Chapter 9: Accounting and Taxation

LEARNING OBJECTIVES:

After studying this chapter, you should know about following:

- Accounting Treatment
- Disclosure Requirement
- Taxation

9.1 Accounting Guideline and Disclosure Requirements

Similar to other Exchange-traded derivatives "Accounting, valuation and capital requirement shall be as per the applicable accounting standards and valuation methods prescribed by ICAI or other standard setting organization or as specified by the respective regulators of participants" will be applicable for Exchange-Traded Currency Derivatives.

9.1.1 ICAI Guidance Notes on Accounting for Derivatives Contract (Revised 2021)[45]

The Institute of Chartered Accountants of India (ICAI) has issued guidance notes on Accounting for Derivatives Contract (Revised 2021). Brief points of the guidance note are given below:

The scope of the note specifies that entities such as banking, non-banking finance companies ('NBFCs'), housing finance companies and insurance entities are required to follow the accounting treatment for derivative contracts, if any, prescribed by the concerned regulators such as the Reserve Bank of India (RBI) in case of banking entities NBFCs, , Housing finance companies (HFCs) and Insurance Regulatory and Development Authority of India(IRDAI) in case of insurance entities. In case the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained herein should be followed.

The accounting for derivatives covered by this Guidance Note is based on the following key principles:
(i) All derivative contracts should be recognized on the balance sheet and measured at fair value.
(ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognized in the statement of profit and loss.
(iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging,

[45] https://resource.cdn.icai.org/65422asb060421.pdf

how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an on-going basis.
(iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.
(v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

Recognition of derivatives on the balance sheet at fair value

This Guidance Note requires that all derivatives are recognized on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation. Fair value in the context of derivative contracts represents the 'exit price' i.e. the price that would be paid to transfer a liability or the price that would be received when transferring an asset to a knowledgeable, willing counterparty. The fair value would also incorporate the effect of credit risk associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.

Hedge accounting

An entity is permitted but not required to designate a derivatives contract as a hedging instrument. Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:
(i) identify its risk management objective;
(ii) demonstrate how the derivative contract helps meet that risk management objective;
(iii) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);
(iv) document this assessment (of points (i), (ii), (v), (vi) and (vii) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;
(v) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring.
(vi) conclude that the risk that is being hedged could impact the statement of profit and loss; and
(vii) adequately disclose its accounting policies, risk management objectives and hedging activities (as required by this Guidance Note) in its financial statements.

Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be

measured at fair value and changes in fair value will be recognized immediately in the statement of profit and loss.

Types of hedge accounting

This Guidance Note recognises the following three types of hedging;

- The fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognized in the balance sheet, or a firm commitment that is not yet recognized.
- The cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- The hedge of a net investment in a foreign operation.

Fair value hedge accounting model

A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognized in the statement of profit and loss. A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect the statement of profit and loss.

An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

Cash flow hedge accounting model

A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period. Under the cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognized in equity, for e.g. cash flow hedge reserves. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedge item are not recognized therein.

Net Investment Hedging

An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation arising from the translation of those assets into the reporting currency of the investor.

Principles relating to the hedge of a net investment in a foreign operation are:

- Foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation's net assets for purposes of consolidation.
- Gains and losses of foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective.

- The ineffective portion of the gains and losses on the hedging instruments is recognised in the statement of profit and loss immediately.
- Any net deferred foreign currency gain and losses i.e. arising from both the net investment and hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.

Presentation in the financial statements

Derivative assets and liabilities recognized on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognized assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should be classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bifurcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.

This Guidance Note does not permit any netting of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognized in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

Disclosures in financial statements

An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks. An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity. The entity should disclose its risk management policies. An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the format specified under this Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.

Hedge Effectiveness:

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those of the hedged item. This Guidance Note does not prescribe one single method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.

9.1.2 Accounting Standard (AS) 30

Accounting Standard (AS) 30, "Financial Instruments: Recognition and Measurement", issued by the Council of the Institute of Chartered Accountants of India, specify the principles for the accounting of derivatives contracts. The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Accounting Standard (AS) 30 has defined derivatives as:

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

AS 30 is applicable to exchange-traded derivatives contracts because the above conditions are satisfied. Participants can refer to AS 30 and similar Indian Accounting Standards for further details.

9.2 Taxation of Exchange Traded Currency Derivatives:

The gains or losses arising from trading in Exchange traded derivatives are taxable under the head 'Profits and Gains from Business or Profession' (PGBP). Any expenditure relating to administration is considered to be deductible. The Income-tax Act classifies the business income into 'speculative' and 'non-speculative'. Though Income arising from speculative transactions are taxable under the head PGBP, yet they are treated differently and rigorously from non-speculative business income. Any loss arising from speculative transaction could be set off only from speculative income.

