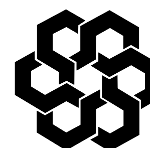

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **22 March 2007, London**

Project: **Financial Statement Presentation**

Subject: **Cash equivalents (Agenda Paper 9C)**

INTRODUCTION

1. The purpose of the March meetings on financial statement presentation is to discuss the continued use, definition, and presentation of cash equivalents. The Boards initially discussed various alternatives for defining *cash equivalents* in their July 2006 meetings related to deciding how to define *treasury assets* (now referred to as *financing assets*). At those meetings, the Boards concluded that:
    a. Treasury assets would include all financial assets (including cash and cash equivalents as currently defined)
    b. Bank overdrafts should be excluded from cash and cash equivalents
    c. The caption "cash and cash equivalents" should be presented separately in the financing section.

The Boards expressed interest in modifying the definition of cash equivalents and asked the staff to bring that issue for discussion at a future meeting.

OUTLINE OF ISSUES

Issue 1–Should the notion of *cash equivalents* be retained in financial statement presentation?

Issue 2–If the Boards retain *cash equivalents*, how should they be defined?

Issue 2a–What should be the defining characteristics of *cash equivalents*?
Issue 2b–Should the *cash equivalents* definition be dynamic?

BACKGROUND

2. *Cash equivalents* are currently defined similarly by both U.S. GAAP and IFRS in their standards on the statement of cash flows. FASB Statement No. 95, *Statement of Cash Flows*, was issued in 1987 in an attempt to standardize the practice that had evolved under the funds statement and a 1981 recommendation from the Financial Executives Institute to its members to concentrate their funds statements on cash and short-term investments.

3. The concept of cash equivalents was introduced in the exposure draft that preceded Statement 95 "to accommodate common practices in the investment of cash in excess of immediate needs," noting that "it may matter very little for users' assessments of future cash flows whether cash is on hand, on deposit, or invested in short-term highly liquid investments."[1] The fact that the concept of cash equivalents was introduced to be responsive to management's perspective on its cash resources is important in considering any revisions to the concept of cash equivalents.

4. Statement 95 defines *cash equivalents* as "short-term, highly liquid investments that are both (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. Generally, only investments with original maturities of three months or less qualify under that definition." *Original maturity*, as defined in Statement 95, means original maturity to the entity holding the investment. Statement 95 also notes that:

> Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those

[1] FASB's Proposed Statement of Financial Accounting Standards, *Statement of Cash Flows*, issued July 31, 1986

> 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. (Statement 95, paragraph 9)

5. IAS 7, *Cash Flow Statements*, paragraph 6, defines *cash equivalents* as "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value," and goes on to note that:

> Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date. (IAS 7, paragraph 7.)

6. Banks and other financial institutions commonly carry instruments in their trading and investment accounts that could be classified as cash equivalents. Thus, both Statement 95 and IAS 7 provided some flexibility to entities regarding the classification of instruments of this nature, and accordingly, require an entity to disclose its policy for determining which items are treated as cash equivalents.[2]

7. Over the last few years, the United States has seen significant activity in the financial reporting community with respect to the cash equivalents classification. Several public companies reclassified certain types of securities out of cash equivalents because of concern over whether the underlying maturities of the securities met the definition of a cash equivalent in Statement 95. These securities include auction rate notes and variable-rate demand notes, as described further below.

    a. Auction rate notes (ARNs) are long-term variable rate bonds tied to short-term interest rates that are reset through a "Dutch auction" process which occurs every 7-35 days. The holder can participate in the auction and liquidate the auction rate securities to prospective buyers through their broker/dealer. The structure of the

[2] Statement 95, paragraph 10, and IAS 7, paragraph 46.

security itself does not provide for liquidity in terms less than the original maturity. The auction process, facilitated by major investment banks acting as auction agents, is a source of secondary market liquidity. In early 2005, many large public accounting firms began to caution clients that ARNs may not qualify as cash equivalents under Statement 95 due to the long maturities of the underlying debt instruments. In March 2005, the U.S. SEC's Division of Corporation Finance included the following guidance in its Current Accounting and Disclosures Issues:

