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MANAGERIAL DECISION MAKING BY ANALYZING THE FINANCIAL FLOWS

Case studies

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Abstract

Financial flows represent a reasonable basis for estimating the capacity of firms to generate cash and cash equivalents necessary to meet debt chargeability. If cash means actual monetary liquidity held in company's cashier or in its bank accounts, cash equivalents represent "short-term investments, highly liquid, which are readily convertible to known amounts of cash and which are subject to an insignificant risk of exchange.

Over time, in an attempt to systematize the information regarding the structure, the origin and destination of the funds used by enterprise, liquidity setters concluded that variation can be explained by the action of three types of activities based on a functional classification, namely operating activities, financing activities and investing activities. The present paper aims to determine the importance and evolution of financial flows in an economic entity using the indirect method.

1. Introduction

Financial flows represent a reasonable basis for estimating the capacity of firms to generate cash and cash equivalents necessary to meet debt chargeability. If cash means actual monetary liquidity held in company's cashier or in its bank accounts, cash equivalents represent "short-term investments, highly liquid, which are readily convertible to known amounts of cash and which are subject to an insignificant risk of exchange. (Achim, 2009)

Over time, in an attempt to systematize the information regarding the structure, the origin and destination of the funds used by enterprise, liquidity setters concluded that variation can be explained by the action of three types of activities based on a functional classification, as it follows.:

operating activities defined as the main revenue-generating activities, and other activities that are not part of the investing or financing activities;

investment activities defined as those activities related to the acquisition and disposal of long-term assets and other investments not included in cash items, including purchase / sale of businesses;

financing activities defined as activities that generate changes in the composition of funding sources (equity and debt), other than those included in cash.

A company liberates cash flows from operating, investing and financing activities in a manner that best suits its business. (Petrescu, 2010)

Delimitation provides information on activities that bring a huge help for users to determine the impact of those activities on the financial position of economic society and the amount of cash and cash equivalents. This information may be used, moreover, to evaluate the relationships that occur among those activities.

A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and borrowed capital, the interest element may be classified as an operating activity and the capital element as a financing activity.

Cash flow statement describes the extent to which the operating, investing and financing cause positive flows (receipts) and negative (payments) of cash during the financial year. (Mironiuc, 2009).

Cash flows are separated through activities that have generated them or consumed them: cash flows from operating activities, cash flows from investing activities, cash flows from financing activities.

2. Cash flows generated from operating activities

Cash flows from operating activities specified in IAS 7 "Cash Flow Statements" are important for assessing the financial performance of the entity. In this manner, the result from operating income becomes a benefit materialized in cash.

Current operations form the main source of income along with other operations that are not part of investing and financing activities.

Operating activity is an activity which involves the most of the operations undertaken in the company.

The result flows generated from operating activities is a key indicator of the extent to which the company's activities have led to sufficient cash flows to repay loans, maintain the operating capability of the company to pay dividends and make new investments without resorting to costly external financing. (Niculescu, 2005)

Information on specific components of historical operating cash flows, together with other significant information is required in forecasting future operating cash flows.

They generally arise from transactions which are subject of determination of net income or net loss

Therefore, cash flows arising from the purchase and sale of trading titles are characterized as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Cash flows released from operating activities are:

- cash proceeds from the placing of the goods and performance of services;
- the cash proceeds derived from royalties, fees, etc.
- amounts paid cash for the payment of suppliers;
- amounts paid for compensation of employees, etc.

Income and received - expenses incurred and paid + / - changes due to gaps cash = cash flow from operating activities released

With regard to extraordinary items, related flows should be presented separately to provide information to users about their contribution to the cash flows.

3. Cash flows from investing activities

The investments include the purchase of fixed assets and contribution titles and revenues from sales of fixed assets registered in the previous period.

Cash flows from investing activities provide information on the manner in which the company ensure its sustainability and growth.

A separate approach of cash flows from investing activity is crucial as cash flows expresses how the costs have contributed to the purchase of resources in order to earn income and future cash flows.

As cash flows from investing activities we distinguish:

- amounts paid for the purchase of land and other assets treated as such;
- the cash proceeds from the sale of land, equipment and facilities;
- amounts paid to obtain the means of equity, etc..

The way of determining the cash flow generated from the investing activity is presented below:

- Acquisition of subsidiary (A) (-) + Assignment purchased treasury branch (B) - Purchase of property - Purchase of investment securities + Cash inflow from the disposal of assets + Cash inflow from the sale of investment securities + Interest + Dividends received /earned = net cash flow from investing activities

4. Cash flows generated from financing activities

Financing activities are activities that result in changes in the size and composition of own and borrowed resources of the economic entity, such as:

- cash amounts obtained as a result of the issuance of new shares and other equity means;
- amounts paid cash for providing or restoring the property to the entity's shares;
- cash back in the form of certain liabilities of the company, etc.

