a firm;
 - (iii) an association of persons or a body of individuals, whether incorporated or not, but

excluding any fund or trust or institution eligible for exemption under clause (23C) of section 10 or registered under section 12AA of the Act;

- (iv) a local authority; and
- (v) every artificial juridical person, not falling within any of the preceding sub-clauses.
- (f) The term 'fringe benefits' means any consideration for employment provided by way of –
 - (i) any privilege, service, facility or amenity, directly or indirectly, provided by an employer, whether by way of reimbursement or otherwise, to his employees (including former employee or employees);
 - (ii) any free or concessional ticket provided by the employer for private journeys of his employees or their family members; and
 - (iii) any contribution by the employer to an approved superannuation fund for employees.
- (g) The fringe benefits shall be deemed to have been provided by the employer to his employees, if the employer has, in the course of his business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profits or gains), incurred any expense on or made any payment for the purposes stated in section 115WB(2) of the Act. Examples of the purposes stated under the said section are entertainment, festival celebrations, gifts, maintenance of guest house, employees' welfare, hotel, boarding and lodging, conveyance, tour and travel (including foreign travel), etc.
- (h) Every employer who during a previous year has paid or made provision for payment of fringe benefits to his employees, is required to furnish a return of fringe benefits to the Assessing Officer in the prescribed form, on or before the due date, in respect of the previous year.
- (i) Fringe Benefits Tax, like any other direct tax, is not an allowable expenditure for the purpose of computation of taxable income.

NATURE OF FRINGE BENEFITS TAX

3. With a view to recommend a proper and uniform accounting treatment for the Fringe Benefits Tax, it is necessary to understand the nature of Fringe Benefits Tax which is discussed in paragraphs 4 to 9.
4. The Fringe Benefits Tax has been introduced under the Income-tax Act, 1961, as 'additional income-tax', vide section 115WA(1) which provides as below:

"In addition to the income-tax charged under this Act, there shall be charged for every assessment year commencing on or after the 1st day of April, 2006, additional income-tax (in this Act referred to as fringe benefit tax) in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees during the previous year at the rate of thirty per cent on the value of such fringe benefits."

Thus, the above stated tax is an additional income-tax payable by the employer on the value of fringe benefits provided or deemed to have been provided to its employees.

RECOGNITION AND MEASUREMENT OF FRINGE BENEFITS TAX

5. An employer becomes liable to pay Fringe Benefits Tax as soon as it incurs an expense which is considered to be a fringe benefit as per the requirements of Chapter XII-H of the Income-tax Act, 1961, even though the actual payment of the tax and/or assessment of the tax takes place on a later date. Accordingly, the employer should recognise, in the financial statements for the period, expense for the Fringe Benefits Tax paid/payable in respect of all expenses giving rise to such tax incurred during that period.
6. As discussed in paragraph 2(c) above, the Fringe Benefits Tax is payable at the specified rate on the value of fringe benefits. The value of fringe benefits is calculated in accordance with the provisions of section 115WC of the Act. The employer should, therefore, measure the amount of the Fringe Benefits Tax keeping in view the aforesaid provisions of the Act.

PRESENTATION OF FRINGE BENEFITS TAX IN FINANCIAL STATEMENTS

7. Paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India, provides as below:

"5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."

Since the Fringe Benefits Tax is an additional tax for the employer, it should be included in the determination of net profit or loss for the period, i.e., the Fringe Benefits Tax, should be charged to the profit and loss account.

8. In the context of presentation of the Fringe Benefits Tax in the profit and loss account of companies, it has been considered whether the tax is covered by the requirement of clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956, which provides as below:

"The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation."

As discussed in paragraph 4 above, the Fringe Benefits Tax is an additional income tax. Accordingly, the Fringe Benefits Tax is covered by the above clause and should be shown separately, if material.

9. Keeping in view the above, the Fringe Benefits Tax should be disclosed as a separate item after determining profit before tax on the face of the profit and loss account for the period in which the related fringe benefits are recognised. An illustration of the disclosure of Fringe Benefits Tax may be as below:

Profit before tax		xxx
Less: Income-tax expense:		
	Current tax	xxx
	Deferred tax	<u>xxx</u> xxx
	Fringe Benefits Tax	<u>xxx</u> <u>xxx</u>
Profit after tax		<u>xxx</u>

10. The amount of the Fringe Benefits Tax (net of the advance tax thereon), outstanding if any, at the year-end, should be disclosed as a provision in the balance sheet.

