MFRS Hot Topics

Accounting for client money

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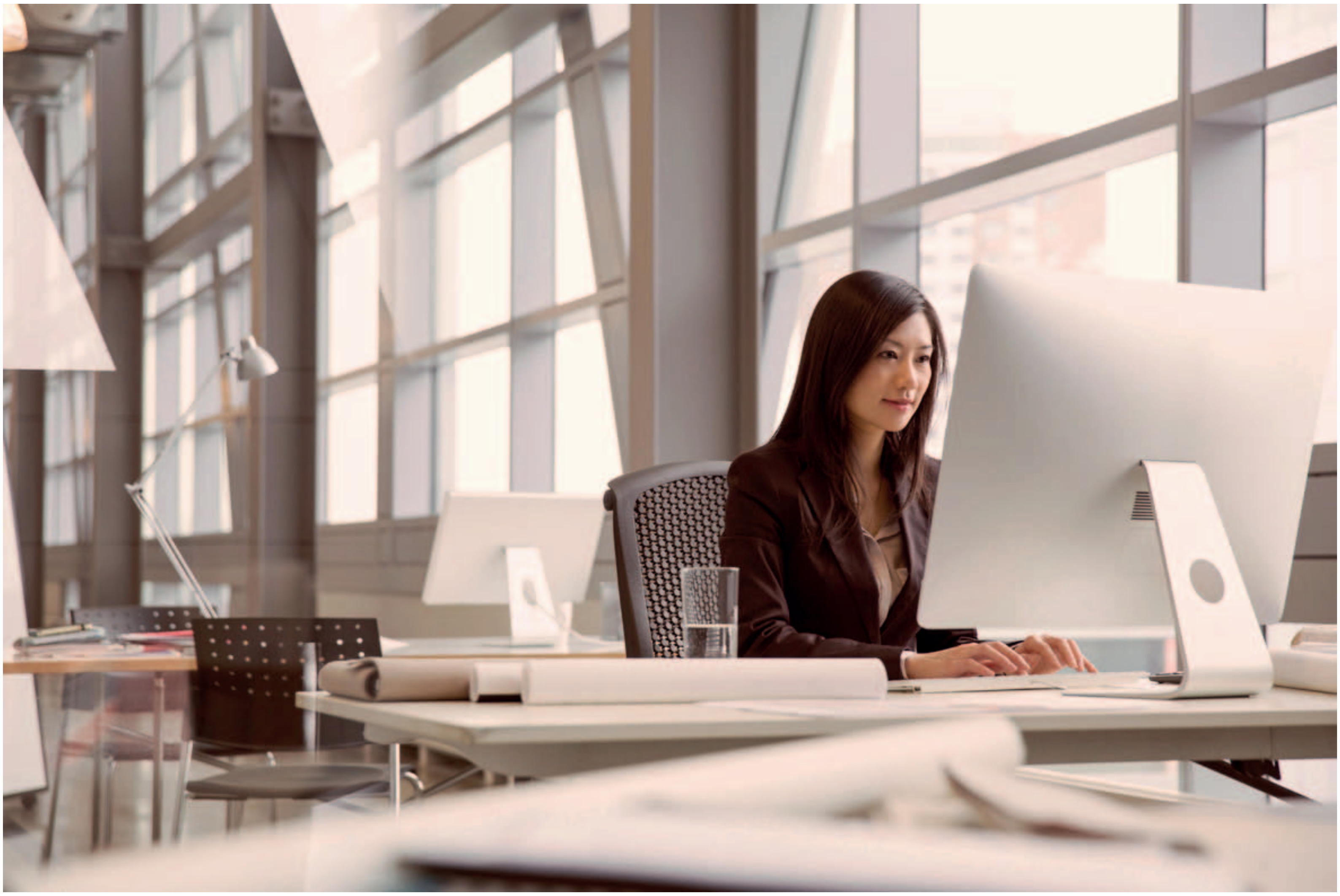

Issue

If an entity holds money on behalf of clients:

- should the client money be recognised as an asset in the entity's financial statements?
- where the client money is recognised as an asset, can it be offset against the corresponding liability to the client on the face of the statement of financial position?

Client money

In this Hot Topic the term 'client money' is used to describe a variety of arrangements in which the reporting entity holds funds on behalf of clients. Client money arrangements are often regulated and more specific definitions of the term are contained in some regulatory pronouncements. The guidance in this Hot Topic is not specific to any particular regulatory regime.

