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The Statement of Cash Flows and the Direct Method of Presentation

By Nathan H. Jeppson, Ph.D., CPA; John A. Ruddy, CPA, CFA; and David F. Salerno, Ph.D., CPA

EXECUTIVE SUMMARY

Which method of presentation is better for the cash flow statement: the direct method (DM) or the indirect method (IM)? The issue is still being discussed.

The Financial Accounting Standards Board (FASB) has traditionally encouraged entities to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method, DM). Very few financial statement preparers, however, adhere to the guidance because the indirect method (IM) continues to be the most favored presentation method for preparers of cash flow statements (*Accounting Standards Codification*® 230-10-45-25).

In 1987, the FASB published Statement of Financial Accounting Standards 95 (SFAS 95), "Statement of Cash Flows," which set the stage for the statement of cash flows as we know it today. Over the Statement's 29-year history, rule-making bodies made two noteworthy attempts to require the DM, and another attempt is probably on the horizon. The first attempt occurred when the Statement was released. The second attempt occurred in 2008 when the FASB and the International Accounting Standards Board (IASB) issued a joint discussion paper titled "Preliminary Views on Financial Statement Presentation." The discussion paper proposed, among other things, a mandate for the DM. As part of an overall tightening of the cash flow activity classification rules, attempts continued in 2014 and 2015.

In this article, we provide a history of the cash flow statement, followed by an analysis of the public's response to the most recent attempt to mandate the direct method. Then we describe the FASB's current ongoing efforts regarding the direct method, and we close with an analysis of which method is preferable.

HISTORY AND TIMELINE OF THE STATEMENT OF CASH FLOWS

Prior to the release of SFAS 95, Accounting Principles Board Opinion 19 (APB 19), "Reporting Changes in Financial Position," allowed the reporting of cash flows, but it was not a requirement. SFAS 95 established the current rules for the statement of cash flows—classifying cash flows into operating, investing, or financing activities.

The guidance of SFAS 95 allowed a choice of either the DM or IM of presentation for cash flows from operating activities. Although SFAS 95 did not require the DM, it encouraged the DM in lieu of the IM. The FASB passed SFAS 95 by a four-to-three vote with two of the three dissenting members concerned that the statement would have reduced usefulness by not requiring the DM. Specifically, they argued that using the IM would fail to "provide relevant information about the cash receipts and cash payments of an enterprise during a period." Providing relevant information about a business entity's cash flows was the stated overall purpose of SFAS 95.

Ever since SFAS 95 was issued, it has become clear that businesses have largely disregarded the FASB's encouragement to use the DM. The FASB and the IASB said they issued the discussion paper in response to users' concerns that "existing requirements permit too many alternative types of presentation and information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between the financial statements and the financial results of an entity." The discussion paper raised the issue of making the DM mandatory and contained guidance concerning a detailed reconciliation of cash flows to comprehensive income.

