REAL WORLD 5.1

STATEMENTS OF CASH FLOWS For the year ended 31 July 2011

	Notes	Consolidated - Year ended 31 July 2011 $'000	31 July 2010 $'000
Cash flows from operating activities			
Cash was provided from:			
Receipts from customers		359,836	380,765
Sales tax received		-	763
Dividends received	3	-	-
Interest received	3	259	192
Other operating income		192	204
Cash was applied to:			
Payments to suppliers and employees		(352,460)	(343,595)
Interest paid	3	(4,033)	(2,549)
Sales tax paid		(2,389)	-
Income taxes paid		(5,979)	(14,979)
Net cash inflow / (outflow) from operating activities	25	(4,574)	20,801
Cash flows from investing activities			
Cash applied to:			
Purchase of property, plant and equipment		(12,793)	(9,593)
Purchase of intangibles		(4,351)	(3,786)
Net cash inflow / (outflow) from investing activities		(17,144)	(13,379)
Cash flows from financing activities			
Cash was provided from:			
Proceeds of borrowings		38,000	2,000
Advances from group companies		-	-
Cash was applied to:			
Repayment of borrowings		-	-
Dividends paid	22	(13,197)	(15,040)
Net cash (outflow)/ inflow from financing activities		24,803	(13,040)
Net (decrease)/ increase in cash and cash equivalents		3,085	(5,618)
Cash and cash equivalents at the beginning of the financial year		6,945	12,563
Cash and cash equivalents at end of year	7	10,030	6,945

The above statements of cash flows should be read in conjunction with the accompanying notes.

Source: Pumpkin Patch Limited Annual Report 2011, p.47. For illustrative purposes, the 2011 and 2010 Parent columns have been deleted.

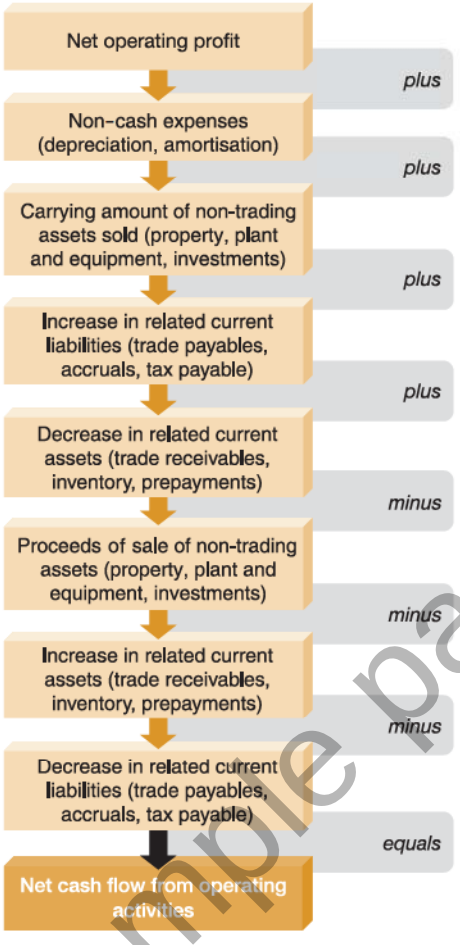

Figure 5.4 The indirect method of deducing the net cash flow from operating activities

Example 5.1 we saw a difference between the sales figure in the income statement and the cash received from customers calculated as follows:

Opening balance of trade receivables	15,000
plus sales for the period	100,000
gives the amount we might expect to receive for the year	115,000
less closing balance of trade receivables	(20,000)
equals the cash received from customers	95,000

Put another way, the cash from customers can be arrived at as follows:

Sales for the period	100,000
less the increase or plus the decrease in trade receivables over the year	(5,000)
Cash received from customers	95,000

An increase in trade receivables over the year (as in this case) means that the cash received will be less than the amount included as revenue over the year, by the amount of the increase.

On the other hand, a reduction in trade receivables over the year means that the cash received will exceed the amount included as revenue over the year, by the amount of the decrease.

Basically the trade receivables figure is affected by sales and cash receipts. It is increased when a sale is made and decreased when cash is received from a debtor. If, over the year, the sales and the cash receipts had been equal, the trade receivables figures *would have remained the same*. Since the trade receivables figure increased, it must mean that less cash was received than the figure for sales included in the income statement. Thus the cash receipts from sales must be $95,000 (i.e. 100,000 – (20,000 – 15,000)). Put slightly differently, we can say that as a result of sales, assets of $100,000 flowed into the business during the year. If $5,000 of this went to increasing the asset trade receivables, this leaves $95,000 to increase cash.