Separation of cash flow depending on their origin is very important because it helps forecasting future cash flows expected by funders of the economic entity. It presents information on the financial position of the company on the basis of partial equilibrium results from the confrontation of receipts and payments for each activity. In the same time, this representation of financial cash flows implies a factorial analysis of their variation during the related period and identification of the activity that released or consumed most part of cash flows.

In accordance with IAS 7 Net cash flow from financing activities is determined as follows:

+ cash capital increase in cash capital repayments + show / borrowing (bonds, bank - excluding cash) - Repayment of borrowings (bonds, bank - excluding cash) - Repayment of liabilities on contracts financial leasing - Interest and dividends payable = net cash flow from financing activities

5. Methods for determining the cash flows

Under accounting regulations harmonized with the 4th European Economic Community and the International

Accounting Standards, or IAS 7 "Cash Flow Statements", cash flows can be determined by two methods: the direct method and the indirect method.

The direct method is based on the net cash flow of receipts and payments using the gross amount in cash determined either directly from the accounting records or indirectly, by adjusting sales and cost with the variations of related assets or liabilities. (Tole, Matei, Ţole, Ruse &Spineanu-Georgescu, 2011)

According to the international regulator, especially the direct method, cash flows for the three activities are obtained as the difference between actual receipts and payments related to transactions and events that have occurred during the financial year.

The direct method is encouraged by international standard setters because it provides useful information in estimating future cash flows, in total or separate on activities, in order to determine the company's value.

However, this method is preferred by the investors.(Tole, Matei, Ţole, Ruse & Spineanu-Georgescu, 2011)

The indirect method is based on the net profit or loss, adjusted with incomes and expenses specific to investing and financing activities as well as income and expenses calculated.

In Romania, because of the accounting method practiced, indirect method is preferred and most commonly used by business managers as they do not want to provide real data about their entity's liquidity and solvency.

Under the indirect method are established net cash flows from ordinary activities, based on data recorded in accrual accounting.

Alternatively, the net cash flow from operating activities is represented by the indirect method emphasizing income and expenses in the statement of global result and variations that occurred during the period in inventories, receivables, and current liabilities. Finally, it proceeds to adjusting net income with changes in working capital.

We add to cash flows from operating activities, cash flows from other activities, determined as in the direct method, resulting a net cash flow as follows:

Net cash flow = Net Cash flow from operating activities + Net cash flow from financing activities + Net Cash flowfrominvesting activities

However, the net cash flow (cash flow) can be determined by deducting cash and cash equivalents at the end and beginning of the financial period:

Net cash flow = Net Cash1 - Net Cash0

Net cash flow and cash flows generated by activities undertaken in the company may take the form of cash surplus or cash deficit, as follows:

- If cash flow from operating activities is positive it means that cash flows from operating activities determine a profit in operating activity.

This aspect arises as a result of an efficient management of the operating activity, which generates more cash than consumes.

- If cash flow from operating activities is negative, it results a cash deficit. Operating cash deficit may be due to multiple causes such as immobilization of financial resources in stocks of raw materials over necessary or in difficult to sell stocks, an inappropriate credit policy, and increasing liabilities to third parties. Operating cash imbalance is detrimental to the investment policy and distribution of company's dividends.
- A positive cash flow from investing activity is the expression of superiority of entries over payments arising from investment operations.
- If cash flow from investing activities is negative, then there is no cash generated from investing activities.
- When net cash flow from financing activities is positive represent a surplus of cash from financing operations that were conducted.
- If the net cash flow from financing activities is negative, it reflects the

expression of debt refunds, mostly from the current activity. This reduces the dependence of lenders with favourable effects on the performance of the economic entity.

A positive net cash flow represents a surplus of cash used for economic development of the enterprise.

A negative net cash flow expresses a deficit of cash, which prevents the execution of current payments. In this case the company is not able to generate financial resources, leading to the company's financial disruption.

Based on the balance sheet and profit and loss account of a company we present the statement of cash flows according to the indirect method (Table 1.Statement of cash flows (indirect method).

6. Conclusions

We extract the following conclusions, based on data presented in Table 1:

In the years 2006, 2008, 2011 we are recording a total cash surplus, except for the years 2007, 2009, 2010, when we are dealing with a shortage of cash. Throughout the period under review the net treasury registers a sinusoidal trend, decreasing every two years, as follows: in 2006-2007 is reduced by 97,39% and in 2008-2009 is reduced by 37,50%. In the other financial years grows significantly due to the large amount of long-term loans contracted and increasing flows generated from operating activities.

Cash flow from operating activities has a major influence in determining total cash flow throughout the period under review with an upward trend with 101,18% in 2011 compared to 2006. This explains the favourable situation of society, justified by the existence of a surplus of resources from operating activities used either for investment or for remuneration and repayment of loans.

