An Overview on Bank Guarantee

By

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Topics to be Covered

- Guarantee and Bank Guarantee
- Scope of Bank Guarantee
- Types of Bank Guarantee
- Advantages and Disadvantages of Bank Guarantee
- Parties to Bank Guarantee
- Procedure for applying Bank Guarantee
- Audit of Bank Guarantee
  - Audit objective
  - Information required
  - Vouching and Verification
- Disclosure requirements of Bank guarantee in Financials
Guarantee

General Law:
An undertaking to answer for the payment or performance of another person's debt or obligation in the event of a default by the person primarily responsible for it.

Indian Contract Act, 1872:
Sec 126 defines “contract of guarantee” as a contract to perform the promise, or discharge the liability, of a third person in case of his default.

Thus, a contract of guarantee is a collateral contract, consequential to a main contract between the applicant and the beneficiary.
Bank Guarantee

A bank guarantee is a *written contract* given by a bank on the behalf of a customer. By issuing this guarantee, a bank takes responsibility for payment of a sum of money in case, if it is not paid by the customer on whose behalf the guarantee has been issued. In return, a bank gets some commission for issuing the guarantee.
Scope of bank guarantee:

- An Agreement Enforceable By Law is a Contract -The Indian Contract Act 1872
- Bank Guarantee is Tripartite Agreement.
- All Rupee/ INR Guarantees covered under The Indian Contract Act 1872.
- All FCY Guarantees governed as per Notification No. FEMA.8/2000-RB dated 3rd May 2000
- ICC Publication: URDG – Uniform Rules for Demand Guarantees 758 ICC
Types of Bank Guarantee

- Performance Guarantee
- Financial Guarantee
- Bid bond Guarantee
- Advance Payment Guarantee
- Foreign Bank Guarantee
## Advantages & Disadvantages

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Parties to bank guarantee:

- **Applicant** -- the party that requests a bank to issue a bank guarantee.
- **Beneficiary** -- the party in whose favor a bank guarantee is opened and who has the right to claim for compensation in accordance with the terms and conditions of the guarantee.
- **Guarantor / Surety / bank** -- the bank that issues a letter of guarantee at the request of its customer.
- **Advising or transmitting bank** -- a bank in the beneficiary’s place that notifies or transmits the guarantee to the beneficiary.
Procedure Of Bank Guarantee (BG)

❖ **Who ?** Anyone can apply for a Bank Guarantee, if his or her company has obligations towards a third party for which funds need to be blocked in order to guarantee that his or her company fulfils its obligations.

❖ **Requirements ?**
✓ To have a current account in that Bank.

❖ **Procedure:**
✓ The Applicant contacts the bank and fills out an application that identifies the amount of and reasons for the guarantee.
✓ Applications stipulate a specific period of time for which the guarantee should be valid, any special conditions for payment and details about the beneficiary.
Audit Objective:

1) To ensure that Bank Guarantees provided by the company are completely and accurately recorded as a *contingent liability* in the Notes to Accounts.

2) To ensure that all recorded Bank Guarantees actually exist.

3) To ensure that the Bank Guarantee commission is inline with the Bank Guarantees provided by the bank.

4) To ensure that all the Bank Guarantees given or taken are presented and disclosed in accordance with the Companies Act 2013 along with the relevant AS/INDAS.

5) To Evaluate the effectiveness and efficiency of the process and related internal controls.

6) To Evaluate the quality and integrity of information systems supporting the process in the Organization.
Audit of Bank Guarantee

- **Information required:**
  1) Board resolution regarding Bank Guarantees (if any)
  2) Copy of Bank Guarantee Application Letter
  3) Bank Guarantee Limit Sanction Letter
  4) List of Bank Guarantees sanctioned by the bank during the Financial Year
  5) Contracts for which Bank Guarantees were obligatory
  6) Bank Guarantee Commission Charge Slips
  7) Fixed deposits linked with Bank Guarantee (if any)
  8) Assets mortgaged against Bank Guarantee (if any)
  9) Bank Guarantee submission / closure letter(s)
  10) Bank Guarantee extension letter(s)
  11) List of Authorized person for each activity
  12) Others
Audit of Bank Guarantee

• Preliminary:
  1) Get the confirmation of the process from the process owners.
  2) Rationalise the purpose of taking or giving the Bank guarantee

• Vouching and Verification:
  - Assess the reasonableness of design of internal control system. Identify the preventive (exercised before incurrence of transactions and event) and detective (exercised after incurrence of transactions and event) controls established by management to support its assertions.
  - Review the Bank Guarantee documentation for a sample selected as per SA 530, in accordance with the terms and conditions of Bank Guarantee.
  - Check the terms and conditions of Bank Guarantee Limit Sanction Letter issued by the bank.
  - Compare the bank guarantees sanctioned by the bank with the limits mentioned in the bank guarantee sanction letter.
  - Compare the bank guarantee with the project for which bank guarantee has been issued. Check the existence of project.
Audit of Bank Guarantee

- In case any project has been terminated prior to the end date, check if the bank guarantee has been obtained from the contractee and the same has been submitted to the bank for cancellation.
- In case of extension of project, check the letter submitted to the bank for extension of bank guarantee.
- Compare the commission charged by the bank with that of commission chargeable.
- In case of expiry of bank guarantee, verify that the bank guarantee agreement has been submitted to the bank.
- In case of bank guarantee linked with mortgage of assets - Post cancellation of bank guarantee, verify that the charge has been relieved.
- In case of bank guarantee provided against fixed deposits - Post cancellation of bank guarantee, verify that the fixed deposits have been relieved.
- For the guarantees entered for the benefit of its subsidiaries / associates, verify the details of the same with statutory register maintained under section 372A of Companies Act, 1956.
- Check on a sample of transactions that detective controls are appropriately been exercised and in case of any detection of error/ fraud, proper steps have been taken to avoid recurrence of the same.
Audit of Bank Guarantee

- Ensure that management does not override the designed controls by:
  i) Enquiring from the designated staff person
  ii) Remain skeptical during performing test of design and test of effective operation
- Document the conclusion after performing test of controls and required level of assurance from substantive procedures.
- Verify board meeting minutes regarding approval of Bank Gaurantees.
Disclosure Requirements of Bank guarantee in Financials:

As per schedule III of Companies Act 2013:

- Bank Guarantee is to be shown as a Contingent Liability in Notes to Accounts.
- When any security by way of Cash margin like security deposit, FD etc and that can be shown under current assets in Balance sheet as Margin money on BG. When BG is settled or expired, entry for margin money should be reversed.
- The commission paid on BG shall be debited to Bank Guarantee commission. If in case BG commission is prepaid then such amount should appear under short term loans and Advances in Current Assets. When bank guarantee is invoked, the concerned banker pays the amount to your creditor and the amount should appear as loan in your books.
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Thank you!!!

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