Recent Attempts to Mandate the Direct Method

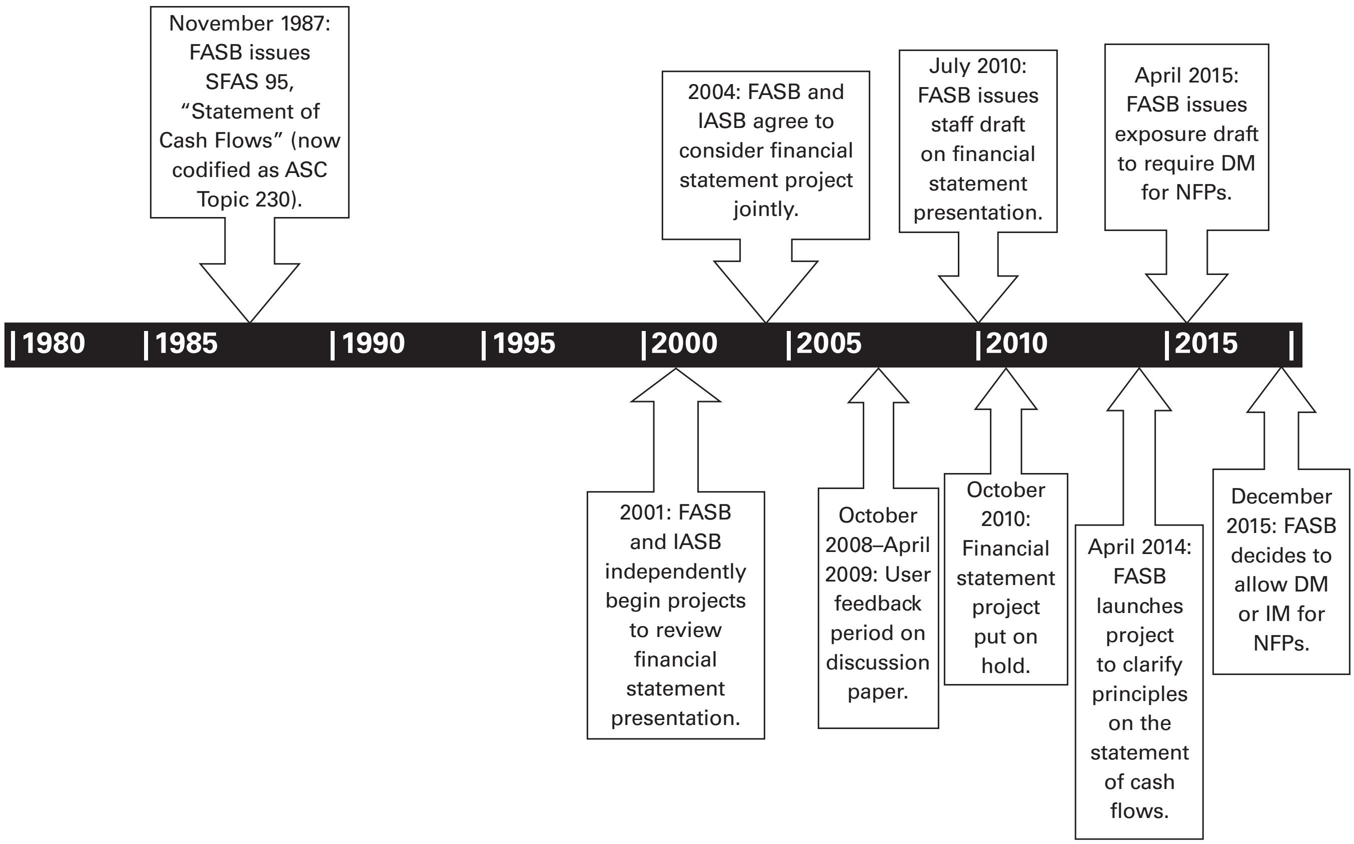
The most significant attempt to mandate the direct method began in 2001, when the FASB and the IASB separately initiated projects to review the presentation of each financial statement. As part of the international accounting standards convergence, the Boards agreed to consider two independent projects in 2004. The rule-making bodies agreed the projects would have three distinct phases:

- Phase A would outline the required financial statements and the required reporting periods.
- Phase B would consider details of financial statement presentation, including whether the DM would be used for the presentation of cash flows from operating activities.
- Phase C would consider the required information and presentation required for interim financial statement information.

By October 2008, the joint project titled Financial Statement Presentation had progressed to the point where the FASB and the IASB were ready to receive preparer and user feedback. They issued the document "Preliminary Views on Financial Statement Presentation." From October 2008 to April 2009, they solicited feedback regarding the proposed changes to financial statements (see Figure 1 for a statement of cash flow event timeline). While the document proposed changes in format and presentation for all four basic financial statements, a substantial amount of responses addressed using the DM in the presentation of cash flows. During the feedback period, the Boards received 229 comment letters. Additionally, they received nine unsolicited comment letters prior to the comment period and one comment letter after the comment period. In the next section we analyze the responses to provide a deeper understanding of the IM popularity and arguments in favor of the DM.

