

## VALUE OF THE NET TREASURY AND ITS IMPLICATIONS ON THE FINANCIAL STABILITY OF THE COMPANY

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### **Abstract**

*Practice proved that the management process cannot be based on routine and intuition, but on scientific analysis, on deep knowledge of the actual situation, as well as on identifying the vulnerabilities and the development opportunities. The economic and financial analysis performed by means the net treasury has the role of using the information supplied by accounting, based on which conclusions will be drawn on the efficiency of the activity performed within an entity. The importance of the net treasury arises from the fact that it shows the amount of liquid assets of an entity at a certain moment in time, being connected to the short-term financial operations, the purpose of which is to ensure the resources necessary to finance the company's economic activity. The net treasury synthetically reflects the method of achieving financial stability within the company on long and short term. Our endeavour ends by determining the strengths and the weaknesses in the activity of a trading company, as well as the measures that are to be applied on short and on long term in order to achieve the present objectives.*

### **Keywords**

working capital; working capital requirement; net treasury; cash-flow; financial stability

### **JEL Classification**

M41; M51

### **Introduction**

The analysis of the financial stability, as a goal and a means for the company management, is essential in order to get high economic results in the case of companies which work in the present-day business environment. The purpose of this analysis is to identify and measure the imbalances which come up on the level of the cash flow, as well as the factors triggering them.

The starting point in drawing up a financial diagnosis is the study of the financial structure of the balance sheet, which has an important role in defining the conditions for the *financial stability* of a company; in other words, they define the capacity of ensuring a company's solvability in order to prevent the risk of bankruptcy. A critical analysis on the way of achieving financial stability will show us that this stability is absolutely necessary, since it is a benchmark according to which decisions concerning the company's activity are made on internal as well as on external level.

Knowing the structure of the company's financial position, reflected in the *balance sheet*, knowing the ratios of the groups of elements (the fixed and the circulating assets, the equities, the long-, medium- or short-term liabilities) of the working capital, the working capital requirement and the net cash, which measure the

evolution of the activity and the company's financial health is a requirement when managing a company, in order to achieve financial management.

Determining the *net treasury* requires calculating the working capital and the working capital requirement, which make up the trio of indicators that denote financial stability, indicators determined after analyzing the horizontal balance sheet which sets correlations between the efficient use of the assets and the way they are financed.

In fact, at a certain point, a company may have high profitability and then, in order to extend its activity, investment becomes necessary. The cash fluxes generated by the investment activity, in case they were not accurately calculated, may affect the need of financial resources expected during the normal functioning of the current activity.

This study started from the idea that the company works in a dynamic environment, the opportunities and the constraints of which are continuously changing, which requires a proper reaction within the company in order to maintain the stability, emphasizing the fact that each stage of development involves altering the existing stability in order to achieve future stability, and that each present imbalance should include the premises for a new state of stability, situations which can only be overcome by achieving an efficient productive activity which should generate profit.

### **Research methodology**

In order to reach the objectives formulated concerning the topic treated here, the study was based on certain methods of scientific research. The fundamental purpose of the methodology is to help us understand not only the broad definitions of the concepts of working capital, working capital requirement, net treasury, cash flow, but also the importance and the influence these indicators have within the company, all this based on a practical example.

For the study of the net treasury we use quantitative (positivist) and qualitative research methods. Among the quantitative research methods, we used the phenomena examination and measurement methods, since the purpose of studying the net treasury analysis is to collect accounting information in order to do an interpretation of the results achieved, as well as numerical methods, due to the fact that the analysis results will be achieved after applying certain calculation formulas. As a qualitative method used in this research, we have the case study. Thus, we start from the real case of an economic entity in the field of trade, we interpret the results gathered in the period of time 2004-2013 and we set the steps to follow in order to improve the "financial health" of this entity.

### **General considerations concerning the analysis of the economic and financial stability**

The economic and financial analysis is the instrument based on which the managers get to know the company's situation at a certain moment in time as well as the previous situation and they can anticipate the future evolution of the company, by supplying accurate and opportune information in order to support the decision-making and the operational processes.

*The balance sheet* is the main financial report which reflects the way in which the balance between the assets and the liabilities in the balance sheet is achieved, as well as the way of covering the financial needs using the available resources (equities, debts) (Petrescu, 2012).

Financial stability is the state at which every company aims, and in order to assess it we start from calculating the financial stability indicators: the working capital, the

working capital requirement so that, in the end, we can determine the level of the *net treasury*.

