Amortized Cost is "Fair" for Money Market Funds

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About the Author

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Summary

Recent events have caused the U.S. Securities and Exchange Commission (SEC) to rethink the long-standing use of amortized cost by money market mutual funds in valuing their investments in securities. This practice supports the use of the stable net asset value (a "buck" a share) in trading shares in such funds. Some critics have challenged this accounting practice, arguing that it somehow misleads investors by obfuscating changes in value or implicitly guaranteeing a stable share price.

This paper shows that the use of amortized cost by money market mutual funds is supported by more than 30 years of regulatory and accounting standard-setting consideration. In addition, its use has been significantly constrained through recent SEC actions that further ensure its appropriate use. Accounting standard setters have accepted this treatment as being in compliance with generally accepted accounting principles (GAAP). Finally, available data indicate that amortized cost does not differ materially from market value for investments industry wide. In short, amortized cost is "fair" for money market funds.

Background

Money market mutual funds have been in the news a great deal recently as the SEC first scheduled and then postponed a much-anticipated late August vote to consider further tightening regulations on the industry.[1] Earlier, Chairman Mary Schapiro had testified to Congress about her intention to strengthen the SEC regulation of such funds, in light of issues arising during the financial crisis of 2008 when one prominent fund "broke the buck," resulting in modest losses to its investors. Sponsors of some other funds have sometimes provided financial support to maintain stable net asset values. And certain funds recently experienced heavy redemptions due to the downgrade of the U.S. Treasury's credit rating and the European banking crisis.

[1] This paper deals exclusively with the issue of accounting for money market funds' investments in debt securities. It does not touch on other measures being considered by the SEC or others relative to liquidity of such funds, such as capital requirements or restrictions on the amounts that investors could withdraw.

Money market funds historically have priced their shares at $1, a practice that facilitates their widespread use by corporate treasurers, municipalities, individuals, and many others who seek the convenience of low-risk, highly liquid investments. This $1 per share pricing convention also conforms to the funds' accounting for their investments in short-term debt securities using amortized cost. This method means that, in the absence of an event jeopardizing the fund's repayment expectation with respect to any investment, the value at which these funds carry their investments is the amount paid (cost) for the investments, which may include a discount or premium to the face amount of the security. Any discount or premium is recorded (amortized) as an adjustment of yield over the life of the security, such that amortized cost equals the principal value at maturity.

Some commentators have criticized the use of this amortized cost methodology and argued for its elimination. In a telling example of the passionate but inaccurate attention being devoted to this issue, an editorial in the June 10, 2012, *Wall Street Journal* described this long-standing financial practice in a heavily regulated industry as an "accounting fiction" and an "accounting gimmick."

This paper seeks to clarify the record on this matter and to inform the public discourse with (1) a factual and historical perspective on the application of amortized cost to securities held by money market mutual funds under GAAP, (2) an analysis of some of the most recent conceptual accounting thinking, and (3) some related matters.

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History

The use of amortized cost to account for securities of money market mutual funds has been embedded in well-established GAAP for more than 30 years. Both the SEC and the Financial Accounting Standards Board (FASB) have explicitly established or endorsed this accounting. And the most recent conceptual thinking by accounting standard setters supports this approach as providing relevant information for the users of the entities' financial statements.

The first authoritative accounting guidance for all investment companies, generally, was in the 1973 "Industry Audit Guide on Audits of Investment Companies" (Guide), issued by the American Institute of Certified Public Accountants (AICPA). The Reserve Fund, established in 1971, was the first money market mutual fund, and only a few funds of this type were in operation in 1973. Accordingly, the Guide did not discuss such funds specifically. The Guide called for mutual funds to account for their investments in securities at market value for securities for which quotations were readily available and fair value as determined in good faith by the board of directors for other securities.

A few years later, money market funds had proliferated, and in late 1975 the AICPA drafted guidance to amend the Guide to cover such funds. After exposure for public comment, that guidance was finalized in April 1977 as AICPA Statement of Position (SOP) 77-1, "Financial Accounting and Reporting by Investment Companies." While dealing exclusively with money market funds, SOP 77-1 did *not* cover their use of amortized cost to value their investments. Rather, it covered distribution policies for dividends, the statement of changes in net assets, supplementary information, reporting gains and losses, and federal income taxes.