The Financial Statement Presentation project was put on hold in October 2010, but subsequent developments indicate the statement of cash flows will likely undergo future revisions. In April 2014, the FASB launched a project aimed at clarifying certain existing principles on statement of cash flows with the objective of increasing "consistency in the classification of cash inflows and outflows as operating, investing, or financing."[1] In April 2015, the Board issued an exposure draft that would require not-for-profit entities to use the

Figure 1: Timeline of Significant Events in Development of Statement of Cash Flows



direct method of cash flow presentation. We discuss this in detail in the section "Current Developments and Ongoing Efforts to Mandate."

As we describe next, the FASB has indicated the mandatory use of the direct method is still preferred for business enterprises.[2]

Discussion of the Public's Response to Mandating the Direct Method

The most recent justification for mandating the DM comes from the objectives of the discussion paper proposals, which state that financial reports should contain three features:

- Cohesiveness, which the FASB and the IASB defined as the ability to clearly see the relationship between items across all the financial statements;
- Disaggregation of information, which only allows combining account balances for presentation if the items are economically similar; and
- Presentation of information such that it allows users to assess the firm's liquidity and financial flexibility.

The Boards believed the DM was superior to the IM in possessing these features.

Letters in response to the discussion paper provide opinions of interested parties. We reviewed the 229 comment letters, but 32 letters did not address the presentation or format of the cash flow statement. Of the 197 that did address the cash flow statement, four did not discuss the debate regarding the direct vs. the indirect format, and 13 letters did not express a format preference.

We analyzed the 180 remaining comment letters that both discussed the debate between cash flow statement formats and expressed a preferred cash flow statement format. We classify the letters by country, business type, segment classification, and financial statement user type and provide summary tables that categorize the

Table 1: Preferences by Country for Method of Presenting Cash Flows from Operations

Country/Region	Total Respondents	Number for Direct Method		Number for Indirect Method	
		Quantity	Percent	Quantity	Percent
Australia	12	5	41.7%	7	58.3%
Austria	1	0	0.0%	1	100.0%
Belgium	3	0	0.0%	3	100.0%
Canada	15	3	20.0%	12	80.0%
Denmark	1	0	0.0%	1	100.0%
Europe	8	0	0.0%	8	100.0%
Finland	1	0	0.0%	1	100.0%
France	8	0	0.0%	8	100.0%
Germany	13	1	7.7%	12	92.3%
Greece	1	0	0.0%	1	100.0%
Hong Kong	1	0	0.0%	1	100.0%
India	1	0	0.0%	1	100.0%
Ireland	3	3	100.0%	0	0.0%
Italy	1	0	0.0%	1	100.0%
Japan	5	0	0.0%	5	100.0%
Malaysia	1	0	0.0%	1	100.0%
Netherlands	4	0	0.0%	4	100.0%
New Zealand	4	3	75.0%	1	25.0%
Pakistan	1	1	100.0%	0	0.0%
Poland	1	1	100.0%	0	0.0%
Scotland	1	0	0.0%	1	100.0%
South Africa	3	2	66.7%	1	33.3%
Spain	1	0	0.0%	1	100.0%
Sweden	2	0	0.0%	2	100.0%
Switzerland	5	0	0.0%	5	100.0%
Taiwan	1	1	100.0%	0	0.0%
U.K.	28	2	7.1%	26	92.9%
U.S.	53	12	22.6%	41	77.4%
Zambia	1	0	0.0%	1	100.0%
Total	**180**	**34**	**18.9%**	**146**	**81.1%**

comment letters and aggregate the results. The remainder of this section provides a detailed breakdown of the 180 comment letters and five tables that classify and summarize the comment letter contents. Tabulating the data presents the reader with the same information the FASB received and does not draw any statistical inferences about the opinions of the overall population.[3]

The comment letter analysis results show that, of the respondents who commented on and expressed a preference for a particular cash flow statement format, 81% disapproved of the DM requirement. These results are in contrast to Wallace, et al., who reported that the majority (57.2%) of respondents of four key countries (Australia, New Zealand, the U.K., and the United States) favored making the DM mandatory.[4] These results are from an FASB survey in 1987 before SFAS 95 was issued.

