

Query No. 3

Subject: *Disclosure in standalone financial statements of contingent liability in respect of Corporate Guarantee (Deed of 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.*¹

A. Facts of the Case

1. A company was incorporated on 16th August 1984 for procuring, transmission, processing and marketing of natural gas. The company has an authorised share capital of Rs. 2,000 crore, out of which Rs. 1,691.30 crore is paid-up share capital. The Government of India holds 54.43% equity of the company at present. The securities of the company are listed on National Stock Exchange, Bombay Stock Exchange and London Stock Exchange.
2. At present, the company owns over 11,000 Kms of pipeline and currently transmits about 206 MMSCM per day of natural gas. The company operates six LPG manufacturing plants in different parts of the country with an installed capacity of 1.30 Million MT of LPG per annum. The company has an integrated petrochemical plant at Pata, Uttar Pradesh for manufacturing polymers. The company has world's longest pipeline from Jamnagar to Loni for transmission of LPG. The company has integrated its business activities and operates the City Gas Distribution (CGD), Exploration of Natural Gas, Wind Power & Solar Power Plant and Telecom Businesses. The company has formed subsidiaries/associates/ joint ventures companies for CGD, Petrochemicals, LNG, Gas Trading, Power Generation and Shale Gas.
3. The company has prepared its accounts as per Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016. In compliance with the Companies (Indian Accounting Standards) Rules, 2015, the company has prepared its financial statements for F.Y. 2016-17 with comparative figures for F.Y. 2015-16. The company has adjusted the impact of transition from Indian Generally Accepted Accounting Principles to Ind ASs in the opening reserve as on 1st April 2015 and in the statement of profit and loss for F.Y. 2015-16. Further, the holding company, subsidiaries, joint ventures, or associate companies of the company also need to make transition to Ind ASs w.e.f. 1st April 2016.
4. The company has a wholly owned subsidiary company 'GG' which was incorporated in the year 2008 for the smooth implementation of CGD projects. 'GG' has been authorised by the Petroleum and Natural Gas Regulatory Board ('PNGRB') for implementing CGD Projects in Dewas (Madhya Pradesh), Kota (Rajasthan), Sonapat (Haryana), Meerut (Uttar Pradesh), Taj Trapezium Zone (Uttar Pradesh) and Bengaluru (Karnataka).
5. 'GG' was authorised in February 2015 (F.Y. 2014-15) through a bidding process to set up CGD business in Bengaluru Rural and Urban Districts (Karnataka) by PNGRB as per the 'Petroleum and Natural Gas Regulatory Board (Authorizing Entities to Lay, Build, Operate or Expand City or Local Natural Gas Distribution Networks) Regulations, 2008' ('the Regulations'). The said authorisation entails submission of Performance Bank Guarantee ('PBG') of Rs. 5,199.99 crore to PNGRB for timely commissioning of the project as per the prescribed target in the bid and for meeting the service obligations during the operating phase of the project. 'GG' contacted State Bank of India ('SBI') for issue of PBG of Rs. 5,199.99 crore. SBI agreed to issue PBG to 'GG' on the basis of guarantee of the company.
6. 'GG' issued a counter guarantee of Rs. 5,199.99 crore in favour of the company for the purpose of giving Corporate Guarantee (Deed of Guarantee), in favour of SBI for issuance of

¹ Opinion finalised by the Committee on 4.4.2018 and 5.4.2018.

PBG. Accordingly, the company (as Guarantor) signed Corporate Guarantee (Deed of Guarantee) in favour of SBI (as lender) to make available the PBG facility for an aggregate principal amount of Rs. 5,199.99 crore up to a period of five years to ‘GG’ (Borrower) on 16th February 2015. ‘GG’ submitted the PBG to the PNGRB (Beneficiary) as a guarantee for timely commissioning of CGD project in Bengaluru as per the Minimum Work Programme (MWP) prescribed by the PNGRB. (Copies of counter guarantee, Corporate Guarantee (Deed of Guarantee) and PBG have been furnished by the querist for the perusal of the Committee).

