Audit Procedures for Derivative Transactions

The Institute of Chartered Accountants of India has issued Guidance note on Audit of accounts of member of Stock Exchanges. The guidance provided for auditing procedures of Derivatives Transactions are summarized in following paragraphs.

FUTURE CONTRACT :
Initial Margin :

The initial margin can be collected either by way of cash or by way of collateral from the client. In case when the margins are collected by way of collateral the entries are made in the memorandum records. The auditor should verify whether or not the memorandum records are regularly updated to account for initial receipt of and subsequent changes thereafter. The auditor should further examine that the initial margin requirements for each clients are monitored on day-to-day basis and there is no shortfall in the initial margin account relating to client at any point of time. For the margins received in cash, the entries are passed in financial books of the members and the same has to be examined. The auditor should further examine that excess of initial margin is not utilised to cover the shortfall of margin requirements of any other client or against the proprietary position of the member himself.

The initial margin account of all the clients whether individually or jointly will always appear on the "Liabilities" side under the head "Current Liabilities". In the case where the initial margin account appears on the Debit side, the same is to be probed further for possible discrepancies or violation.

Mark-to-Market Margin :

Mark-to-Market Margin is always settled in cash on day-to-day basis. The amount of Mark-to-Market Margin can be verified from the open position of a particular client. It can also be verified from the daily Mark-to-Market Margin statement down loaded from the exchange. The payment and the receipts of the margin shall also be verified with the relevant records of the exchange. The auditor should also examine that there is no shortfall in Mark-to-Market Margin account relating to any of the client. The excess of Mark-to-Market

Margin shall not be utilised against the shortfall of margin of any other client or against the proprietary position of the member himself.

Settlement of contract :

At the time of settlement of contract the initial margin is released and the auditor should examine the collateral register for release of collaterals or the entries in books of accounts for repayment of margin in cash. Auditor should further examine that no profit or loss pertaining to the clients are accounted in the books of a member.

OPTION CONTRACT :

Initial margin :

In case of option contract the buyer of the contract is not required to pay initial margin unlike in future contract. However, a seller of a contract is required to pay the initial margin as determine by the Exchange from time to time. The Audit procedures are similar to that of initial margin related to future contracts.

Mark-to-Market Margin :

No Mark-to-Market Margin is required to be paid by the holder of the option. However, the seller of the option is required to pay Mark-to-Market Margin on daily basis. The audit procedure to be followed are similar to that of auditing of future contracts.

Option premium :

The buyer of the contract is required to pay option premium while entering into contract and on the other hand seller of the contract is entitled to receive the premium. The buyer and the seller deals through member of the Exchange in the capacity of the client. The Auditor should verify that the premium has been duly collected from the buyer and paid to the Exchange in case of buy contract. Similarly in case sale contract whether premium received from the Exchange has been properly remitted to the client or not. Auditor may place reliance on the data downloaded by the Exchange in this regard.

General Guidelines :

The Auditor should study and evaluate the internal control procedures regarding Derivative Transactions entered into by member either on account of client or on his own account. The internal control instituted by the Member of the Stock Exchange should be capable of properly segregating fiduciary assets from those belonging to the member of the Stock Exchange. Auditor should also examine that all known assets and liabilities arising on account of Derivative Transactions are recorded and stated at appropriate amount.

DERIVATIVES, FUTURES AND OPTIONS

GLOSSARY

Arbitrage

Making profit from price differential existing in two markets by simultaneously operating in two different markets. An arbitrageur exploits the price differentials on the same instrument or similar assets, often by trading on different exchanges.

Ask price

The price at which, the market is willing to sell. Also called the offer price.

Basis

The difference between the cash price of a financial instrument and the price of a particular Futures contract relating to that instrument.

Beta

A measure of movement of a security or portfolio to movements in the stock market as a whole. It measures systematic risk.

Calendar spread

The simultaneous purchase and sale of Futures contracts for different delivery months of the same financial instrument.

Clearing House

Clearing House means the Clearing House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/Segment. For example, Clearing Corporation of India limited is a Clearing House.

Clearing Member

Clearing Member means a member of the Clearing House of the relevant stock exchange and includes all categories of clearing members as may be admitted as such by the Clearing House to the Derivatives Segment.

Client

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

Contract Month

Contract month means the month in which the Exchange/Clearing Corporation or Clearing House Rules require a contract to be finally settled.

Contract multiplier

The monetary value that is multiplied by the index value to determine the market value of the contract.

Contract specification

The standard terms of the contract to be traded, e.g. size of the contract, tick size, settlement and margining methodology, trading times and delivery procedures.

Cross hedge

Hedging a risk in one asset by initiating a position in a different but related asset.

Daily Settlement Price

Daily settlement price is the closing price of a underlying in a contract for the day or such other price as may be decided by the Clearing House from time to time.

Default risk

The risk that the counterparty will fail to meet their obligations under a contract.

Execution risk

The risk that prices may move between the time an order is initiated and executed.

Exercise Date

The date on which the option is actually exercised. In case of European Options the exercise date is same as the expiration date while in case of American Options, the options contract may be exercised any day between the purchase of the contract & its expiration date.

Expiration Date

The date on which the option expires is known as Expiration Date. On Expiration date, either the option is exercised or it expires worthless.

Far contract

The Future that is furthest from its delivery month i.e. has the longest maturity.

Forward contract

An agreement between two parties to trade an asset at a specified future date and price.

Futures option

An option written on a Futures contract.

Maintenance margin

The minimum amount, which a person is required to keep in their margin account.

Marking to the market

The evaluation of open positions to reflect profits and losses based on closing market prices at the end of the trading day.

Option Holder

The one who buys an option which can be a call or a put option. He enjoys the right to buy or sell the underlying asset at a specified price on or before specified time. His upside potential is unlimited while losses are limited to the Premium paid by him to the option writer.

Option Seller/Writer

A person who is obligated to buy (in case of Put option) or to sell (in case of call option), the underlying asset in case the buyer of the option decides to exercise his option. His profit are limited to the premium received from the buyer while his downside is unlimited.

Open positions

Contracts, which have been initiated and are not yet offset by a subsequent sale of purchase, or by making or taking delivery.

Settlement

The process by which, clearing members close positions.

Settlement Date

Settlement date means the date on which the settlement of outstanding obligations in a contract are required to be settled as provided in the bye-laws of the Derivatives Exchange/Segment.

Short Position

Short position in any contract means outstanding sell obligations of an underlying in respect of contract at any point of time.

Strike Price or Exercise Price

The strike or exercise price of an option is the specified/pre-determined price of the underlying asset at which the same can be bought or sold if the option buyer exercises his right to buy/sell on or before the expiration day.

Synthetic Futures

A combination of a long call option and a short put option, or debt and the underlying asset, that replicates the behaviour of a long Futures contract.

Trading member

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

Underlying

The specific security/asset on which an Future or option contract is based.

VAR

Value at Risk. A risk management methodology, which attempts to measure the maximum loss possible on a particular position, with a specified level of certainty or confidence.