

## TECHNICAL NOTE ON IAS 7 DEALING WITH CASH FLOW STATEMENT

### 1. BACKGROUND:

■ In the meeting of the Budget and Accounting Meeting of the Central Bank held in July 2005, in the offices of the Central Bank of Brazil, with the participation of the Central Banks of Argentina, Brazil, Chile, Guatemala, Peru, Uruguay and CEMLA and the Bank of Spain as a guest, the issues dealt with included the application of the International Financial Reporting Standards in central banks and the identification of the standards that will be difficult to apply because of their characteristics; as in the case of Standards 2, 7, 14, 21, 32, 37 and 39. On this occasion, it was agreed to make technical notes that would furnish legitimate accounting criteria aimed at improving the position of the central banks associated with CEMLA in the application of the IFRS.

Argentina was chosen as the country to present the technical note on IAS 7. It is difficult to specifically apply this standard to central banks. This financial analysis facilitates analysis of the capacity to generate cash and cash equivalents by the entity and its liquidity needs; nevertheless, central banks do have the capacity to generate cash because they have a monopoly over cash issuance and can thus fully comply with the monetary policy goals that make up their basic activity, with the consequent generation of margin for the interpretation of application adopted.

### 2. SUMMARY OF THE IFRS:

■ **Goals:** Information about cash flows is useful because it provides the users of financial statements with the bases to assess the capacity of a company to generate cash and cash equivalents, in addition to liquidity needs. This standard requires the company to provide information about the historic movements of cash and its equivalents depending on whether they arise from exploitation, investment or financing activities.

■ **Scope:** Companies must formulate a cash flow statement in accordance with the requirements set forth in this Standard and must present it as an integral part of their financial statements for each fiscal period in which the presentation of such is obligatory.

■ **Benefits:** It makes it possible to evaluate changes in a company's net assets, its financial structure (liquidity and solvency) and its capacity to modify both the amounts and dates of collections and payments in order to adapt to the evolution of the circumstances and opportunities that may arise. This also permits the comparison of the information on the performance of various companies because it eliminates the effect of using diverse accounting procedures for the same transactions and economic events.

The historic information on cash flows is often used as an indicator of the amount, time of appearance and reliability of the future cash flows. Furthermore, it can be used to examine the relationship between net cash flows and the impact of changes in prices.

- **Definitions:** - Cash includes both cash and sight bank deposits.
  - Cash equivalents are short-term, high liquidity investments that are easily convertible into given amounts of cash and are subject to insignificant changes in value.
  - Cash flows are the inflow and outflow of cash and cash equivalents.
  - Exploitation activities are the activities that make up the main source of a company's ordinary income, as well as other activities that cannot be classified as investment or financing.
  - Investment activities are the acquisition, sale or abandonment of long-term assets, as well as other assets not included in the cash and cash equivalents.
  - Financing activities are activities that lead to changes in the size and composition of the company's capital and the loans taken on by the company.
- **Presentation:**
  - Each company presents its cash flow arising from exploitation, investment or financing activities in the manner that is most suitable to its activities.
  - A single transaction may contain cash flows that are classified differently. For example, when loan redemptions include capital and interests, the interest part may be classified as an exploitation activity, while the return of the principal part is classified as financing.
  - The information on cash flows of the exploitation activities may be shown through the direct method (gross cash receipts and payments are presented separately) or through the indirect method (profits and losses are given in net terms, corrected by the accrual basis of the non-cash transactions, deferred payment items, accruals that give rise to cash movements in the past or present, and profits and losses associated with cash flow activities classified as investment or financing).
  - The company must separately report the main gross cash receipts and cash payments arising from investment and financing activities that could be presented in net terms: cash receipts and payments by clients provided that the cash flows reflect the client's activity to a greater extent than that of the company, and receipts and payments from high-turnover items, with high amounts and maturity in the near future.
  - The cash flows from the activities of a financial entity that may be presented in net terms are: payments and receipts from the acceptance and reimbursement of deposits with a fixed date for maturity, placement and recovery of deposits in other financial entities and advance payments and loans made to clients, as well as the reimbursement of these items.
  - Flows from transactions in foreign currencies must be converted into the currency used by the company to present its financial statements by applying the exchange rate in effect on the date when each flow in question was made.