7. As per the Regulations, an authorised entity shall abide by all the terms and conditions specified in these regulations and any failure in doing so, except *force majeure*, shall be dealt with as per the following procedure, namely:

- (a) the Board shall issue a notice to the defaulting entity allowing it a reasonable time to fulfil its obligations under the Regulations;
- (b) no further action shall be taken in case remedial action is taken by the entity within the specified period to the satisfaction of the Board;
- (c) in case of failure to take remedial action, the Board may encash the performance bond of the entity equal to percentage shortfall in meeting targets of inch-kms and/or domestic connections. Provided that, the value so encashed would be refunded, if the entity achieves the cumulative targets at the end of exclusivity period for exemption from the purview of common carrier or contract carrier. In case of failure to abide by other terms and conditions specified in these Regulations, performance bond shall be encashed as under:
 - (i) 25% of the amount of the performance bond for the first default; and
 - (ii) 50% of the amount of the performance bond for the second default:

Provided that the entity shall make good the encashed performance bond in each of the above cases within two weeks of encashment failing which the remaining amount of the performance bond shall also be encashed and authorisation of the entity terminated.

- (iii) 100% of the amount of performance bond for the third default and simultaneous termination of authorisation of the entity.

(Relevant extract of the Regulations with reference to encashment of PBG in case of failure to meet the performance target has been furnished by the querist for the perusal of the Committee). It may be noted that there is no specific clause for PBG encashment in case of failure in a particular year. The performance obligation is to be completed by the 5th year.

8. The MWP as per the bid has to be completed during a period of five years commencing from February 2015. During the last two years i.e., up to 17th February 2017, ‘GG’ has timely completed the yearly MWP’s target of the PNGRB. The actual work executed by ‘GG’ during last two years is given below.

(a) Pipeline to be laid

Description	Year I [18.02.2015 to 17.02.2016]	Year II [18.02.2016 to 17.02.2017]
MWP (in Inch-KM)	316	475

Actual Work Done (in Inch-KM)	347	1,011
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(b) PNG Domestic Connections

Description	Year I [18.02.2015 to 17.02.2016]	Year II [18.02.2016 to 17.02.2017]
MWP (in Numbers)	----	19,673
Actual Work Done (in Numbers)	1,308	23,568

9. As per the querist, during the FY 2016-17, no liability either actual or contingent, has arisen on account of non-fulfilment of MWP by the subsidiary company ('GG'). Accordingly, the company has not included the amount of Corporate Guarantee (Deed of Guarantee) given to SBI on behalf of 'GG' for its business performance, as part of contingent liabilities in the Notes to standalone financial statements. Considering the above, the Company has also not disclosed Corporate Guarantee (Deed of Guarantee) issued to SBI for issue of PBG on behalf of 'GG' for its business performance, as a separate note in the Notes to standalone financial statements. The company has followed this practice on consistent basis as was done in previous financial years. Further, the Comptroller and Auditor General of India ('C&AG') had not given any observations on non-disclosure of Corporate Guarantees (Deed of Guarantee) in the audited financial statements for F.Y. 2014-15 and F.Y. 2015-16.

10. The C&AG has conducted supplementary audit on the accounts of the company for F.Y. 2016-17 under section 143(6) of the Companies Act, 2013. The C&AG, while conducting the supplementary audit, has made observation on non-inclusion of Corporate Guarantee (Deed of Guarantee) given by the company to SBI on behalf of 'GG' under the head 'Contingent Liabilities and Commitments' in its standalone financial statements.

11. The company replied to audit query and submitted that as on 31st March 2017, there is no liability, either actual or contingent, towards non-performance of MWP under Regulations, in the books of the subsidiary company ('GG'). Further, as per the querist, the said position is dealt with in more detail in an earlier Guidance Note on 'Guarantees & Counter-Guarantees Given by Companies (Revised 1976)'² issued by the Institute of Chartered Accountants of India, which states that 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.

There is no reason to believe that 'GG' will commit a default or that it will fail or has failed to comply with its obligations. In any case, this is a matter which is in the control of 'GG' itself and the mere chance of a commission of a default by 'GG' in the future cannot be said to involve the existence of a contingent liability as on the balance sheet date.

Considering that no liability, either actual or contingent, has arisen on account of non-fulfilment of MWP by 'GG', the company has not included the amount of Corporate Guarantee (Deed of Guarantee) under the head "Contingent Liabilities and Commitments". The company is also of opinion that inclusion/ disclosure of Corporate Guarantee (Deed of Guarantee) in its Notes to standalone financial statements will depict misleading information

² The Guidance Note on Guarantees & Counter-Guarantees Given by Companies (Revised 1976) has been withdrawn from April 1, 2009 as AS 30 became mandatory.

towards liabilities of the company to the investors and may affect the credit rating of the company.

12. However, the C&AG has not accepted the views of company/joint statutory auditors considering that as per paragraph 8.8.7.2 of the erstwhile ‘Guidance Note on the Revised Schedule VI to the Companies Act,1956’, issued by the Institute of Chartered Accountants of India, “A contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to *guarantee the loan given to a subsidiary* or to another company *or gives a guarantee that another company will perform its contractual obligations*”.

