Grant Thornton

Technical Accounting Alert

Unclaimed on-demand financial liabilities

Introduction

The purpose of this alert is to highlight accounting for financial liabilities with a demand feature (on-demand financial liabilities). In particular, this alert considers the accounting implications when the entity no longer expects the counter-party to demand repayment.[1]

On-demand financial liabilities

This alert addresses financial liabilities that are repayable at a date of the counter-party's (lender's) choosing. In Grant Thornton's view this is what is meant in IAS 39.49 by a 'financial liability with a demand feature'. Most liabilities, such as fixed term borrowings, become repayable at some point. However, we do not believe that a stated future repayment date is a demand feature.

Common examples of on-demand liabilities include many bank overdrafts (for the borrower) and customers' current accounts for banks. However, on-demand financial liabilities also arise in commercial arrangements outside the banking sector. A characteristic of many such transactions is that the counter-party's right to demand repayment might not be exercised for a considerable time, and sometimes not at all (for example in the case of so-called 'dormant bank accounts').

The main accounting issue relating to on-demand financial liabilities is whether the entity can or should derecognise or reduce the liability (and recognise income) if it no longer expects the counter-party to demand repayment. A related issue is whether the entity should 'discount' an on-demand liability if it expects the counter-party to demand repayment at a future date. This alert provides guidance on these issues.

Relevant Australian standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

[1] Although the alert is intended to address on-demand financial liabilities, the guidance relating to derecognition will also be relevant to other circumstances involving financial liabilities where the entity no longer expects the counter-party to demand repayment. An example might be where a debtor has in the past overpaid an amount in error, and the reporting entity does not expect the overpayment to be demanded back, despite having previously notified the customer of the error.

Overview

Initial recognition

An on-demand financial liability is a liability whose contractual terms include a right of the counterparty to demand settlement at a date of its choosing.

As with all financial liabilities, IAS 39 requires that an on-demand financial liability is recognised initially at its fair value (adjusted for transaction costs if appropriate (IAS 39.43)). IAS 39 states that "the fair value of a financial liability with a demand feature… is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid" (IAS 39.49). This precludes initial recognition at an amount less than the amount repayable on demand when settlement can be required immediately. This is the case even if the reporting entity does not expect repayment.

Subsequent measurement

On-demand financial liabilities will usually be measured at amortised cost subsequent to initial recognition. Not all creditors will demand their money at the earliest opportunity however and the amounts payable may in some cases remain outstanding for long periods of time. Re-estimation of timing of future cash flows arising from a financial liability carried at amortised cost normally results in a change in carrying amount since the revised estimated cash flows are discounted at the original effective interest rate. The necessary adjustment is recognised in profit and loss (IAS 39.AG8).

The effective interest rate of demand financial liabilities will be 0%. This follows from the fact that the amount payable could be required to be settled immediately and is therefore the same as the initial fair value or carrying amount. Accordingly, if the entity subsequently revises its expectations about the timing of the contractual cash flows this will have no impact on amortised cost as the present value of those cash flows discounted at 0% will always equal the amount payable and initial carrying amount.

Derecognition

An on-demand financial liability is derecognised when it is extinguished. That is when the obligation specified in the contract is discharged or cancelled or expires (IAS 39.39). This condition is met when the creditor either pays the debtor or is legally released from its obligation to the debtor (IAS 39.AG57). An expectation that repayment will not be made is not in itself sufficient for derecognition to occur.

The creditor may be discharged from its obligation by process of law or by the terms of the contract. For example, where amounts due remain unclaimed after a specified period of time these may be legally extinguished or the creditor may be able to apply a management charge against the unclaimed balances progressively to settle them. In the absence of such legal or contractual provisions, the creditor will continue to recognise the unclaimed demand liabilities until they are paid. Income will only be recognised when the legal or contractual provisions enable derecognition of the unclaimed liabilities. Even then, in some cases the terms of these provisions do not enable income to be recognised.

Examples

Example	Analysis
Entity A provides online share dealing services and has financial liabilities (customer accounts) which are non-interest bearing and where there is a contractual obligation to pay amounts in full immediately on demand. The counterparties are individuals and the accounts comprise a substantial number of individually small balances. A large number of these balances have gone unclaimed for a significant period. Past history suggests that most of these monies will remain permanently unclaimed as the counterparties will not access their internet accounts to action repayment.	Entity A should initially record these accounts at the full amount repayable on demand (IAS 39.49). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if A revises its estimates of the timing of future cash flows (IAS 39.AG8). The financial liabilities are not derecognised until they are extinguished.
Facts are as in Example 1 except that A has obtained agreement from an external regulator to apply a management charge against such balances to clear them progressively and will change the relevant contractual terms and conditions with its customers accordingly.	As in example 1, Entity A should initially record these accounts at the full amount repayable on demand (IAS 39.49). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if A revises its estimates of the timing of future cash flows (IAS 39.AG8). Entity A will take the contractual changes into account when they are binding and enforceable. From that date, A will derecognise the financial liabilities and recognise management fee income in accordance with the revised terms.
Entity B carries out banking business. B has demand deposit liabilities with customers including current accounts. Current account holders can demand immediate settlement in full in cash of the balance of their account. There is however normally a core of such deposits that is left outstanding for long periods of time. Entity B treats customer demand deposit accounts as dormant when there have been no deposits or withdrawals for a period of one year and B has written to the customer and no reply has been received. Where there have been no customer initiated transactions for a period of 15 years, B is statutorily discharged from its obligation to the customer on transfer of the monies to an independent unclaimed asset fund for use on community causes.	As in examples 1 and 2, Entity B should initially record these deposit accounts at the full amount repayable on demand (IAS 39.49). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if B revises its estimates of the timing of future cash flows (IAS 39.AG8). Dormant accounts will be derecognised when the monies are transferred to the independent unclaimed asset fund and B's obligation to the customer is extinguished by process of law.

Note

On 12 November 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's prokect to replace IAS 39. However at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 39. Work has begun on Phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 was issued in Australia as AASB 9 Financial Instruments with anm effective date of 1 January 2013 and therefore AASB 9 requirements have not been considered for the purpose of this alert.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact member or a member of the National Audit Support team via the GTAL IT Service Desk http://gtassist.au.gt.local/