The *financial working capital (FWC)* is that part of the permanent capital used to finance the current assets, determined by the difference between the amounts that are to be cashed and the amounts due, as well as by the time span between the due date when the current assets must be turned into cash and the average time in which short-term debts are due (Spătaru, 2010). The way of calculating this indicator consists in two procedures, emphasized using the formulas no. 1, 2 or 3, respectively:

a) *through difference*:

- starting from the information supplied in the upper part of the balance sheet:

$$FWC = (\text{Equities} + \text{Medium and long term debts}) - \text{Fixed assets} \quad (1)$$

- using the information supplied in the lower part of the balance sheet:

$$FWC = \text{Current assets} - \text{Short term debts} \quad (2)$$

b) *directly*:  $WC = \text{Net current assets} / \text{Net debts} = \text{Item E}$  in the balance sheet (3)

The *working capital requirement (WCR)* is the difference between the temporary needs and the temporary sources, designating the financial needs generated by the repetitive operations which require payments necessary for the current activity, and it is the difference between the current assets (only liquid assets) and the short-term debts (only current bank credits). The method for calculating this indicator can be seen in formula no. 4.

$$WCR = (\text{Stock} + \text{Accounts receivable} + \text{Prepaid expenses}) - (\text{Debts due in less than 1 year} - \text{Current bank credits} + \text{Deferred income}) \quad (4)$$

The *net treasury (NT)* is the balance account of the liquid assets existing in the company's patrimony at a certain moment in time, which can be seen in the bank accounts or in the cash accounts (Petrescu, 2010). The positive net treasury is the result of the company's financial stability.

We can determine this indicator of stability by reading the horizontal balance sheet, as we can see in formulas no. 5 and 6:

a) the top part:  $NT = FWC - WCR$  (5)

b) the bottom part:  $NT = \text{Liquid assets} - \text{Liquidity credits}$  (6)

The relationships listed above convey the value of the net treasury at the *end of the financial year*, which can differ from the value of the net treasury at the moment of the assessment; that is why it is useful to assess the *variation of the net treasury* ( $\Delta NT = \text{cash flow}$ ) calculated according to formula no.7 and used in the dynamic analysis of the financial stability in order to estimate the future cash flows in which the potential investors are interested.

$$\Delta NT = \Delta FWC - \Delta WCR \quad (7)$$

where:

$\Delta NT$  = the variation of the net treasury, calculated as the difference between the value of the net treasury at the end of the period subjected to the analysis ( $NT_1$ ) and the value of the net treasury at the beginning of the same period ( $NT_0$ ),  $\Delta NT = NT_1 - NT_0$ .

$\Delta FWC$  = variation of the financial working capital.

$\Delta WCR$  = variation of the working capital requirement.

### **Case study concerning the implications of the net treasury level in assessing the financial stability of S.C. ALFA S.A.**

S.C. ALFA S.A. is a company situated in Bacau, listed at Bucharest Stock Exchange, which deals with *retail trade of food and non-food products, renting commercial property to other trading companies dealing in the field of food trade and food services*. In order to study the evolution of the net cash, we started from the study of the annual balance sheets of the company for the last ten years, starting with 2004 and ending in 2013.

## Analysis of the financial working capital of S.C. ALFA S.A.

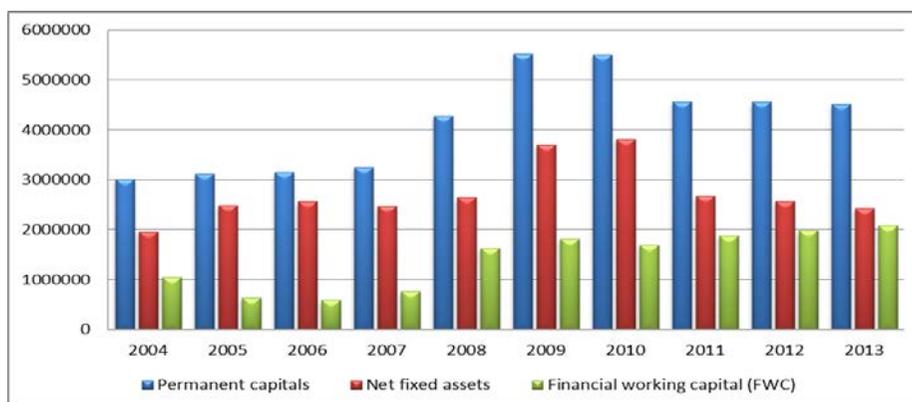
The data necessary for the analysis of the *working capital* is presented in table 1.

