**Examining Preferences in Cash Flow Statement Format**

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In November 1987, FASB issued SFAS 95, *Statement of Cash Flows*, which required businesses to issue a statement of cash flows rather than a statement of changes in financial position, effective July 15, 1988. FASB made the decision to encourage, but not require, the use of the direct method for reporting. Both the direct and indirect methods (illustrated in [Exhibit 1](http://www.nysscpa.org/cpajournal/2004/1004/images/p58ex1.pdf)) require cash flows to be classified according to operating, investing, and financing activities. The different presentation affects the operating section only. The investing and financing sections do not differ between the two presentations.

The direct method, also referred to as the income statement method, reports major classes of operating cash receipts and payments. In this respect, it is more consistent with the objective of SFAS 95. Supporters of the direct method contend that it is more revealing of a company’s ability to generate sufficient cash from operations to pay debts, reinvest in operations, and make distributions to owners. Detractors point out that many corporate providers of financial statements do not currently collect information that would allow them to determine the information necessary to prepare the direct method. More important, the direct method effectively presents income statement information on a cash rather than an accrual basis and may erroneously suggest that net cash flow from operations is as good as, or better than, net income as a measure of performance (Mahoney, Sever and Theis, 1988).

The indirect, or reconciliation, method focuses on the difference between net income and net cash flow from operations. Advocates of the indirect method note that it provides a useful link among the statement of cash flows, the income statement, and the balance sheet. Critics point out that the direct method requires a supplemental disclosure to present a reconciliation of net income and net cash. The incremental cost of providing the additional information disclosed in the direct method is, however, not significant.

The first column of Exhibit 1 illustrates the format of the indirect cash flow statement. The operating section starts with net income for the current period. Then, all noncash transactions are negated. Finally, the changes in the balance sheet accounts that relate to operations are reconciled. For example, when accounts receivable increases, sales included in net income must be reconciled for the additional uncollected amounts. Ultimately, the operating section reconciles net income with net cash provided by operations. The second column of Exhibit 1 displays the direct cash flow statement format. Operating cash receipts and payments and their sources are presented. The format is similar to a cash-basis income statement for operations.

**Cash Flow Format and Decision Making**

Research has shown that a relationship exists between the presentation of financial information and users’ decisions. A study conducted by Stock and Watson (1984) concluded that judgment can be influenced by the accounting report format used. Hard and Vanecek (1991) concluded that different formats are appropriate depending on the user’s task.

Cash flow information is integral to investment and credit decisions. With SFAS 95, FASB has provided better access to cash flow information. While earnings information is extremely important, balance sheet and cash flow items have value to financial analysts as well. A survey of investors revealed that investors’ appreciation for the value of the cash flow information has increased significantly and is useful in the assessment of investment decisions (Epstein and Pava, 1992).

Since the issuance of SFAS 95, the debate has continued over the virtues of the direct versus the indirect format. Advocates for the direct format claim it better fulfills clients’ information needs because of the breakdown of major classes of cash inflows and outflows (Collins, 1990). In addition, the format is simpler to understand and provides performance evaluation via the expected and actual cash flows (Bohannon and Edwards, 1993). Those in favor of the indirect method point out that one of the major reasons cited in SFAS 95 for requiring a statement of cash flows is to assist the users in determining the reasons for the difference between net income and associated cash receipts and payments to provide a basis for evaluating the quality of income (Carslaw and Mills, 1991).

**Survey of User Preferences**

[Exhibit 2](http://www.nysscpa.org/cpajournal/2004/1004/images/p59ex2.pdf) presents a cross-tabulation of the survey results. In the manager category, 82% of CEOs, CFOs, and managers preferred the indirect method, compared with 70.3% of investors and analysts.

Overall, 78.9% of users prefer the indirect method. Although investors reported a preference for the indirect method, they showed a greater preference for the direct method than managers (29.7% versus 18%).