- Cash flows associated with extraordinary items must be classified, according to origin, as either exploitation, investment or financing activities and presented separately within such groups.

- Cash flows corresponding to both interests received and paid, such as dividends received and satisfied, must be disclosed separately and classified according to whether they are exploitation, investment or financing activities.

- The company must disclose the components of the cash flow and cash equivalent item and must present a conciliation of the balances that appear in its cash flow statement with the equivalent items in the balance.

- In the financial statements, the company must disclose any significant amount in its cash and cash equivalent balances that is not available for use by the company or the group it belongs to, with a comment made by the administration.

■ **Life:** For financial statements that cover fiscal periods starting from January 1, 1994.

## **2. ANALYSIS OF THE IFRS. SPECIFY THE POTENTIAL PROBLEM FOR APPLICATION IN CENTRAL BANK ACCOUNTING:**

■ The purpose of the Statement of Origin and Application of Funds is the analysis of the net flow of funds between two successive movements that coincide with the date of the balances, at the beginning and end of the period, because this facilitates the study of liquidity and solvency of an economic entity, in the short term, through the evaluation of how the company's resources are obtained and used.

The base for the analysis of the origin and use of resources during an accounting period lies in knowing whether:

- The funds are provided by third parties (increase in third-party resources) or by the owners (increase in own resources furnished) or by operations, or by releasing money previously used in assets (decrease in assets account).
- The resources thus obtained are used to increase the existing assets (increase in assets account) or reduce debts (decrease in third party resources) or to pay dividends, taxes or other obligations taken on.

The balance sheets make it possible to analyze the liquidity and solvency of an enterprise fluctuate according to many variables and therefore there are different definitions of funds, depending on the analysis to be made.

Thus, when the concept of immediate liquidity is taken into account, only the most liquid resources will be considered as funds. This includes the cash and cash equivalent, in which case it would be a "Cash Flow Statement", which makes it

possible to identify the activities that generated cash funds during the fiscal period and the use given to the funds obtained.

The problem of applying IAS 7 to central banks is basically focused on two main aspects:

- The central bank is a monopolistic cash issuing entity and therefore it has a capacity to generate cash that is only limited by its compliance with monetary policy objectives.
  - The cash issued by the central banks is a component part of the so-called monetary base that is integrated in its liability and which forms the counterpart of the cash accounts that the rest of the actors of the economy reflect in their funds flow statements.
  - The primary and fundamental function of a central bank is focused mainly on preserving the value of the currency, for which it has powers in monetary, financial and exchange rate matters that enable it to fulfill its mission. Consequently, the definition of “cash” or its “equivalents” would seem to be different and particular regarding what is given to the concept of “cash” envisaged in the current IAS for enterprises in general.
- If only sight bank deposits and cash equivalents consisting of short-term, highly liquid investments (that is, easily convertible into given amounts of cash and are subject to insignificant changes in value, as defined in the standard) are considered as “cash”, only the operational aspect of the central bank associated with the administration of international reserves would be covered, to the exclusion of investment and financing activities and those used as monetary regulation instruments.

### **3. ALTERNATIVE GENERAL FRAMEWORK OF ACCOUNTING CRITERIA PROPOSAL:**

Monetary and exchange rate policies are the basic tools used by all central banks to protect the value of the national currency in an effort to have low and stable inflation.

Central banks basically use two monetary policy instruments; money supply over which they have an issuance monopoly and the interest rates on their operations, which are usually a benchmark for the rest.

By using monetary policy, the central bank determines the amount of money (monetary base) in the system in order to try to control the evolution of short-term interest rates, for example, through loans granted to the banking system or the government, through open market operations like the sales-purchase of foreign currency or debt or the Treasury and rescuing (issuing) money in exchange.

