

**Are Your Operating Activities Cash-generating? – The Direct and Indirect Methods under HKAS 7**  
**(Relevant to AAT Examination Paper 7 – Financial Accounting)**

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This article discusses the presentation of the cash flows from operating activities in a statement of cash flows as set out in HKAS 7 "Statement of cash flows".

**Introduction**

Under HKAS 1 (Revised) "Presentation of financial statements", paragraph 10, a complete set of financial statements comprises:

- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes, comprising a summary of significant accounting policies and other explanatory information;
- comparative information in respect of the preceding period as specified in paragraphs 38 and 38A of the accounting standard; and
- a statement of financial position as at the beginning of the earliest comparative preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with paragraphs 40A - 40D of the accounting standard.

While HKAS 1 (Revised) stipulates further requirements for a statement of financial position, a statement of profit or loss and other comprehensive income, and a statement of changes in equity for the period, the requirements for the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows are set out in HKAS 7.

**Cash flows from operating activities**

HKAS 7 stipulates that cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. In other words, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

- (a) cash receipts from the sale of goods and the rendering of services;
- (b) cash receipts from royalties, fees, commissions and other revenue;

- (c) cash payments to suppliers for goods and services;
- (d) cash payments to and on behalf of employees;
- (e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;
- (f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- (g) cash receipts and payments from contracts held for dealing or trading purposes.

An entity shall report cash flows from operating activities using either the direct method or the indirect method.

### Direct method

Under the direct method, major classes of gross cash receipts and gross cash payments are disclosed.

Major classes of operating cash receipts include:

Cash received	Computation formula
From customers	Sales revenue (+) Decrease in accounts receivable or (-) Increase in accounts receivable
As investment returns, such as interest and dividends	Interest revenue (or dividend revenue) (+) Decrease in interest receivable (or dividend receivable) or (-) Increase in interest receivable (or dividend receivable)
From other sources, such as rent revenue	Rent revenue (+) Decrease in rent receivable or (-) Increase in rent receivable

Major classes of operating cash payments include:

Cash paid	Computation formula
To suppliers for merchandise	Step 1 - Compute purchases: Costs of goods sold (+) Increase in merchandise inventory or (-) Decrease in merchandise inventory  Step 2 – Compute cash paid for purchases Purchases from step 1 (+) Decrease in accounts payable or (-) Increase in accounts payable
For operating expenses (including wages and salaries to employees,	Wages (salaries) expense and other operating expenses (+) Increase in prepayments or (-) Decrease in prepayments

excluding depreciation, interest and income tax expenses)	(+) Decrease in wages payable and other payables/ accruals or (-) Increase in wages payable and other payables/ accruals
For interest and income Taxes	Interest expense or income tax expense (+) Decrease in interest (or income tax) payable or (-) Increase in interest (or income tax) payable

### Indirect method

Under the indirect method, profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Specifically, the indirect method starts from the profit before tax figure on the income statement and is followed by a list of adjustments to arrive at the net cash amount provided by (or used in) operating activities.

Adjustments can be grouped into 4 major categories:

<b>Adjustments for</b>	<b>Adjustments required</b>
Non-operating items on the income statement, such as gains and losses from disposal of long-term assets or retirement of debt	(+) Losses from disposal of long-term assets or retirement of debt or (-) Gains from disposal of long-term assets or retirement of debt
Non-cash operating items, such as depreciation, depletion, amortization	(+) Depreciation expense, depletion expense, amortization expense
Interest and income taxes expense	(+) Interest expense (-) interest paid and income tax paid (see computation formula below*)  <i>*Interest expense or income tax expense (+) decrease in interest or income tax payable or (-) increase in interest or income tax payable</i>
Changes in current assets (except cash) and current liabilities (except interest and income tax payable)	(+) Decrease in current assets (except cash) or (-) increase in current assets (except cash) And (+) Increase in current liabilities (except interest and income tax payable) or (-) Decrease in current liabilities (except interest and income tax payable)

## Illustration

To demonstrate the “cash flows from operating activities” section of the statement of cash flows under both direct and indirect methods, the following extracted information from Sunlight Trading is used. All sales and purchases of merchandise inventory are on credit. Sunlight Trading classifies items for which HKAS 7 allows a choice in classification as operating activities.

<b>Extracts from the statement of financial position</b>	<b>2013 (\$'000)</b>	<b>2012 (\$'000)</b>
Trade receivables	120	80
Merchandise inventory	180	150
Trade payables	70	90
Wages payable	12	10
Interest payable	8	6

<b>Extracts from the statement of comprehensive income</b>	<b>2013 (\$'000)</b>
Net sales	1,500
Costs of goods sold	770
Wages and other operating expenses	220
Depreciation of property, plant and equipment	20
Interest expense	15
Loss on disposal of equipment	12
Profit before income tax	463
Income tax expense	92
Dividend paid in cash	30

### **Sunlight Trading Statement of Cash Flows For the year ended 31 December 2013 (DIRECT METHOD)**

Cash flows from operating activities:	\$'000	
Cash receipts from customers (note 1)	1,460	
Cash paid to suppliers (note 2)	(820)	
Cash paid for wages and other operating expenses (note 3)		<u>(218)</u>
Cash generated from operations	422	
Interest paid (note 4)	(13)	
Income tax paid (note 5)	(92)	
Dividend paid	<u>(30)</u>	
Net cash from operating activities	<u>287</u>	

**Sunlight Trading**  
**Statement of Cash Flows**  
**For the year ended 31 December 2013**  
**(INDIRECT METHOD)**

Cash flows from operating activities:	\$'000
Profit before income tax	463
Adjustment for:	
Loss on disposal of equipment	12
Depreciation	20
Interest expense	15
Increase in trade receivables (120-80)	(40)
Increase in merchandise inventory (180-150)	(30)
Decrease in trade payables (90-70)	(20)
Increase in wages payable (12-10)	<u>2</u>
Cash generated from operations	422
Interest paid (note 4)	(13)
Income tax paid (note 5)	(92)
Dividend paid	<u>(30)</u>
Net cash from operating activities	<u>287</u>

Notes:	\$'000
(1) Net sales	1,500
<u>(-) Increase in trade receivables (120-80)</u>	<u>(40)</u>
(=) Cash receipts from customers	1,460
(2) Costs of goods sold	770
<u>(+) Increase in merchandise inventory (180-150)</u>	<u>30</u>
(=) Purchases	800
<u>(+) Decrease in trade payables (90-70)</u>	<u>20</u>
(=) Cash paid to suppliers	820
(3) Wages and other operating expenses	220
<u>(-) Increase in wages payable (12-10)</u>	<u>(2)</u>
(=) Cash paid for wages and other operating expenses	218
(4) Interest expense	15
<u>(-) Increase in interest payable (8-6)</u>	<u>(2)</u>
(=) Interest paid in cash	13

(5) Since there is no change in income tax payable (the balance being \$0 at both year ends) the \$92,000 income tax expense represents the cash amount of income tax paid in 2013.

## **Conclusion**

Although the direct and indirect methods are presented differently and use different computations for adjustment items, they share the same definition of operating activity under HKAS 7. Therefore, as demonstrated in the illustration above, both methods generate the same amount of net cash from operating activities.