

CHAPTER 2

Accounting for corporate guarantees in standalone financial statements of a parent company

This article aims to:

Provide guidance on accounting for financial guarantees and covers a recent EAC opinion on accounting for corporate guarantees issued by a parent entity.



Introduction

Indian Accounting Standards (Ind AS) 32, *Financial Instruments: Presentation*, and Ind AS 109, *Financial Instruments*, provide guidance on classification, recognition, and measurement of financial guarantees.

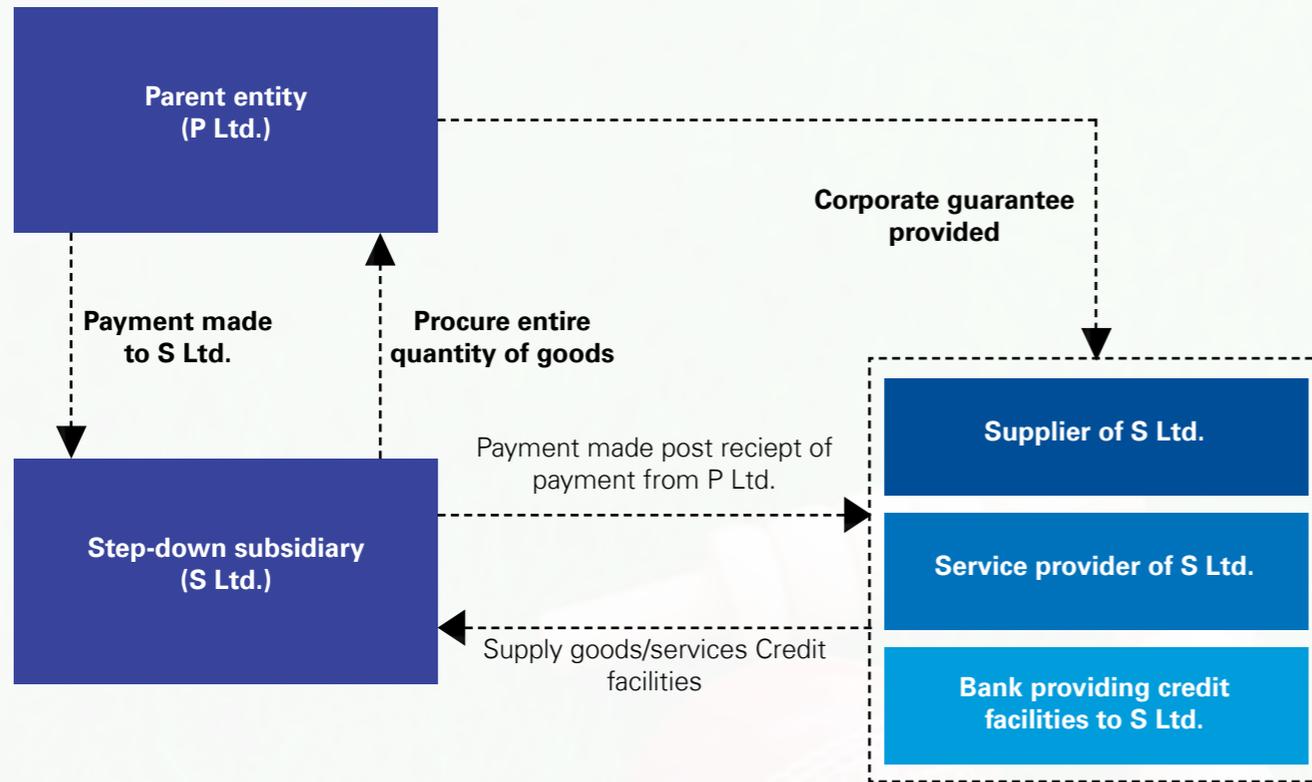
Ind AS 109 defines a financial guarantee as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make a payment when due in accordance with the original or modified terms of a debt instrument.

