



LETTER OF COMMENT NO. 5

January 26, 2007

Mr. Christopher Bolash  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Comment on FAS 95 – Cash and Cash Equivalents

Dear Mr. Bolash:

Treasury Strategies, Inc. (Treasury Strategies) appreciates the opportunity to comment on potential changes to FAS 95, specifically concerning the definition of cash and cash equivalents. Our view is gleaned from over twenty-five years of experience in treasury and financial strategy consulting to companies, financial services providers and regulators. We also annually survey corporations in both the U.S. and Europe on their cash and short-term investment practices. In 2006 we surveyed 650 U.S. corporations and 500 European corporations. This breadth of coverage has afforded us with unique perspectives on the impacts of financial regulations.

We have come together as the respective heads of our corporate and securities industry consulting practices to offer FASB our comments on how FAS 95 defines cash equivalents. This issue is pertinent and timely for our clients who are both purchasers and issuers of investment products.

## Summary

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We understand that FASB is re-visiting the definition of cash and cash equivalents under FAS 95. Domestically, this effort is driven by recent controversy over which investment instruments should be included under the current definition. Globally, FASB is continuing its joint efforts with the IASB to standardize financial statements, which include the definition of cash and cash equivalents. To provide FASB with support in both of these efforts, we have presented our thoughts in this letter.

We believe that the definition of cash and cash equivalents, as written under FAS 95 in 1987, is generally adequate and appropriate in guiding corporate accounting and investment practices. However, we believe minor additions to the current verbiage would greatly reduce further misinterpretation in the market.

We propose the following additions to current FAS 95 language:

1. Include a more comprehensive list of investment products regarded as cash equivalents as stated in FAS 95, paragraph 9 (see Appendix A).

While we do not suggest the list is finite and exhaustive, we do believe the list should explicitly include or exclude the most controversial investment products – auction rate securities, variable rate demand notes and enhanced cash mutual funds. We know our corporate clients would welcome this clarification, as it would eliminate confusion while still allowing flexibility.

2. Amend footnote 2 to allow investments whose original maturity was in excess of ninety days, to be included as cash and cash equivalents at the point in time that their time to final maturity reaches ninety days or less.

This would account for the liquidity of a security based on its remaining maturity, regardless of what its maturity may have been when the enterprise originally included it in its portfolio. This is consistent with the way in which the financial markets and our securities dealer clients view the liquidity of a fixed-income or money market investment instrument.

We also believe that the phrase “*generally, only investments with original maturities of three months or less*” is an important component of FAS 95. While we believe that three months is a good guideline for maturity considerations, we do not believe this should be an absolute cutoff. Maturity is certainly an integral component of measuring an investment’s liquidity, but one must also evaluate the credit and liquidity risk associated with the instrument.

We believe the credit ratings assigned to individual securities are currently under-utilized in evaluating the liquidity of an investment. Specifically, we believe that the only securities with maturities greater than three months that should be reviewed for inclusion as cash equivalents should have the highest credit ratings from the top two rating agencies (S&P and Moody’s).

With respect to specific investment instruments, we believe that cash equivalents should include variable rate demand notes and select enhanced cash funds, but should exclude auction rate securities.

Additionally, we believe that a key element in ensuring companies and their auditors appropriately interpret the definition of cash and cash equivalents lies in the two aspects of FAS 95 that have received the least amount of attention:

1. The requirement that an enterprise establish a policy stipulating what it considers to be cash and cash equivalents.
2. Full disclosure of the policy on the enterprise’s financial statements.



## **Background: Trends in Corporate Cash**

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We understand that the primary objective of FAS 95 is to shed light on the *Statement of Cash Flows*. The definition of cash and cash equivalents is a minor element of FAS 95. However, this has accounted for more than 99% of the publicity and corporate controversy surrounding FAS 95 over the last several years.

The recent popularity of auction rate securities and variable rate demand notes has fueled the scrutiny of the definition of cash and cash equivalents. Historically, companies have invested their cash and cash equivalents in instruments that have not fueled controversy – repurchase agreements, commercial paper, money market funds, etc. However, when interest rates fell below 2% from 2002 to 2004, companies began to look at alternative instruments for even slightly better investment returns.

