

# Standing of the Treasury Flows – Indirect Method

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## Abstract

*Any economic company or entity is regarded as a system which exists and operates based on the relations it has with third parties (creditors, debtors, state budget, investors), relations which take shape in the form of patrimonial flows. Irrespective of the size of the business of an economic entity, the users of accounting information are interested only when the company has liquidities, in order to recover investments or debts.*

*The capacity of a company to generate cash is reflected in financial standing, titled table of treasury flows (standing of treasury flows as it is named in the International Accounting Standard). This indicator includes elements generated by the types of activities of a company, thus providing a link between the analysis of financial results and the analysis of economic results.*

**Key words:** *treasury, accounting data, international standard, profit and loss account, balance sheet*

**JEL Classification:** *M41*

## Introduction

Drawing up the treasury assists the company in controlling the existing balance between internal and external financing, thus providing its continuity and being able to control short term solvency and long term financing needs. At the same time, the data contained in the standing of cash flows offers users the possibility to assess entity's capacity of generating cash, as well as the mode in which these assets are used to provide the payments required by the safety of the continuity of exploitation, investment and financial operations. Thus, entity's financial position, established according to the liquidities it generates, as well as the mode of using them, can be assessed.

## Body of the Paper

For an economic entity, a balance of treasury flows is an essential issue. The importance of treasury flows standing as well as the model of balance consists in the fact that its controlled evolution can characterize the development of the entity.

Considering that the balance sheet presents the financial standing of a company at a certain time, and the profit and loss account reflects the transactions made during the financial year, drawing up the table of treasury flows imposed itself through the need of information regarding the way in which liquidities are obtained and how they are used.

## Legal Framework

The International Accounting Standard IAS 7 defines the treasury flows (also named cash flux or cash-flow in certain papers) as incomes and outgoings of cash and cash equivalents<sup>1</sup>. In Romania, Order no. 3055/2009 of the Minister of Public Finances approaches this definition in a different manner, specifying that the standing of cash flows drawn up at the level of an entity presents the way in which the company generates and uses cash and cash equivalents.

The general framework for drawing up and presenting financial standings specifies the fact that the users (actual and potential investors, shareholders/associates, hired personnel, creditors, suppliers and other commercial creditors, customers, government and its institutions, as well as population) must assess the ability of the economic entity to generate cash and the certainty of generating cash. The aim of drawing up financial standings is to obtain and supply useful information to substantiate decisions and justify the way in which the financial resources are used.

As for the standing of cash flows, International Accounting Standard 7 considers that it offers such information as: financing of company's activities (either from internally generated funds, or from external funds), capacity of the company to cover its payment obligations, ability of the company to finance its development by cash flows related to the exploitation activity, elasticity of the entity in financing its own activities, capacity of the company to pay dividends to its shareholders.

In Romania, the standing of treasury flows is considered a component of the annual financial standings as per the provisions of the Order of the Minister of Public Finances no. 3055/2009, for the Approval of the Accounting Regulations harmonized with the Directive IV of the European Economic Community and the International Accounting Standards.

The standing of cash flows must be detailed on the three types of activities: exploitation, investment and financing. Thus there appear the following treasury flows:

- treasury flows from the exploitation activity;
- treasury flows from the investment activity;
- treasury flows from the financing activity.

The treasury flows<sup>2</sup> (generated by the exploitation, investment and financing activities) can be drawn up by two methods:

- the direct method;
- the indirect method.

The direct method is elaborated using certain data regarding collections and payments in gross sizes, being recommended by the specialists in the field who deem that it offers a better prognosis for future flows. The direct method shows the items that affected the cash flow and impact of these flows. Collections and payments on specific sources, such as clients or suppliers, are presented separately, unlike the indirect method which involves the conversion of net profit calculated on a cash basis in the cash flows through a series of additions or subtractions. An important advantage of the direct method is that it allows to users to better understand the relationship between net profit / loss of the company and its cash flows. For example, payment of expenses is presented as an outflow of cash and it is deducted from collections. In this way, users are able to recognize collections and payments of the period.

The indirect method<sup>3</sup>, known as reconciliation, is the most common method of presenting cash flows from operating activities, because it is much easier. It focuses on the differences between

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<sup>1</sup> \*\*\* International Accounting Standards, IAS 7 – Standing of Treasury Flows, paragraph 6;

<sup>2</sup> Order no. 3055/2009 of the Minister of Public Finances for the Approval of the Accounting Regulations according to European directives, published in the Official Monitor no. 766 bis/10.1.2009, with the subsequent modifications and supplements.

exploitation net result and cash flow. The indirect method format starts with net profit or loss, an indicator that can be taken directly from the profit and loss account. Revenues and expenses that do not affect the cash flows are then added or subtracted in order to reach to the net flow generated by operating activities (amortization or depreciation are added because they are expenses that reduced net profit, without affecting cash).

The indirect method implies that the result shown in the profit and loss account be corrected, adjusted by certain values in order to take in consideration the following:

- influence of the operations which have a monetary character;
- collections and payments associated with the treasury flows which concern investment or financing activities;
- influence of the modifications/variations of the working capital elements on the treasury.