(Emphasis supplied by querist.)

13. The provisional comment of the C&AG and the reply submitted by the company are as follows:

Provisional Comment	Reply
<p><u>Contingent Liabilities and commitments</u></p> <p>The above does not include Rs. 5,199.99 crore being the value of Guarantee Deed as signed (Feb. 2015) by the company in favour of State Bank of India (as lender) to make available the bank guarantee for the similar value for a period of five years to its wholly owned subsidiary viz. ‘GG’ towards submission of the same to PNGRB against the Bengaluru CGD MWP commitment.</p> <p>Management / Joint Statutory Auditors accepted the above said fact and also stated that as on 31st March 2017, there is no liability - either actual or contingent, in the books of ‘GG’ towards non-performance of minimum work plan under PNGRB.</p> <p>Management’s/Joint Statutory Auditors’ replies are not acceptable as Guidance Note on Revised Schedule VI (Para 8.8.7.2) explicitly states that “A <i>contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations</i>”.</p>	<p>It is submitted that ‘GG’, wholly owned subsidiary of the company, undertook the authorisation for City Gas Distribution business in Bengaluru Geographical Area. The said authorisation requires submission of Performance Bank Guarantee of Rs. 5,199.99 crore to Petroleum and Natural Gas Regulatory Board (PNGRB), backed by Counter Guarantee of the company.</p> <p>The company (as Guarantor) signed deed of guarantee in favour of State Bank of India (as lender) to make available a Bank Guarantee facility for an aggregate principal amount of Rs.5,199.99 crore up to a period of five years to ‘GG’ on 16th February 2015. Further, ‘GG’ submitted Performance Bank Guarantee to PNGRB as a guarantee for timely commissioning of city gas distribution project in Bengaluru as per the minimum work plan prescribed by PNGRB.</p> <p>It is submitted that ‘GG’ has submitted Performance Bank Guarantee and as on 31st March 2017, there is no liability - either actual or contingent, in the books of ‘GG’ towards non-performance of minimum work plan under PNGRB.</p> <p>The above position is dealt in more detail in an earlier Guidance Note on ‘Guarantees & Counter-Guarantees Given by Companies’ issued by the Institute of Chartered Accountants of India, which states that the mere possibility or chance of such an event taking place in the</p>

<p>Hence, the Company is contingently liable in case of non-timely commissioning of the CGD Project at Bengaluru by its wholly owned subsidiary and the guarantee deed signed by the Company also falls under the purview of contingent liability and needs disclosure.</p> <p>Thus, contingent liabilities are understated by Rs. 5,199.99 crore and Note No.29 (I) (b) – “Corporate Guarantee” is also deficient to that extent.</p> <p>(Emphasis supplied by querist.)</p>	<p>future would not involve any question of contingent liability on the balance sheet date. There is no reason to believe that ‘GG’ will commit a default or that it will fail to comply with its obligations.</p> <p>In any case, this is a matter which is in the control of the Company itself and the commission of a default by the Company in the future cannot be said to involve the existence of a contingent liability.</p> <p>It is pertinent to mention that ‘GG’ has decent track record for completion of projects and there is no default in performance of minimum work plan for timely commissioning of city gas distribution project in Bengaluru prescribed by PNGRB.</p> <p>In view of above, no disclosure is made – either of the possible future liability or of the guarantee which has been given in order to cover such possible future liability. Thus, contingent liabilities are not understated by Rs. 5,199.99 crore.</p> <p>Considering above, Provisional Comment may please not be pursued further.</p>
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14. It is further mentioned that there is no specific Guidance Note issued by the Institute of Chartered Accountants of India/Ministry of Corporate Affairs towards inclusion and disclosure of Corporate Guarantees (Deed of Guarantee) furnished by the company on behalf of its subsidiary company (‘GG’) for its business performance on which no liability, either actual or contingent, has arisen on account of non-fulfilment of MWP. As per the querist, Ind AS 37, ‘Provision, Contingent Liabilities and Contingent Assets’, also does not provide any specific guidance on the subject.