Table 1 provides preferences for cash flow formats by country/region. Of the 180 response letters, 53 were from the U.S. and 127 (70%) from the remaining coun-

Table 2: Preferences by Segment for Method of Presenting Cash Flows from Operations

Classification	Total Respondents	Number for Direct Method		Number for Indirect Method	
		Quantity	Percent	Quantity	Percent
Public accounting firms	42	12	28.6%	30	71.4%
Industry	87	7	8.0%	80	92.0%
Other	46	14	30.4%	32	69.6%
Undisclosed	5	1	20.0%	4	80.0%
Total	**180**	**34**	**18.9%**	**146**	**81.1%**

tries. These responses are consistent with the notion that strong support exists for the DM in countries where it has been a required format in the past. For example, three of the four respondents in New Zealand favored the direct cash flow format. In Australia, where 12 respondents expressed a preferred method, 41.7% favored the direct cash flow format. Table 1 also shows the preference for countries where the DM has not been mandated in the past. For example, in the U.K., where the direct cash flow format has never been required, only 7.1% of the 28 respondents were in favor of mandating direct cash flow disclosures.

Table 2 presents preferences for the two methods by segment classification. At 92%, respondents from industry are the most supportive of the IM, presumably because of the ease of compilation since all of these respondents need to make regular cash flow disclosures. Respondents from public accounting firms and other organizations had nearly equal support for the DM with 28.6% and 30.4%, respectively.

Table 3 shows the respondents' preferences categorized as either preparers or users of financial statements. To make the categorization, we coded public accounting firms and industry respondents as preparers and financial analysts as users. We classified the remaining responses as either preparers or users based on whether they crafted their response letter from the perspective of a preparer or user. Note that substantially more respondents commented as preparers than as users (153 vs. 27). Less than 16% of the preparers favored the DM, and 37% of users preferred the DM. Clearly the IM enjoys favor with both groups as more than 84% of preparers and 63% of users prefer to use it. As might be expected, a larger percentage of users (37%) preferred the DM, reflecting the likelihood that users of financial statements attach more value to direct cash flow information.

Regarding financial statement users, two financial analyst organizations submitted comment letters worth noting. The first was from the CFA Institute Centre for Financial Market Integrity, representing 100,000 analysts, portfolio managers, financial advisors, and other

Table 3: Preferences by Role for Method of Presenting Cash Flows from Operations

Classification	Total Respondents	Number for Direct Method		Number for Indirect Method	
		Quantity	Percent	Quantity	Percent
Preparers	153	24	15.7%	129	84.3%
Users	27	10	37.0%	17	63.0%
Total	**180**	**34**	**18.9%**	**146**	**81.1%**

Table 4: Preferences for Financial Classification for Method of Presenting Cash Flows from Operations

Classification	Total Respondents	Number for Direct Method		Number for Indirect Method	
		Quantity	Percent	Quantity	Percent
Banks and financial institutions	21	1	4.8%	20	95.2%
Other industries	159	33	20.8%	126	79.2%
Total	**180**	**34**	**18.9%**	**146**	**81.1%**

investment professionals in 134 countries. The Institute indicated strong support for the DM, suggesting it would improve transparency of operating cash flows and thus be more useful to analysts and other users. The letter indicated that the IM makes it more difficult for investors to perceive any possible earnings management. An illustration showed the extent to which Enron engaged in financial engineering to overstate operating cash flows and suggested that the company did not expect investors would notice the diminishing cash flows under the IM.

The Institute also responded to the allegation that the transition cost to the DM is prohibitive. It suggested that these costs are notoriously difficult to estimate and that, in the past, preparers have overstated implementation difficulties associated with proposed reporting improvements. The comment also addressed the difference between the indirect-direct method that involves an accrual-to-cash approach and the direct-direct approach that captures cash transaction data. It points out the contradictory and counterintuitive positions of those opposed to the direct mandate; opponents agree cash is king yet they support less useful methods to present cash flows. Although it prefers the direct-direct method, the Institute indicates concerns about the indirect-direct method are unwarranted. It argues that if a company maintains proper accrual records, adjustments to cash basis will be reliable and useful.