Financial guarantee contracts may have various legal forms, such as a guarantee, different types of letters

of credit, a credit default contract, or an insurance contract. However, their accounting treatment does not depend on their legal form.

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) issued guidance on accounting for financial guarantees through its opinion on 'Accounting treatment in the company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the company to banks/suppliers/service providers on behalf of its step-down subsidiary company'. In this article, we aim to discuss the main principles enunciated in this opinion.

Case study: Facts of the case



A parent entity (say P Ltd.) entered into an agreement with its step-down subsidiary (say S Ltd.), to procure entire quantity of goods obtained by S Ltd. from its suppliers. For this purpose, P Ltd. issued corporate guarantee to S Ltd.'s suppliers (including service providers) and banks that provided credit facilities to S Ltd. (together termed as suppliers) for prompt payment by S Ltd. of all amounts that become due and payable. In case of default in payment of guaranteed obligation by S Ltd., P Ltd. would pay the suppliers and/or banks promptly.

Based on the structure of the contracts, S Ltd. can make timely payments to suppliers only if it receives timely payments from P Ltd. Since payment to third parties is solely within the control of P Ltd., no guarantee fee has been charged from S Ltd., and Expected Credit Loss (ECL) has not been recognised on the corporate guarantee contract.

Considering these facts, EAC (a) opined on the accounting treatment for corporate guarantees issued by P Ltd. in its separate financial statements, (b) determined whether any expected credit loss is to be recognised on the corporate guarantee contracts and (c) prescribed disclosure requirements for the guarantee.

Overview of the EAC opinion

The EAC provided the following clarifications with regard to accounting for financial guarantee contracts:

A. Whether a corporate guarantee is a 'financial guarantee'

For a contract to be accounted for as a 'financial guarantee', it should meet the definition of a financial guarantee under Ind AS 109. Accordingly, a contract needs to comply with the following conditions:

- The reference obligation is a debt instrument
- The holder is compensated only for a loss that it incurs
- The contract does not compensate the holder for more than the actual loss that it incurs.

While Ind AS 32 or Ind AS 109 do not define a 'debt instrument', the EAC was of the view that it implies a contractual right to receive cash arising on account of a debtor-creditor or lender-borrower relationship.

In the extant case, there is a debtor-creditor relationship between S Ltd. and its suppliers. Further, the suppliers of S Ltd. have a right to receive compensation for the loss incurred by them, if S Ltd. fails to make the payments.

(Source: EAC opinion on 'Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company' issued in ICAI journal in February 2022.)

Accordingly, the corporate guarantee issued by P Ltd. meets the definition of financial guarantee under Ind AS 109. The EAC also noted that the contingent right of the suppliers of S Ltd. to receive payment and the contingent obligation of P Ltd. to make payment in case S Ltd. fails to make payment met the definition of financial guarantee contract under paragraph AG8 of Ind AS 32¹.

Accordingly, the corporate guarantee contract would be considered as a financial guarantee and account for the same in accordance with Ind AS 109².

B. Accounting for financial guarantees in separate financial statements of a parent

The EAC believes that the financial guarantee provided to an external party on behalf of a subsidiary is required to be accounted for in the separate financial statements of the parent company as per Ind AS 109. This is notwithstanding the fact that a subsidiary's financial performance and position may be dependent on the business that is generated with the parent company, and the parent entity is the ultimate beneficiary of the subsidiary's operation.

In the extant case, although all guarantees that have been provided by P Ltd. on behalf of S Ltd. are in furtherance of P Ltd.'s business, wherein P Ltd. is the ultimate beneficiary for these guarantees, it would still account for these financial guarantees in its separate financial statements.



C. Accounting for financial guarantee contract

Ind AS 109 prescribes the accounting for financial guarantee contracts on initial recognition and subsequent measurement. These provisions are given below:

(i) Initial recognition of financial guarantee

As per Ind AS 109, a financial guarantee contract is initially recognised at fair value. If the financial guarantee contract was issued in a standalone arm's length transaction to an unrelated party, then its fair value at inception is likely to equal the premium received unless there is an evidence to the contrary.