B. Query

15. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) In the absence of any default by the subsidiary company (‘GG’) and any claim or action by the PNGRB (Beneficiary) for payment of part or full of the PBG amount, whether the company has to disclose Corporate Guarantee (Deed of Guarantee) issued to SBI for issue of PBG on behalf of its subsidiary company for its performance, as a separate note in the Notes to standalone financial statements of the company.
- (i) In the absence of any default by the subsidiary company (‘GG’) and any claim or action by the PNGRB (Beneficiary) for payment of part or full of the PBG amount, whether the company has to include the amount of Corporate Guarantee (Deed of Guarantee) issued to SBI for issue of PBG on behalf of its subsidiary company for its performance, in the amount mentioned under the head

“Contingent Liabilities and Commitments” in its standalone financial statements of the company.

- (ii) In case the answers to (i) and (ii) above are not in the affirmative, whether any other disclosure and/or inclusion of amount of Corporate Guarantee (Deed of Guarantee) issued to SBI is required in the Notes to standalone financial statements of the company and if so, what is the manner and form of such disclosure, etc.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised by the querist relates to disclosure, in the standalone financial statements of the company, of contingent liability in respect of the corporate guarantee given to State Bank of India (hereinafter referred to as ‘the bank’) in the context of Indian Accounting Standards (‘Ind ASs’) notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as ‘the Rules’). The Committee has, therefore, considered only this issue in the light of the Rules and has not examined any other issue that may be contained in the Facts of the Case, such as treatment under Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006, adjustments on transition to Ind ASs, treatment in the consolidated financial statements of the company, treatment of counter guarantee received, initial measurement of the corporate guarantee etc. The Committee notes from paragraph 5 above that performance obligations of the subsidiary cover not only timely commissioning of the CGD project but also service obligations during the operating phase, which is also evident from the copy of the Performance Bank Guarantee (‘PBG’) furnished by the querist for the perusal of the Committee. However, at other relevant places, in particular in paragraphs 6 and 13 above, there is no reference to service obligations during the operating phase. This apparent inconsistency, however, does not affect the opinion of the Committee.

17. Before examining the issue raised by the querist, the Committee wishes to point out that not all the contingent liabilities are within the scope of Indian Accounting Standard (Ind AS) 37, ‘Provisions, Contingent Liabilities and Contingent Assets’, notified under the Rules. As per paragraph 1 of Ind AS 37, contingent liabilities covered by another Standard are outside the scope of Ind AS 37. Based on this scope exclusion, paragraph 2 of Ind AS 37 reads as follows:

- “2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments*.”

Thus, while the corporate guarantee issued by the company may give rise to a contingent liability, first it has to be examined whether any other Ind AS covers the same before considering the applicability of Ind AS 37.

18. The Committee notes that in the extant case, the company has given a corporate guarantee to the bank on the basis of which the bank has issued a PBG to Petroleum and Natural Gas Regulatory Board (‘PNGRB’), which is the beneficiary, on behalf of the company’s wholly owned subsidiary (hereinafter referred to as ‘the subsidiary’). For this purpose, the company has received a counter guarantee from the subsidiary. On perusal of the documents furnished by the querist, the Committee notes that, in effect, the purpose of the PBG issued by the bank is to guarantee performance obligations of the subsidiary and to pay the beneficiary against any breach in this regard by the subsidiary. As per clause 2.1 of the corporate guarantee, the company guarantees that it will pay the ‘guaranteed obligations’ upon issue of ‘demand certificate’ by the bank. As defined in the counter guarantee, the guaranteed obligations, *in simple terms*, means guarantee by the company for due payment by

its subsidiary due to the bank under the 'Facility' (under which the PBG was given by the bank). As per clause 2.2 of the corporate guarantee, the company will compensate the bank for any loss that might be suffered under the 'Facility'. As per clause 8 of the corporate guarantee, the company may be treated as a principal debtor.

19. The Committee now examines whether having regard to the discussion in paragraph 18 above, the corporate guarantee given by the company is a financial guarantee. In this regard, the Committee notes the definition of the term 'financial guarantee contract' given in Ind AS 109, 'Financial Instruments', notified under the Rules, reproduced below:

“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.”

The Committee notes that the term 'debt instrument' is neither defined in Ind AS 109 nor in Ind AS 32, 'Financial Instruments: Presentation', notified under the Rules. The Committee is of the view that the term implies a contractual right to receive cash arising on account of a debtor-creditor relationship. In case the PBG issued by the bank is encashed by the beneficiary, the bank has a right to recoup the loss suffered by it from the subsidiary. In such an eventuality, the subsidiary is indebted to pay the bank towards the loss incurred by it, thereby establishing a debtor-creditor relationship between the subsidiary and the bank. Under the terms of the corporate guarantee, the 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. The Committee is, therefore, of the view that the corporate guarantee issued by the company to the bank meets the definition of financial guarantee contract given in Ind AS 109. In this context the Committee notes the following clause from the deed of guarantee entered between the company and the bank:

“2.1 The Guarantor hereby irrevocably, absolutely and unconditionally guarantees to the Lender that it shall, upon issuance of the Demand Certificate and no later than 5 (Five) days of the date of issuance of the Demand Certificate, pay to the Lender, without demur or protest, the Guaranteed Obligations of an amount as stated in the Demand Certificate.”