The second most important monetary policy instrument is the use of benchmark interest rates on its own certificates.

Currency reserves are also a crucial monetary and exchange rate policy instrument. Consequently, it is essential that this national resource be managed prudently and

efficiently. The incorrect handling of international reserve investments could endanger other elements of the monetary policy (for example, the official exchange rate policy).

The combination of monetary policy instruments and the preservation of monetary reserves are an inseparable part of the central bank's functions. Transparency plays a key role in conducting the policies of the central bank, which is not an isolated entity in society, and which has a high political responsibility; consequently, it must provide open and transparent information for all third parties interested in such. This would therefore considerably strengthen the respect and confidence that official public policy inspires and make a material contribution to the success of macroeconomic management.

In reference to IAS 7, given the impossibility of specifically applying the standard, yet the concurrent need for accountability in central banks, an alternative would lie in the incorporation of a new specific standard adapted for central banks that "redefines" the concepts of "cash" and "cash equivalent" in accordance with the inherent functions and which permits the supply of quality, consistent and highly transparent information about the way in which the central bank has used its capacity to generate monetary and currency resources and how it has administered the international reserves in order to obtain maximum benefit.

The case of the New Zealand Central Bank could be used as an example. Their definition of "cash" is assimilable in certain aspects to what has been adopted by the Argentinean Central Bank (BCRA) in that, in addition to calculating those items that are convertible into cash, the short-term liabilities, with a convergence in the function of both financial entities: the development of monetary policy in order to maintain currency stability, the administration of international reserves used as a resource to comply with the bank's functions, maintenance of the bank's capacity to intervene in the financial markets, the supervision and monitoring of financial system's soundness, acting as a financial agent of the central government and depository of national and international financial institutions.

In this respect, the BCRA started to incorporate a Cash Flow Statement as an annex table to its financial statements as from the closing of the 2001 fiscal period, in accordance with the particular characteristics of the Institution and the specific nature of its operations the parts not assimilable to the remaining financial entities or other kinds of entities.

The following items should be considered as "funds" in reference to the above: "Freely Available Funds" (foreign assets representing genuine resources that allow the BCRA to carry out its basic mission as monopolistic issuer of money and financial agent of the National State), net "Monetary Liabilities" (Monetary Base and Current Account in Other Currencies) and "National Government and Other Deposits".

The Monetary Liabilities have been calculated because their variations reflect the handling and capacity applied to the generation of monetary resources of the Central Bank. This could be exemplified as: giving re-discounts to financial entities or paying the administrative expenses incurred by the Bank; situations that would not be envisaged if only the International Reserves are considered as cash, which would consequently undermine central bank's real cash position.

In the case of National Government Deposits, when a foreign loan comes in or a foreign payment is made, the cash effect is zero because the increase or decrease in the International Reserves is conditioned to crediting or charging such amounts in the accounts of the National Government held by BCRA because it acts as a financial agent of the government, which would not happen if these deposits were accounted for. The operations carried out by the National Government in pesos would be treated in an identical fashion; for example, the placement or redemption of national certificates would have a neutral cash effect because they imply an expansion or contraction of the Monetary Base.

## **5. CONCLUSION:**

- A central bank's Funds Origin and Application Statement should be an additional "macroeconomic" tool from which it is possible to obtain the most important variations affecting the most sensitive economic-financial variables for a country's economy, such as International Reserves and Monetary Liabilities. By comparing them between to accounting periods it is possible to determine which ones are sources or resources generated as a result of the management applied to them and to thus determine whether the activity carried out was as expected in terms of the monetary policy objectives projected by the bank, the way in which it complies with current legislation and the budgets authorized when applicable.
  - This financial statement contributes to transparency in central bank administration and would provide a follow-up tool for financial management with an exceptional characteristic, given the monopolistic money issuing capacity.