COMMENT LETTER

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ICI Comment Letter on FASB and IASB Draft Proposal That Would Eliminate "Cash Equivalents" From Financial Reporting (pdf)

5/31/20115/31/20115/31/2011 May 31, 2011 Nicholas Cappiello Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06956-5116 Denise Gomez Soto IFRS Foundation 30 Cannon Street London EC4M 6XH Re: July 2010 Staff Draft of an Exposure Draft on Financial Statement Presentation Dear Mr. Cappiello and Ms. Gomez Soto: The Investment Company Institute (the “Institute”)1 is writing to provide input regarding the July 2010 staff draft of an exposure draft of the International Accounting Standards Board (“IASB”) and the Financial Accounting Standards Board (“FASB”) (together, the “Boards”) for the Boards’ joint project to develop a standard on financial statement presentation (“Staff Draft”).2 A significant proposal in the Staff Draft is the elimination of the concept of “cash equivalents,” which would result in the classification of shares of US registered money market funds (“money market funds,” as defined below) as short-term investments. The Institute strongly objects to this result and believes that classifying shares of money market funds as short-term investments in a company’s financial statements would misrepresent the purpose and use of this asset in a company’s business. Further, we believe it is highly problematic to combine money market fund holdings with other instruments that may be included in short-term 1 The Investment Company Institute is the national association of US investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of the Institute manage total assets of $13.1 trillion and serve over 90 million shareholders. 2 Staff Draft of Exposure Draft IFRS X Financial Statement Presentation (July 1, 2010) available at http://www.ifrs.org/NR/rdonlyres/1CCDE163-47FF-4563-A6DD-5A7EFFA80E08/0/FSP_standard_BC_and_guidance.pdf or http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820952978 &blobheader=application%2Fpdf. 2 investments, i.e., any debt security maturing in 12 months or less, regardless of credit quality, as such instruments may present significantly greater risks than money market funds. The Institute believes that money market funds are, and will continue to be, an asset held by companies for the purposes of preserving principal and maintaining liquidity. Unlike a short-term investment, money market funds are well-suited to meeting a customer’s cash management objectives of minimizing exposure to credit, liquidity, counterparty and market risks, and can be quickly converted to cash at a predictable value. We therefore urge the Boards to preserve the concept of cash equivalents and recommend that any final standard require that cash equivalents be presented as a separate line item on the balance sheet. A separate category for cash equivalents would address the Boards' concerns regarding the aggregation of cash and cash equivalents while avoiding the problems that we believe would result if cash equivalents are eliminated and aggregated with short-term investments. US Registered Money Market Funds In the United States, a money market fund is a type of mutual fund that has as its objective the generation of income and preservation of capital and liquidity through investments in short-term high quality securities. These funds also typically seek to maintain $1.00 net asset value per share. Money market funds, like all US mutual funds, are subject to a comprehensive regulatory scheme under the US federal securities laws that has worked extremely well for over 70 years. Their operations are subject to all four of the major US securities laws administered by the US Securities and Exchange Commission ("SEC"), including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940 ("Investment Company Act").3 We refer to these very specific US money market funds as "money market funds." The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other US securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund's assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.4 3 Mutual funds also are subject to most of the requirements that apply to US corporate issuers under the Sarbanes-Oxley Act of 2002. 4 Each of these core objectives is discussed in detail in Section 4 of the Report of the Money Market Working Group Report (March 2009) ("MMWG Report") available at http://www.ici.org/pdf/ppr_09_mmwg.pdf. 3 In addition to the substantive requirements of the Investment Company Act, money market funds are subject to the strict requirements of Rule 2a-7 under the Investment Company Act. Rule 2a-7 includes several risk-limiting conditions intended to help a fund stabilize its share price at $1.00. These conditions limit risk in a money market fund's portfolio by governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments.5 Early last year, Rule 2a-7 was amended to further strengthen investor protections through provisions such as explicit liquidity standards, stress testing, "know your investor" procedures, shorter portfolio maturities, improved credit quality, and more detailed and more frequent disclosure.6 The amendments have made money market funds even more consistent with the objectives of preserving principal and maintaining liquidity. For example, with respect to the objective of preserving principal, the maximum dollar-weighted average maturity ("WAM") of portfolio holdings permitted by Rule 2a-7 as recently amended is now 60 days rather than 90 days. The amendments to Rule 2a-7 also imposed a new 120-day limit on a money market fund's weighted average life ("WAL").7 All money market funds now are subject to a uniform limit of 3 percent of total assets on the acquisition of second tier securities as defined under the rule, with not more than 0.5 percent of total assets permitted in any issuer of second tier securities. In addition, there are diversification requirements for all repurchase agreements not secured by government securities, which require funds to determine the creditworthiness of every counterparty. Amended Rule 2a-7 also requires funds to conduct periodic stress tests and report the results to their boards of directors. These stress tests seek to quantify the changes in interest rates, spreads, credit ratings and redemptions that could cause a money market fund to no longer be able to maintain a stable share price. The stress tests improve the directors' ability to oversee and manage the risks taken by their funds. With respect to maintaining liquidity, amended Rule 2a-7 requires money market funds to maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests. To comply with this requirement, funds must have "know your investor" procedures for gauging the redemption risks posed by individual shareholders or types of shareholders. Also, 10 percent of a taxable money market fund's portfolio must consist of daily liquid assets, which include cash (including demand deposits), direct obligations of the US government (e.g., Treasury securities), and securities (including repurchase agreements) for which a money market fund has a legal right to receive cash in one business day and all money market funds must have 30 percent of total assets invested in weekly liquid assets which include cash, Treasury securities, short-term government agency discount notes with remaining maturities of 60 days or less, and securities that must be repaid within 5 Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7. 