(Withdrawn as AS 30 became recommendatory from April 1, 2009)

GN(A) 2 (Revised 1976)

Guarantees & Counter-Guarantees Given by Companies*

1. INTRODUCTION

1.1 Companies are often required to furnish guarantees, warranties or indemnities (hereinafter collectively called guarantees) to parties. While normally these guarantees are furnished directly by the company, often they are furnished by other parties like banks, directors etc. on behalf of the company. In such cases, the company issues counter-guarantees to the persons who furnish the guarantee. As there appears to be considerable divergence of practice in the treatment given to guarantees in published accounts of companies, this Note is issued to offer guidance in this matter.

1.2 In a strictly legal sense, it is possible to distinguish between guarantees, warranties and indemnities. However, for the purposes of this Note this distinction is not important.

2. PRACTICES RELATING TO DISCLOSURE PRESENTLY FOLLOWED

The treatment of guarantees and counter-guarantees in published accounts generally follows one of the under mentioned methods:

(a) The guarantees and counter-guarantees are disclosed as a separate item on the balance sheet under the general heading of "Contingent Liabilities".

(b) The guarantees and counter-guarantees are disclosed by way of a footnote, on the balance sheet but not under the general heading of "Contingent Liabilities".

(c) The guarantees and counter-guarantees are not disclosed at all.

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* This note replaces the note published in "The Chartered Accountant", November 1967, page 247.

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3. SUGGESTED METHOD OF DISCLOSURE

3.1 The method of disclosure would depend upon the nature of the guarantee. It is possible to group guarantees into the following classes:

(a) A guarantee furnished as security or cover for an existing liability which is already recorded in the books of account.

(b) A guarantee furnished as security or cover for a contingent liability.

(c) A guarantee furnished by way of security for the performance of certain obligations or by way of security to ensure the non-commission of certain statutory or other defaults.

(d) A guarantee furnished in respect of a matter for which no liability, actual or contingent existed prior to the issue of the guarantee.

(e) Other forms of guarantee.

3.2 Where a guarantee falls in category (a) of paragraph 3.1 above, it is not necessary to refer to the guarantee by way of a note, since the principal liability is already recorded and the guarantee does not create any further liability either actual or contingent. Where the guarantee is given by a party other than the company, to secure the liability of the company, a note may, if so desired, be made merely by way of information.

3.3 Where a guarantee falls in category (b) of paragraph 3.1 above, it would be more appropriate to disclose the contingent liability itself rather than the guarantee, not only because it is the former which requires disclosure under the provisions of the Companies Act but also because the guarantee may have been furnished for a possible aggregate sum not equal to or related to the estimated amount at the balance sheet date of the contingent liability required to be disclosed.

3.4 Guarantees which fall in category (c) of paragraph 3.1 above are often issued to public authorities who require guarantees to be furnished to them either by the Company itself or by its bankers in order to protect such authorities from any financial loss which they may suffer as a result of the non-performance of obligations or the commission of defaults by the Companies concerned. For example, an importer may be required to furnish a bond or guarantee to the Customs Authorities which would protect the latter in case the importer either fails to perform certain statutory obligations under the Customs Act and Regulations or commits any statutory defaults. Similarly, the Railway Authorities may require

a guarantee from Companies which wish to transport goods without prepayment of freight or which wish to avail of any other facilities offered by the Railways. In all such cases, there is no liability - either actual or contingent which requires to be disclosed, nor does the mere submission of a guarantee constitute a contingent liability. Where the guarantee is furnished as security against statutory defaults, there is no reason to believe that a Company will commit a statutory default or that it will fail to comply with its statutory obligations. In any case, this is a matter which is in the control of the Company itself and the commission of a statutory default by the Company in the future of its statutory obligations cannot be said to involve the existence of a contingent liability, even though in any such eventuality, the Company would be financially liable for penalty or damages. It should also be recognised that all Companies face a situation of this type and if disclosure is to be made at all, it should be made by all Companies and not merely by those which have furnished a guarantee against the financial liability which they may incur in the future by the commission of statutory defaults or by the non-observance of statutory requirements. If it is accepted that a situation of this type does not involve any actual or contingent liability, it must equally be accepted that there is no obligation to disclose the guarantees given by the Company in respect of its possible future obligations. The question which should be asked is whether any event had taken place at the balance sheet date – or even at the date the balance sheet is signed which has resulted in a liability. The mere possibility or chance of such an event taking place in the future would not involve any question of contingent liability on the balance sheet date. It is therefore suggested that no disclosure need be made – either of the possible future liability or of the guarantee which has been given in order to cover such possible future liability. It would not be appropriate in such cases to suggest that disclosure of the guarantee may be made by way of abundant caution or in order to provide additional information to the shareholders and others, because such disclosure, in fact, can be positively misleading, by conveying a false impression to the casual reader of the balance sheet as to existence of actual or contingent liabilities related to such guarantee.