The first authoritative accounting guidance on accounting for investments in securities for money market mutual funds came from the SEC in May 1977, when it issued Accounting Series Release 219 (ASR 219) (also known as SEC Release IC-9786). It appears that before the issuance of this release, money market funds, still a relatively new type of fund, were applying amortized cost to all investments and sought to stabilize their net asset value. ASR 219 was an interpretation of a rule under the Investment Company Act. ASR 219 indicated that it would be appropriate for money market funds to determine the fair value of debt portfolio securities on an amortized cost basis, provided the securities had remaining maturities of 60 days or less. This release also articulated a materiality standard of $.01 on a $10.00 per share net asset value.

In September 1979, the FASB issued Statement 32, "Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters." It stated that the "specialized accounting and reporting principles and practices contained in the AICPA Statements of Position and Guides on accounting and auditing matters designated herein are preferable accounting principles for purposes of justifying a change in accounting principles as required by APB Opinion No. 20, Accounting Changes." This Statement, therefore, effectively brought the accounting guidance in those AICPA SOPs and Guides under the umbrella of GAAP. The 1973 Investment Companies Guide and SOP 77-1 were among the AICPA pronouncements specifically cited by Statement 32. (This FASB action did not affect ASR 219, which remained the applicable guidance at that time.)

In February 1982 the SEC proposed and in July 1983 finalized Rule 2a-7, "Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)." This Rule was issued following several years of SEC hearings and exemptive orders that permitted individual money market funds to use either penny-rounding or the amortized cost method to stabilize their share prices. The former was used in computing current price per share and the latter was used in both valuing portfolio instruments and computing current price per share. The exemptive orders required funds to adhere to limits on the maturity of their investments. These limits extended the maturity restrictions in ASR 219. In particular, money market funds were required to limit the weighted average maturity of the portfolio to 120 days and the maturity of all fund investments to one year. Rather than continuing to provide exemptive orders to individual funds, the SEC concluded that it should establish standards that all funds could follow that would permit use of these methods.

The Rule noted that it was designed to "limit the permissible portfolio investments of a money market fund seeking to use either penny-rounding or the amortized cost valuation method to maintain a stable price per share to those instruments that have a low level of volatility and thus will have a greater assurance that the money market fund will continue to be able to maintain a stable price per share that fairly reflects the current net asset value per share of the fund." Accordingly, the Rule established maturity limitations that were consistent with the SEC's exemptive orders as follows:

- The entire portfolio must consist of instruments with a maturity of one year or less.

- The dollar-weighted average maturity of the overall portfolio must not exceed 120 days.

The Rule also required that all investments must represent minimal credit risks and be rated "high quality" by a major rating service, or if unrated, determined by the board of directors to be of comparable quality.

Rule 2a-7 thus became GAAP for money market mutual funds as they applied the Rule's requirements both in calculating their daily stable price per share and in reporting the value of their investments in their financial statements.

In November 1986 the FASB voted not to object to the issuance of a proposed revision of the 1973 Guide. This was the first time the FASB had formally exercised its oversight of the AICPA literature pursuant to Statement 32 with respect to investment companies. According to the minutes of the meeting at which the FASB voted not to object to the AICPA issuing the Guide, the FASB discussed a few specific accounting issues, but did not comment on the accounting for money market funds. That topic was covered in the Guide in paragraph 2.37, which referred to the SEC's Rule 2a-7 permitting use of the amortized cost method of accounting for debt securities. Thus, this accounting treatment became part of the professional accounting literature, in addition to the SEC rules, through the inclusion of this information in the Guide and the FASB's implicit endorsement thereof. While there were several amendments to the Guide between its early 1987 new issuance and the present, there has been little change in the attention given to money market mutual fund accounting for investments.[2]

As a result of events in the financial markets in 2008, the SEC revisited Rule 2a-7 through a proposal in July 2009 that was finalized in January 2010. The 2010 amendments shortened portfolio maturity and implemented specific liquidity requirements. The weighted-average maturity of the portfolio now cannot exceed 60 days, with no individual security's maturity more than 13 months.[3] The 2010 amendments require taxable funds to hold at least 10%

[2] However, in February 1991, the SEC amended Rule 2a-7 to, among other things, tighten the maximum weighted average portfolio maturity from 120 days to 90 days.
[3] There are exceptions for certain types of securities—including variable- and floating-rate securities—that have a demand feature or an interest rate reset of not more than 397 days.

of their investments in cash, U.S. Treasuries, or securities that mature or are subject to a demand feature within one business day. And all funds must hold 30% of their investments in cash, U.S. Treasuries, other government securities with remaining maturities of 60 days or less, or securities that mature or are subject to a demand feature within one week or less. Also, the credit quality of permitted investments was further limited. Thus, the long-standing assumption of amortized cost closely approximating market value was strengthened by a substantial tightening of the conditions under which it is being applied—namely, shorter maturities and high credit quality.