The same general point is true in respect of nearly all of the other items taken into account when deducing the cash flow from operating activities figure. The exception is depreciation. This is not associated with any movement in cash during the accounting period, but rather represents an estimate of *service potential* or *economic benefits* of property, plant and equipment used up during the period.

Using the indirect method, the net cash flow from operating activities in Example 5.1 can be determined as follows:

	$000
Operating profit after tax	10
Depreciation	5
Increase in inventory	(8)
Increase in trade receivables	(5)
Increase in trade payables	5
Increase in tax payable	1
Net cash flow provided by operating activities	8

The net cash inflow of $8,000 from operating activities is the same as the amount shown on the cash flow statement in Example 5.1, which was prepared using the direct method.

Basically, the indirect method starts with the assumption that the net profit equals the cash generated. We know that this is not true, because the following things happen to prevent it being true:

- Depreciation does not involve a cash outflow, so the cash flow from operations will be higher than the net profit by the amount of the depreciation.
- Any increase in current assets (trade receivables, prepayments or inventory) over the course of the year can be seen as representing a drain of cash (trade receivables—cash not collected from sales during the period; inventory and prepayments—cash paid related to inventory and other expenses exceeds the cost of goods sold and expense amounts). So increases can be seen as an effective decrease in cash flow. Any decrease in current assets means that these assets over the course of the year can be seen as releasing cash (trade receivables—cash collected exceeds the sales: inventory and prepayments—cash paid for inventory and other expenses is less than the cost of goods sold and expense amounts). So reductions represent an effective increase in cash flow.
- Any increase in current liabilities (trade payables, income tax payable, deferred tax payable and accruals) must mean that less has been paid out over the course of the year than one might have expected on the basis of the expenses included in the income statement. This means that an increase in such liabilities over the year can be seen to represent an effective increase in cash flow. Any decrease in these current liabilities must mean that more has been paid out over the course of the year than one might

have expected on the basis of the expenses included in the income statement. This means that a decrease in such liabilities over the year (they have been paid off) can be seen to represent an effective decrease in cash flow compared with profit.

- Any gain or loss on the disposal of non-trading assets (e.g. property, plant and equipment; investments; intangibles) needs to be adjusted for. Both the gain and the loss are non-cash in nature and simply represent the difference between the *proceeds on disposal* and the *carrying amount* of the asset sold. The cash proceeds are included as a cash inflow in the investing activities section of the cash flow statement. To determine net cash flow from operating activities, the *loss* is added back to operating project and the *gain* is deducted.

All of this means that if we take the operating profit for the year, add back the depreciation charged in arriving at that profit and adjust this total by movements in non-cash current asset and current liability accounts (e.g. inventory, trade receivables, trade payables, prepayments and accruals), we have the effect of operations on cash.

In many ways, the indirect method provides more useful information than the direct method. Cash can be positively or negatively affected by changes in working capital. These effects are not obvious when using the direct method, but the indirect method highlights

activity 5.6

The relevant information from the accounts of Dodo Ltd for last year is as follows:

	$m
Sales	500
Cost of sales	300
Depreciation	34
Other expenses	44
Net operating profit	122
At the beginning of the year	
Inventory	15
Trade receivables	24
Trade payables	18
At the end of the year	
Inventory	17
Trade receivables	21
Trade payables	19

Required:

1. Prepare the cash flows from the operating activities section of the cash flow statement using the direct method.
2. Prepare the cash flows from operating activities section of the cash flow statement using the indirect method.

them. Certainly, inefficient working capital management is more easily identified by the indirect method.

Preparation of the cash flow statement — a more complex example and further problems

In preparing the cash flow statement we need to adjust for non-cash transactions, as well as for accrual transactions. In the simple example covered in Example 5.1, only a few adjustments were required:

- Depreciation
- Changes in year-end balances
  - —Trade receivables/debtors
  - —Inventory
  - —Trade payables/creditors
  - —Income tax payable
  - —Dividend payable.

All other changes were of a cash nature.

With more-complicated and more-realistic situations, additional non-cash transactions occur and must be adjusted for (eliminated) in preparing the cash flow statement.

activity 5.7

Can you think of other non-cash business transactions that must be adjusted for in preparing the cash flow statement?

Further problems are discussed in the next section, some of which are based on the following example. Some of the additional non-cash transactions identified in Activity 5.7 are illustrated in Example 5.2.

Example 5.2

Fab Tees Limited has continued to grow rapidly. Its income statement for the year ended 31 March 2018 and balance sheets as at 31 December 2017 and 2018 are as follows:

Fab Tees Limited

Income statement for the year ended 31 March 2018

	$000	*$000*
Sales		591
Cost of sales		307
Gross profit		284
Other expenses (including amortisation and depreciation of $79m)		91
		193