3.5 Guarantees which fall in category (d) of paragraph 3.1 above are usually in respect of the obligations of parties other than the company. For example, a company may issue a guarantee to a bank in respect of a loan granted by the bank to the company's subsidiary. In this case the issue of the guarantee creates the contingent liability and disclosure becomes necessary. However, the amount of the contingent liability is not the full value of the guarantee but the amount of the loan outstanding at the balance sheet date. It is therefore suggested that the note regarding the contingent liability should disclose both the amount of the guarantee and the amount outstanding at the balance sheet date.

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3.6 Where a guarantee does not fall within any of the categories (a) to (d) mentioned in paragraph 3.1 above, disclosure would be necessary only if the issuance of the guarantee has created a contingent liability which did not exist prior to the issue of the guarantee.

4. COUNTER-GUARANTEE

4.1 The principles governing the method of disclosure regarding counter-guarantees should be the same as applicable to guarantees. Counter-guarantees are furnished by a company to the banker or other third party who furnished the principal guarantee on behalf of the company. Obviously, if the principal guarantor is called upon to meet his guarantee obligation, he will proceed against the company in order to recover the amount which he has paid under his guarantee obligation. The only difference between a guarantee and a counter-guarantee in so far as the company is concerned, is that in the former case, the company is obligated on the guarantee to the person to whom it is furnished whereas in the latter case, it is obligated to the banker or other third party who has furnished the original guarantee.

4.2 Where tangible security has been provided to the principal guarantor, this fact should also be disclosed. This situation is frequently encountered in the cases of borrowings from financial institutions, where one institution, after obtaining tangible security, guarantees, on behalf of the borrower, the loans given by another institution. In such cases the classification of the loan has led to much divergence in practice, some companies classifying it as an unsecured loan (as the security is not provided to the lender), and other companies classifying it as a secured loan (as the assets of the company are encumbered). On a strict legal view of the matter, in such cases, the loan is unsecured, but considering the overriding requirement that the accounts should provide a true and fair view of the financial position, the recommended procedure is to classify it as a secured loan, (making it clear that the security is given to the guarantor and not the lender).

4.3 An exception to the rule stated in paragraph 4.1 above would arise in a case where persons connected with the company- e.g. managers, directors, etc. furnished guarantees in respect of the company's obligations and disclosure thereof is required under the provisions of the Companies Act. If any commission is paid to such persons for the issue of the guarantee, the requirements of the Companies Act will have to be observed both with regard to the method of disclosure as also regarding the validity of the payment.

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5. GUARANTEES GIVEN BY A COMPANY ON BEHALF OF OTHERS

The foregoing remarks apply either where a company has given a guarantee on its own behalf or where third parties have given a guarantee on behalf of the company and the company has given a counter-guarantee or counter-indemnity to such third parties. Where, however, a company has itself given a guarantee on behalf of third parties, it would certainly be necessary to disclose the same as a contingent liability. Moreover, if such guarantee has been given on behalf of persons concerned with the management of the company – for example directors or managing agents – a further disclosure of this fact would also be required.

6. DISCLOSURE OF GUARANTEES IN THE ACCOUNTS OF A COMPANY RECEIVING A GUARANTEE

A question of disclosure would also arise in the case of a company which receives a guarantee from a debtor or from person to whom a loan has been advanced or from whom money or other obligation is owing to the company, or who is obligated to the company for the performance of services or otherwise. In all such cases, no disclosure of the guarantee is required unless the guarantee is supported by tangible security in which case the classification of the debt, loan, or advance, as the case may be would be "secured" to the extent of the value of the security.