Client Money

Extract, IFRS® Discussion Group Report on the Meeting – June 20, 2019

The term “client money” is used to describe a variety of arrangements in which an entity holds funds on behalf of its clients. Such arrangements may include:

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

The variety in contractual terms, conditions and the economic substance of these arrangements can make the recognition of financial asset analysis complex for the entity. To properly conclude the client money is a financial asset, the entity assesses whether the “control” and “benefits” aspects of the definition of an asset have been met. The relevant legal, regulatory and contractual requirements must be reviewed to make this assessment.

Two examples are used to illustrate a more straightforward analysis of “control” and “benefit”:

Example 1: A bank that 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 can use it to fund its investing and lending activities or to meet operating costs. It also has a financial liability to the customer who can draw on the funds and receives interest income.

Example 2: Under current practice, a lawyer that holds client money in a separate bank account would not recognize 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.

Neither the “control” nor “benefits” aspects of the definition of an asset have been met because:

- the funds are held in a separate bank account and their use by the lawyer is restricted; and
- the lawyer does not appear to have the rewards of ownership of the funds in that it does not receive the benefit of the interest income.

In other cases, the substance of the contractual arrangements may not be as clear, and a more detailed analysis will be required. The Group is asked to consider the accounting for client money in these not- straightforward situations.

Issue 1: What matters should be considered when applying the concepts of 'control' and 'benefit' to client money arrangements?

In applying the concepts of "control" and "benefits" to client money arrangements, an entity should consider:

(a) the evaluation of control should take account of the extent to which the reporting entity is able to determine the use of the monies; and

(b) the evaluation of the benefits should take account of which party obtains the risks and rewards associated with ownership.

The following matters should be considered when applying the asset recognition criteria to client money arrangements:

(a) The extent (if any) that the entity has the right to use the funds.

(b) Consider whether the entity has the right to control the investment policy in relation to the funds and the ability to commingle the funds.

(c) Whether the entity obtains the benefit of interest income earned from the funds.

(d) Whether the entity retains all the interest or pays a lower rate of interest to clients and receives an economic benefit from the client money.

(e) Whether the entity bears the credit risk associated with bank accounts in which funds are placed on deposit.

(f) Whether the entity has a contractual obligation to compensate its clients if the deposit-holding bank fails.

(g) The status of the funds in the event of the insolvency or bankruptcy of the reporting entity.

(h) Whether the funds are available to fund general claims from creditors or are ring-fenced and only available to reimburse the clients.

The legal capacity in which the entity holds client money is also important. The following matters should be considered in this context:

(a) 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.

(b) 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).

(c) 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 (e.g., rules on using separate legal trust client bank accounts and restrictions on commingling of funds).

The Group's Discussion

The Group agreed with the analysis, noting that the matters outlined in the analysis are important when applying the control and benefit concepts to the client money arrangements.

One Group member noted that it might also be useful to consider whether the entity should recognize a financial liability payable to the client, for example, through its responsibility of safe-keeping the client's money. If so, there would also be a financial asset for the client money held to satisfy that liability. Another Group member further commented that when the asset is recognized, the criteria described in the analysis are also important to assess whether the asset is restricted.

Several Group members noted that it is important to consider all the facts and circumstances related to the client arrangement. The entity may obtain a fee in the form of interest income from holding the client money without controlling the funds. In addition, the entity should consider the applicable law and regulations when reviewing the contract terms to determine whether an asset should be recognized.

One Group member also provided an example in the banking sector where a bank receives cash as collateral in a securities lending arrangement. In this situation, the bank generally recognizes the cash collateral received as an asset and an obligation on its balance sheet.

Issue 2: Where client money is recognized as an asset, can it be offset against the corresponding liability to the client on the statement of financial position?

Analysis

Paragraph 42 of IAS 32 *Financial Instruments: Presentation* permits the offset of financial assets and financial liabilities when "an entity currently has a legally enforceable right to set off the recognized amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously."

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 due to different counterparties. Offsetting will, therefore, not be appropriate.

The Group's Discussion

The Group agreed with the analysis. One Group member observed that there generally is no legally enforceable right to offset financial assets and financial liabilities when the "due from" and "due to" amounts are with different counterparties.

Several Group members considered practical examples of client money. One Group member observed that in the investment fund industry, investors typically make investments in a fund through an investment manager. The money invested by the investors is put into a separate trust account. The investment manager will recognize on its balance sheet an asset cash held-in-trust and a liability for a corresponding amount. A similar observation was made by another Group member that the client money in the brokerage account is recognized as an asset and obligation by the broker-dealer. Another Group member commented on a trust mechanism set up by the National Energy Board[1] (NEB) in the energy industry. Entities that own regulated pipelines collect funds from their customers for future betterment of their assets. The funds are held in a trust. Although the investment strategy is set by the entity owning the assets, the timing and the amount of disbursement from the trust is controlled by the NEB. Since the funds are not controlled by the entities with the pipelines, the funds held-in-trust are not recognized as assets on these entities' balance sheets.

Issue 3: What disclosures should be made for client money arrangements?

Analysis

An entity's accounting policy for client money should be applied consistently and disclosed in accordance with paragraph 117 of IAS 1 *Presentation of Financial Statements* if significant.

If the client money arrangements are significant, the entity should also disclose the judgments made in the process of applying the entity's accounting policy and that have the most significant effect on the amounts recognized in the financial statements.

Additional disclosures may be necessary in some circumstances, such as:

- Restricted cash: if client money is recognized as an asset on an entity's financial statements, it may be necessary to disclose the existence of restricted cash and cash equivalents as required by IAS 7.48.
- Disclosure by trustees, such as banks that engage in significant trust activities and holds third-party assets: these third-party assets are not included in the entity's statement of financial position. These entities should consider disclosure of those activities. 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 entities were to fail in their fiduciary duties.

[1] The National Energy Board is Canada's energy and safety regulator. It regulates the construction and operation of oil and natural gas pipelines crossing provincial or international borders

The Group's Discussion

The Group agreed with the analysis. The required disclosures provide useful information on the risks and obligations taken by the entity holding client money.

One Group member noted that restricted cash is often erroneously recorded as cash equivalents and that due to its restricted nature, it should usually not be presented as cash and cash equivalents. The change in the restricted cash should be separately reported by the entity in the statement of cash flows. Another Group member commented that IFRS 12 *Disclosure of Interests in Other Entities* also requires disclosure on the nature and extent of restrictions on the entity's ability to access or use assets in a group.

Overall, the Group's discussion of the issues raises awareness about the factors to be considered to account for client money and related disclosure requirements. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).