Cash flow statement prepared by the indirect method illustrates changes in most parts of current assets and liabilities. Changes in inventories, trade receivables or trade payables are used to calculate cash flow from operating activities. Although most of these adjustments are obvious, some variations require a detailed analysis. For example, it is important to calculate collections from customers taking into account income from sales, but also the variation of trade receivables and provisions for related doubtful.

The disadvantage of the indirect method refers to the user's difficulty to understand the information presented. This method does not show how was collected or on what was paid the cash. Only adjustments to recognized incomes on accrual basis are presented.

The result obtained by the application of the direct method is the same as the one obtained by the application of the other one, indirect method, the difference residing at the level of cash flows related to the exploitation activity. It should be specified that the cash flows from investment activities and those from financing activities are determined by the direct method.

### **The Indirect Method**

According to IAS 7<sup>4</sup> and Order no. 3055/2009 of the Minister of Public Finances, the existence and movements of cash are divided into:

1. treasury flows from the operational (exploitation) activity: the main income generating activities of an economic unit, which include production and supply of goods or rendering of services;
2. treasury flows from the investment activity: acquisition and surrendering of land, buildings, equipment or other permanent capital, cash advances and lending to third parties, other than those made by a financial institution;
3. treasury flows from the financing activity: obtaining and reimbursement of resources from/to owners, obtaining of resources by loans (short- or long-term loans) and reimbursement of borrowed amounts.

In order to determine the cash flows, within the frame of the indirect method there are operated adjustments, starting from the accounting value of the financial year result (gross result before deducting the expenses with the income tax). It is taken into account the fact that by practicing an engagement accounting, there are recorded incomes and expenses at the time they are invoiced and not at the time of collection or payment (the effects of transactions and other events are recognised when the transactions and events take place and not while cash or its equivalent is collected or paid, and are recorded in accounting and reported in the financial standings of the related periods), and for the calculation of profits there are taken into

<sup>3</sup> Epstein, B.J., Mirza, A.A., *The interpretation and application of international standards of accounting and financial reporting*, BMT Publishing House, p.82, 2005

<sup>4</sup> IAS 7, *Statement of Cash Flows*, disponibil la [www.WorldGAAPInfo.com](http://www.WorldGAAPInfo.com)

consideration certain non-monetary income and expense elements, which do not imply cash incomings into, or outgoings from the treasury. This aspect leads to the increase of the difference between the size of the achieved result and the size of the cash in the treasury.

The objectives pursued by operating adjustments are:

- elimination of the effects of engagement accounting. Thus, from the result of year is deducted the variation of stocks (raw materials and consumables, production under way, finite products and goods, down payments to buy stocks), variation of debts (commercial and other debts), and is added the variation of debts related to exploitation activities (payment gaps favourable to the company, highlighted by the variation of balances of the related accounts);
- elimination of non-monetary incomes and expenses by addition of the expenses with depreciation and provisions made and deduction of incomes from the cancelation of provisions;
- elimination of those elements of incomes and expenses which are not related to the exploitation activity.

To illustrate below the standing of treasury flows and the calculation of cash flows from the exploitation activity by the indirect method, we will make use of the data taken over from the yearly financial standings for the years 2010 and 2011.

**Table 1.** Presentation of the synthesis elements taken from the accounting balance sheet of the company for the 2010-2011 period

<b>Balance Sheet</b>	<b>2010</b>	<b>2011</b>	<b>+/-</b>
<b>A. Immobilized Assets</b>			
Tangible assets (gross value)	64,494	64,494	-
- Depreciation of tangible assets	29,890	51,689	+21,799
= Net value	34,604	12,805	- 21,799
<b>B. Circulating Assets</b>			
Stocks of goods	99,597	95,629	- 3,968
Customers and similar accounts	9,087	7,452	- 1,635
Currency availabilities	2,414	6,547	+ 4,133
Total circulating assets	111,098	109,628	+ 1,470
<b>C. Advance Expenses</b>	6,282	8,420	+ 2,138
<b>D. Debts to be paid in less than one year</b>			
Suppliers	132,144	96,312	- 35,832
Debts related to personnel	16,030	11,015	- 5,015
Total debts to be paid in less than one year	148,174	107,327	- 40,847
<b>E. Net circulating assets (current obligations) (B+C-D-I)</b>	-30,794	10,721	- 20,073
<b>F. Total assets minus current obligations (A+E)</b>	3,810	23,526	+19,716
<b>G. Debts to be paid in more than one year</b>			
Bank credits	-	-	-
Total debts to be paid in more than one year	-	-	-
<b>H. Provisions for risks and expenses</b>	-	-	-
<b>I. Advance income</b>	-	-	-
<b>J. Capital and reserves</b>			
Equity capital	200	200	-
Reserves	-	-	-
Total capital and reserves + other own capitals	3,810	38,503	+42,313

Source: synthesis of information taken over from the annual financial standings of the commercial company

It can be found that, although the gross value of the tangible assets has the same level, that is lei 64,494, their depreciation on December 31, 2011, increased by lei 21,799, which determined a diminution of their net value by the same amount.

