

1757

NAV OF MUTUAL FUNDS

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The small investors for whom mutual funds emerged as an alternative investment avenue, talk of NAV probably without knowing what it represents, how it is calculated and what are its implications. In this article the author has explained the concept of Net Asset Value, its computation and accounting policies relevant to such computation.

In mutual fund literature Net Asset Value (NAV) is the most common concept to be used and for any one concerned with mutual fund it is most sought after criterion for making decision. It is an indicator of the capital appreciation of the funds under a scheme. It is as important as earnings per share (EPS) is to a shareholder. NAV, meant to be an indicator of the 'worth' of a mutual fund scheme, is the composite of the value of its net portfolio divided by the number of units outstanding.

Computation of NAV

SEBI, an agency to protect investors interest, requires every scheme to declare NAV at regular intervals and to communicate it to investors at desired intervals. How NAV is to be calculated has not been specified till now but the only requirement in this regard has been to get the NAV formula approved from SEBI. It implies that different mutual funds can follow different formula to compute NAV. Despite it, the ingredients of NAV calculations are the same. There are two approaches for NAV. One is based on assets of the scheme, other is based on capital of the scheme. In the former case the market value of investment or cost of investments alongwith the net unrealised gains on investments and accrued incomes are reduced by liabilities and resultant is divided by outstanding number of units. In the later case, to the capital and reserves and surpluses, appreciation of all listed and unlisted securities is added alongwith net revenue, after providing for issue expenses and other operational expenses and resultant is divided by number of units.

'Unit Trust of India' computes NAV as (unit capital + Reserves + Surplus + Net appreciation of all listed and unlisted securities + All interest and dividend income) - (Amortisation of issue expenses + stamp fee + handling charges)/outstanding units. On the other hand 'Morgan Stanley' in their circulars has been computing NAV following both the methods i.e.

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- (i)
$$\frac{\text{Value of assets} + \text{Net unrealised gains} - \text{Liabilities}}{\text{No. of outstanding units}}$$
- (ii)
$$\frac{\text{Capital} + \text{Net Unrealised gains} - \text{Issue cost} + \text{Net revenue}}{\text{No. of units outstanding}}$$

Such NAV to a great extent is influenced by valuation method of securities and accounting policies of mutual funds which matter most in determining the numerator of NAV formula. How it happens is discussed in the following paras.

Valuation Methods

In both situations valuation method of securities, play a significant role. There are variety of valuation basis, viz. cost price, fair price, highest/lowest/ mid market price, yield to maturity etc. As the adopted method varies NAV also varies. There is no hard and fast rule as to adherence to any method neither there is any bar on change of method once adopted. Some bank sponsored mutual funds undertake valuation as per RBI norms. The 'accounting policies' (disclosed in Annual Report) of Can Bank Mutual Fund disclose that their fixed income securities like non-convertible debentures or public sector bonds are valued on the lower of the cost or marked down value based on the expected Yield to Maturity (YTM). They also add back to this value the accrued interest. But 20th century Assets Management Company' favours adjusting bond values periodically for interest rate movements to ensure more realistic NAV of their scheme. 'Canbank Mutual Fund' values money market obligations at book value whereas 'SBI Mutual Fund' values these at latest available market price. SBI Mutual Fund is of the opinion that since YTM is a measure of inherent internal rate of return of the security, it is not suitable for NAV. They use latest available market prices which are real indicator of value of debt securities.

Valuing unquoted securities also differs from fund to fund. UTI values unquoted debentures, bonds and preference shares at lower of cost or marked down cost calculating at the current rate of yield. Canbank Mutual Fund values unquoted shares lower of cost and book value. SBI mutual fund value such shares at cost. In such case U.S. practice may be followed where independent quotation for such scrips are invited from different merchant bankers and the least quotation forms the basis of valuation. It is the most crucial part of investment which urgently needs spelling out valuation norms.

On face of it quoted securities should not pose a problem for valuation but here again practice differs. 'PNB Mutual Funds' values their investments, at lower of cost of market price. Canbank Mutual Fund takes such securities at year end closing market rates. But those investments which have not been traded for a period of one month prior to Balance Sheet date are taken at a fair valuation so as to reflect their realisable value. UTI also takes quoted

securities at year end market rate. Year end market rate is of course required but problem arises as to which market rate on the last day. There can be three alternatives — highest rate, lowest rate, mid market rate. Choice of out of these three is very crucial. Following principle of conservatism lowest rate should be acceptable. Lowest rates will maintain NAV at lower ebb thus, atleast for open ended schemes where repurchase at NAV is frequent, cash outflow will be lesser. Further, such practice is more nearer to reality as what actually is realisable on sale of securities is further reduced by brokerage etc. which is not taken as such while valuating. In case of fully convertible debentures which are normally valued on market prices some resort to discounting as to the dividend element whereas others may not.