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In May 2010, the FASB issued an exposure draft of a Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities." While mutual funds and more specifically money market funds were not a principal focus of that exposure draft, it appears the draft could be read to change the accounting for money market funds through paragraph 26b, wherein it stated, "An investment company that is subject to the guidance in Topic 946 shall measure both its financial assets and its financial liabilities at fair value and include all changes in their fair value in the net increase (decrease) in net assets for the period. Neither the option to report changes in the fair value of a qualifying financial asset or financial liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities is available to an investment company." That exposure draft, however, has not yet been finalized. And more recently, in an October 2011 exposure draft, "Financial Services—Investment Companies," the FASB stated in paragraph BC29,

> The FASB also concluded that money market funds, which currently report their investments at amortized cost, would be considered to be managing their investments on a fair value basis. This conclusion is based on money market funds being managed to minimize the differences between the carrying value and the fair value of their investments to maintain a constant net asset value.

Thus, both the SEC, from its initial action in 1977 through the latest revision of Rule 2a-7, and the FASB, from its 1986 endorsement of the AICPA Audit Guide through its latest thinking on this topic in 2011, have clearly articulated the amortized cost basis of accounting as being GAAP for investments of money market mutual funds.

Reasoning for Use of Amortized Cost

The FASB has been considering various aspects of the accounting for financial instruments for approximately 25 years. During that time it has issued standards on topics such as accounting for marketable securities, accounting for derivative instruments and hedging, impairment, disclosure, and others. Also, the FASB has issued standards or endorsed standards issued by the AICPA of a specialized nature applying to certain industry groups such as investment companies, insurance companies, broker/dealers, and banks. Further, the FASB is presently involved in a major project that has encompassed approximately the past 10 years, whereby it is endeavoring to conform its standards on financial instruments to the related standards issued by the International Accounting Standards Board. Aspects of that project have stalled recently, and the two boards have reached different conclusions on certain key issues. Other aspects of that project are moving forward.

> The maturity, credit quality, and liquidity restrictions in SEC Rule 2a-7 ensure that the difference between market value and amortized cost generally is immaterial.

> [M]oney market fund investments are often held to maturity and any discount or premium in the purchase price is realized by the fund.

Over this 25-year period, probably the most controversial aspect of the financial instruments project has been to what extent those instruments should be carried at market or fair value in financial statements rather than historical cost. On several occasions the FASB has indicated a strong preference for fair value as a general objective. But there has been a great deal of opposition from many quarters, and the FASB has tended to determine the appropriate measurement attribute for particular instruments (fair value, amortized cost, etc.) in different projects based on the facts and circumstances in each case.

Mutual funds typically value their investments using readily available market quotes, or in the absence of such quotes, at an estimate of fair value. However, as noted above in the "History" section, the amortized cost convention has long been used by money market funds as they invest in short-term, high-quality instruments. The maturity, credit quality, and liquidity restrictions in SEC Rule 2a-7 ensure that the difference between market value and amortized cost generally is immaterial. Further, money market fund investments are often held to maturity and any discount or premium in the purchase price is realized by the fund. To consider the reasoning underlying money market funds' use of amortized cost, it may be useful to look at one of the FASB's recent documents.

Paragraphs BC69-BC80 of the FASB 2010 exposure draft on "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" provide some of the latest thinking on the use of amortized cost as a measurement attribute for financial instruments. In particular, BC75 notes,

> Preparers have generally favored the use of amortized cost for instruments that an entity intends to hold and realize its benefits through collection of contractual cash flows. Amortized cost accounting recognizes reported interest as the primary "earnings" of the entity and also places emphasis on the timing of the realization of changes in value by the entity rather than simply on the amount of the change in value. For example, an entity that is in the "spread" business is concerned about maximizing interest margin through collection of interest income and payment of interest expense while minimizing credit losses. Realizing temporary value changes is not the immediate goal of that business strategy.

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In paragraph BC79 of that same exposure draft, the FASB noted that "… amortized cost information may be relevant for certain financial instruments that an entity intends to hold for collection or payment(s) of contractual cash flows." But debt securities would have been accounted for at fair value according to the exposure draft, which also would have changed the specialized industry accounting for money market funds, as noted earlier. However, the extent of the use of fair value accounting was very controversial, as two of the five FASB members at that time dissented on that issue and comment letters on the exposure draft were largely negative, although for many reasons in addition to this issue.