Investment activity generates a shortage of cash, with the exception of 2009 when cash flow from investment activity registers a positive value equal to 4058,49 million.

The positive cash flow from investing activity is due to the fact that the company has received from the sale of assets more than has paid for new investments.

Cash flows from financing activities were negative in the first period under review as a result of lower revenues from financing activities versus increasing payments for funding.

Towards the end of the period there is a positive cash flow from financing activities, hence a surplus of cash due to the some new loans.

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Table 1.
Statement of cash flows (indirect method)

No.	Name of the element (million)	Financial year					
		2006	2007	2008	2009	2010	2011
1	Cash flow from operating activities						
2	Profit before tax	2.546,16	2.149,63	1.605,56	1.697,51	2.215,64	4.478,64
3	Adjustments for:						
4	Interest expense	38,61	0,00	23,57	104,14	128,84	73,18
5	Interest income	-315,16	-233,59	-135,26	-119,40	-121,89	-125,28
6	Income from dividends	0,00	0,00	0,00	0,00	-202,28	-303,22
7	Net movement in provisions and value adjustments for:						
8	Impairment of fixed assets	-27,87	284,20	1.085,09	285,82	286,26	423,94
9	- Financial assets	149,60	-93,98	135,56	125,95	449,67	192,10
10	- Inventory	9,81	0,00	48,72	62,85	5,60	56,63
11	- Claims	-47,40	-74,84	19,99	64,47	-123,71	-16,73
12	- Litigation	22,28	179,80	692,72	-360,52	1,23	-114,24
13	- Expenditure on environmental	-95,91	-100,58	-29,05	-53,51	-22,18	-141,71
14	- Employee Benefits	20,77	6,77	-15,67	31,68	5,53	-94,87
15	- Other provisions for risks and charges	-105,40	-12,50	-34,17	60,00	-84,70	498,60
16	- Restructuring	127,72	-94,33	48,22	-141,60	-79,26	-75,48
17	Loss / (Gain) on disposal of fixed assets	-196,65	14,74	-54,08	201,90	0,00	-17,44
18	Depreciation and amortization expenses	846,67	860,46	1.170,90	1.466,49	1.700,86	1.828,56
19	(Gain) / Loss on financial assets	0,00	-11,18	-64,35	50,32	421,29	73,15
20	Other non-cash items	0,00	0,00	0,00	0,00	-13,63	-78,53
21	Net cash generated from operating activities before changes in working capital	2.973,23	2.874,95	4.497,77	3.476,09	4.566,74	6.657,30
22	(Increase) / decrease in inventories	397,73	-457,60	-520,78	233,70	66,02	54,16
23	(Increase) / decrease in receivables and prepaid expenses	0,00	-604,11	368,55	-268,36	-874,17	-188,81
24	Increase) / decrease of debts and revenues in advance	0,00	699,42	658,62	-549,25	286,74	-204,86
25	Interest received	277,52	235,25	68,72	96,36	68,56	131,66
26	Interest paid	-52,08	0,00	-5,38	-95,20	-120,13	-86,73
27	Income tax paid	-641,62	-262,54	-683,90	-236,39	-341,63	-720,36
28	Dividends received	0,00	0,00	0,00	0,00	202,28	302,23
29	Net cash generated from operating activities	2.954,79	2.485,38	4.383,62	2.656,97	3.854,40	5.944,59
30	Cash flow from investing activities						
31	Purchase of tangible and intangible	- 1.920,36	- 3.637,79	- 6.217,80	- 4.072,74	- 4.063,06	- 4.659,13
32	Proceeds from sale of fixed assets	410,11	180,31	176,55	136,67	185,97	107,84
33	Proceeds from sale of financial	0,00	54,72	1.198,35	217,42	69,99	51,80
34	Purchase of financial investments	- 1.657,38	-358,02	-685,87	-56,56	-147,31	-180,03
35	Loans to subsidiaries	0,00	0,00	0,00	-283,30	-195,89	78,90
36	Net cash used in investing activities	- 3.167,63	- 3.670,78	- 5.528,76	4.058,49	- 4.150,31	- 4.600,63

37	*Cash flow from financing activities*						
38	*Net loans received / (repaid) during the year*	*-478,26*	*0,00*	*1.768,39*	*1.434,80*	*1.433,98*	*-1.199,78*
39	*Dividends paid*	*-395,51*	*-1.422,98*	*-1.114,44*	*-14,69*	*0,00*	*-993,24*
40	*Acquisition of own shares*	*37,66*	*0,00*	*0,00*	*0,00*	*-1,78*	*-2.193,03*
41	*Net cash used in financing activities*	*-836,10*	*-1.422,99*	*653,95*	*1.420,13*	*1.431,97*	*-2.193,03*
42	*Total cash flow*	*-1.048.93*	*-2.698,00*	*-493,00*	*20,00*	*1.135,00*	*-847,00*