Additionally, corporate liquidity levels have reached record levels totaling \$5.4 trillion in 2006 (Treasury Strategies defines corporate liquidity as cash, cash equivalents and short-term investments with maturities less than three years). This is up from \$3.6 trillion in 1999 and up from \$4.7 trillion in 2004. The media has showered a lot of attention on the build-up in corporate liquidity over the past two years, especially highlighting companies with enormous cash pools like Microsoft who at one time held over \$50 billion in cash and cash equivalents. Accordingly, the tremendous growth in corporate liquidity has also fueled greater scrutiny of these dollars.

### **Percentage of Total Corporate Liquidity Dollars by Instrument 1999 – 2006**

(Based on Treasury Strategies' 2006 U.S. Corporate Liquidity Research, which surveyed 650 companies on their liquidity management practices.)

<b>Instrument</b>	<b>1999</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Comm. Paper/Repo/CDs	45%	15%	24%	25%
Notes/Bonds (corporate and government - includes auction rates and variable rate demand notes)	13%	21%	29%	23%
Money Market Mutual funds	10%	36%	21%	27%
Other (demand deposits, money market deposits/MMDA, Eurodollar deposits, sweep investments, asset/mortgage backed securities, fixed income/bond funds)	32%	28%	26%	25%

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## **Treasury Strategies' Assessment of Current and Proposed Definitions of Cash and Cash Equivalents**

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We understand that FASB is considering the following alternatives to the definition of cash equivalents.

### Alternative 1

Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates (generally, only investments with original maturities of three months or less).

### Alternative 2

Cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and that present insignificant risk of changes in value because of changes in interest rates.

### Comments

We support Alternative 1 (FAS 95's current language) because it provides both clarity and flexibility to corporate investors. However, this definition can lead to continued confusion without further clarifications included in FAS 95, paragraph 9 (states examples of specific investment instruments) and FAS 95, footnote 2 (defines original vs. remaining maturity).

Through work with our corporate clients, we often see companies apply a very narrow definition of cash and cash equivalents. Many corporations and their accounting firms focus on the following three criteria perceived as being the hard line definition of cash equivalents:

- a. Readily convertible to known amounts of cash.
- b. So near their maturity they present insignificant risk of changes in value because of changes in interest rates, and
- c. Only investments with original maturities of three months or less qualify under that definition.

This perception ignores the word "*generally*" in the phrase "generally, only investments with original maturities of three months or less". We believe the "generally" appropriately provides the flexibility to include certain investments whose original maturity is beyond 90-days, but clearly meets the other requirements for this classification.

While we believe that three months is a good guideline for maturity considerations, we do not believe this should be an absolute cutoff. Maturity is



certainly an integral component of measuring an investment's liquidity, but one must also evaluate the credit and liquidity risk associated with the instrument.

We believe the credit ratings assigned to individual securities are currently under-utilized in evaluating the liquidity of an investment. Liquidity is evaluated when assigning a credit rating, and credit rating should impact whether an investment is considered under cash equivalents. We believe that highly rated investments with maturities greater than three months may be classified under cash equivalents, while a lower or non-rated investment with maturity of less than three months may not. Specifically, we believe that the only securities with maturities greater than three months that should be reviewed for inclusion as cash equivalents should have the highest credit ratings from the top two rating agencies (S&P and Moody's).

We believe that Alternative 2 is inadequate because it eliminates any reference to an investment's maturity. While this approach clearly provides additional flexibility to an enterprise, it provides far less clarity to investors, creditors and other outsiders as to the liquidity of the enterprise's cash and cash equivalents.

#### Suggested Changes to FAS 95

To help eliminate confusion, we propose the following additions to current FAS 95 language:

1. Include a more comprehensive list of investment products regarded as cash equivalents as stated in FAS 95, paragraph 9 (see Appendix A).

While we do not suggest the list is finite and exhaustive, we do believe the list should explicitly include or exclude the most controversial investment products – auction rate securities, variable rate demand notes and enhanced cash mutual funds. We know our corporate clients would welcome this clarification, as it would eliminate confusion while still allowing flexibility.

2. Amend footnote 2 to allow investments whose original maturity was in excess of ninety days, to be included as cash and cash equivalents at the point in time that their time to final maturity reaches ninety days or less.

This would account for the liquidity of a security based on its remaining maturity, regardless of what its maturity may have been when the enterprise originally included it in its portfolio. This is consistent with the way in which the financial markets and our securities dealer clients view the liquidity of a fixed-income or money market investment instrument.