It is also useful to consider the "primary perceived disadvantages of amortized cost" as cited by the FASB in paragraph BC78 of that exposure draft. The fact that those arguments are *not* relevant in the case of money market funds is another indication that amortized cost is an entirely appropriate valuation methodology for money market funds, assuming no credit impairment.

First, the FASB states that "Amortized cost reflects a historical transaction price that is not relevant for current investment decisions. For example, amortized cost does not reflect current market conditions such as interest rates and market prices. Some argue that an entity that relies on amortized cost measures may not fully understand the risks inherent in its financial instruments and may lose out on certain current opportunities as a result. Fair value would provide information about opportunity cost because it reflects current market conditions."

As noted by the FASB in its 2011 exposure draft on investment companies mentioned earlier, by reporting their investments at amortized cost, money market funds would be considered to be managing those investments at fair value. That is because they are being managed to minimize the differences between the carrying value and the fair value of their investments to maintain a constant net asset value. In other words, the difference between amortized cost and fair value is purposely managed to be immaterial by rule. Further, any "opportunity cost" information is addressed by the market value information filed with the SEC monthly and made publicly available on a delayed basis.

Second, the FASB states that "Under amortized cost, an entity can change its intent and realize in net income short-term changes in value. Some view the use of amortized cost as delaying the recognition of economic gains and losses. An entity could sell assets that are performing favorably and hold on to underperforming assets to meet short-term market expectations."

> [T]he difference between amortized cost and fair value is purposely managed to be immaterial by rule.

Given the current SEC liquidity requirements, this is relatively unlikely for most money market funds as a significant portion of the portfolio will be in securities that mature in a week or less and, thus, not subject to significant market fluctuations. Further, with a weighted average portfolio of 60 days or less, a high percentage of investments will be held to maturity and not sold to generate short-term gains or losses.

Third, the FASB states that "The use of amortized cost relies on complex impairment models. Estimating impairment losses and using valuation accounts are complicated and subjective and could create opportunities to smooth the recognition of income."

According to Rule 2a-7, money market funds are required to determine net asset value per share based on market prices for their portfolio securities at appropriate intervals and promptly consider taking action should the market value based net asset value deviate from the amortized cost-based net asset value by more than ½ of 1%. They are also required to report market values (or estimates of fair value) for their portfolio securities to the SEC on a monthly basis. Impairment models are necessary mainly in situations where there are no market-based prices broadly available for assets, such as bank loans. Generally, fair values can be readily and objectively determined for the securities in which money market funds invest. In limited instances, the fund may estimate the fair value of certain securities based upon procedures approved by the fund's board of directors. Accordingly, there is no need for money market funds to develop or employ complex impairment models.

The fourth and final point made by the FASB is that "Complex tainting rules may be necessary if some instruments are measured at amortized cost and others are measured at fair value with management's intentions used as the basis for determining which measurement basis should be used for a particular instrument."

That argument would only apply in a situation where an entity had a mixture of assets and liabilities with some of them carried at cost and some at fair value. That is not the case for money market mutual funds.

In addition to the conceptual arguments for using the amortized cost method of accounting for securities rather than market or fair value, it can be argued that for money market funds, amortized cost is materially the same as fair value in nearly all cases. FASB Concepts Statement No. 8, "Conceptual Framework for Financial Reporting," in Chapter 3, "Qualitative Characteristics of Useful Financial Information," defines materiality as follows:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

The SEC staff has issued similar guidance on accounting materiality in Staff Accounting Bulletin Nos. 99 and 108, which specify that materiality cannot be reduced to a numerical measure but must include qualitative considerations as well. However, it is reasonable to assume that amounts that are less than the ½ of 1% of net asset value threshold at which directors must take action to address a difference between fair value and amortized cost would not be considered material by most parties.

It should also be noted that many, if not most, of the securities owned by money market funds would be considered as “cash and cash equivalents” if they were owned by commercial entities. The FASB’s GAAP Codification in Section 305-10-20 defines cash equivalents as “short-term, highly liquid investments that have both of the following characteristics: a. readily convertible to known amounts of cash, and b. so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.” This would, of course, include investments in money market funds owned by commercial entities. In addition, the GAAP Codification gives examples of a three-month U.S. Treasury bill (T-bill), commercial paper, and federal funds sold.

[M]any, if not most, of the securities owned by money market funds would be considered as “cash and cash equivalents”

T-bills are very common investments of money market mutual funds, as are short-term agency obligations. Other common money market mutual fund investments that would qualify as cash equivalents if held by commercial entities are commercial paper and repurchase agreements. Under current GAAP, all of these cash equivalents would be carried at cost in the financial statements of commercial entities because they are short-term highly liquid investments and are usually held to maturity—just like those that meet the requirements for the amortized cost method for investments of money market mutual funds.