Relevant IFRSs
MFRS 101 Presentation of Financial Statements
MFRS 132 Financial Instruments: Presentation

Guidance

Recognition

Entities should recognise client money as an asset (and an associated liability) if the general IFRS definition of an asset is met. This requires a careful analysis of the contractual terms and conditions and economic substance of the arrangements for holding client money to determine whether:

- the client money is a resource controlled by the entity
- economic benefits associated with the client money are expected to flow to the entity.

If both conditions apply, the client money should be recognised as an asset of the reporting entity. This determination may involve significant judgement in which case disclosures should be made in accordance with MFRS 101.122.

Offset

If a client money arrangement results in recognising cash at a bank as an asset and an associated liability to a client, it is not appropriate to offset those items.

Discussion

General

Entities may hold money on behalf of clients under many different contractual arrangements, for example:

- a bank may hold money on deposit in a customer's bank account
- a fund manager or stockbroker may hold money on behalf of a customer as a trustee
- an insurance broker may hold premiums paid by policyholders before passing them onto an insurer
- a lawyer or accountant may hold money on behalf of a client, often in a separate client bank account where the interest earned is for the client's benefit.

These arrangements are often subject to regulation as well as industry custom and practice. Because of the variety of arrangements it is not possible to provide a uniform answer to the question of whether client money should be recognised as an asset. The contractual terms and conditions and economic substance of each arrangement must therefore be analysed to determine whether or not the client money is a financial asset of the reporting entity as defined in MFRS 132.

Recognition

The definition of a financial asset includes cash (MFRS132.11). Where the reporting entity has legal title to cash (e.g. because funds are held in a bank account to which the entity is the contractual beneficiary) there is clearly a financial asset in most circumstances. However, the MFRS 132.11 definition also requires that to be a **financial asset** the item in question must also be an asset. Accordingly, entities should recognise client money as an **asset** (and an associated liability) if the general MFRS definitions of an asset and liability are met:

> "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" (Conceptual Framework 4.4(a),(b)).

There is no specific guidance in MFRS on applying these definitions to cash or client money arrangements. The relevant legal, regulatory and contractual requirements should therefore be carefully reviewed and judgement applied if necessary to determine whether the 'control' and 'benefits' tests have been met.

The terms 'control' and 'benefits' are not themselves defined in this context. In applying these terms to client money arrangements we consider:

- the evaluation of control should take account of the extent to which the reporting entity is able to determine the use of the monies

- the 'benefits' test should take account of which party obtains the risks and rewards associated with ownership. Having done this, the next question that needs to be addressed is what kind of asset does the rental guarantee represent? There are two possible views here:

In some cases the analysis will be straightforward. A bank which holds money on deposit in a customer's bank account should record a financial asset (cash) on initial receipt and a financial liability (customer deposits). The bank has control of the cash and is able to use it to fund its investing and lending activities or to meet operating costs. It also has a financial liability to the customer who is able to draw on the funds and receives interest income. A lawyer which holds client money in a separate bank account would not recognise an asset where the funds may only be disbursed pursuant to the client's instructions and the lawyer is not entitled to any interest income. In this second example neither the 'benefits' nor 'control' test has been met. In other cases the substance of the contractual arrangements may not be as clear and a more detailed analysis will be required.

In applying the asset recognition criteria, we believe the following matters should be considered:

- the extent (if any) that the entity has the right to use of the funds. This will include consideration of whether the entity has the right to control the investment policy in relation to the funds and the ability to commingle the funds (i.e. the ability to use one client's money to settle another client's account or to include its own cash in the same bank account as the client money or to use the funds for its own purposes and replace them when settlement is due to clients)

- whether the entity obtains the benefit of interest income earned from the funds. Where the entity retains all of the interest or pays a lower rate of interest to clients, it receives an economic benefit from the client money which indicates that an asset should be recognised

- whether the entity bears the credit risk associated with bank accounts in which funds are placed on deposit. Where the entity is contractually obliged to compensate clients if the deposit-holding bank fails (or there is a constructive obligation to reimburse any losses) this indicates that an asset should be recognised

- the status of the funds in the event of the insolvency or bankruptcy of the reporting entity. If the funds are available to fund general claims from creditors this indicates that they are an asset of the reporting entity. Conversely, the funds are less likely to be the reporting entity's asset if they are ring-fenced and only available to reimburse the clients.