> Auction rate securities are considered highly liquid by market participants because of the auction process. However, because the auction rate securities have long-term maturity dates and there is no guarantee the holder will be able to liquidate its holdings, these securities do not meet the definition of cash equivalents in paragraphs 8 and 9 of SFAS 95. Registrants should refer to SFAS 115 to determine the proper accounting and SFAS 95 to determine the proper classification on the Statement of Cash Flows. To determine if the auction rate securities should be presented on the balance sheet as current or noncurrent assets, registrants should refer to ARB No. 43, Chapter 3A, *Working Capital – Current Assets and Current Liabilities*.

b. Variable Rate Demand Notes (VRDNs) are long-term bonds whose rates are reset at periodic intervals. Although the bonds are structured with maturities often in excess of ten years, they contain a "put" feature, whereby the investor can put the security upon a seven-day notice. A remarketing agent (a bank or other entity) will purchase the notes for par plus accrued interest and attempt to resell them. If they cannot sell the notes, the remarketing agent holds them in their inventory. While the put feature does not allow the holder to receive liquidity from the issuer, the put] is a feature of the security itself. The liquidity is not provided to the holder based on the results of a secondary market.

   While variable rate demand notes contain a put feature in the instrument itself, the SEC staff and many audit firms believe that variable rate demand notes are also not cash equivalents because the liquidity feature in the instrument (that is, the put) is not to the issuer, but rather to a remarketing agent.

8. Many preparers disagree with these views on the basis that the SEC and the audit firms ignore the word "generally" in paragraph 8 of Statement 95: "**Generally**, only investments with original maturities of three months or less qualify under that definition."

(Footnote reference deleted.) The preparers believe that three months was not intended to be a bright line, but rather was based on common cash management instruments at the time, and was a reflection of the types of instruments that would meet the other characteristics of cash equivalents. Cash management practices and the financial markets have evolved since then, but using three months as a bright line does not take that evolution into account. Absent the "three months" criteria, some preparers believe that both ARNs and VRDNs meet the other criteria for cash equivalent classification, and they use them as such in their cash management programs.

9. Those who do not believe that ARNs and VRDNs are cash equivalents point to the fact that the short-term liquidity associated with these instruments does not come from the issuer of the instrument, but rather from the auction market or a remarketing agent, respectively. Supporters of classifying ARNs and VRDNs as cash equivalents note that Statement 95 does not refer to the maturity of the underlying instrument, so this consideration should not be relevant to the analysis.

10. The staff is not asking either Board to address the definition of cash. The staff proposes to retain the current definition of cash, which is defined similarly in Statement 95 and IAS 7 as currency on hand and demand deposits with banks and other financial institutions. Statement 95 also notes that "cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty"(paragraph 7, footnote 1).

ISSUE 1: SHOULD CASH EQUIVALENTS BE RETAINED IN THE FINANCIAL STATEMENTS?

11. In the papers for the July 2006 meetings, the staff presented alternatives for defining *treasury assets*. An integral part of those alternatives was the definition of *cash equivalents*. Board members expressed an interest in the proposed changes to the definition of cash equivalents and asked the staff the research the issue further.

12. In researching this issue, the staff received informal comments from preparers and had discussions with users of financial statements (members of the Joint International Group

and the FASB's Investors Technical Advisory Group ("ITAC")). As a result of these comments and discussions, the staff is asking the Boards to consider whether "cash equivalents" as a financial statement line item is relevant and should be retained in financial reporting. The Boards' decision would apply to both the statement of financial position and the statement of cash flows. In other words, the statement of cash flows would reconcile cash only, and not "cash and cash equivalents."

Alternative 1: *Cash equivalents* should be retained, but the Boards should reconsider its definition.

Alternative 2: *Cash equivalents* should no longer be a financial statement caption. The statement of **cash** flows should provide information on movements of **cash** only.

Analysis of Alternatives

Alternative 1: Retain Cash Equivalents Concept

13. Proponents of Alternative 1 believe that the cash equivalents caption can, with appropriate changes to the definition, provide important liquidity information. Cash equivalents serves as a useful indicator of an entity's liquid resources that is easily identifiable on the balance sheet, as opposed to reviewing detailed footnotes to determine the relative liquidity of an entity's short-term investments.

14. Opponents of Alternative 1 note that cash equivalents currently do not present accurate liquidity information because they are constrained by the original maturity to the purchaser. It is possible to have short-term investments that are more liquid than some cash equivalents. (Issue 2b addresses whether the original maturity constraint should be removed.)