The EAC was of the view that this requirement is also applicable in respect of a guarantee issued by a parent on behalf of its subsidiary, and where no fee or commission is charged by the parent for issuance of such a guarantee.

Accordingly, in the extant case, in its separate financial statements, P Ltd. should initially recognise a liability (such as unearned financial guarantee commission) at fair value. The guarantee obligation has been undertaken by P Ltd. in its capacity as the ultimate parent of S Ltd., and as per the facts of the case, it is not charging any

guarantee commission or other consideration to S Ltd. Since P Ltd. has the right to future economic benefits arising from overall investments in S Ltd., upon initial recognition of the financial guarantee liability, P Ltd. should recognise deemed investment in S Ltd. and the same should be accounted for as per requirements of Ind AS 27, *Separate Financial Statements*.

Impact of credit risk on fair value of financial guarantee

The EAC was of the view that the extent of credit risk³ that the financial guarantee contracts carry would not affect the initial recognition of the financial guarantee liabilities. However, this may be one of the factors that P Ltd. may consider for the purpose of fair valuation at the time of initial measurement and for measuring the Expected Credit Loss (ECL) at the time of subsequent measurement.

1. As per paragraph AG8 of Ind AS 32, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower.

2. Issuers of financial guarantee contracts have an irrevocable option (which can be applied for each contract) to treat the financial guarantee contracts as insurance contracts and apply the accounting provisions applicable to insurance contracts. However, where such option is not chosen, provisions of Ind AS 109 would be applied while accounting for financial guarantees

3. This refers to the history of default by the entity for the benefit of whom the financial guarantee contract has been issued.

(ii) Subsequent measurement

Subsequently, a financial guarantee contract is measured at the higher of:

- The amount of loss allowance (ECL) determined in accordance with Ind AS 109, and
- The amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115

Some of the clarifications issued by EAC with regard to recognition and measurement of financial guarantees is given below:

Whether recognition of trade payables and financial guarantee obligation for same transaction results in overstating a company's liabilities

In the extant case, P Ltd. recognised a trade payable for goods purchased from S Ltd., and also recognised a loss allowance for guarantee given on behalf of S Ltd. for the same transaction. In this regard, EAC noted that the trade payable for the goods purchased from S Ltd. and the financial guarantee issued by P Ltd. to third party on behalf of S Ltd. are separate financial liabilities emanating from separate transactions. P Ltd. has obligations towards different parties in the two transactions, therefore EAC was of the view that recognising the two financial liabilities and providing for loss allowance on the financial guarantee contract would not result in duplication or overstating of liabilities.

Recognition of ECL

As per Ind AS 109, ECL is a probability-weighted estimate of credit losses (i.e., the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

Cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor, or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfall for the asset subject to guarantee.

Considering this, EAC noted that as per Ind AS 109, ECL should be considered for financial guarantee contracts at the time of subsequent measurement.

In the extant case, even though failure to pay third parties is solely within the control of P Ltd., there could be a time lag in payment made by P Ltd. to S Ltd. and payment made by S Ltd. to its suppliers, which could result in recognition of ECL, in such a case, in EAC's view such time lag could result in recognition of ECL.

D. Presentation and disclosures

The EAC noted, that Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets* does not apply to financial instruments that are within the scope of Ind AS 109. Therefore, financial guarantee contracts governed by Ind AS 109 cannot be classified as contingent liabilities, and instead should comply with the relevant presentation and disclosure requirement of Ind AS 107, *Financial Instruments: Disclosures* and related disclosures of Division II of Schedule III to the Companies Act, 2013 for financial liabilities.

Consider this

While EAC has provided an opinion on accounting for financial guarantee contracts issued by a parent on behalf of its subsidiary, in the parent's separate financial statement, entities would need to reassess the accounting for such contracts while preparing their consolidated financial statements.

(Source: EAC opinion on 'Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company' issued in ICAI journal in February 2022.)

