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MFRS News

Accounting for client money

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What's the issue?

If an entity holds money on behalf of clients ('client money'):

- 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?

Our MFRS News series provides insights from our global MFRS team on applying MFRS in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance. This edition provides guidance on client money – arrangements in which a reporting entity holds funds on behalf of clients.

Relevant MFRS

The Conceptual Framework for Financial Reporting (2018)

MFRS 101 Presentation of Financial Statements

MFRS 107 Statement of Cash Flows

MFRS 132 Financial Instruments: Presentation

Executive summary

The term 'client money' is used to describe a variety of arrangements in which the reporting entity holds funds on behalf of clients. Our view is that entities should recognise client money as an asset (and an associated liability) if the general definition of an asset contained in the Conceptual Framework for Financial Reporting (2018) is met.

The Conceptual Framework for Financial Reporting (2018) defines an asset as "a present economic resource controlled by the entity as a result of past events", with an economic resource being defined as "a right that has the potential to produce economic benefits".

Determining whether this definition is met 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 reporting entity
- confers a right that has the potential to produce economic benefits to the reporting 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 appropriate disclosures should be made in accordance with MFRS 101 'Presentation of Financial Statements'.

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

Introduction

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 sometimes contained in regulatory pronouncements. The guidance in this MFRS News however is not specific to any particular regulatory regime.

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 on to 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. Although the answer may be obvious in some circumstances, this will not always be so. Where uncertainty exists, the contractual terms and conditions and economic substance of each arrangement must therefore be analysed to determine first of all whether the client money is a financial asset of the reporting entity.

Recognition

MFRS 132's definition of a financial asset includes cash. In many arrangements involving client money, the reporting entity will have legal title to cash (eg because funds are held in a bank account to which the reporting entity is the contractual beneficiary) meaning that this part of the definition will clearly be met in most circumstances. However, the definition in MFRS 132 requires that for there 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 contained in the Conceptual Framework for Financial Reporting[1] (2018) are met. These definitions are as follows:

Asset

- A present economic resource controlled by the entity as a result of past events.
  An economic resource is defined as a right that has the potential to produce economic benefits.

Liability

- A present obligation of the entity to transfer an economic resource as a result of past events.

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' aspects of the definition of an asset 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 evaluation of the 'benefits' aspect of the definition should take account of which party obtains the risks and rewards associated with ownership.

In some cases, the analysis will be straightforward. For example:

Example 1:
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).

In this simple example, 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.

Example 2:
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' aspects of the definition of an asset have been met.

[1] The Conceptual Framework for Financial Reporting (2018) was issued in March 2018. It is not a Standard and will not change or override any existing Standards, however, entities that develop accounting policies using the Conceptual Framework will have to apply the changes from 1 January 2020. In the interests of best practice, this Viewpoint references the new Conceptual Framework now.

In other cases, the substance of the contractual arrangements may not be as clear, and a more detailed analysis will be required. Our view is that in applying the asset recognition criteria, 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 (ie 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.

"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."

Legal form and substance

The legal capacity in which a 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 and will clearly be relevant to recognition. 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).

Presentation

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…" (IAS 32.42)

MFRS 132.45 defines a right of set off as a debtor's 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.

Disclosure

Application of the guidance in this MFRS Viewpoint will often involve professional judgement and appropriate disclosures may need to be made in accordance with the requirements of MFRS 101.

An entity's accounting policy for client money should be applied consistently and disclosed in accordance with MFRS 101.117 if significant.

Where client money arrangements are significant, management may also need to disclose the judgements made in the process of applying the entity's accounting policy and that have the most significant effect on the amounts recognised in the financial statements as per the requirements of MFRS 101.122.

Restricted cash

It may also be necessary in some circumstances to disclose the existence of restricted cash and cash equivalent balances as required by IAS 7.45. These are balances held by the entity that are not available for use by the group, such as escrow accounts. They are typically disclosed in the notes to the financial statements together with narrative commentary, and are presented as a separate line item in the primary financial statements.

Of course, an assessment should be made as to whether a client money account should be recognised as an asset by the entity in its statement of financial position before considering the guidance in MFRS 107. If the entity does not recognise the client money account, then the MFRS 107 guidance will not be relevant.

Disclosure by trustees

Where an entity such as a bank engages in significant trust activities, and concludes that it holds assets which are not its assets and which are therefore not included in its statement of financial position, the entity should consider disclosure of those activities. In our view disclosure of the nature and extent of such activities may be in the overall interest of the fair presentation of the accounts because of the potential liability if the entity were to fail in its fiduciary duties.

Examples

Money transfer services

A post office provides money transfer services collecting payments for utilities such as gas and electricity from customers and remitting the amounts collected 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

Our view is that neither an asset nor a liability would 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 (and a corresponding liability) 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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