THE STANDARD STANCE

Financial Guarantee Contracts Under Ind AS 109

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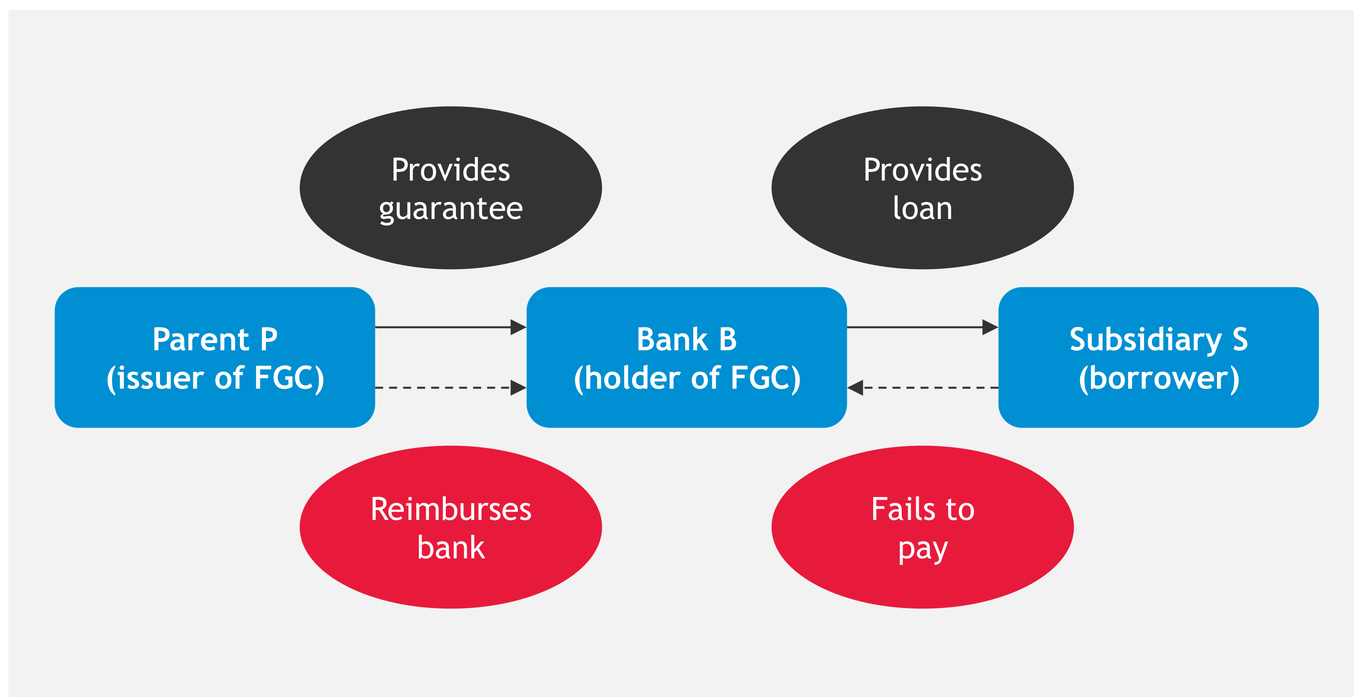
BDO

Financial Guarantee Contracts (FGC) come in various forms. The accounting of FGCs under Ind AS does not depend on their legal form but requires analysing their terms and conditions to determine the right accounting treatment. FGCs are commonly seen within group entities, which can make things more complex in each group entity's standalone financial statements. This article provides guidance on accounting for FGCs under Ind AS 109 “Financial Instruments”, covering the essential aspects from identification and measurement to practical challenges and illustrative examples to assist in understanding FGCs and navigating accounting complexities for such items.

Identifying FGCs

In simple terms, an FGC is a contractual promise by an entity (such as a bank or a parent) to guarantee payment of the debt obligation of another entity so as to reduce or mitigate risk for the debt provider. For example, Parent P issues an FGC to Bank B for a loan obtained by Subsidiary S. In the event that Subsidiary S fails to repay the loan to Bank B, Parent P is obliged to reimburse B for the loss incurred.



Ind AS 109 defines FGC 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.”