15. Proponents of Alternative 1 note that, as discussed above, the concept of cash equivalents was introduced in the U.S. in Statement 95 in response to comments from constituents that their cash management programs consisted of more than demand deposits. The Board responded by identifying a class of highly-liquid investments that was "readily convertible to cash" and that "presented insignificant risk of changes in value due to changes in interest rates."

16. Some proponents of Alternative 1 believe that cash equivalents should only be retained if there are significant changes to the current definition. They do not believe that the "bright line" of original maturities of three months or less that has been interpreted in current practice is adequate, and that more information on the liquidity of the investment is required to determine the appropriate classification. These proponents point to the discussion of ARNs and VRDNs as an illustration of that fact.

Alternative 2: Eliminate Cash Equivalents Concept

17. Proponents of Alternative 2 believe that any definition of cash equivalents will always include an arbitrary bright line or will require so much judgment to implement that the line item will not be comparable from one entity to the next. They also believe that it will be difficult to arrive at an appropriate consensus definition. Such was the case in 1996 when the United Kingdom Accounting Standards Board (UK ASB) revised its standard on cash flow statements (Financial Reporting Standard 1 (revised 1996), *Cash Flow Statements*) to focus on movements in cash rather than cash and cash equivalents. The UK ASB noted that:

    > the [cash equivalents] definition was criticized as not reflecting the way in which businesses were managed: in particular, the requirement that to be a cash equivalent and investment had to be within three months of maturity when acquired was considered unrealistic.

18. Proponents of Alternative 2 believe that the presentation of "cash and cash equivalents" in financial statements groups dissimilar items, for example, demand deposits and debt securities. Some users have noted that this grouping is not useful for financial analysis, as there is always a level of uncertainty on the part of users with respect to the components of cash equivalents.

19. Proponents of Alternative 2 believe that eliminating cash equivalents and requiring additional disclosures in the notes to the financial statements would result in more useful information about an entity's liquidity and financial position than the cash equivalents caption currently provides. [If the Boards agree to eliminate the cash equivalents concept, the staff will include disclosures related to this aspect of an entity's liquidity position in its broader research on presentation of liquidity information (a follow on to the meetings held in February regarding liquidity.)]

Staff Recommendation (Issue 1)

20. The staff recommends that the concept of cash equivalents be eliminated (Alternative 2), because the staff believes that it is not possible to develop a definition of cash equivalents that will meet the needs of users of financial statements without being overly burdensome on preparers. In addition, the cash equivalents caption does not necessarily advance the working principle that the "financial statements should present information in a manner that helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash or time to conversion to cash)." Under the current definition of *cash equivalents*, it is possible to have short-term investments that are more liquid (that is, closer to maturity) than a cash equivalent. The staff is of the view that presenting what are now cash equivalents in the statement of financial position as short-term investments will provide users with the same, if not more, liquidity information than what they receive today. In addition, based on the Boards' leanings, some entities (for example, financial institutions) will be required to present detailed maturity information about their short-term investments, thus possibly even more information will be provided than if the concept of cash equivalents was retained (even with a modified definition).

21. Based on the staff recommendation to eliminate the concept of cash equivalents, the statement of cash flows would present only flows related to cash; items currently classified as cash equivalents would be classified in the same manner as other short-term investments.

Question for the Boards

1. Should the concept of cash equivalents be retained?

ISSUE 2 – DEFINITION OF CASH EQUIVALENTS

22. If the Boards agree to retain the concept of cash equivalents under Issue 1, then the staff will ask the Boards to address the definition of cash equivalents. The staff will discuss this issue in two parts:

    a. What should be the defining characteristics of cash equivalents?
    b. Should the cash equivalents definition be dynamic, that is, should the criteria for cash equivalents be reassessed at each reporting date?

Issue 2a: The Defining Characteristics of Cash Equivalents

23. The staff developed the following four alternatives for the definition of cash equivalents (underlined terms are defined in paragraph 24):

    a. **Alternative 1:** Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and that have contractual maturities of three months or less.

    b. **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.

    c. **Alternative 3:** Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and present insignificant risk of changes in value because of changes in interest rates. There is a presumption that only investments with contractual maturities of three months or less meet these criteria. Investments with effective maturities of one year or less may overcome this presumption provided that they have investment-grade ratings from at least two nationally or internationally recognized credit ratings agencies. In the United States, for example, such agencies would be the Nationally Recognized Statistical Ratings Organizations (NRSROs), as determined by the U.S. Securities and Exchange Commission from time to time.

    d. **Alternative 4:** Cash equivalents are any highly liquid investments that are readily convertible to known amounts of cash and are used by management as a part of its cash management program.