The legal capacity in which the reporting entity holds client monies is also important. The contractual arrangements for holding client money, considered in conjunction with applicable laws, regulations and established custom and practice will determine the rights and obligations of the reporting entity. However, the way in which the legal arrangement is described is relevant only as far as it affects the applicable rights and obligations. In other words, the substance of the contractual arrangement should be considered in addition to its legal form.

The following factors should be considered in this context:

- the terms and conditions of an agency agreement where one exists. An agency agreement may have the effect that the risks and rewards of the client money remain with the client and may also restrict the reporting entity's control over the funds. The reporting entity will typically earn an agent's fee for providing services to the client. A fee earned in exchange for services is not the same as obtaining the benefits associated with ownership of the funds
- the entity may hold the funds as a trustee or in a similar fiduciary capacity, supported by law. Such arrangements may serve to ring-fence client monies and will also be relevant to the evaluation of risks and rewards and of control. In these cases the entity has fiduciary responsibilities and is obliged to discharge them with due care. This fiduciary duty is not the same risk as the risk of ownership of the funds (an example of the latter being credit risk - see above)
- specific regulations applicable to the arrangements, which may for example specify the type of bank account in which funds are to be held and restrict the use of those funds. If the entity is a regulated entity, the regulator may establish specific rules to protect customer assets which will be relevant to the application of the recognition criteria, for example, rules on the use of separate legal trust client bank accounts and restrictions on commingling of funds (see above).

Application of this guidance will often involve professional judgement. Where judgement is significant appropriate disclosures should be made in the financial statements in accordance with MFRS 101.122. The entity's accounting policy should be applied consistently and disclosed in accordance with MFRS 101.117 if significant.

Offset

MFRS 132 sets out the conditions under which financial assets and financial liabilities should be offset:

> "A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when and only when an entity:
>
> (a) currently has a legally enforceable right to set off the recognised amounts; and
>
> (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously…" (MFRS 132.42)

MFRS 132.45 defines a right of set off as a debtors legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. Client money will ordinarily be held in a bank account with a third party financial institution and hence the financial asset and financial liability will be due from and to different counterparties. Offsetting will therefore not be appropriate in most circumstances.

Guidance note

The IASB published Disclosures – Offsetting Financial Assets and Financial Liabilities (Amendments to MFRS 7) in December 2011 (effective for annual periods beginning on or after 1 January 2013) which modifies existing disclosure requirements to allow users of financial statements to better evaluate the effects (or potential effects) of netting arrangements.

Examples

Money transfer services

A post office provides money transfer services collecting payments for utilities such as gas and electricity from customers and remitting these amounts to the utility companies. The post office acts as a payment agent for the utility companies and earns a commission for the service it provides. The funds are held in trust bank accounts on behalf of the utility companies who bear the credit risk. Interest earned is for the benefit of the utility companies. The post office does not have the ability to commingle client funds with other funds.

Analysis

We believe that an asset should not be recognised in the post office's financial statements in respect of the client money held. The post office does not have an economic interest in the funds as:

- the post office is acting as agent on behalf of the utility companies
- the funds are held in a separate trust bank account with a legal status, which restricts their use by the post office
- the post office does not appear to have the risks and rewards of ownership of the funds in that it does not bear the risk of losses should the bank holding the funds fail nor does it receive the benefit of the interest income.

Futures and options broker

A broker purchases futures and options by order of and on behalf of its clients under the terms of client brokerage agreements. It receives a fee from the client for these services. The broker calls margins gross from clients and pays these amounts net to counterparties. Regulations require the broker to fund overdue margin calls and the client's money and the broker's money is commingled in the same bank accounts. The broker pays a lower rate of interest to clients than it earns from investment of the client money. Clients bear the credit risk in the event of failure of the bank holding the funds. The broker is at risk where the client defaults on gross margin calls.

Analysis

We believe that an asset should be recognised in the broker's financial statements in respect of client monies held as the broker:

- benefits directly from the interest rate spread on the funds
- commingles client money with its own money
- bears the liability for margin calls whether or not they are compensated for by the client and hence may have to top up the funds.

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