Accordingly, to meet the definition of an FGC per Ind AS 109, the contract must provide for reimbursement of a loss that the holder of the contract actually incurs. Where a loss is not required for a payment to be made or the contract compensates the holder for more than the actual loss, the contract is not an FGC under Ind AS 109. The term ‘debt instrument’ is not specifically defined in Ind AS, but it generally includes items like trade debt, overdrafts and other borrowings.

Entities often provide guarantees with respect to other items and determining whether these are consistent with the definition of an FGC may not be straightforward. Some common examples of contracts, that meet or do not meet this definition, are set out in the following table:

#	Contract type	Whether FGCs?
1	A parent provides a guarantee to the bank to reimburse the losses incurred on loan provided to a subsidiary for non-payment of contractual dues by the subsidiary.	Yes; because it relates to a specific debtor, a debt instrument and only reimburses the holder for losses incurred for the failure to make contractual payments.
2	A bank B issues a letter of credit of up to INR 100,000 on behalf of its customer C, identifying a foreign supplier S as the beneficiary. Under the letter of credit, B promises to reimburse S for actual losses that S incurs if C fails to make the payments when due for its future specified purchases of INR 100,000 from S.	Yes; because under the terms of the letter of credit, B is required to reimburse S for a loss incurred if C - i.e. the specified debtor - fails to make a payment when it is due in accordance with the original debt instrument - i.e. the trade receivable. Hence this contract would be expected to be an FGC from the bank's perspective.
3	A parent company provides a guarantee over the general obligations of a subsidiary.	No; because it is not specific in nature and may include obligations other than debt instruments.
4	A subsidiary of a group takes out a loan with a bank. The parent provides a comfort letter to the subsidiary such that, if the subsidiary fails to repay the loan to the bank when due, the parent will pay on its behalf.	No; because the parent has not provided any guarantee to the bank (nor would the bank be able to enforce payment under what is, effectively, a private arrangement between the parent and its subsidiary) to repay the loan if the subsidiary defaults.
5	A credit default swap paying out in the event of a credit downgrade not necessarily equating to an incurred loss.	No; because it reimburses the holder for losses that it may not incur.
6	An entity provides a guarantee to a reseller for a minimum margin on sales to end customers.	No; it does not meet the definition of a financial guarantee.
7	An entity guarantees a certain level of 'uptime' for a network (for example, 99.999%) or guarantees that service call response times will be below a maximum time limit.	No; since it is not in respect of debt instrument.
8	Product warranties issued by a manufacturer, dealer, or retailer.	No; since it is not in respect of debt instrument.
9	Performance guarantee contracts that provide compensation if the party fails to perform a contractual obligation (such as an obligation to construct a building).	No; since it is not in respect of debt instrument.
10	A residual value guarantee contract where an insurer is required to make payments to the insured party based on the fair value of a non-financial asset at a future date.	No; since the payment would not be arising due to the loss incurred on account of failure to pay.

Scoping

There is no detailed guidance on accounting for FGCs from the holder’s perspective under Ind AS 109. For an issuer of an FGC, all contracts that meet the definition of an FGC are accounted for as financial liabilities under Ind AS 109. However, an issuer can elect to apply Ind AS 117 “Insurance Contracts” instead of Ind AS 109, if it has previously asserted explicitly that it considers and accounts for FGCs as insurance contracts.

There is a common misconception that FGC is a contingent liability under Ind AS 37 “Provisions, Contingent Liabilities and Contingent Assets” as payment is contingent on non-payment by a specified debtor. This is not the case as Ind AS 37 explicitly excludes financial instruments (including FGCs) within the scope of Ind AS 109.

