

ICI VIEWPOINTS

NOVEMBER 2, 2012

Paper Concludes Amortized Cost Is Appropriate for Money Market Funds

By Gregory Smith

A recently released [paper](#) examines the use of amortized cost by money market funds and concludes that its use is appropriate given the short-term, high-quality nature of these funds' investments. The paper also discusses how use of amortized cost is well supported by more than 30 years of regulatory and accounting standard-setting consideration. Author Dennis R. Beresford is the Ernst & Young executive professor of accounting at the J. M. Tull School of Accounting, Terry College of Business at the University of Georgia. Beresford served as chairman of the Financial Accounting Standards Board (FASB) for more than ten years.

What Is Amortized Cost?

Amortized cost is the purchase price of the security, adjusted for accretion of discount or amortization or premium. Accretion of discount involves increasing the value of the security ratably over its life so that at maturity its amortized cost value is equal to the maturity value. Money market funds use amortized cost, rather than market value, to value their securities when calculating net asset value (NAV). The Securities and Exchange Commission (SEC) allows a money market fund to use the amortized cost method only if the fund follows Rule 2a-7 under the Investment Company Act of 1940.

Some have called money market funds' use of amortized cost an "accounting gimmick," arguing that it somehow misleads investors by obfuscating changes in value or that it implicitly guarantees a stable share price. Beresford clarifies the record with a look at the history of amortized cost, its conceptual underpinnings, and key data showing that any deviation between the amortized cost and mark-to-market NAV per share is extremely small.

Historical Perspective on the Application of Amortized Cost

The paper describes how the SEC and the FASB have considered and approved money market funds' use of amortized cost through the years. The SEC first approved funds' use of amortized cost in May 1977, provided that the securities had remaining maturities of 60 days or less. In November 1986, the FASB approved funds' use of amortized cost when it cleared the *AICPA Investment Companies Audit and Accounting Guide*.

Beresford also describes how the regulatory requirements associated with funds' use of amortized cost have become more restrictive in order to provide greater assurance that the use of amortized cost is appropriate.

The Conceptual Reasoning Behind the Use of Amortized Cost

The paper notes that the FASB has been debating the appropriate measurement attribute (i.e., amortized cost or fair value) for different financial instruments for more than 25 years. Generally, standard setters agree that the use of amortized cost is appropriate for instruments that an entity intends to hold and collect the contractual cash flows. The paper indicates that given the limited maturity of their permissible investments, money market funds generally intend to hold their investments and realize the contractual cash flows, in order to provide their shareholders with a market-based yield. Realizing temporary changes in value is not their investment strategy.

Tiny Deviations Between Amortized Cost and Mark-to-Market Values

Finally, the paper references [ICI data](#) demonstrating that any deviation between funds' amortized cost and mark-to-market NAV per share is extremely small. Average per-share market values for a sample of prime money market funds ranged from \$1.0020 to \$0.9980 from 2000 to 2010. This study period preceded the [SEC's most recent amendments to rule 2a-7](#), which further reduced the likelihood that per-share market values would deviate from the amortized cost NAV.

Beresford acknowledges that funds may suffer credit losses from time to time and references other work that estimates the magnitude of these losses and related fund sponsor support. Importantly, these losses do not negate the use of amortized cost accounting by money market funds. Providing for possible impairment is a necessary part of any cost-based accounting convention. The SEC's shadow pricing requirement, combined with the fund board's regular review of the portfolio, ensure that any impaired security will be identified promptly and that action is taken to ensure all shareholders are treated fairly.

You can find more on money market funds at ICI's [Money Market Fund Resource Center](#).

Gregory Smith was senior director of operations, compliance, and fund accounting for ICI.