A transaction is deemed as speculative if it is periodically or ultimately settled otherwise than through actual delivery or transfer. However, Section 43(5) has specifically excluded certain derivative transactions from the meaning of speculative transaction as these instruments are used for hedging underlying assets. Further, an eligible transaction in respect of trading in derivatives referred to in clause (*ac*) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognized stock exchange shall not be deemed to be a speculative transaction. Thus, income or loss from dealing in exchange traded currency derivatives shall be deemed as normal business income (non-speculative business) even though delivery is not effected in such transactions. Consequently, any loss arising from Exchange traded derivatives can be set off against any normal business income. The business income of an assessee is charged to tax at normal rates as applicable in case of an assessee.

However, securities held by FPIs are always treated as capital asset. Therefore, any profit and gains arising to FPI from derivative transactions shall always be taxable under the head capital gain. Generally, if the derivatives positions are held for less than 12 months, any gain or loss arising to an FPI from dealing in derivatives shall be chargeable to tax as short-term capital gain or loss.

9.2.1 Computation of Turnover

The Income-tax Act does not contain any provision or guidance for computation of turnover in Exchange traded derivatives trading. However, the Guidance Note on Tax Audit issued by the ICAI prescribes the method of determining turnover which shall be as under:

a) The total of favourable and unfavourable differences is taken as turnover.
b) Premium received on sale of options is also to be included in turnover.
c) In respect of any reverse trades, the difference thereon should also form part of the turnover.

The computation of turnover is a very important factor as the applicability of tax audit is determined on the basis of turnover. Also, if the taxpayer is opting for the presumptive taxation scheme under section 44AD (subject to total turnover not exceeding Rs. 2 crores), he can declare the profit at the rate of 6% of such turnover in case of receipts in

cheque or any digital modes or 8% of turnover in case of cash receipts. Further, A tax audit will be mandatory if the turnover or income arising from trading of Exchange traded derivatives is above and beyond Rs 2 crore. The Union Budget for FY 2024-25 has increased the turnover limit to Rs. 3 crore subject to a condition that 95% of the receipts must be through online modes.

9.2.2 Scheme of Taxation

The income from Exchange traded derivatives trading can be offered to tax under the normal scheme of taxation or the presumptive scheme of taxation under Section 44AD (subject to total turnover not exceeding Rs. 2 crores). Under the presumptive scheme, the investor can choose to declare the profits at the rate of 6% of turnover as the payment is always received through banking channels. The presumptive income computed as per the prescribed rate is the final income and no further expenses will be allowed or disallowed. Also, the person opting for this scheme is not required to maintain the books of accounts prescribed under section 44AA and get them audited. Further, he can pay 100% of the advance tax in a single instalment up to 15th March of the relevant financial year. As mentioned above, the Union Budget for FY 2024-25 has increased this turnover limit to Rs. 3 crore subject to a condition that 95% of the receipts must be through online modes.

9.2.3 Set-off and Carry Forward of Losses

The losses from the trading of Exchange traded derivatives, if treated as a normal business loss, can be set off against the income from the other heads. However, the business loss cannot be set off against the income from salary. The unabsorbed loss can be carried forward up to 8 assessment years. It can be set off only against the business income in the subsequent years. It is important to note that the assessee is entitled to carry forward the business loss provided the return of income is filed on or before the due date. If such return is not filed within the prescribed due date, the right to carry forward and set-off is lost.

Sample Questions and Answers

1. Guidance Notes on Accounting for Derivatives Contract recognize following type of hedging for hedge accounting.
    a. fair value hedge accounting model
    b. The cash flow hedge accounting model
    c. The hedge of a net investment in a foreign operation
    d. All of the above

2. Which of the following accounting standards of Institute of Chartered Accountants of India (ICAI) defines the accounting for derivatives?
    a. AS 6
    b. AS 10
    c. AS 9
    d. AS 30

3. Usually, income from Exchange traded derivatives is treated as _____.
    a. Business income
    b. Income from other sources
    c. Salary income
    d. None of the above

4. Loss on derivative transactions which are carried out in a "recognized stock exchange" can be set off against any other income during the year except _____.
    a. Business income
    b. Income from other sources
    c. Salary income
    d. None of the above

5. Loss on derivative transactions which are carried out in a "recognized stock exchange" can be carried forward for period _____ assessment years
    a. 5
    b. 6
    c. 7
    d. 8