**Findings**

[Exhibit 3](http://www.nysscpa.org/cpajournal/2004/1004/images/p60ex3.pdf) cross-tabulates the format by different respondents’ perspectives. Exhibit 3 indicates the percent of respondents who agree or disagree under different reasons. An analysis of the five possible reasons for the preferred format is summarized as follows:

* Familiarity with the format was more important to those preferring the indirect method. This may be because the indirect format more closely resembles the statement of change in financial position previously required. Managers considered familiarity slightly more important than did investors (85.7% versus 80.8%). For those preferring the direct method, however, investors placed more importance on familiarity than did managers (50% versus 39%).
* Regarding the ability to see the difference between net income and cash from operations, 82.7% of managers ranked this factor as important, compared with only 72% of investors. Investors preferring the direct method also placed importance on seeing the difference between net income and cash from operations. This information would appear in the supplemental reconciliation of net income and net cash.
* The main difference between the indirect and direct methods is that cash paid can be determined using the direct method. It is no surprise that, for those preferring the direct method, this feature was considered very important (95.6% for managers and 100% for investors). For respondents preferring the indirect method, seeing cash paid was not important (30.8%).
* Whether the indirect or direct method is preferred, one might expect consistency to be somewhat important. Respondents that preferred the direct method, however, did not put much emphasis on consistency (52.2% and 50%). Perhaps the need to see items such as cash paid is considered more important than the need for consistency.
* Regardless of the method preferred, investors seemed to place more importance than did managers on change in accounts receivable and payable (92.3% versus 78.8% for indirect and 60.0% versus 38.1% for direct).

*Respondents in different business sectors emphasized different factors.* Of the four items that most likely reflect a preference for the indirect method, familiarity is, on average, more important (84%) than consistency (82.2%), seeing change in accounts receivable and payable (80.8%), and understanding the difference between net income and cash from operations (80.6%).

When examining by business types, the following trends were found:

* n Manufacturing, which favors the indirect method (85.9%), ranked familiarity most important (86.9%). Understanding the difference between net income and cash from operations (77%) and knowing the change in accounts receivable and payable (78.7%) were somewhat less important.
* Merchandising prefers the indirect method, but by a much lesser percentage than do other business types (63.6%), and reported knowing the change in accounts receivable and payable most important (100%) versus understanding the difference between net income and cash from operations (85.7%) and familiarity (85.7%).
* Financial companies equally preferred the indirect and direct methods. But for those preferring the indirect method, familiarity is most important (100%), followed by knowing the change in accounts receivable and payable (75%) and understanding the difference between net income and cash from operations (66.7%). For those preferring the direct method, familiarity was least important (25%).
* Services preferred the indirect method by 76.7%, but ranked familiarity (69.7%) lower than did all other business types. For those preferring the direct method, only 30% placed importance on consistency.
* Utilities, which are required to use the direct method, strongly preferred the indirect method (88.9%). All utility companies that preferred the direct method agreed on the importance of consistency, while only 75% of those preferring the indirect method thought consistency was important. Familiarity is the most important (100%) for those preferring the indirect method, followed by understanding the difference between net income and cash from operations (87.5%) and knowing the change in accounts receivable and payable (71.4%). For those preferring the direct method, other reasons for the preference equally as important as consistency included understanding the difference between net income and cash from operations, and seeing cash paid.

For those preferring the direct method, seeing cash paid is very important. All firms except financial firms (75%) agree unanimously. For utilities preferring the indirect method, 50% want to see cash paid. This is higher than any other sector, with financial companies in second (33.3%).

**Analysis**

A sufficient number of users prefer the direct method (over 20% overall and almost 30% of investors) to warrant further investigation of, comment on, or changes to the operating cash flow statement. One can argue that “familiarity with format” and “consistency for comparison with prior years” are weak positions to defend. The usability of financial statements should be driven by market needs and evolving financial models. The familiarity issue is one that disappears over time as users become familiar with new presentations, as occurred when the working capital definition of funds was abandoned. The consistency issue is easily addressed by recasting previous years’ cash flow statements using the current method, as is now done on the income and financial position statements with changes in accounting principles. The argument that providers of financial statements do not collect information in a manner that allows them to determine the information necessary to apply the direct method is no longer legitimate. The integrated software in use by many companies allows data to be mined for myriad purposes, including direct cash flows from operations.

One alternative would be to include a supplemental schedule of direct cash flows on the bottom of indirect method cash flow statements. This would serve both preferences, and would align financial statement preparers with the FASB recommendation that the direct method be employed.

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