Accounting For Financial Guarantees under Ind AS

The article deals with accounting for support letter and guarantee given by a parent to banks in respect of borrowings of its subsidiary, in the parent's stand-alone Financial Statements under Ind-AS. The issue tackled is one which has recently arisen in the first Ind-AS Financial Statements being drawn in such a situation. This is an aspect which appearingly needs improvement in IFRS 9 (which has carried forward the treatment of Financial Guarantee Contracts accounting by the issuer from IAS 39 unchanged). This article relates to corporate borrowers – not lenders and is confined to a specific aspect of the Standard: Guarantee/Letter of Support given by the parent company for borrowing by its subsidiary. The facts are very common to Corporate borrowings in India and are based on a real life case study.

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Overview - IFRS 9/Ind-AS 109

IAS 39 *"Financial Instruments: Recognition and Measurement",* is one Standard that caused a major disconnect between Indian GAAP and IFRS over the yearssince AS 13 – *Accounting for Investments,* covered only very limited aspects of Financial Instruments and that too not harmonised with IAS 39. As part of the Global Convergence initiative unfurled between IASB (the Board for

IFRS) and FASB (the Board for US GAAP), this standard has been replaced by IFRS 9 *"Financial Instruments".* Globally, IFRS 9 will be mandatory for the accounting periods beginning January 2018 with early adoption permitted based on certain conditions. In its initiative to converge to IFRS, the Government of India in Feb'15 opted - and rightly so – to notify Ind AS 109 as the Standard on Financial Instruments in correspondence to IFRS 9 and not in correspondence to IAS 39. This has meant that Indian entities adopting Ind AS in the 1st or 2nd phase have had no ability to fall back on Global experience or to benchmark with global practices. The Global Convergence initiative was started with great gusto with the Norwalk agreement in 2002 and gained momentum with the hammering that both the Boards received from G20 group in the wake of the 2008 Financial Meltdown.

One critical issue for IASB in revising the standard (IAS 39) was the volatility in the Income Statement caused by changes in the credit risk of a borrower whose Financial Statements measure the liabilities at fair value. This meant, quite counter-intuitively, that when an entity's credit quality declined, the value of its liabilities fell, and for liabilities measured at fair value, a gain was recognised in profit or loss (and *vice versa*). Many investors, academicians and others obviously found this result queer and confusing. IFRS 9 still includes the same treatment as IAS 39 that permits entities to elect to measure financial liabilities at fair value if particular criteria are met; however, the changes in the fair value due to the entity's own credit risk are now to be recognised in other comprehensive income (adjustment in Reserves – in Indian parlance) and not in the profit or loss. It is very important to note that on this aspect, Ind AS 109 boldly deviates from IFRS 9 ("carve out") and requires that any change in fair value of the financial liability (i.e. the borrowing) consequent to changes in the entity's own credit risk shall be ignored. This does away with the irrational depiction of enhanced Net Worth of an entity with declining creditworthiness that IFRS can still be faulted with.

The application of Ind AS to Banks and NBFCs in India is deferred and will kick-in only for the accounting periods beginning 1st April 2018 or later. On the transition date, the Expected Credit Loss model (ECL) will likely have a significant negative impact on the Net-Worth of banking system in the current situation of stressed assets of humungous value.

The recognition of credit losses on loans (and other financial instruments) was identified as another weakness in accounting standards during the global financial crisis with the **'incurred loss model'** delaying the recognition of credit losses until there being an evidence of the trigger event. The **'expected credit loss'** model now requires an entity to recognise losses that arise from past events and current conditions without waiting for any trigger event but based on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information.

This article, however, relates to corporate borrowers – not lenders and is confined to a specific aspect of the Standard: Guarantee/Letter of Support given by the parent company for borrowing by its subsidiary. The facts are very common to corporate borrowings in India and are based on a real life case study.

Accounting Financial Guarantee Contract as Financial Instrument

At the outset, it needs to be noted that accounting for Financial Guarantees is explicitly scoped out of Ind-AS 37. Ind AS 109 defines "Financial Guarantee Contract" 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 payment when due in accordance with the original or modified terms of a debt instrument.*

It may be noted that IAS 39's treatment of Financial Guarantees given by an entity is carried forward to IFRS 9 largely unchanged. In this article, the discussion is with reference to Separate (i.e. stand-alone) Financial Statements of the guarantor

The Fair Value for initial recognition is based on the premise that the 'consideration' charged by the issuer of the guarantee is at Arm's Length i.e. equal to that charged by a market participant to issue a guarantee which is identical to the one being valued – in terms of conditions and credibility. From the eyes of the beneficiary, the commission (periodical payment) or Premium (lump sum payment) should be such that another bank would have charged the Subco without Holdco intervention/ support/charge on the assets.