Initial Recognition

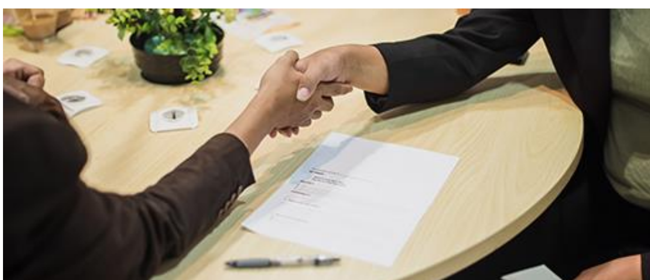
Issuer

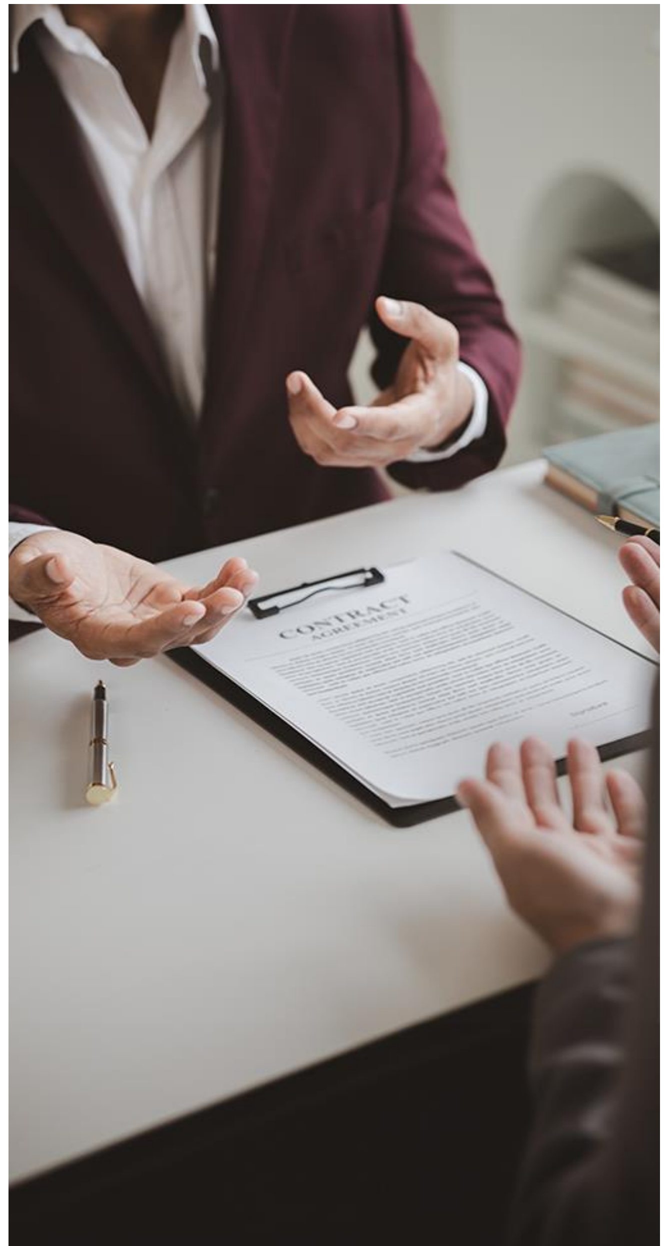
Under Ind AS 109, the issuer shall recognise the FGC in its balance sheet, when it becomes a party to the contractual provisions of the FGC (usually at the time the FGC is issued) at its fair value. The accounting impact of the FGC will need to be given, whether or not any consideration is received by the issuer for providing such guarantees.

Purchaser

The purchaser of the FGC is the entity that purchases the FGC and is generally the entity in whose financial statements the debt instrument (i.e. borrowing or payable) is recorded. The purchaser's accounting treatment of the cost of the FGC depends on whether the FGC is both, in substance, part of the contract terms (that is, integral to the debt instrument) and not recognised separately by the purchaser. In summary:

- If the financial guarantee is both integral to the guaranteed debt instrument and not recognised separately, it is treated as an adjustment to the effective interest rate of the guaranteed debt instrument as a transaction cost, unless the financial instrument is measured at fair value through profit and loss.
- However, if the financial guarantee is not integral to the debt instrument or it is recognised separately, it is outside the scope of Ind AS 109 and Ind AS 117 and the entity would need to develop an accounting policy in this regard. Ordinarily, the cost is recognised as a prepayment asset and amortised over the shorter of the life of the guarantee and the expected life of the guaranteed debt instrument. The prepayment asset is tested for impairment under Ind AS 36 “Impairment of Assets”.





