CHAPTER 1

Disclosure of contingent liability in the standalone financial statements

This article aims to:
Discuss an EAC opinion on disclosure of a corporate guarantee issued by a parent company on behalf of its wholly owned subsidiary in the standalone financial statements of the parent company.

Introduction

Under Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, contingent liabilities are defined as liabilities that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Additionally, such liabilities do not meet the recognition criteria under the standard because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made. Accordingly, a contingent liability is not recognised. A contingent liability is required to be disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Recently, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) has issued its opinion[1] on 'Disclosure in standalone financial statements of contingent liability in respect of corporate guarantee issued by the parent company to the bank for furnishing performance bank guarantee on behalf of wholly owned subsidiary company towards its performance obligation'.

Case study

In this case, a parent company (guarantor) had signed a deed of guarantee in favour of a bank (lender) to make available a Performance Bank Guarantee (PBG) for a prescribed amount and time period on behalf of its wholly owned subsidiary (borrower) towards its performance obligation. This PBG was submitted to the beneficiary and would be encashed by the beneficiary under certain circumstances.

The parent company did not disclose the amount of corporate guarantee as part of contingent liabilities in the notes to the standalone financial statements on the basis that there is no liability either actual or contingent towards non-fulfillment of the minimum work programme as prescribed by the beneficiary of the guarantee, in the books of the subsidiary company (borrower).

The EAC deliberated upon the disclosures that would be required in the standalone financial statements (in the context of Ind AS) of the parent company, of the contingent liability in respect of the corporate guarantee given to the bank.

Guidance under Ind AS

The EAC pointed out that not all the contingent liabilities are within the scope of Ind AS 37. Thus, while the corporate guarantee issued by the parent company may give rise to a contingent liability, first it had to be examined, whether any other Ind AS covers the same before considering the applicability of Ind AS 37. Thus, the EAC examined whether the corporate guarantee given by the parent company is a financial guarantee as defined in Ind AS 109, *Financial Instruments*.

Financial guarantee

Ind AS 109 defines a financial guarantee contract as *'a contract that requires the issuer to make specified payment to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a* ***debt instrument.****'* The term debt instrument is neither defined in Ind AS 109 nor in Ind AS 32, *Financial Instruments: Presentation.* However, EAC is of the view that the term implies a contractual right to receive cash arising on account of a debtor-creditor relationship. Under the terms of the corporate guarantee, the parent company guarantees that it will pay the prescribed amount specified in the PBG in order to reimburse the bank for a loss it incurs because of encashment of the PBG.

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The EAC is, therefore, of the view that this arrangement complies with the debtor-creditor relationship between the subsidiary and the bank. Under the terms of the corporate guarantee, the parent company guarantees that it will pay 'guaranteed obligations' specified therein in order to reimburse the bank for the loss it incurs because of encashment of the PBG by the beneficiary due to non-performance by the subsidiary of its contractual obligations to the beneficiary. Therefore, the corporate guarantee issued by the parent company to the bank meets the definition of a financial guarantee and falls within the scope of Ind AS 109 and not Ind AS 37. As per Division II of Schedule III to the Companies Act, 2013, financial guarantees should not be disclosed under the head *'Contingent liabilities and Commitments'* in the notes to the balance sheet.

The EAC also noted that the company has neither previously nor on transition to Ind AS asserted explicitly that it regards financial guarantee contracts as insurance contracts and uses accounting that is applicable to insurance contracts.

Conclusion

Based on the given analysis, EAC is of the view that the requirements of Ind AS 109 and Ind AS 107, *Financial Instruments: Disclosures*, to the extent relevant should be met for the purpose of measurement and disclosure of the financial guarantee respectively. Ind AS 107 requires disclosure of maximum exposure of the financial guarantee to credit risk, which is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.

The company, if so desires, may give reference of such disclosures under the head 'Contingent Liabilities and Commitments' for better understanding of the users of the financial statements.