**Table 1 Analysis of the financial working capital**

Indicators	Financial year									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Equities	3007624	3111526	3141245	3222358	4253659	4424411	4432148	4561664	4562506	4515756
2. Debts due in over 1 year	7682	7682	7682	23526	23526	1102864	1079628	0	0	0
3. Permanent capitals (1+2)	3015306	3119208	3148927	3245884	4277185	5527275	5511776	4561664	4562506	4515756
4. Net fixed assets	1961249	2485709	2563319	2475012	2642958	3706219	3813249	2677297	2576502	2430144
5. Current assets	3237108	2315370	2157478	2316517	2476709	2482402	2374437	2451906	2709321	2555018
6. Prepaid expenses	0	69	74	9433	6869	7908	7037	2817	1172	13527
7. Temporary needs (5 + 6)	3237108	2315439	2157552	2325950	2483578	2490310	2381474	2454723	2710493	2568545
8. Debts due under 1 year	2183051	1681940	1571944	1555078	849351	669254	682947	570356	724489	482933
9. Deferred income	0	0	0	0	0	0	0	0	0	0
10. Temporary resources(8+9)	2183051	1681940	1571944	1555078	849351	669254	682947	570356	724489	482933
<b>11. Net current assets/ Net current debts (E)</b>	<b>1054057</b>	<b>633499</b>	<b>585608</b>	<b>770872</b>	<b>1634227</b>	<b>1821056</b>	<b>1698527</b>	<b>1884367</b>	<b>1986004</b>	<b>2085612</b>
<b>12. Financial working capital (FWC) (3-4) or (7-10)</b>	<b>1054057</b>	<b>633499</b>	<b>585608</b>	<b>770872</b>	<b>1634227</b>	<b>1821056</b>	<b>1698527</b>	<b>1884367</b>	<b>1986004</b>	<b>2085612</b>
Variation of the working capital $\Delta FR$ (RON)	-	-420558	-47891	185264	863355	186829	-122529	185840	101637	99608
Indexes %	-	60,10	92,44	131,64	212,00	111,43	93,27	110,94	105,39	105,02
Growth rate %	-	-39,90	-7,56	31,64	112,00	11,43	-6,73	10,94	5,39	5,02

Source: Annual balance sheets of S.C. ALFA S.A. and the author's calculations, 2014

Diagram, the evolution of the *financial working capital* of S.C. ALFA S.A. is presented in figure 1.



**Figure 1 Evolution of the financial working capital at S.C. ALFA S.A.**

Source: own calculations, based on the historical data for the period of time 2004-2013

During the period of time subjected to the analysis, the working capital has positive but fluctuating values, which is a relatively favorable situation for the company. The permanent sources manage to finance all the permanent allocations, also leaving a surplus for financing the cyclical needs (renewing the current assets).

Companies have to avoid the immobilization of financial resources in products stocks that cannot be sold in the near future period, because otherwise would attract the danger of costs increasing. (Deju & Dragomirescu, 2010)

The value of the working capital has a downward trend in 2005 and 2006, while in the next period of time it increased reaching in 2009 the amount of 1821056 RON. In 2010, the value of the working capital decreases by 6.73% compared to 2009, but it is still positive. During the last three years, we can notice a favorable evolution of this indicator, which reached its maximum value in 2013, when it amounted to 2085612 RON.

The company has enough permanent capital to ensure the financing of fixtures in case of unexpected events, during the last 3 years its level consisting only in equities (the value of the medium and long-term debts being 0 for the period of time 2011-2013), the company choosing to appeal to long-term financing using only its own resources. Although the working capital has a fluctuating trend, the amount of the current assets which can be turned into cash is higher than the short-term debts, which means that there is a favorable situation of solvability. This way, the company has a margin of safety which protects it from the effects of any disturbance in the influx-outflow cycle.

### Analysis of the working capital requirement for S.C. ALFA S.A.

The data necessary for the analysis of the *financial working capital requirement* is presented in table 2.