The second notable analyst letter was from the CFA Society of the UK. The letter represented an unofficial supplement to the Institute's letter discussed earlier and provided survey results from the Society's members. The Society received 351 responses, which constituted slightly less than 5% of its membership of 8,000 U.K. investment professionals. It reported that a small majority favors the DM and suggested that the benefits outweigh the costs. At least 80% of the Society's members, however, stated that the FASB and the IASB needed to improve the statement's transparency through increased note disclosures.

Table 4 compares the responses of a group titled "banks and financial institutions" ("banks") to other industries. Banks submitted 21 comment letters, and businesses from other industries submitted 159 comment letters. An overwhelming 95.2% of banks preferred the IM, and 79.2% of businesses from other industries preferred the IM. Twenty banks preferred the IM because of its usefulness to users of bank financial statements. The one bank that preferred the DM commented on its usefulness when reading the financial statements of other businesses, such as when a bank reviews a client's financial statements to decide whether to make a loan.

Regarding the overall tone of the 21 bank comment letters, many respondents suggested that the statement of cash flows (regardless of the method prepared) lacks the functionality needed for analyzing banking institutions. For example, the banks indicated the statement does not contain information about a given bank's liquidity risk exposure. The letters also emphasized that banks manage cash flows on a comprehensive basis that does not fit easily into the statement categories.

The banks also maintained it would be too costly to change to the DM. Several banks stated they were unaware of any user groups that would prefer banks to use the DM. Of the banks currently using International Financial Reporting Standards (IFRS), they preferred mandating IFRS 7, "Financial Instruments: Disclosures,"

Table 5: Arguments Provided by Respondents in Support of Their Preferences

	Frequency[a]	Percent
Panel A: Reasons for Direct Method of Cash Flow Presentation Taken from the 34 Letters Written in Support of Direct Cash Flow Format		
Direct method provides useful information	17	50.0%
Direct method achieves cohesiveness and disaggregation	12	35.3%
Benefits outweigh costs	3	8.8%
Other	9	26.5%
Panel B: Reasons against Direct Method of Cash Flow Presentation Taken from the 146 Letters Written in Dissent		
Cost concern/costs outweigh benefits	89	61.0%
Not convinced direct method better information	36	24.7%
Indirect method provides useful information	14	9.6%
Management should have the choice	11	7.5%
Statement of cash flows rarely used in decision making	10	6.8%
Direct method too complex to implement/understand	9	6.2%
Does not achieve cohesiveness and disaggregation	4	2.7%
Indirect method connects better to other financial statements	4	2.7%
Other	19	13.0%

[a]The sums of the frequencies and percentages do not match the total number of letters because some respondents provide more than one reason.

disclosure requirements instead of changing the cash flow statement format. As a matter of background, IFRS 7 requires two main categories of disclosures: information about the significance of financial instruments and information about the nature and extent of risks arising from financial instruments.

The bank and financial institutions respondents generally agreed that although the DM might be relevant for other industries, it should remain optional for banks, which is in contrast to prior banker survey results. As stated in the responses to Exposure Draft #23 for SFAS 95, bankers preferred the DM.[5] They said that the DM is more useful to financial statement users and suggest converting from IM data to DM information imposes an additional cost for users. We found no such preference by bankers in the recent data.

Table 5 outlines the arguments from respondents in support of their preferences regarding cash flow format.[6] As shown in Panel A, of the respondents who favored the DM format, the most common reason was that the DM provided useful information (50.0%). The second most common reason was "cohesiveness and disaggregation (35.3%)," which was the rationale the FASB and the IASB cited for undertaking the financial statement presentation project. Several respondents stated they believed the benefits outweighed the costs of DM disclosures (8.8%). Last, the category titled "Other" includes any remaining reason for support of the DM.