The value of the stocks of goods was reduced by lei 3,968, the same negative modification being recorded by lei 1,635, to debts to clients and third parties.

The short term debts were reduced by lei 35,832, and those to personnel, by lei 5,015.

We notice that no long term debts were recorded.

The variation of the balance sheet elements from one year to the other and the analysis thereof are presented in the table below.

**Table 2.** Variation of balance sheet elements

Balance sheet elements	Differences	Outgoings treasury flows	Incomings treasury flows
Tangible assets (gross value)	21,799	21,799	
- Depreciation of tangible assets	-21,799		21,799
Stocks of goods	-3,968		3,968
Customers and similar accounts	-1,635		1,635
Currency availabilities	+4,133	4,133	
Suppliers	-35,832		35,832
Debts related to personnel	-5,015		5,015
Bank credits	-		-
Equity capital	+42,313	42,313	-
Reserves	-	-	-
<b>Total</b>		68,245	68,245

Source: synthesis of information taken over from the annual financial standings of the commercial company

Remarks:

- depreciation implies an allotment of the acquisition cost of the tangibles in several years and does not involve treasury flows. However, since it represents an expenditure, depreciation is deducted from the profit and by the diminution of the taxable and distributable result, there are reduced the outgoings of treasury flows. Diminution of the outgoings of treasury flows is assimilated to incomes of treasury flows;
- reduction of the stock values is achieved by the use thereof and this determines obtaining future incomes;
- diminution of debts assimilated to clients signifies the fact that commercial credit was granted to clients which covered it, and this affects positively the treasury;
- cash availability balance increase is the effect of various incomes and payments;
- increase of the debts to suppliers, employees and banking institutions signifies the fact that credit was received, and this affects positively the treasury.

**Table 3.** Table of treasury flows

Treasury flows related to exploitation activities (indirect method)	2011
Accounting result before tax	5.821
<b>Elimination of non-monetary incomes and expenses</b>	
+ Expenses with depreciations and provisions și	21.799
- Incomes from provisions	-
<b>Elimination of incomes and expenses not related to exploitation</b>	
± Resulting from cession of tangibles	-
± Resulting from cession of investment titles	-

*Table 3 (cont.)*

+ Expenses related to interests	477
- Incomes from interests and dividends	- 2
- Subsidies for investments transferred to incomes	-
= Result from exploitation before variation of NFR elements	28.095
± Variation of stocks	16.400
± Variation of customer accounts and other exploitation liabilities	1.635
± Variation of advance expenses	- 2.138
± Variation of supplier accounts and other exploitation liabilities	- 39.859
± Variation of advance incomes	-
Other processing which involve information of the income and payment type	
- Paid interests and dividends	-
- Payments related to taxes on benefits	-
± Extraordinary elements	-
= Net treasury flow related to exploitation activities	4.133

Source: synthesis of information taken over from the annual financial standings of the commercial company

## Conclusions

The table of treasury flows represents an appropriate instrument available to the management of the commercial company in order to prove the good administration of operations characteristic to any entity. Thus, in the case of the company, examining the operations carried out, the following are found:

- lack of investment activities, disinvestments, respectively, that is, there were not acquired, transferred, respectively, tangibles of all categories;
- as far as the financing activity is concerned, there can be remarked the reimbursement of a long term bank credit contracted and the related interest. In a functional market economy, the crediting activity represents a state of normality;
- in matters of current exploitation activity, the development of a specific activity of commerce is remarked, with all advantages it generates.

The standing of treasury flows must contain data required by the large range of users in order to make economic decisions. To be useful, these data must have certain qualitative characteristics, such as<sup>5</sup>: relevance, credibility (offering the complete and true image of the activity carried out by the economic entity and to be free of errors), comparability in time and space with other data and easily perceptible by all categories of users.

The standing of treasury flows is an important component of the annual financial standings, being a major instrument for the analysis of the economic entity's solvability and its financial risk.

<sup>5</sup> Focșan, E.I., *Table of treasury flows: component of financial standings*, CECCAR Magazin – Accounting, Expert Appraisal and Audit of the Business, Bucharest, page 30, April 2012.

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## Situația fluxurilor de trezorerie – metoda indirectă

### Rezumat

*Orice întreprindere sau entitate economică este privită ca un sistem ce există și funcționează pe baza relațiilor pe care le are cu terțele persoane (creditori, debitori, bugetul de stat, investitori), relații ce se concretizează sub forma fluxurilor patrimoniale. Indiferent de dimensiunea afacerii unei entități economice, utilizatorii informațiilor contabile sunt interesați numai dacă întreprinderea deține lichidități, în scopul de a-și recupera investițiile sau creanțele.*

*Capacitatea unei întreprinderi de a genera numerar este reflectată într-o situație financiară, denumită tabloul fluxurilor de trezorerie (situația fluxurilor de trezorerie - așa cum este denumită în Standardul Internațional de Contabilitate). Acest indicator cuprinde în componența sa elemente generate de tipurile de activitate ale unei firme, asigurând astfel o legătură între analiza rezultatelor financiare și analiza rezultatelor economice.*