(the parent or Holdco). In the Consolidated Financial Statements of the parent, all the obligations of the Group are subsumed in the Borrowings recognised in the Financial Statements of the parent and the separate elements – 'Guarantee' and 'specified debtor' collapse in the reporting entity/group. Thus, the nuances of reporting a Financial Guarantee do not arise in the context of the Consolidated Financial Statements of the parent/group.

The guarantee dealt with here is what is commonly given by the Flagship Company of the group or the Holding company of the borrower. The facts of the case study mentioned later, will make this point clear. There could be more complex situations which are not common in India. For instance, one may refer to the 'Application Guidance' which is an integral part of the Standard, which states: *Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this Standard, and are not insurance contracts as defined in Ind AS 104. Such guarantees are derivatives and the issuer applies this Standard to them.*

Ind AS 109 mandates that every issuer/guarantor (i.e. the parent company, in our case study) should initially recognise the liability in respect of the financial guarantee contract at 'Fair Value' as per Ind-AS 113. After initial recognition, an issuer of such a contract shall subsequently measure it at the higher of:

(i) the amount of the loss allowance determined **and**
(ii) the amount initially recognised less the cumulative amount of income recognised in accordance with the principles of Ind-AS 18.

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Accounting Financial Guarantee issued as an insurance contract

While IFRS 9 was evolving, IFRS 4, that deals with accounting by insurers was a work-in-progress – not a full-fledged Standard yet. The IASB issued IFRS 17 in May 2017 which will replace IFRS 4 (which corresponds to Ind AS 104) for accounting periods commencing from January 2021. A Financial Guarantee is an Insurance Contract in terms of IFRS 4/Ind AS 104 which defines the term as *"a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."* For applying the Standard, the fact that the issuer is not an Insurer as understood under regulations or in general does not matter.

This Standard can be applied for Financial Guarantee Contracts if the issuer asserts explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. In that case, the issuer may elect to apply either the Financial Instruments Standards (i.e. Ind AS 109, Ind AS 32 and Ind AS 107) or Ind AS 104 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

For periodic reporting, this standard stipulates "Liability adequacy test" - an assessment of whether the carrying amount of an insurance liability needs to be increased (or *the carrying amount of related deferred acquisition costs or related intangible assets decreased)*, based on a review of future cash flows. The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from

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embedded options and guarantees. If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss, considering present value of the shortfall.

Case Study- facts

With the background as discussed earlier, we proceed to understand the implications with facts as below:

- Holdco has issued an undertaking for making good shortfall in cash generation of its 100% overseas subsidiary in favour of the Singapore branch of an Indian Bank who has lent to the subsidiary - Subco primarily against a guarantee for the outstanding loan balance issued by the Indian branch of the Bank. The wordings are reproduced below:

  In order to induce the Lenders to make the Facility available to the Borrower, we hereby unconditionally and irrevocably undertake to the Agent for the benefit of the Lenders that if:

  the Project Costs exceed the amount identified under the Facility Agreement and/or there occurs a cost overrun due to any circumstance or reason whatsoever during the Facility Period, we shall fund (whether by group loan or by equity injection and to the extent permissible under the Foreign Exchange Management Act, 1999 or rules and regulations issued thereunder by the Reserve Bank of India) or procure one or more companies/persons, whether situated in India or abroad to fund by way of subordinated debt (to the satisfaction of the Lenders) such amounts as may be required for meeting the aforesaid cost overrun/shortfall of funds required for the acquisition of the Ships and for payment of other associated costs in relation thereto which are due for payment or discharge at such time.

  Subco is the shipping subsidiary of Holdco and the future availability of cash from freight earnings to service the debt of Subco is very uncertain in view of absolutely depressed global freight market.
- The Indian Bank is also the lender to the Holdco for India operations and has a charge on the assets of Holdco for the fund-based facilities as well as the non-fund based facility comprising of the guarantee to the Singapore branch. The Indian bank, considering these facts, charges Holdco a guarantee commission @ 1.50% p.a. on the guarantee amount i.e. the loan amount. This is charged back by Holdco to subco.
- The auditors of Holdco insist on accounting for the guarantee under IND-AS 109 as a Financial Instrument in the separate INDAS Financial Statements. It is clear that the Bank would have charged significantly higher commission/premium had it not been for the charge it has on the assets of the Holdco. This too, is on the presumption that a Bank would want to issue a guarantee in the first place despite the bleak scenario. The two accounting implications are:
  - To the extent the amount charged to Subco by Holdco is less than the fair consideration to be so reckoned, the difference has to be recognized as additional investment or Capital contribution by Holdco in Subco.
  - The re-measurement required by the Standard as specified above results in the total consideration (initially recognised as liability) being amortised as revenue on a straight-line basis over the tenor of the guarantee. For the sake of simplicity, we assume that there are no Expected Credit Losses; else there is an added dimension of recognising the outflow.
- Holdco contends that based on the manner in which the Letter of Support is worded, it cannot be construed that the undertaking is a Financial Guarantee Contract as defined in the Standard (ref definition above). This is so because there is no commitment by Holdco to reimburse the Bank. The commitment is to fund the Subco. Further, they also maintain that in so far as revenue recognition aspect of this standard is concerned, as per accounting framework no amount can be recognised and brought into books based on an estimate/notional amount which is not reliable. Considering the facts discussed, there is little doubt that it is impracticable to determine the fair consideration on an Arm's Length basis.