Panel B of Table 5 shows that cost (61.0%) was the largest concern to those who responded negatively to the DM format. Generally, large companies with elaborate structures and complicated enterprise resource planning (ERP) systems are most affected. Yet only a limited number of respondents provided a cost estimate for their implementation and ongoing budget estimate for DM presentation. To the researchers' knowledge, no one has conducted a comprehensive investigation of the cost/benefit tradeoff of converting to the DM.[7] Intel Corp., however, estimated it would cost more than

$5 million to implement the DM and another $2 million per year post-implementation. Alcoa and Deutsche Bank estimated implementation would cost between $20 million and $30 million and in the double-digit million euro range ($15+ million), respectively.

The respondents who opposed a DM mandate stated they did not believe the DM provided more useful information (24.7%). Some respondents' explanations did not appear to consider the financial statement user's perspective. For example, 7.5% of respondents stated management should choose the method. Others said the DM was too complicated (6.2%) or did not achieve the cohesiveness and disaggregation (2.7%) goals of the FASB and the IASB.

CURRENT DEVELOPMENTS AND ONGOING EFFORTS TO MANDATE

The FASB recently again began efforts to require the DM for business enterprises. As the Figure 1 timeline shows, two recent developments indicate this is the case. In April 2014, the Board began a new project titled Clarifying Certain Existing Principles on Statement of Cash Flows. The project includes two main objectives. The first objective is to provide guidance on how to classify particular cash flows that may contain aspects of more than one category, such as a cash flow from a derivative instrument that may have features of both investing and financing activities. The second objective is to provide classification guidance for specific transaction types. In the last five years, as many as 600 companies have had to file restatements because of cash flow misclassifications.[8] These objectives indicate that the FASB had plans to further develop the Statement.

Even more recently and more importantly, the Board initiated a project that seemed to signal a new attempt to mandate the direct method for business enterprises. In April 2015, it issued an exposure draft for not-for-profit organizations titled "Presentation of Financial Statements of Not-for-Profit Entities." The Board requested comments on a requirement for not-for-profit entities to prepare their statements of cash flow using the DM. In a departure from prior proposed guidance, including the 2008 discussion paper we discussed, the proposal did not require entities to simultaneously prepare a separate reconciliation of net income to net cash flows from operating activities.

To obtain feedback on the proposal, the FASB surveyed 227 members of its Not-For-Profit Resource Group (NFPRG), which included auditors and preparers who had specific experience with the DM. The Board received 91 responses, and the results were consistent with the reported results for the 2008 discussion paper. While 39% agreed the DM conveyed information that provided incremental benefits, 51% did not believe the incremental benefit outweighed the incremental cost.

Although the 2015 project pertains to not-for-profit organizations, the FASB may have intended to extend the not-for-profit DM mandate to for-profit business entities. FASB Vice Chairman James L. Kroeker said, "I'd challenge you to look at the changes we're making for not-for-profits that would eliminate the use of the indirect method of cash flows." He added, "There's the idea that perhaps we would extend that to business enterprises as well," thus indicating that the Board may make another attempt to mandate the direct method presentation for business enterprises.[9]

Kroeker's comments also indicated that the mandate may not require the DM to be accompanied by a reconciliation to net income. In December 2015, however, the FASB voted four to three to allow not-for-profit entities to use either method in their presentation of cash flows. They also decided to allow not-for-profit entities to utilize the direct method without requiring the inclusion of an indirect reconciliation of operating cash flows. Prior to the decision, the FASB had received mixed support from respondents to its proposals, with some respondents indicating the direct method should not be required for not-for-profit entities until it is required for business entities.

CONSIDER THE POTENTIAL COSTS AND BENEFITS

While it is true that the DM's straightforward presentation may be more advantageous to some users, the IM brings another level of usefulness to the statement. The reconciliation of accrual basis net income with cash provided by operating activities offers an initial assessment of earnings quality by showing the magnitude of accrual changes employed to arrive at net income each period.