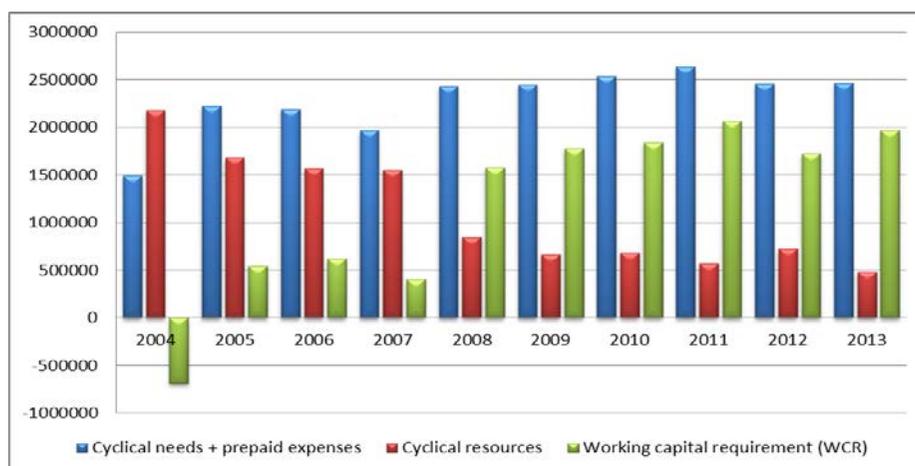
During the period of time subjected to the analysis (except for 2004), the working capital requirement had *positive values* and increasing values with negative effects for the financing of the company's activity, situation which is unfavorable for the company due to the unfavorable disparity between the cashing of the accounts receivable and the payment of debts. The maximum level of the financing requirement was registered in 2011 when it amounted to 2067901 lei.

**Table 2 Analysis of the working capital requirement at S.C. ALFA S.A.**

Indicators	Financial year									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Current assets	3237108	2315370	2157478	2316517	2476709	2482402	2374437	2451906	2709321	2555018
2. Cash and bank accounts	1513550	885195	951366	1264986	1825111	1980500	1905095	1923407	2107130	2065090
3. Cyclical needs (stocks+accounts receivable) (1-2)	1494074	2226331	2189879	1957372	2428548	2443911	2527053	2638257	2455376	2450666
4. Prepaid expenses	0	69	74	9433	6869	7908	7037	2817	1172	13527
5. Cyclical needs + prepaid expenses	1494074	2226400	2189953	1966805	2435417	2451819	2534090	2641074	2456548	2464193
6. Cyclical resources	2183051	1681940	1571944	1555078	849351	669254	682947	570356	724489	482933
<b>7. Working capital requirement (5-6)</b>	<b>-688977</b>	<b>544391</b>	<b>617935</b>	<b>402294</b>	<b>1579197</b>	<b>1774657</b>	<b>1844106</b>	<b>2067901</b>	<b>1730887</b>	<b>1967733</b>
Variation of the working capital requirement $\Delta WCR$ (RON)	-	1233368	73544	-215641	1176903	195460	69449	223795	-337014	236846
Indexes %	-	279,01	113,51	65,10	392,55	112,38	103,91	112,14	83,70	113,68
Growth rate %	-	179,01	13,51	-34,90	292,55	12,38	3,91	12,14	-16,30	13,68

Source: Annual balance sheets of S.C. ALFA S.A. and the author's calculations, 2014

Diagram, the evolution of the *financial working capital requirement* at S.C. ALFA S.A. is presented in figure 2.



**Figure 2 Evolution of the financial working capital requirement at S.C. ALFA S.A.**

Source: own calculations, based on the historical data for the period of time 2004-2013

The working capital requirement was reduced by 34.90% in 2007, compared to 2006, and by 16.30% respectively in 2012 compared to 2011, with favorable trends due to the decrease in the cyclical needs (stocks + accounts receivable) and to the increase in the liquid assets, which suggests that less and less of the temporary needs are financed using permanent resources.

The working capital requirement shows the current stability of the company, it is rather fluctuant, more unstable than the working capital, and it depends on the turnover, the inventory turnover, the time span between the cashing due date and the payment due date.

Although it is impossible to recommend a certain level for the working capital requirement, S.C. ALFA S.A., as a trade company and service provider, should have a working capital requirement as low as possible, or even a negative one if possible.

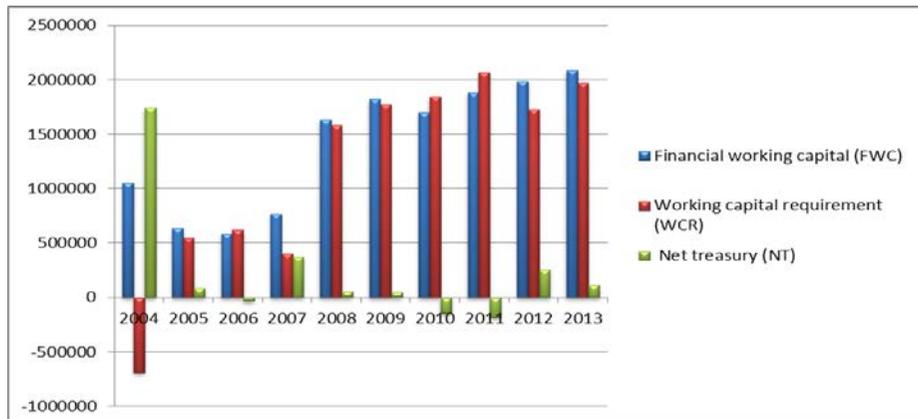
### Analysis of the net treasury of S.C. ALFA S.A.

