BY DEFINITION . . .

WILL REFORMED MMFs BE DEEMED CASH OR CASH EQUIVALENTS UNDER INTERNATIONAL ACCOUNTING STANDARDS? REYER J KOOY LOOKS AT THE DETAIL

As Europe prepares for money market fund (MMF) reform, it looks probable that most prime funds will convert to the new low-volatility net asset value (LVNAV) structure. Treasurers and other investors have indicated strong interest in LVNAVs, which will be similar in most respects to today's constant NAV (CNAV) funds – offering security, liquidity and yield, with some welcome additional features, such as greater diversification.

But will LVNAVs be considered 'cash and cash equivalents' for accounting purposes, as prime funds usually are? A decision on this question will matter to treasurers, but it will likely be accountants who ultimately determine how LVNAVs will be treated on balance sheets, generally on a company-by-company basis.

Revisiting definitions

To help treasurers prepare for future discussions, it is useful to examine the likely real-world characteristics of LVNAVs in light of the formal definition of cash equivalence. According to the International Accounting Standards (IAS), cash equivalents are "short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of change in value". Will LVNAVs fit the bill?

'Short term' – Like CNAV funds today, LVNAVs will be formally defined as short term. The criteria for this are the existing European regulatory guidelines, which include having a weighted-average maturity of 60 days or less, and a weighted-average life of 120 days or less.

'Highly liquid investments' – Our expectation is that LVNAVs will be extremely liquid – so much so that returns will be somewhat constrained relative to today's prime funds. This is because LVNAVs will be subject to stricter liquidity rules, aimed at ensuring they can always convert sufficient assets into cash to meet investors' withdrawal requests.

'Readily convertible' – To slow redemptions in times of market stress, LVNAVs are permitted to impose fees and gates, which may clearly affect how 'readily convertible' an investment may be. The conditions in which LVNAVs may impose restrictions include weekly liquidity falling below 30% and daily net redemptions exceeding 10%. Of course, prime funds can already impose restrictions. LVNAVs will be slightly more conservative than they are, so we expect a low likelihood of gates being imposed.

'To a known amount of cash' – Under a 1.00/share approach, investors have usually felt confident they could redeem their holdings for an amount that was 'known'. In reality, CNAV funds have always had the potential to switch to variable pricing — just as LVNAVs will. The difference is that LVNAVs will be subject to stricter limits governing when they can offer constant pricing. However, our analysis suggests LVNAVs should be able to offer constant share prices in all but the most extreme circumstances.

'Subject to an insignificant risk of changes in value' – Whether or not a risk is 'insignificant' is clearly a matter of judgement, but it is important to understand how the value of an LVNAV is calculated. LVNAVs must use mark-to-market accounting to value assets with residual maturities greater than 75 days, and to value any individual asset if its market price differs by more than 10 basis points from its amortised cost value. Currently, prime funds use amortised cost accounting for all of their assets. The new approach will make LVNAVs' net asset values less predictably linear, but we expect the variations in NAV to be small.

Taking a view

From a portfolio manager's perspective, an examination of the IAS definition of cash equivalence reveals similarities between today's CNAVs and LVNAVs. However, as noted earlier, it will likely be up to accountants to determine whether LVNAVs are sufficiently 'cash-like'.

Moreover, the IAS definition is not the only yardstick used to determine cash equivalence. There are typically two other methods: looking through to the underlying investments (which, again, will be slightly more conservative for LVNAVs); and by considering the intended use of the holding – whether it is being used as cash or for investment purposes. The latter will clearly be a case-by-case determination.

Ultimately, we expect LVNAVs to form an important part of treasurers' cash management strategies. And, ascertaining the continued cash equivalence of MMFs is an important step in preparing thoroughly for the new MMF regime. Speaking to a fund provider about the likely real-world characteristics of LVNAVs may be useful in this regard.

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