Fair Value Determination

The determination of the fair value of the FGC has been one of the most difficult practical challenges under Ind AS, particularly given that there is no mature market for such instruments in India.

If the FGC is issued to an unrelated party in an arm’s length transaction, the initial fair value is likely to equal the premium received unless there is evidence to the contrary.

FGCs are commonly seen in intra-group transactions with often no premium charged (or premium charged not at arm’s length). In such cases, the fair value must be determined using a method that quantifies the economic benefit of the FGC to the holder. There is no specific guidance in Ind AS 109 in this regard. Considering the broad principles of Ind AS 113 “Fair Value Measurement”, the following approaches may be considered; and if applied properly, the results from different approaches are generally unlikely to differ widely.

#	Approach	Methodology	Examples
A	Market price of similar instruments	Based on the amount that an unrelated, independent third party would have charged for issuing the FGC	For example, parent P has guaranteed INR 100 million of five-year debt issued by subsidiary S. It might be possible to identify credit insurance products issued by a third party (say a bank) relating to a debt of similar amount, maturity and credit quality and use such pricing for initial fair value determination (with adjustment for liquidity or credit risk, etc.).
B	Interest rate differentials	Based on the present value of the amount by which the interest (or other similar) cash flows in respect of the loan are lower than what they would have been if the loan were an unguaranteed loan.	For example, if an interest rate of 7% is charged with the benefit of a guarantee and a rate of 10% would be charged without it, the interest rate differential of 3% could be considered to represent the economic benefit of the FGC to the holder and the present value of such differential over the loan term would therefore be the initial fair value.
C	Discounted cash flow approach	Based on the present value of the probability-weighted estimated cash flows that may arise under the FGC (i.e. the expected value of the liability).	For example, parent P has guaranteed INR 100 million of five-year debt issued by subsidiary S. The probability of default by subsidiary S is estimated at 0.05% (based on historical default rates amongst companies with the same credit rating as subsidiary S), and the loss in the event of default is estimated at 60% (based on subsidiary S's asset base and other collateral available to secure the issued debt). So the expected value of the liability would be INR 30,000 (INR 100 Million X 0.05% X 60%), which should then be adjusted, as necessary, to incorporate the guarantor's risk of non-performance in order to determine the fair value of the liability.

Intra-group FGCs

There is no exemption under Ind AS 109 for FGCs issued between members of a group or entities under common control in their respective standalone financial statements. However, on a consolidated basis (for guarantees given with respect to borrowings of a subsidiary), the FGC is not recognised as a separate contract, but is part of the group's liability to the third party. For example, a guarantee is given by the parent to a subsidiary's bankers in the event the subsidiary fails to repay a loan to the bank when due. In such cases, the guarantee will not be recognised in the consolidated financial statements of the group, rather it will be considered as a part of the group's obligations for the bank loan availed by the subsidiary.

In many cases, the fair value of the intra-group guarantee given by the parent for borrowings availed by the subsidiary does not equal the fee charged by the parent (if any).

- In such cases, the parent needs to determine whether the difference between the fair value and the fee charged (if any) should be treated as an expense or as a capital contribution via an increase in investments in the subsidiary (considering that the guarantee might have been provided in the capacity of a shareholder). The method used should reflect the transaction's economic substance, should be applied consistently to all similar transactions, and should be clearly disclosed in the financial statements.
- Ind AS 109 does not address the accounting for FGCs by the subsidiary in such cases. Therefore, the subsidiary has an accounting policy choice and could either:
  - fair value the loan from the bank by reference to a normal market rate of interest that it would pay on a similar but unguaranteed loan, and take the benefit of the interest differential to equity as a capital contribution from the parent; or
  - view the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the proceeds that the subsidiary receives.

Subsequent Recognition

From an issuer's perspective, the FGC is subsequently measured at the 'higher of':

- The amount of expected credit loss (ECL) allowance as per Ind AS 109, and
- The amount initially recognised (i.e., fair value) less any cumulative amount of income recognised applying Ind AS 115 "Revenue from Contracts with Customers".

However, the above requirements do not apply:

- If the FGC was designated at fair value through profit or loss at inception – such FGCs are measured at fair value subsequently
- If the FGC was entered into or retained on transferring financial assets to another party and prevented derecognition of the financial asset or resulted in continuing involvement as per Ind AS 109 – in such cases, there are specific accounting requirements under Ind AS 109.