The data necessary for analyzing the *net treasury* is presented in table 3.

**Table 3 Analysis of the net treasury of S.C. ALFA S.A.**

Indicators	Financial year									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Financial working capital (FWC)	1054057	633499	585608	770872	1634227	1821056	1698527	1884367	1986004	2085612
2. Working capital requirement (WCR)	-688977	544391	617935	402294	1579197	1774657	1844106	2067901	1730887	1967733
3. Net treasury (NT) (2-1)	1743034	89108	-32327	368578	55030	46399	-145579	-183534	255117	117879
$\Delta$ NT= variation of the net treasury = cash-flow (RON)	-	-1653926	-121435	400905	-313548	-8631	-191978	-37955	438651	-137238
Indexes %	-	5,11	-36,28	1140,16	14,93	84,32	-313,75	126,07	139,00	46,21
Growth rate %	-	-94,89	-136,28	1240,16	-85,07	-15,68	-413,75	26,07	239,00	-53,79

Suggestively, the evolution of the financial stability indicators for S.C. ALFA S.A. is presented in figure 3.



**Figure 3 Evolution of the financial stability indicators at S.C. ALFA S.A.**

Source: author's calculations

In the case of the company analyzed here, the net treasury evolution is a fluctuating one, the highest level being registered during the first year subjected to the study (in 2004 it amounted to 1743034 RON).

Comparing the financial working (FWC) capital with the working capital requirement (WCR), in order to determine the net treasury, we could notice the following situations:

- $FWC > WCR$ , during the period of time 2004-2005, 2007-2009, 2012-2013 *the net treasury is positive*, which shows the fact that there is excess financing, a cash surplus, which is a proof of the efficient activity, denoted by the existence of liquid assets in the bank account and in the cash desk. Under these conditions, we can speak of the company's short-term financial autonomy. The positive net treasury shows excess financing, a growth of cash, and it is a guarantee that the company functions efficiently, having liquid assets in the bank accounts and in the cash desk. Thus, creditors have a guarantee that the company could pay its debts at any time.
- $FWC < WCR$ , during the period of time 2006, 2010, 2011, *the net treasury is negative*, which means that there is a *financial imbalance* manifested in a cash deficit which should be covered by accessing new short-term credits in order to finance the imbalance, which is a proof of the defective management and of a precarious economic state.

The dynamic analysis shows the fluctuating levels of the cash flow (variations of the net treasury): lower in 2007, 2012 and even negative during the rest of the period, reaching its lowest level in 2008, when it amounted to 313548 RON. The highest level of the cash flow was in 2012, when there was a level of the net treasury variation of +438651 RON.

## Conclusions

The net treasury, as factor of the financial stability, has the role of informing the managers concerning the degree of financial autonomy and the level of liquid assets of their company, which will implicitly allow paying the debts as well as doing some efficient investments on the money market as well as on the financial market.

Calculating and the assessing the net treasury is important since: it reflects the ratability of the activity carried out by the company when the net treasury is positive as the result of a favorable evolution of the influx and outflow, of the investments made using the cash surplus; it helps setting the best moment for short-term bank loans, when the cash is negative, loans which will be allotted for financing the current asset deficit.

The analysis of the financial stability of S.C. ALFA S.A. emphasizes the fact that the scientific tools allow us to picture the current situation and point out the measures that need to be taken for a good progress of the company's activity. Although highly contested, the statistical analysis based on the study of the balance sheet does not lead to total ignorance of this traditional tool of the financial analysis, due to the fact that it provides irreplaceable data concerning the economic stability. According to our objective, we can emphasize the fact that the company has an oscillating evolution, it does not manage to cover the working capital requirement using the permanent working capital during the whole period of time subjected to the analysis, thus resulting a negative net cash; however, the situation improves during the last two years, when the value of the cash is positive, meaning that there was a cash surplus and it was not necessary to resort to credits. If S.C. ALFA S.A. will continue its activity and will improve its resource management, the managers and the creditors will be able to have the guarantee that their book debt will be paid back, and they will be fairly paid according to their own participation to the economic activity.

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