Another typical item which may pose problem is warrants in the portfolio of mutual funds. Quoted share warrants can be valued at market rates if the option to exercise right against warrants has a price less than market price. Problem may arise if the situation is otherwise. Unquoted share warrants may be taken at the market rate or fair rate of the relevant shares as reduced by the cost of acquisition payable. In case cost of acquisition is more than the market rates then the value of warrants is taken as Nil. Thus comparing NAV, investor has to consider which method is adopted by the mutual fund in question since there is hardly a parity in these methods.

Accounting Policies

Besides valuation, the accounting policies adopted by mutual funds also influence the NAV since profits shown by current years 'Revenue Account' is also considered for computing NAV. One point which is most crucial is revenue recognition. Expenses can be accounted for on an accrual basis or cash basis. Normally mutual funds treat these on accrual basis. But on expense side there are items which have diversities in their treatment and accordingly influence NAV. One important item is treatment of initial issue expenses which are capitalised by all but amortised differently. In some mutual funds the practice is to spread such expenses throughout the life span of a scheme whereas others charge it to first three to five years. SBIMF amortises it over life of the scheme whereas Morgan Stanley is to recover in first 5 years for its 15 years scheme. Some mutual funds may like to associate amortisation with total revenue earnings of the year say 3 per cent. If amortisation in initial years is higher it will be beneficial for investors who hold with for longer period. Another point is capitalisation of expenses like brokerage. SBIMF records purchase of investments at cost net of brokerage whereas Canbank Mutual Fund accounts the investments at cost including brokerage. Still another point is provision for depreciation (when aggregate cost of investment exceeds their aggregate market value). SEBI (MF) Regulations require a mutual fund to provide for such provision before declaring any dividend. This implies that for the schemes not paying dividends such provisions are not obligatory. Thus their NAV will certainly be higher than a similar scheme paying dividends. Whereas in both cases

at least pre-dividend NAV should be the same, since payment of dividends requires for providing depreciation which brings down the NAV. Morgan Stanley Growth Fund did not provide for such depreciation in its first Annual Revenue Account, which comes to Rs. 0.72 per unit in contrast to Net income of Rs. 0.03 per unit. -

Similarly items of income which influence the NAV also have varied accounting treatment making NAV uncomparable. Dividend may be recorded by mutual funds either on accrual basis or realisation basis. Most prudent practice is to account for these on realisation basis since conceptually like interests, dividends cannot be easily ascertained on accrual basis. This is why SBIMF changed its accounting policy (upto 1992-93), followed for recognition of dividend income from accrual basis to realisation basis (during 1993-94). Morgan Stanley recognised dividends on accrual basis for the year 1994-95.

Canbank Mutual Fund in 1994-95 accounted for dividend on ex-dividend date whereas as per 1993-94 balance sheet dividend was accounted when realised. PNB Mutual Fund also accrues dividend on shares when the concerned share is quoted ex-dividend. Such practice is followed on the logic that on ex-dividend rate the price of share is adjusted automatically which is considered while taking valuation of that share. Interests on investments are generally accounted on accrual basis which is logical since coupon rate as well as time framework of debt is certain.

By virtue of firm allotment of shares to mutual funds, they are now earning 'fund-end fee' which can be put to different accounting treatments. This fee can be considered as an income of the year increasing net revenue of the year. Another alternative is deducting such fee from the cost of securities; thus effect on revenue is postponed. Like valuation, there are constant changes in income and expenses regularly. Thus their monitoring, recording and treatment has to be spelled out clearly so that frequent (daily, hourly-etc.) disclosures of NAV is reliable and comparable.

Thus investors in mutual fund are to be clear in their mind that a value of NAV differs as practice of valuation and accounting treatment differ. It is important since the offer price and bid price are also based on the declared NAV. The offer price is NAV - Load Charges (back end load as some percentage of NAV). Buy back price is also based on NAV of the scheme. One very obvious feature of NAV is that if dividend is declared NAV consequently decreases; that is why to have NAV on upper side for growth oriented schemes fund managers hesitate to declare any dividend. Quoting of units at discount to NAV does not mean that intrinsic value of scheme has lowered. Such discounting is on account of market features like demand and supply and speculative instinct. Closed end scheme holders if emerge as long term investors, the gap in NAV and market price will reduce. Quoting of close end scheme at discount to NAV is a universal experience but still SEBI should implement the recommendations of L.C. Gupta Committee at the earliest possible to make NAV more transparent and reliable for investors.