## Classification of Commonly Used Treasury Products

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Over the past several years, concerns and debate have arisen about the inclusion of specific investment instruments that are classified as cash and cash equivalents. The most controversial instruments include auction rate securities, variable rate demand notes and enhanced cash money funds.

### Auction Rate Securities

Based on their current structure, Auction Rate Securities (ARS) should not be eligible for inclusion as cash and cash equivalents under FAS 95 (as written or proposed). These instruments are structured with maturities ranging from 10 to 30 years, with no "put" back to the issuer. Thus the structure of the security itself does not provide for liquidity for terms less than the original maturity. This should be the key driver in disallowing them to be classified as cash and cash equivalents.

The floating rate feature made available through the auction process and the associated interest-rate resets help to mitigate the interest-rate risk borne by the investor normally associated with a long-term bond issued with a fixed rate of interest. However, the fact that the auction process provides a source of secondary market liquidity should not be a factor in making the determination as to how to classify these investments. This is consistent with the approach taken with other long-term securities, such as US Treasuries. The highly liquid secondary market for trading 10 to 30-year US Treasuries does not lead to their classification as cash and cash equivalents. The exception lies in instances where their *remaining* maturity would logically place them in this category.

It should also be noted that money market mutual funds, registered under the Investment Company Act of 1940, may not invest in Auction Rate Securities. This is due to the maturity restriction included in SEC Rule 2a-7, which disallows a money market mutual fund from including any investments whose remaining maturity is in excess of 397 days.

### Variable Rate Demand Notes

Subject to the structure of individual issue, variable rate demand notes (VRDN) should qualify as cash and cash equivalents under FAS 95 (as written and as proposed). VRDNs are floating rate instruments whose rate is reset at periodic intervals, usually daily, weekly or monthly. Although VRDNs are structured as long-term bonds with maturities in excess of 10 years, the instrument contains a "put" feature that effectively converts the security to a short-term investment. Referred to as "7-day floaters", the bondholder (investor) has the right to tender the VRDN to a "Tender Agent" through a "Remarketer" or "Remarketing Agent" at par on any interest-rate reset date by providing 7 days advance notice. Thus the structure of the security itself provides liquidity for terms less than the original maturity.



The remarketing agent is generally a bank or other financial institution whose role is to remarket the instrument through the secondary market. The liquidity to repurchase the VRDN is “guaranteed” through a “credit enhancement” feature known as a liquidity back-up facility issued by a bank or other lender. The short-term investment safety and liquidity of the VRDN is dependent upon the credit worthiness (and credit rating) of the issuer of the liquidity back-up facility.

In assessing the appropriateness of a specific VRDN issue for inclusion as cash and cash equivalents, it is critical to consider both the rating of the issue itself and the rating of the financial institution providing the credit enhancement facility. Even though the instrument has a stated maturity well in excess of 90-days, the inclusion of the 7-day “put” feature, in combination with the credit quality of the issue itself should qualify a VRDN to be included as cash and cash equivalents. This is a prudent example of the flexibility provided by the word “generally” in paragraph 8 of FAS 95.

It should also be noted that money market mutual funds, widely considered to be acceptable as cash equivalents, may invest in VRDNs. This is a direct result of the intra-month liquidity provided through the 7-day “put” feature.

#### Enhanced Cash Money Funds

Certain AAA-rated enhanced cash funds should be eligible for inclusion as cash and cash equivalents, while others should not. The funds that should be eligible are those whose properties are similar to the following properties of a 2a-7 money market mutual fund - diversification across issuers, industry sectors and asset classes, stable \$1.00 net asset value (NAV) and generally possessing a weighted average maturity of 90-days or less. The target WAM should be 90-days or less, even-though the fund might be eligible to extend this maturity slightly under certain market conditions.

While same-day liquidity is a benefit, it should not be a requirement for an enhanced cash fund to be included as cash and cash equivalents. Provided the liquidity is made available within a reasonable timeframe, possibly defined as one week or less (e.g. VRDNs are fully liquid with 7-day advance notice), an enhanced cash fund should be considered under cash and cash equivalents.