Validating and Challenging the Proposition

The IFRS Framework describes the basic concepts that underlie the preparation and presentation of financial statements for external users and serves as a guide to the Board. Financial information is useful when it is relevant and represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

The substance of IFRS (and Ind-AS) is that recognition, measurement and disclosure taken holistically, should portray the financial position, financial performance and cash flows fairly (information "useful to a wide range of users in making economic decisions") and comply with the Framework & IAS 1/Ind-AS 1. Can the application guidance and the 'letter of support' clause be read to conclude that the treatment as Financial Guarantee should not apply? Or would it be fair to conclude that there is no real difference in a commitment to infuse capital in the subsidiary (which it may use to pay the borrowing) and a commitment to make good the default to the lender, considering that IFRS (and Ind-AS) are based on Substance rather than Form?

Even assuming that the later view should prevail based on the 'principle based approach', the recognition and measurement of Financial Guarantee as prescribed in Ind-AS 109 may not squarely meet the fundamental requirements of the Framework on two counts:

(i) While the recognition/measurement as Financial Guarantee as above is based on an attempt to recognise the related liability at Fair Value, determination of Fair Value in cases as above (which by the way is almost the standard mode of financing subsidiary entities/Special Purpose Vehicles in India) is impracticable (costs exceeding the benefits – as referred in the Framework) if not impossible.

(ii) Secondly, the recognition as 'Revenue' seems inconsistent with the framework in as much as it relates to the notional amount i.e. difference between Arm's Length consideration and the consideration actually charged. Indeed, revenue is never so reported under IFRS in respect of any other standard/aspect. The question that merits attention is: whether such treatment goes against the fundamental definition of the term, which is: *"Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."*

Response to the aforesaid dilemma could be to conclude that accounting as an insurance contract is the appropriate treatment in the case as discussed. This appears to present yet another technical issue. Ind-AS 104 stipulates that *"the carrying amount of related deferred acquisition costs or related intangible assets"* be considered in recognising the liability. It does not refer to the impairment or diminution in the value of the investment in Subco. However, it may be fair to say that where the cash outflow represents amounts lent to or capital invested in Subco to make good the shortfall, the logical conclusion should be that once impairment is recognised in measuring the receivable or investment, there should be no reckoning of any liability. The fact that the standard specifically considers only decrease in the carrying amount of intangibles, but not that of financial instruments, should not really matter when dealing with a 'principles based reporting frame-work' that IFRS stands for.

Conclusion

Any discussion about the implications of Ind AS is incomplete without the considerations of Minimum Alternate Tax or Book Profits Tax. On a review of the amendments in Sec 115 JB by Finance Act 2017, it will be realised that the impact of accounting of revenue from Financial Guarantee under Ind AS 109 will be considered in the computation of book profits.

In situations where the Arm's Length consideration for the guarantee can be reliably ascertained, the fundamental points to consider are: (i) *whether there would be significant difference in the reported performance or position with/without treatment as Financial Guarantee (ii) would the difference between Expected Credit Loss and the guarantee income largely equate the impairment to be recognised by Holdco in Subco without resorting to FG accounting?*

If the answers warrant recognition of the Guarantee, would it be appropriate to fall back on para 122 of Ind-AS 1 (IAS 1)? This para requires disclosure of judgements - as distinct from estimates - To do justice to the third dimension ('recognition' and 'measurement' being the first two) of reporting i.e. 'disclosure', the judgment about not recognising revenue but accounting for the guarantee as an insurance contract and the rationale for measurement of liability may be appropriately disclosed. ICAI has taken a laudable stance by having certain carve-outs based on sound rationale. This too appears to be a situation where a deviation or specific guidance may be necessary to address the situations as discussed.■