Cash accounting

GAIL LE COZ EXPLAINS THE ACCOUNTING TREATMENT OF MONEY MARKET FUND INVESTMENTS.

Money market funds are designed to provide investors with a short-term cash management solution. Since the beginning of 2007, total assets in the money market funds represented by the Institutional Money Market Funds Association (IMMFA) have grown by 67%. This growth can be attributed to the ability of the funds to provide security and liquidity for short-term cash. However, whether these funds can be categorised as cash equivalent in a cashflow statement is of fundamental importance to a corporate treasurer.

A money market fund invests in high-quality, short-term debt instruments. By virtue of its investments, and given the daily liquidity it provides to investors, a money market fund has cash-like qualities. On this basis, the assessment of whether these funds should be categorised as cash equivalent under accounting rules would appear to be simple. However, there is no blanket classification of certain types of money market funds as cash equivalent. Instead, this categorisation needs to be conducted on a case-by-case basis, and there are a number of factors to consider. Before investigating these in detail, let us investigate the control environment within which a money market fund will operate.

STANDARDS AND CODES The money market funds that are available throughout Europe normally operate in accordance with the UCITS Directive. This legislation, along with recent guidance from the Committee of European Securities Regulators (CESR), defines the legal structure and high-level investment parameters to which these funds must adhere. To complement this legislation, and to ensure that its membership comply with the highest standards in the money market fund industry, IMMFA implemented a code of practice in 2003. This code, which all IMMFA members must follow, requires a number of quantitative and qualitative standards to be adopted by the funds.

There are three major risks to which a money market fund may become exposed. First, credit risk, which can materialise if and when the credit quality of any asset in the fund deteriorates. Second, interest rate risk: a money market fund buys fixed income assets, whose value can change if interest rates move, impacting the overall value of the fund. And finally, liquidity risk, which relates to how easily a money market fund can liquidate assets to meet redemptions.

The IMMFA code of practice is designed to establish standards which manage these three sources of risk. IMMFA money market funds are characterised by a maximum weighted average maturity (WAM) of 60 days (which limits interest rate risk), a maximum weighted average final maturity (WAFM) of 120 days (which limits credit risk), minimum amounts of overnight and one-week securities (5% and 20% respectively, managing liquidity risk), a triple-A money market fund rating (further limiting credit risk) and a constant net asset value. Each of these obligations is designed to ensure that the funds are capable of providing stability of principal and same-day liquidity, mirroring the qualities of cash while also providing a competitive money market return.

GUIDANCE ON CASH EQUIVALENCE In light of the control environment in which a money market fund operates, the International Financial Reporting Interpretations Committee (IFRIC) was asked to provide guidance on the definition of cash equivalence under the International Accounting Standards (IAS). The request specifically related to whether accounting standards should recognise that money market funds could universally be acknowledged as cash equivalent without individual assessment. The IFRIC subsequently considered the issue, but concluded that no formal guidance on the matter was necessary. Consequently, a case-by-case assessment of cash equivalence continues to be required for all corporate investors in a money market fund.

Recognising the importance of the issue and the need to assist treasurers in their individual analysis, IMMFA has produced a short paper specifically on this issue. This note outlines the factors which need to be considered under the applicable IAS rule (IAS 7), how these factors may be interpreted when investing in an IMMFA money market fund, and an opinion on whether these specific money market funds may be categorised as cash equivalent. This paper on the treatment of investment in an IMMFA money market fund is designed to assist treasurers, both when considering investment in such funds, and also when preparing the cashflow statement once invested.

The key aspects in the analysis of cash equivalence are:

- whether the investment may be convertible at all times into a known amount of cash;
- whether it is subject to an insignificant risk of changes in value due to both the short time to maturity and the high quality of the underlying instruments; and
- whether it has a short maturity of three months or less from the date of acquisition.

SATISFYING THE THREE KEY ASPECTS The IMMFA code of practice requires funds to provide daily liquidity; this ability will be prescribed within the fund's prospectus, resulting in the fund being convertible to cash at all times. IMMFA money market funds all operate with a constant net asset value – achieved by the use of amortised cost accounting – which also allows the fund to be convertible into a known amount of cash. Again, this is required by the code of practice and included within the fund prospectus.

The combination of the requirements of the credit rating agencies in achieving and maintaining a triple-A money market fund rating, and the regulatory requirements (which are mirrored in the IMMFA code of practice) relating to maximum WAM and WAFM, result in limited potential for any change in value of an IMMFA money market fund.

All IMMFA money market funds have a maximum WAM of 60 days, as required by each credit rating agency, the IMMFA code of practice, and European regulation. Therefore, these funds are obliged to limit their average maturity to well within three months.

Although IFRIC concluded that no formal guidance on this topic was necessary, the staff papers produced while initial consideration was given to this matter provide an indication of its thinking. These papers include the opinion that if the units in a fund are readily convertible into cash and have an insignificant risk of value changes, the fund can be considered "in substance" to meet the cash equivalent definition.

Given the analysis here and the IFRIC staff paper, it is IMMFA's opinion that investment in an IMMFA money market fund should be considered as cash equivalent, provided that the investment is made to meet short-term commitments. Comprehensive guidance on this issue can be found in the IMMFA paper entitled Treatment of Investment in a Money Market Fund, which is available at: **www.immfa.org/press/2010-023-01.pdf**

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