An AAA-rating by at least one securities ratings agency should also be a requirement. The rating validates that a respected and objective third-party has *evaluated the fund and assigned its highest possible rating, based on a combination of the fund's credit quality, investment guidelines, adherence to prudent investment management practices and overall liquidity.* Requiring a AAA-rating will also help the enterprise differentiate between those enhanced cash funds that may be eligible for inclusion as cash and cash equivalents and those that are not.



## **Additional Considerations**

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Common perception does not appear to take into account paragraph 10 of FAS 95 that requires “an enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 8 shall be treated as cash equivalents”, and “an enterprise shall disclose its policy for determining which items are treated as cash equivalents.” From the perspective of an investor, creditor or other outsider viewing the enterprise’s financial statements, while the verbiage in paragraph 8 provides the enterprise with limited flexibility, compliance with paragraph 10 provides full disclosure as to the policies surrounding the reporting of cash and cash equivalents.

Taking paragraph 10 into account, it would be totally appropriate for an enterprise to include under cash and cash equivalents a highly liquid investment with an original maturity of 100 days, provided that it is consistent with the enterprise’s established policy and fully disclosed on the enterprise’s financial statements. An example of this type of investment might be the AAA-rated “enhanced cash” money funds that have become popular over the last five years. These funds operate slightly beyond the guidelines of SEC rule 2a-7 that governs money market mutual funds, but are considered highly liquid by the Nationally Recognized Statistical Rating Organization (NRSRO) that assigns these funds their AAA rating (Moody’s, Standard and Poor, or Fitch).

In a situation where the enterprise chooses to include certain investments that are outside the 90-day maturity line, but still considered to be highly liquid by investment industry standards, and provided the investment is consistent with the enterprise’s established policy, both the enterprise and the audit firm should be comfortable with its inclusion. Among the means available to determine if an investment is considered to be highly liquid by industry standards is to rely on the analytical process used by and credibility associated with the NRSRO that issued the investment product its rating. In the example alluded to above, the NRSRO subjects a pooled investment vehicle to a collection of criteria designed to validate both the credit quality and liquidity of the investment vehicle.



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## **Conclusion**

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With some minor modifications, we believe the definition of cash and cash equivalents as stated in FAS 95 will provide clear guidance to practitioners tasked with classifying investments for financial reporting purposes. The aforementioned modifications provide needed clarity in areas that had been subject to misinterpretation.

As FASB continues its joint efforts with the IASB to standardize financial statements, it is critical that areas of ambiguity be properly addressed. Addressing these types of issues in advance of this joint work, will facilitate congruence between the FASB and IASB efforts.

Again, we appreciate the opportunity to provide our comments to the FASB. As corporate liquidity is a key area of focus for us and our clients, we look forward to continued participation in issues that have a meaningful impact on the market. If you have any questions or would like further information, please contact us at 312.443.0840 or [Mike\\_Gallanis@TreasuryStrategies.com](mailto:Mike_Gallanis@TreasuryStrategies.com) or [Jeff\\_Avers@TreasuryStrategies.com](mailto:Jeff_Avers@TreasuryStrategies.com).

Sincerely,



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Partner



Jeffrey P. Avers  
Managing Director



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## **Appendix A: Excerpt from FASB 95**

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The following is an excerpt from FAS 95, wherein paragraphs 8, 9 and 10 serve as the definition of Cash and Cash Equivalents:

8. For the purposes of this Statement, cash equivalents are short-term highly liquid investments that are both:
  - a. Readily convertible to known amounts of cash
  - b. So near their maturity they present insignificant risk of changes in value because of changes in interest rates.

*Generally*, only investments with original maturities of three months or less qualify under that definition.

9. Examples of items commonly considered to be cash equivalents include Treasury bills, commercial paper, money market funds, and federal funds sold. Cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing and financing activities, and details of those transactions need not be reported in a statement of cash flows.
10. Not all investments that qualify are required to be treated as cash and cash equivalents. An enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 8 shall be treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash and cash equivalents. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be affected by restating financial statements for earlier years presented for comparative purposes.



Footnote 2: *Original maturity* means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury bill purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.

## **Appendix B: About Treasury Strategies, Inc.**

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Founded in 1982, Treasury Strategies, Inc. is a client-focused management consulting firm serving corporations, public sector organizations and financial institutions. As a thought leader in treasury, liquidity, payments and working capital management, we develop customized and actionable solutions unparalleled in the marketplace.