Where the FGC tenure is more than one year, it might indicate that it contains a significant financing component in the contract and hence an entity would be expected to present the effects of financing (i.e. interest expense) separately from revenue from contracts with customers in profit and loss.

Impairment/ ECL requirement

Entities are not allowed to use the simplified approach to measure ECL on FGC. The amount of the loss allowance at each subsequent reporting period is equal to 12-month expected credit losses. However, where there has been a significant increase in the risk that the specified debtor will default on the contract, the ECL is based on lifetime expected credit losses. In addition, the issuer entity should also separately assess ECL on premium receivable from the holder (if any).

Derecognition

FGC issued is derecognised by the issuer when the obligation is discharged, cancelled or expired.

Disclosures

Ind AS mandates detailed disclosures relating to FGCs. Effective disclosure practices involve providing qualitative and quantitative information that allows stakeholders to understand the impact of FGCs on the entity's financial position and performance, including:

- Nature and extent of FGCs
- Exposure to credit risk and liquidity risk arising from FGCs and how these are managed
- Information about the inputs, assumptions, and estimation techniques used in calculating ECLs and fair values of FGCs

Illustrative Examples

The following two examples illustrate the above accounting requirements for an intra-group FGC in practice in the books of the issuer.

Example one

- On 1 April 2024, Company P guarantees INR 1,000 loan of Subsidiary S provided by Bank B for three years at 7%. Interests are to be paid at each year-end and the principal is to be repaid at the end of the loan term (with no prepayment allowed). If Company P had not issued a guarantee, Bank B would have charged Subsidiary S an interest rate of 10%. Company P does not charge anything from Subsidiary S for providing the guarantee.
- On 31 March 2025, there is a 1% probability that Subsidiary S will default on the loan in the next 12 months. If Subsidiary S defaults on the loan, Company P does not expect to recover any amount from Subsidiary S.
- On 31 March 2026, there is a 4% probability that Subsidiary B will default on the loan in the next 12 months. If Subsidiary S defaults on the loan, Company P does not expect to recover any amount from Subsidiary S.

1 April 2024

The guarantee must be initially recognised at fair value. The fair value of the guarantee can be computed using the interest differential approach as follows.

Table 1	Year 1 (INR)	Year 2 (INR)	Year 3 (INR)	Total (INR)
Cash flows based on interest rate of 10% (A)	100	100	100	300
Cash flows based on interest rate of 7% (B)	70	70	70	210
Interest rate differential (A-B)	30	30	30	90
Interest rate differential discounted at 10%	27	25	23	75
Fair value of the FGC				**75**

The journal entry would be:

Investment in subsidiary	Dr	INR 75
Financial guarantee (liability)	Cr	INR 75

(Being the fair value of FGC on initial recognition)

If Subsidiary S was an unrelated party, the above journal entry would likely result in an expense in the books of Company P.

31 March 2025

At 31 March 2025, there is 1% probability that Subsidiary S will default on the loan in the next 12 months. This is not considered as a significant increase in the probability of default. If Subsidiary S defaults on the loan, Company P does not expect to recover any amount from Subsidiary S. The 12-month ECL is therefore INR 10 (INR 1,000 x 1%).

The initial amount recognised less amortisation is INR 52 (INR 75 + INR 7.5 (interest accrued under the EIR)) – INR 30 (benefit of the guarantee in year 1) - see table below. Company P would recognise the unwound amount as income, being the benefit derived by Subsidiary S not defaulting on the loan during the year.

Table 2	Opening balance (INR)	10% EIR (INR)	'Benefits' provided (INR)	Closing balance (INR)
Year 1	75.00	7.50	(30.00)	52.50
Year 2	52.50	5.30	(30.00)	27.80
Year 3	27.80	2.20(*)	(30.00)	-

**Ignore rounding off differences*

The carrying amount of the financial guarantee liability after amortisation is, therefore, INR 52.50, which is higher than the 12-month ECL of INR 10. The liability is, therefore, adjusted to INR 52.50 (the higher of the two amounts) as follows:

Financial guarantee (liability)	Dr	INR 22.50
Profit and Loss	Cr	INR 22.50

(Being amortisation of the liability recognised for the FGC – calculated as INR 75.00 less INR 52.50)

31 March 2026

On 31 March 2026, there is 4% probability that Subsidiary S will default on the loan in the next 12 months. If Subsidiary S defaults on the loan, Company P does not expect to recover any amount from Subsidiary S. The 12-month ECL is therefore INR 40 (INR 1,000 x 4%).