The Committee further notes that assumption by the company of its subsidiary's liability to the bank towards reimbursement of loss incurred by the bank itself is sufficient to treat the corporate guarantee issued by the company as a financial guarantee. Consequently, the Committee is of the view that the corporate guarantee issued by the company falls within the scope of Ind AS 109 and, consequently, is outside the scope of Ind AS 37. In this regard, the Committee also observes from the company's financial statements that the company has neither previously nor on transition to Ind ASs in the financial year 2016-17, asserted explicitly that it regards financial guarantee contracts as insurance contracts and uses accounting that is applicable to insurance contracts. Consequently, the irrevocable option to treat the corporate guarantee as an insurance contract available under paragraph 2.1(e) of Ind AS 109 is not applicable.

20. The Committee notes that Division II of Schedule III to the Companies Act, 2013 (hereinafter referred to as 'Ind AS Schedule III') is applicable for companies adopting Ind ASs. As per Note 6 of the 'General Instructions for Preparation of Balance Sheet' companies are required to disclose certain information in the Notes. Note 6(H) of the said Instructions requires the following information to be disclosed in the Notes:

“H. Contingent Liabilities and Commitments:

(to the extent not provided for)

- (i) Contingent Liabilities shall be classified as-
 - (a) claims against the company not acknowledged as debt;
 - (b) guarantees excluding financial guarantees; and
 - (c) other money for which the company is contingently liable.
- (ii) ...”

From the above, the Committee is of the view that corporate guarantee issued by the company, being of the nature of financial guarantee, should not be disclosed under the head ‘Contingent liabilities and Commitments (to the extent not provided for)’. Further discussion is made in paragraphs 21 and 22 below.

21. The Committee notes that the Guidance Note on ‘Guarantees & Counter-Guarantees’, issued by the Institute of Chartered Accountants of India (‘ICAI’) has already been withdrawn from 1st April 2009 and, in any case, is not relevant in the context of Ind ASs. Further, the Committee notes that ICAI has issued the ‘Guidance Note on Division II-Ind AS-Schedule III to the Companies Act, 2013’ (hereinafter referred to as ‘the Guidance Note’). Paragraph 8.2.14.1 and 8.2.14.2 of the Guidance Note reads as below:

“**8.2.14.1.** A contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations. However, ...”

“**8.2.14.2.** Ind AS Schedule III requires guarantees other than financial guarantees to be disclosed as a part of contingent liabilities, since financial guarantees are recognized on the balance sheet in accordance with Ind AS 109. Ind AS 107 specifies certain disclosure in respect of the exposure to credit risk on financial guarantee contracts as a part of the disclosures on ‘credit risk exposures’, which an entity should provide in its Notes to Accounts.”

Thus, it is clear that the purpose of the first sentence of paragraph 8.2.14.1 of the Guidance Note is to give instances of contingent liabilities whereas the treatment of financial guarantee contract should be in accordance with the relevant Standard, which is Ind AS 109 in the extant case.

22. Based on the above discussion, the Committee is of the view that the requirements of Ind AS 109 and Ind AS 107, ‘Financial Instruments: Disclosures’, notified under the Rules, to the extent relevant, should be met in accounting and disclosure of the corporate guarantee issued by the company. In particular, Ind AS 109 contains measurement requirements of financial guarantees while paragraph B10 of 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.

D. Opinion

23. On the basis of paragraphs 18 to 22 above, the Committee is of the following opinion on the issues raised by the querist in paragraph 15 above:

- (i) The recognition /disclosure of corporate guarantee is required to be made in accordance with the requirements of Ind AS 109 and Ind AS 107, as discussed in (iii) below.
 - (ii) The corporate guarantee provided will be recognised/disclosed in accordance with the requirements of Ind AS 109 and Ind AS 107, as discussed in (iii) below.
 - (iii) Corporate Guarantee (Deed of Guarantee) issued to SBI being in the nature of financial guarantee is to be recognized and measured in accordance with the requirements of Ind AS 109 and has to be disclosed considering requirements of paragraph B 10 of Ind AS 107, Financial Instruments: Disclosures as discussed in paragraph 22 above. 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.
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