24. The staff notes that in all the alternatives above, investments in equity securities are excluded from cash equivalents, unless they are, in substance, cash equivalents (for example, preferred shares acquired within a short period of their maturity and with a specified redemption date).

25. The underlined terms used in the alternatives above are defined as follows (Exhibit A includes a summary of the alternatives and their key features):

a. Contractual maturity relates to the maturity from the perspective of the issuer of the instrument. (Issue 2b will address the type of maturity, for example, "maturity from the date of acquisition" or "maturity from the reporting date.")

b. In order to be a highly liquid investment, an entity must have the ability (and intent) to sell the investment in an active market and convert it to cash within a normal settlement period.

c. An instrument has insignificant risk of changes in value from changes in interest rates when it has either a variable interest rate based on a recognized index (for example, the prime rate or LIBOR) or a fixed interest rate and an effective maturity of less than 3 months.

d. Effective maturity is the point at which it is probable that the investor could realize their investment in cash. ("Probable" is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies*: "the future event or events are likely to occur.")

Analysis of Alternatives

Alternative 1

26. Alternative 1 is similar to the current definition of cash equivalents, but contains a "brighter" line. That is, it specifies that only contractual maturities greater than three months are cash equivalents. For example, an ARN with 30 years to maturity would not be a cash equivalent even if it was probable that the holder could liquidate the investment in the next auction. On the other hand, a Treasury bill that matures in two months would be a cash equivalent. This definition does not consider an entity's ability to liquidate an investment in the market prior to its maturity for the purpose of being a cash equivalent.

27. Proponents of Alternative 1 believe that a strict and unambiguous definition of cash equivalents will promote consistency and comparability across entities to better facilitate a user's analysis. If the concept of cash equivalents is retained, users want to be certain that they understand what the term means and what a given entity's cash equivalents consist of.

28. Opponents of Alternative 1 believe that such a narrow and restrictive definition is practically useless for financial reporting purposes because there are not very many attractive cash management options that would qualify as cash equivalents under this definition.

Alternative 2

29. Alternative 2 is a broader definition of cash equivalents and places more emphasis on liquidity through market mechanisms. It requires an entity to be able to sell the security in an active market, as well as to have the intent to do so if necessary. For example, held-to-maturity securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, would not qualify because the entity has declared a contrary intent through that classification.

30. Alternative 2 introduces the concept of an effective maturity, under which ARNs and VRDNs could be classified as cash equivalents. The auction and put features of those instruments, respectively, would be an example of an effective maturity as contemplated for Alternative 2.

31. Proponents of Alternative 2 believe that it is an appropriate balance between a principle (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) and operational specificity (ability and intent to sell in an active market; variable or short-term fixed interest rates to address changes in value; and effective maturities of less than three months, which introduces probability into the market mechanism through which an entity can obtain liquidity). Proponents also believe that this definition will allow many common cash management instruments to be classified as cash equivalents.

Alternative 3

32. Alternative 3 introduces the concept of credit quality into the evaluation of whether an instrument is a cash equivalent. Many users believe that, in addition to maturity and liquidity, credit quality is an important characteristic to consider in defining a cash equivalent. They note that under the current guidance, a junk-rated bond with 85 days to maturity is a cash equivalent, while an Aaa-rated bond with 95 days to maturity is not. They believe that this answer is counterintuitive given the significant difference in the credit qualities of these instruments.

Alternative 4

33. Alternative 4 is based on a management approach. As discussed above, the concept of cash equivalents was introduced in Statement 95 to accommodate common cash management practices at the time. Under Alternative 4, an entity would classify instruments as cash equivalents that it considers to be the functional equivalent of cash, that is, instruments that the entity manages in order to fund its operations on a current basis, regardless of the nature of the instrument.

34. Proponents of Alternative 4 note that this approach is consistent with the Boards' agreed upon approach for classifying assets and liabilities as operating, investing, or financing—that is, based on how an entity manages its business. Opponents of such an approach believe that it is not in the best interests of users, as it will not promote transparent financial reporting.

Staff Recommendation (Issue 2a)

35. The staff recommends Alternative 2, because the staff believes that definition effectively captures the intent of Statement 95 and permits many of today's common cash management practices to be reflected as cash equivalents.

