Client assets: to recognize or not to recognize on balance sheet?

Some individuals or entities may be required to hold client assets on behalf of clients. Usually this is stipulated in contractual arrangements as part of transactions conducted in the ordinary course of business. For example:

- A bank may hold cash on deposit in a client's bank account;
- An insurance broker may hold premiums paid by policyholders before passing them onto an insurer;
- A securities broker may hold cash or securities on behalf of a client; and
- A lawyer may hold cash or other valuables on behalf of a client.

This article explores key areas to consider when determining whether client assets that are financial instruments in nature should be recognized on or off balance sheet under HKFRS.

What the standards say

HKAS 39 *Financial Instruments: Recognition and Measurement*, paragraph 14, states that an entity shall recognize a *financial asset* in its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.

HKAS 32 *Financial Instruments: Presentation*, paragraph 11, defines a financial asset as *any asset* that is:

a. Cash;
b. An equity instrument of another entity;
c. A contractual right:
   (i) To receive cash or another financial asset from another entity; or
   (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
d. A contract that will or may be settled in the entity's own equity instruments..."

An asset is defined in paragraph 4.4(a) of the *Conceptual Framework* as "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." Paragraph 4.8 of the *Conceptual Framework* further clarifies that future economic benefits embodied in an asset are "the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity."

In summary, in determining whether to recognize a client asset on its balance sheet, an entity should consider whether:

- The client asset is a resource controlled by the entity;
- The economic benefits from the client asset are expected to flow to the entity; and
- The entity is a party to the contractual arrangements associated with the client asset.

When a client asset is recognized on an entity's balance sheet, the entity should consider whether a corresponding liability due to the client should also be recognized as the entity assumes an obligation to return the client asset.

Observations in practice: control over a client asset

The definition and application of the term "control" in the context of client assets are not provided in HKFRS. "Control" also appears to be the least straight-forward concept when applied to entities that hold client assets. Professional judgment is therefore required to determine whether an entity "controls" the client asset from which future economic benefits are expected to flow to the entity.

When exercising judgment, entities could consider indicators of control over a client asset. Indicators should be considered in the light of the nature of the business and the terms and conditions of the contractual arrangement between an entity and its client. Judgment is also required to assess whether one or more indicators is sufficient to conclude whether there is control over a client asset.

The following are some example indicators that are commonly used in practice to assess whether an entity has control over a client asset.

Does the entity have a right to use the client asset?

Having the "right to use" is a common indicator used in practice to assess whether an entity has control over a client asset.

An entity that is entitled to use the client asset for its own purposes, for example, to settle the entity's own debt, indicates that the entity has the right to use the client asset. An entity that handles the client asset in accordance with the client's instruction indicates that the entity is only administering the client asset in its capacity as an agent. Likewise, a service performed in an entity's fiduciary capacity should not be mistaken for activities associated with having a right to use the client asset.

Consider this example: Banks generally hold client monies on deposit in bank accounts. Banks are permitted to use the client money, for example, to lend to their borrowers or meet their operating costs. Using the client money to pay creditors and operating costs, or to lend to borrowers, are examples of having the right to use. This suggests that the bank has control over the client money.

Does the entity obtain significant risks and rewards of ownership from holding the client asset?

Exposure to significant risks and rewards of ownership is another common factor to consider in assessing whether an entity has control over a client asset. Examples of situations in which an entity obtains significant risks and rewards of ownership from holding a client asset are explained below.

Does the entity obtain the benefit of income from holding the client asset?
Some entities may have the benefit of income from holding the client asset.

An entity that is permitted to retain all or substantially all of the income from holding a client asset indicates that the entity has the benefit of income from holding the client asset.

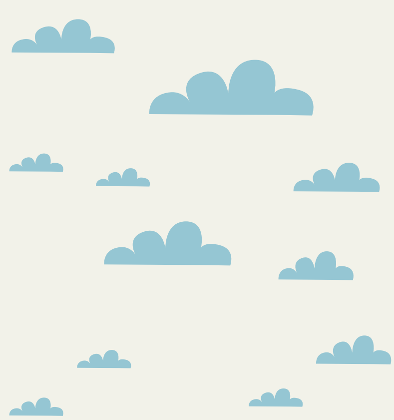
Consider this example: A client places money in a savings account with a bank at 3 percent interest. The bank in turn invests the client money with a third party bank with a return of 5 percent interest. If the bank earns the interest rate spread, it indicates that the entity obtains the benefit of ownership from holding the client money. However, judgment may be required to assess whether the income earned is compensation for specific services provided by the entity. A fee earned in exchange for contracted services is not the same as obtaining the benefits associated with holding the client asset.

Does the entity bear the risk of holding the client asset?
An entity may be required to compensate its client for the loss of a client asset. In other words, the entity may be required to bear the risk of holding the client asset. If the entity is contractually obliged to compensate clients for losing the client asset, it indicates that the entity has the risk of ownership from holding the client asset.

Consider this example: A client places money in a current account with a bank. The bank in turn invests the client money with a third party bank. The third party bank becomes insolvent and is unable to repay the client money that the bank had placed. The bank is required to replace the client money that was deposited with the insolvent third party bank. This indicates that the bank has the risk of ownership from holding the client money.

In some cases, the contract between a client and an entity may not explicitly state who bears the loss of the client asset, therefore judgment may be needed to make the assessment. For example, industry laws and regulations, or a customary business practice to reimburse any loss of a client asset to avoid reputation damage may create a constructive obligation.

Again, care should be taken when assessing an entity's obligation to compensate the client. An entity's fiduciary duty in compensating a client, in the event of a breach of duty, should not be mistaken for having the risk of ownership from holding the client asset.



The conclusion

Because of the variety of contractual arrangements it is not possible to provide a uniform answer to the question of whether client assets should be recognized on balance sheet. The contractual terms and conditions and economic substance of each arrangement between an entity and its client must be carefully analysed. Contractual arrangements for holding client assets should be considered in conjunction with applicable laws, regulations and established practice to determine the rights and obligations of an entity.

In some cases the analysis will be straightforward. In other cases, the underlying substance of the contractual arrangements may not be clear-cut and management would have to exercise judgment.

HKAS 1 *Presentation of Financial Statements*, paragraph 122, requires an entity to disclose the judgments, apart from those involving estimations, that management has made in the process of determining whether client assets are on or off balance sheet if it significantly affects the amount recognized in the financial statements.

An entity should also observe other disclosure requirements under HKFRS 7 *Financial Instruments: Disclosures* if client assets are recognized as financial assets in the entity's financial statements.

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