Note : For the Annexure of the Guidance Note, the students are advised to refer the 'The Chartered Accountant Journal' August, 2005 pages 334 to 338. The Annexure provides the relevant extracts from chapter XII-H of the Income Tax Act, 1961 governing the Fringe Benefits Tax (for assessment year 2006-2007).

APPENDIX-V

Accounting – Recent Developments

- Limited Revision to AS 29 on 'Provisions, Contingent Liabilities and Contingent Assets' has been made effective for accounting periods commencing on or after 1st April, 2006, which clarifies that AS 29 will apply to executory contracts and operating leases which are onerous.
- As a consequence to the Limited Revision to AS 29, Accounting Standard Interpretation (ASI) 30 on 'Applicability of AS 29 to Onerous Contracts' has been issued by the Institute of Chartered Accountants of India (ICAI). This interpretation deals with the manner in which the recognition and measurement principles of AS 29 should be applied to 'onerous contracts'. An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
- Accounting Standard Interpretation (ASI) 4 on 'Losses under the head Capital Gains' has been revised by the ICAI to make criteria for recognition of deferred tax assets in respect of losses under the head 'capital gains' more stringent. This revised ASI 4 replaces ASI 4 issued in December, 2002.
- Announcement on 'Disclosures regarding Derivative Instruments' has been recently issued by the ICAI which is applicable in respect of financial statements for the accounting period(s) ending on or after March 31, 2006. Pending issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', this announcement details the disclosure requirements and guides about the treatment of derivative instruments.

For the full text of Limited Revision to AS 29, ASI 30, Revised ASI 4 and Announcement on Derivative Instruments, students are advised to refer the December, 2005 issue of 'The Chartered Accountant' Journal. Alternatively, they can also visit the Institute's website (www.icai.org) where the information is hosted on the 'Resources - Accounting Standards' section. Students may note that the above revisions / updates are applicable for November, 2006 Examinations.

- Announcement on Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction

The Institute of Chartered Accountants of India (ICAI) has issued an announcement on Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment¹ or a highly probable forecast transaction² (published in the 'The Chartered Accountant', January 2006 (pp.1090, 1091)). This Announcement is applicable in respect of accounting period(s) commencing on or after April 1, 2006. Earlier application of the Announcement is however encouraged.

The council of the ICAI had already issued an announcement on 'Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction' in June, 2004 (published in the 'The Chartered Accountant', July 2004 (pp. 110)). As per the earlier announcement issued in June, 2004, paragraphs 36 and 37 of AS 11(revised 2003) are not applicable to the exchange differences arising on forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. It is stated in the Announcement that the hedge accounting, in its entirety, including hedge of a firm commitment or a highly probable forecast transaction, is proposed to be dealt with in the Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation.

It has been noted that in the absence of any authoritative pronouncement of the Institute on the subject, different enterprises are accounting for exchange differences arising on such contracts in different ways which is affecting the comparability of financial statements. Keeping this in view, the matter has been reconsidered and the Institute is of the view that pending the issuance of the proposed Accounting Standard

¹ A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

² A forecast transaction is an uncommitted but anticipated future transaction.

on '*Financial Instruments: Recognition and Measurement*', which is under formulation, exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction should be recognised in the statement of profit and loss in the reporting period in which the exchange rate changes. Any profit or loss arising on renewal or cancellation of such contracts should be recognised as income or expense for the period.

- Limited Revision to AS 15 (Revised)

Accounting Standard (AS) 15 (revised 2005) on 'Employee Benefits' comes into effect in respect of accounting periods commencing on or after April 1, 2006. AS 15 (revised 2005) was originally published in March, 2005 issue of the ICAI's Journal 'The Chartered Accountant'. Subsequently, the ICAI, in January 2006, made limited revision to AS 15 (revised 2005) primarily with a view to bring the disclosure requirements of the standard relating to the defined benefit plans in line with the corresponding International Accounting Standard (IAS) 19, Employee Benefits; to clarify the application of the transitional provisions ; and to provide relaxation/exemption to the small and medium-sized enterprises(SMEs). The limited revision has been duly incorporated by the ICAI in AS 15 (revised 2005) which has been published in published in the 'The Chartered Accountant', March 2006 (page nos. 1354 to 1385).

- Deferment of Announcement on Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction

The Institute of Chartered Accountants of India (ICAI) has deferred the announcement on Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction by one year.

Pending the issuance of the proposed Accounting Standard on '*Financial Instruments: Recognition and Measurement*', which is under formulation, the said announcement prescribes the accounting treatment which should be followed in respect of the exchange differences arising on the foreign exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction.

It is to be noted that now this announcement will be applicable in respect of accounting periods on or after April 1, 2007(published in the 'The Chartered Accountant', June 2006- page 1774).