6 See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010) ("Adopting Release"), 75 FR 10060 (March 4, 2010). 7 WAL is the WAM calculated without reference to interest rate adjustments to floating and variable rate securities. 4 five business days. The shares of money market funds and bank time deposits fall within the definitions of daily and weekly liquid assets if they satisfy the applicable maturity terms.8 Further, a fund may not invest more than 5 percent of its total assets in illiquid securities. The SEC also amended Rule 17a-9 under the Investment Company Act to permit affiliated persons of a money market fund to protect a fund from losses or provide liquidity by purchasing portfolio securities for the higher of their amortized cost or market value. The SEC has increased the transparency of money market funds by requiring them to provide updated portfolio information on their websites as of the end of each month. In addition, each month money market funds must file with the SEC new Form N-MFP, which contains detailed information about the fund and its portfolio, including the market value of each security held. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report. Finally, while the Investment Company Act strictly limits any suspension of redemptions, new Rule 22e-3 allows the board of directors of a money market fund that intends to liquidate to suspend the redemption of its shares. This rule is intended to help assure a fair and orderly resolution of any money market fund that can no longer maintain a stable NAV. Shareholders in the liquidating money market fund will receive pro rata distributions of cash as rapidly as the portfolio can be liquidated. Even in adverse market conditions, this should not be an extended period, given the limitations on a money market fund's WAM and WAL and the required levels of daily and weekly liquid assets. We also note that both industry and policymakers in the United States are continuing to consider money market funds and ways to bolster their resilience to severe market stress so as to assure their continued ability to serve investor and market interests. In October 2010, the President's Working Group on Financial Markets ("PWG") issued a report on Money Market Fund Reform Options ("PWG Report") describing a number of possible reforms to be examined by the newly organized Financial Stability Oversight Council. Comments on this report were due in January 2011. The cumulative effect of the reforms enacted to date has been to improve meaningfully the safety and liquidity of money market funds. Any additional reforms will only further support these goals. Classification as Short-Term Investments We believe that the proposal to eliminate the concept of cash equivalents, with the result that money market funds will instead be included in short-term investments, raises serious concerns regarding the presentation of a company's assets in its statement of financial position. As described above, retail and institutional investors alike rely on money market funds as a low-cost, efficient cash 8 Adopting Release at note 249. 5 management tool that provides a high degree of liquidity, stability in principal value, and a market- based yield. The reforms to date have only served to improve and strengthen the liquidity and stability of money market funds. In the Staff Draft, the Boards' propose to eliminate the concept of cash equivalents on the rationale that "cash equivalents do not possess the same characteristics as cash and have different risks from cash." The Boards believe that "presenting cash equivalents separate from cash avoids grouping dissimilar assets in the same line item . . . [and that such a] presentation better reflects liquidity in the statement of financial position."9 We believe the proposal, however, appears to result in the same problem that the Boards are seeking to prevent, i.e., grouping dissimilar assets. If cash equivalents are eliminated, assets in money market funds will be grouped with a range of assets in short-term investments, including investments with markedly different risks, characteristics and regulatory requirements from a money market fund. We do not believe the proposal in the Exposure Draft solves the Boards' stated problem; rather, it only puts the perceived problem in a different place. We also do not believe grouping cash equivalents with short-term investments "better reflects liquidity." In fact, we believe this would obscure liquidity. We also note the statement in the Staff Draft that while firms typically manage cash and cash equivalents together, the Boards believe these are different assets. According to the Staff Draft, "the proposal to classify assets and liabilities on the basis of their use was not meant to provide management with flexibility to aggregate items that do not have the same economic characteristics."10 The Boards must be cautious, however, as they consider cash, cash equivalents and short-term investments. For example, all demand deposits cannot be viewed as meeting the Boards' apparent standard for aggregation - possessing the "same economic characteristics." A demand deposit that exceeds the amount protected by any governmental insurance certainly presents liquidity and counterparty risks.11 Accordingly, we believe the Board cannot set aside or ignore how firms regard cash, cash equivalents and short-term investments. Companies and market participants have reasonably viewed, and will 9 Staff Draft, Basis for Conclusions on the Exposure Draft Financial Statement Presentation, paragraph BC 126, page 32. 10 Id. at BC 127, page 32. 