It is also appropriate to consider the “going concern assumption.” As noted in FASB Concepts Statement No. 1, “Objectives of Financial Reporting by Business Enterprises,”

> Investors and creditors ordinarily invest in or lend to enterprises that they expect to continue in operation—an expectation that is familiar to accountants as “the going concern” assumption. Information about the past is usually less useful in assessing an enterprise’s future if the enterprise is in liquidation or is expected to enter liquidation. Then, emphasis shifts from performance to liquidation of the enterprise’s resources and obligations.

Thus, absent evidence to the contrary, companies assume that the entity will continue in business and will carry out its operations according to the terms of understandings with customers, vendors, and others. An entity that is considered not to be a going concern would adopt liquidation accounting principles and assume that its assets would be sold immediately, for example. Market value accounting for money market fund securities would certainly be appropriate if a fund were not a going concern. But given that only one or two funds have liquidated due to breaking the buck in more than 40 years of operations for the industry, it seems that funds can reasonably assert that they are going concerns. And use of the amortized cost method is supported by the going concern assumption.

Related Matters

According to the SEC's regulations in Rule 2a-7, use of the amortized cost method of accounting for investments in securities by money market mutual funds must be justified on an entity-by-entity basis. Therefore, it may not be fully representative to evaluate the application of this method using broad industry data. However, it is still useful to know that, in general, such data show that deviations between money market funds' shadow prices and amortized costs are small. A January 2011 study issued by the Investment Company Institute noted the following for a sample of taxable money market funds covering one-quarter of industry assets.

> [I]n general, data shows that deviations between money market funds' shadow prices and amortized costs are small.

> Average per-share market values of all funds in the sample varied within a narrow range over the decade from 2000 to 2010—a period when financial markets experienced wide variations in interest rates and asset prices. Average shadow prices for funds in the sample ranged from $1.0020 in 2001–2002, when the Federal Reserve reduced interest rates sharply, to $0.9990 in the fall of 2008, at the peak of the financial crisis.

> Average per-share market values for prime money market funds in the sample—those taxable funds that invest in corporate as well as government securities—varied between $1.0020 and $.9980 during the decade from 2000 to 2010.[4]

In spite of strict guidelines on the quality of individual securities that money market funds may purchase, it is inevitable, of course, that such funds will occasionally suffer credit losses. In many cases during the recent financial crisis, fund sponsors provided support to avoid losses to the funds through purchase at face amount of troubled securities or in other ways. According to a Federal Reserve Bank of Boston Working Paper by Brady, Anadu, and Cooper, “The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011” (August 13, 2012), at least $4.4 billion was provided by sponsors of 78 funds. Another Federal Reserve Bank official, Eric Rosengren, presented remarks on April 11, 2012, at the Federal Reserve Bank of Atlanta’s 2012 Financial Markets Conference on “Money Market Mutual Funds and Financial Stability.” Using a different method of estimating sponsor support than the Brady et al. paper, Rosengren’s figure for the 2007 to 2010 period was at least $3.2 billion

> Accounting for investment securities by money market mutual funds appropriately remains based on amortized cost.

While these amounts are very large, it is important to keep them in perspective. These losses represent approximately one-tenth of 1 percent of total money market fund assets under management and occurred during a period of unprecedented market volatility. Of more relevance from an accounting standpoint is that occasional losses such as these do not negate use of the amortized cost method of accounting for securities. Providing for possible impairment is a necessary part of any accounting convention based on historical cost. Just a couple of examples of this are accounting for long-term debt investment securities under the hold-to-maturity method and accounting for loans. The board of directors’ regular review of the portfolio should ensure that prompt action will be taken to identify and account for securities with impaired values.

[4] Given that this study covers a period prior to the 2010 SEC changes to Rule 2a-7, the magnitude of fluctuation in subsequent periods is nearly certain to be much smaller.

Conclusion

Accounting for investment securities by money market mutual funds appropriately remains based on amortized cost. The amortized cost method of accounting is supported by the very short-term duration, high quality, and hold-to-maturity nature of most of the investments held. The SEC's 2010 rule changes have considerably strengthened the conditions under which these policies are being applied. As a result of the 2010 SEC rule changes, funds now report the market value of each investment in a monthly schedule submitted to the SEC that is then made publicly available after 60 days. That provides additional information for investors. And the FASB's current thinking articulates this accounting treatment as GAAP.

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