The initial amount recognised less amortisation is INR 27.80, which is lower than the 12-month ECL (INR 40). The liability is therefore adjusted to the higher of the two amounts i.e., INR 40 as follows:

Financial guarantee (liability)	Dr	INR 12.50
Profit and Loss	Cr	INR 12.50

(Being the FGC measured at the amount of loss allowance being higher than the amortisation amount - calculated as the carrying amount at the end of 31 March 2025 of INR 52.50 less 12-month ECL of INR 40.00).

Example two

- Same facts as Example one, except that at 31 March 2025, there is a significant increase in the risk that Subsidiary S will default on the loan. The probability of default over the remaining life of the loan (two years) is 60%. If Subsidiary S defaults on the loan, Company P does not expect to recover any amount from Subsidiary S.

31 March 2025

As Company P does not expect to recover any amount from Subsidiary S, the lifetime ECL is INR 600 (60% x INR 1,000), and the carrying amount is adjusted as follows:

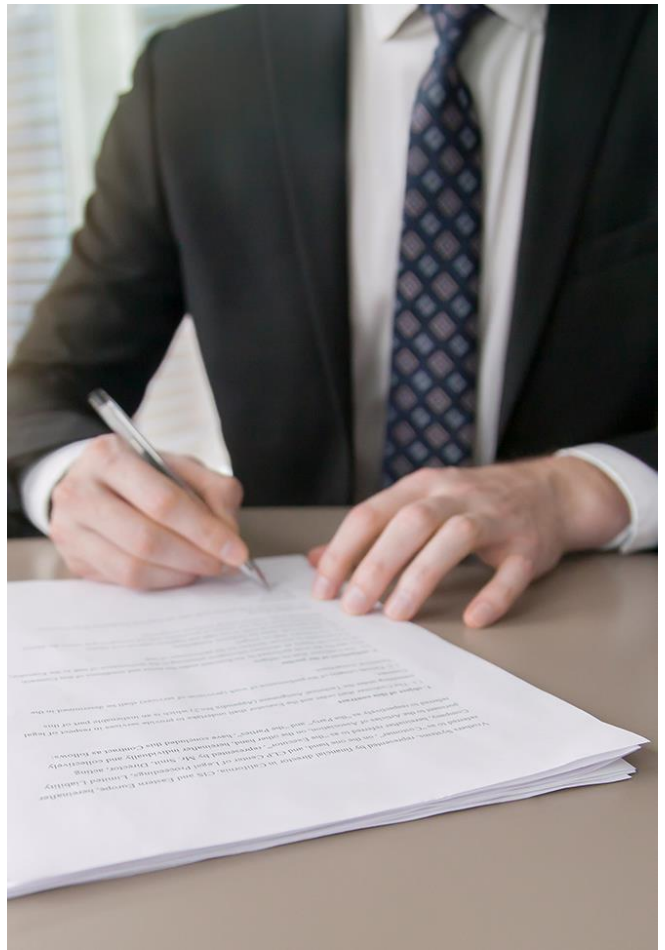
Profit and Loss	Dr	525
Financial guarantee (liability)	Cr	525

(Being the FGC measured at the amount of loss allowance – calculated as INR 600 – INR 75).

Concluding Remarks

FGCs under Ind AS 109 require careful consideration of recognition, measurement, and impairment requirements. Careful monitoring of the debts for which FGCs have been provided is essential for both risk management and accounting purposes. Finance teams should ensure that they have processes in place to undertake such monitoring on a regular basis.

The accounting for FGCs can significantly impact an entity's financial statements. They can affect key financial ratios such as leverage and liquidity ratios, and influence stakeholders' perceptions of the entity's financial health.



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