11 In the United States, more than 370 banks have failed since September 2007. See Federal Deposit Insurance Bank ("FDIC") available at http://www.fdic.gov/bank/individual/failed/banklist.html. In addition, according to the FDIC, as of the end of the first quarter of 2011, the number of institutions on the FDIC's "Problem List" was 888, with total assets of "problem" institutions reaching $397 billion. FDCI Quarterly Banking Profile (First Quarter 2011), available at http://www2.fdic.gov/qbp/2011mar/qbp.pdf. Non-US banks have not been immune from failure either. See e.g., MMWG Report at 65-66 (describing the collapse and rescue of certain non-US banks in 2008); "Danish Bank Amagerbanken Falls into State Hands," February 6, 2011, available at http://www.reuters.com/article/2011/02/06/amagerbanken-idUSLDE7150IB20110206 (the 10th Danish bank to fall into the state's hands since 2008); "Ireland Bank Boss Dukes Bombshell: Republic needs another €15bn," Belfast Telegraph, February 9, 2011, available at http://www.belfasttelegraph.co.uk/news/local-national/republic-of-ireland/general-election/ireland-bank-boss-dukes-bombshell-republic-needs-another-euro15bn-15078167.html (The Republic of Ireland will have to go to the IMF/EU for another €15bn - on top of the €35bn already earmarked - to save the banking system, according to the government-appointed chairman of Anglo Irish Bank). 6 continue to view, cash equivalents and short-term investments differently and therefore they should not be aggregated.12 The Boards have also acknowledged the difficulties and tensions posed by the elimination of the concept of cash equivalents. For example in a 2008 discussion paper, it was recognized that the elimination of “cash equivalents” would significantly increase the volume of cash receipts and payments presented in most entities’ statements of cash flows.13 To address the issue and consequently to prevent purchases and sales of cash equivalents from giving rise to cash payments and receipts within the cash flow statement, the paper included a recommendation to continue to allow the net presentation of cash and cash equivalent flows for receipts and payments for items under circumstances in which the turnover is quick, the amounts are large, and the maturities are short. While we appreciate the rationale for this approach, it results in a differing treatment of “cash equivalents” between the balance sheet and the cash flow statement, with the former presenting money market funds as short-term assets held for investment purposes and the latter as cash-like instruments. Again, we do not think this is an optimal result, nor does it improve financial statement presentation. Lastly, given the long-standing view of cash and cash equivalents as closely related assets, we urge the Boards to weigh the possible unintended consequences of eliminating the concept of cash equivalents. We believe that having the accounting standards abandon cash equivalents will place financial statement standards out of step with the market and the users of financial statements. Aligning cash equivalents and short-term investments in the balance sheet (but not in the statement of cash flows) could result in confusion as it will depart from the market and operational realities of how cash equivalents are used and viewed by a variety of market participants. For example, many entities have guidelines for their corporate treasurers relating to holdings of cash and cash equivalents (and in some cases, only certain cash equivalents, such as AAA rated money market funds or government-only money market funds). Financial statements with only cash and short-term investments would adversely impact the presentation and understanding of an entity’s liquidity and cash management position. As a result, we are concerned that to avoid the impression of holding “too large” a position in short-term investments, entities may seek to divest short-term investments (including cash equivalents) at the end of reporting periods and move to cash to ensure that their financial statements more accurately reflect their liquidity. Such a result, i.e., needless switching of assets in and out of cash and cash equivalents, 12 We believe that cash equivalents and short-term investments have, and will continue to be, regarded as different and distinct categories of assets. Under existing accounting standards, cash equivalents are short-term, highly liquid instruments that are both: i) readily convertible to known amounts of cash; and ii) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Examples of items commonly considered to be cash equivalents include Treasury bills, commercial paper, and money market funds. See ASC 305-10-20 and IAS 7.6. In contrast, short- term investments would include any security maturing in one year or less, without regard to credit quality. 13 Financial Accounting Series: Preliminary View on Financial Statement Presentation (October 2008), available at: http://www.fasb.org/DP_Financial_Statement_Presentation.pdf (paragraphs 3.70-3.74, statement of cash flows, changes to the categories in the statement of cash flows). 7 would not serve the interests of companies, investors, the market, banks or the issuers of cash equivalents. 14 For the reasons described above, we therefore recommend that the standards recognize a separate category of “cash equivalents” on the balance sheet, rather than wholly eliminating it. We believe that such instruments are quite different from short-term investments and that cash equivalents should not be aggregated into the category of short-term investments. As a result, we strongly urge the Boards to have a category for cash equivalents. We believe that having a cash equivalents category, rather than eliminating the concept, will more accurately present a firm's assets as well as its liquidity. The Institute appreciates the Board's attention to our comments. If you have any questions, please contact the undersigned at 202-326-5851. Sincerely, /s/ Gregory M. Smith Gregory M. Smith Director – Fund Accounting cc: Holger Obst IASB Technical Manager 14 As another example, cash has significant meaning under the Investment Company Act. Under the Investment Company Act, an "investment company" includes any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis" (so called "40 percent test"). For purposes of this 40 percent test, money market funds are viewed as cash items. To avoid being deemed an investment company and therefore subject to the rules intended for entities that are primarily investing in and holding securities, operating companies very carefully monitor this ratio. It is unclear how the elimination of cash equivalents may impact the evaluation of a company for its status as an investment company under the Investment Company Act.