Indeed, the level of discretionary accruals and portion of accruals that result in actual cash flows in a timely manner are two methods for assessing earnings quality that are discussed in the academic literature.[10]

Because companies often manage earnings to meet a targeted amount of earnings per share with the aggressive use of accruals, persistent increases in current receivables accompanied by accrual net income similar to that of the prior period (or close to zero) could indicate the presence of earnings management. While professionals can conduct earnings quality assessments by other means, the cash flow statement prepared using the IM readily shows the differences in accrual- vs. cash-basis income and the changes in accruals. Therefore, in our opinion, eliminating the option for the IM or allowing the DM without reconciliation to net income could result in a less useful statement for some users.

As the accounting community struggles to come to terms with the presentation of cash flows, many respondents state the DM is likely more advantageous for some users. This is a position that the existing literature supports, but the consensus favored the IM throughout the life of the statement. Over the years, opinions remained remarkably consistent. As we described, the comments from the NFPRG in 2015 are consistent with those for the 2008 discussion paper and with the 1987 consensus for Exposure Draft #23 issued for SFAS 95 at the Statement's inception. The one notable exception is banks that preferred the DM for SFAS 95 but favor the IM in the 2008 discussion paper. Over the Statement's life, interested parties have indicated that the cost of switching to the DM is not worth any incremental benefit over the IM that might exist. Because rule makers have consistently favored mandating the DM, it is likely that the Statement will undergo a transformation in the future. The discussion to mandate the DM is almost certainly going to continue, so accounting and finance professionals will need to consider the potential costs and benefits of the DM and IM going forward. ■

Note: On August 18, 2016, the FASB issued ASU No. 2016-14, "Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities." The Board says these new rules complete Phase I of the project. They continue to allow nonprofits to choose either the DM or IM to present operating cash flows, and they no longer require the inclusion of an indirect reconciliation of operating cash flows. But more could happen in other areas.

Nathan H. Jeppson, Ph.D., CPA, is an assistant professor in the accounting department at Montana State University at Bozeman. You can reach Nathan at (406) 994-6204 or nathan.jeppson@montana.edu.

John A. Ruddy, CPA, CFA, is an assistant professor in the finance department at the University of Scranton in Scranton, Pa. You can reach John at (570) 941-4303 or john.ruddy@scranton.edu.

David F. Salerno, Ph.D., CPA, is an assistant professor in the accounting department at the University of Scranton. You can reach David at (570) 941-4313 or david.salerno@scranton.edu.

Endnotes

1 David M. Katz, "FASB Revisits the Cash-Flow Statement," *CFO*, September 30, 2014.
2 Tammy Whitehouse, "FASB Proposal May Foreshadow Changes to Cash Flow Rules," *Compliance Week*, April 24, 2015.
3 It should be noted that the 91 respondents in the 2015 NFPRG and the 229 respondents to the 2008 discussion paper were self-selected participants when they commented. Thus, similar to prior studies, self-selection bias may exist, so it cannot be assumed the discussion represents the opinions of all preparers and users of financial statements.
4 R.S. Olusegun Wallace, Mohammed S.I. Choudhury, and Maurice Pendlebury, "Cash Flow Statements: An International Comparison of Regulatory Positions," *The International Journal of Accounting*, Volume 32, Issue 1, January 1997, pp. 1-22.
5 *Ibid*.
6 While some letter writers only provided one explanation for their preference, many provided two. No more than two arguments were tallied for each letter.
7 Jeffrey Hales and Steven Orpurt, "A Review of Academic Research on the Reporting of Cash Flows from Operations," *Accounting Horizons*, September 2013, pp. 539-578.
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10 For a discussion of discretionary accruals, see Jennifer Jones, "Earnings Management During Import Relief Investigations," *Journal of Accounting Research*, Volume 29, Issue 2, Autumn 1991, pp. 193-228; for a discussion of accruals and cash flows, see Patricia Dechow and Ilia Dichev, "The Quality of Accruals and Earnings: The Role of Accrual Estimation Errors," *The Accounting Review*, Volume 77, Supplement 2002, pp. 35-59.