Question for Boards

2a. What should be the defining characteristics of cash equivalents?

Issue 2b: Should the Cash Equivalents Definition Be Dynamic?

36. Paragraphs 7 and 8 of IAS 7 and Statement 95, respectively, require an instrument to be classified as either a cash equivalent or an investment at the date it is acquired based on the "maturity . . . from the date of acquisition" or the "original maturity to the entity holding the investment." This initial classification does not change with time, as noted in Statement 95 (footnote 2 to paragraph 8):

> For example, both a three-month U.S. Treasury bill and a three-year Treasury note 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.

37. As a result, it is possible to have short-term investments that are more liquid (or, closer to maturity) than a cash equivalent under the current definition of *cash equivalents*. One could argue that an entity should be required to reassess its cash equivalents at each reporting date. However, it is helpful to remember that *cash equivalents* was introduced for the purposes of a cash **flow** statement. If remaining maturities from the reporting date was used in the definition of *cash equivalents* instead of original maturities, cash flow statements would present inflows of cash that were solely due to the passage of time. If that was the case, the cash flow statement would reflect flows of cash when the entity did not necessarily generate any additional cash. Thus, reconsidering the concept of original maturity requires a reconsideration of the cash flow statement. The following paragraphs analyze the two possible alternatives.

38. Under **Alternative 1**, **the current concept of original maturity/maturity from date of acquisition would be retained**. Proponents of Alternative 1 argue that this approach is most in line with the concept of cash equivalents as a reflection of cash management programs. The objective of these programs is generally to earn interest on temporarily idle funds rather than to put capital at risk. Accordingly, items that are purchased for such purposes and qualify as cash equivalents should be assessed at that point, and not re-assessed in the future. In addition, continually re-assessing the classification of these instruments based solely on the passage of time would make the statement of cash flows unnecessarily confusing and difficult for management to prepare and for users to analyze.

39. Under **Alternative 2**, **the maturities of an entity's investments would be re-assessed at each reporting date**. Proponents of Alternative 2 believe that the cash equivalents caption is also an indicator of liquidity, so it should reflect the next most liquid items after cash on the statement of financial position. Under Alternative 1, there could be short-term investments that are closer to maturity than some cash equivalents.

40. If the Boards' preference is Alternative 2, then the staff will ask them to consider the impact on the cash flow statement. That is, how should a reassessment of the cash equivalents category be reflected on the cash flow statement? Possible solutions would be to focus only on cash in the cash flow statement, or to permit presentation of net activity with respect to maturing short-term investments that become cash equivalents.

Staff Recommendation (Issue 2b)

41. Based on its recommendation for Issue 2a, the staff recommends Alternative 1 for Issue 2b, to retain the current concept of original maturity from the date of acquisition. In Statement 95, the FASB noted "that the objective of enterprises' cash management programs generally is to earn interest on temporarily idle funds rather than to put capital at risk in the hope of benefiting from favorable price changes that may result from changes in interest rates or other factors." The staff believes that the combination of its recommendations for Issues 2a and 2b faithfully represent in the financial statements this objective of entities' cash management programs. Instruments purchased with longer original maturities are perhaps more of an investment with capital at risk, rather than generating additional interest income on idle funds.

Question for Boards

2b: Should the current concept of original maturity from the date of acquisition be retained in the definition of cash equivalents?

The following table summarizes the key features of the alternatives under Issue 2a (paragraphs 23-25).

	Alternative 1	**Alternative 2**	**Alternative 3**	**Alternative 4**
Text	Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and that have contractual maturities of three months or less.	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.	Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and present insignificant risk of changes in value because of changes in interest rates. There is a presumption that only investments with contractual maturities of three months or less meet these criteria. Investments with effective maturities of one year or less may overcome this presumption provided that they have investment-grade ratings from at least two nationally or internationally recognized credit ratings agencies.	Cash equivalents are any highly liquid investments that are readily convertible to known amounts of cash and are used by management as a part of its cash management program.
Key features	A "bright line" approach – only securities that contractually mature within three months qualify as cash equivalents.	Permits liquidity from market interactions to be considered in the classification.	Presumption that only Alt. 1 items are cash equivalents, but permits securities with longer effective maturities, but high credit quality, to be considered cash equivalents.	Based on a management approach, that is, items considered by management liquid and available for use in operations are cash equivalents.