



Which is a Better Method for Reporting Cash Flows from Operating Activities-Direct or Indirect Method?

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Author's contribution

The sole author designed, analyzed and interpreted and prepared the manuscript.

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ABSTRACT

This paper is a response to the ongoing debate in the accounting profession on whether the direct method is better than the indirect method when reporting cash flows from operating activities. The debate has its roots from the standard setters who prefer the direct method and are even debating on whether to make the direct method mandatory. The contention being that the direct method is a better method than the indirect method when reporting cash flows from operating activities since the disaggregation of its components suggests more disclosure. More disclosure in financial statements has been a cry from the financial statement users such as the creditors and investors. This qualitative argument will therefore show the merits of both the direct and the indirect method before getting to a conclusion on which method is better than the other. Further, it is a contribution to the ongoing debate in the accounting profession that can guide the standard setters as they deliberate on the possibility of making the direct method mandatory. In addition, a contention map and an argument map are used as roadmaps of the ideas being discussed in this study.

Keywords: Direct method; indirect method; cash flows; operating activities.

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1. INTRODUCTION

1.1 Background to the Study

“Cash is king” is a common phrase in the business world. Companies realize the importance of cash in running their daily activities. This led to the development of a third primary financial statement, statement of cash flows which is explained by International Accounting Standard (IAS) 7- statement of cash flows. The statement has three sections namely, cash flow from operating activities, cash flow from investing activities and cash flow from financing activities. However, this paper’s focus is on the cash flow from operating activities.

There are two methods that can be used for reporting cash flow from operating activities and these are; the direct method or the indirect method. There is no consensus on which method is better than the other although the International Accounting Standard Board (IASB) and the Financial Accounting Standard Board (FASB) have the direct method as the preferred method. Furthering this debate is the discussion among the standard setters as they seek to harmonize accounting standards that direct method of reporting operating cash flows be made mandatory. Despite all these moves in favor of the direct method, most companies still prefer to report using the indirect method. This has therefore kept the debate alive hence this contention on the direct method as a better method for reporting cash flows from operating activities.

1.2 Problem Statement and Gap in Research

The cash flow from operating activities contains revenue –producing activities and other activities that are not investing or financing activities (IAS 7). Financial statements, including the statement of cash flows’ main purpose is to provide the present and potential investors, lenders, and other creditors with relevant information for economic decision-making (IFRS framework, 2008). Most creditors and investors prefer the direct method because of its usefulness in predicting future earnings and operating cash flows [1]. In addition to this, the direct method is the preferred method by both the IASB and FASB [2].

Despite the advantages that the direct method has, most financial statement preparers still use

the indirect method when reporting cash flows from operating activities [3;4;1]. In their study, Lightstone, Wilcox, and Beaubien, [5] found that 99.9 percent of their observations used indirect method which support the popularity of the indirect method among the preparers of financial statements. Some of the reasons cited by the preparers are that, the indirect method is less costly to construct, it uses readily available information from the income statement and the statement of changes in owner’s equity, the information used for the indirect method can be converted to the direct method hence no need of making the direct method mandatory. In addition, they argue that once indirect method has been used, there will not be a need for the reconciliation of operating income to the net cash flows that is usually required where direct method has been used [1].

The non-use of the direct method would mean less disclosure on how the cash came in and went out of the organization thereby defeating the overall purpose for cash flow statement preparation, which is to report the historical changes in cash and cash equivalents (IAS 7). This little disclosure could then lead to investors and creditors making uninformed decisions on their investments, which then might lead to financial crises such as the one experienced during 2008-2009 period.

In order to address these issues, this paper is an argument paper that seeks to table the reasons the direct method is better than the indirect method when reporting cash flow from operating activities. The direct method approach is supported by the disclosure theory while the indirect method is supported by the agency theory. This argument paper will display the two sides of the same coin (direct versus indirect) to guide in making a choice of the side that is better. This will also guide the standard setters as they deliberate on the need to make the use of the direct method mandatory.

1.3 Objectives of the Study

- To weigh the advantages of the direct method over the indirect method when reporting operating cash flows.
- To develop a contention/argument paper in the ongoing debate on whether the direct method is better than the indirect method.
- To guide the standard setters by contributing in their debate of making the direct method mandatory.

1.4 Historical Setting of the Study/ Situating the Study in the Discipline

Literature review was mainly done from academic journals and that is where the gap in research imaged. With the way cash is valued in business, cash flow analysis seems to be one of the hot topics in accounting. The introduction of the cash flow statement came as a result of corporate failures due to liquidity problems [5]. Scholars, regulators, standard setters and the accounting profession agree on the importance of reporting cash flows from operating, investing and financing activities but seem not to agree on the best method to use on operating activities hence this debate. The IASB and the FASB allow either the direct method or the indirect method of reporting cash flows from operating activities, the preferred method being the direct method [2;1]. Despite the direct method being the preferred method by the standard setters, studies have shown that most companies report using the indirect method [5]. This has kept the argument on whether the direct method is a better method than the indirect method ongoing. Moreover, the standard setters have not concluded on making the direct method mandatory hence the debate continues.

Those from the direct method school of thought have the following as some of the advantages of using the direct method:

- The direct method provides the financial statement users with the relevant information to make economic decisions,
- It eliminates allocations which are as a result of using different accounting methods such as different depreciation policies,
- The direct method format can easily be used for cash flow variance analysis by infusing the cash budget to the report,
- The direct method improves predictability of future earnings and future operating cash flows, and
- The direct method is the preferred method by both the IASB and the FASB.

On the other hand, those supporters of the indirect method have the following as its advantages:

- It is easier for preparers to create since it uses readily available information from the income statement and balance sheet,
- It highlights the differences between net income and net cash from operating activities, and

- That the information disclosed in the indirect method can be used to convert it to the direct method if need be.

From literature, there is an imaging group that is proposing the use of both methods and their argument is that 'there is no one best way' since each method can be better than the other depending on the context, thus, the disclosure of both methods becomes necessary [3]. This paper is however focusing on the use of either the direct or indirect method and not both.

2. THEORETICAL FRAMEWORK

The agency theory has an influence on the choice of method used for operating activities. The managers (agents) might choose a method that safeguards their interest even at the expense of the shareholders [6;7]. For instance, the managers might choose to report cash flows from operating activities using the indirect method to the shareholders who are not financially literate as a way of covering up their misuse of cash flows. The motive behind the choice of the method in this case would be to protect the agents' interests and not the shareholder's interests [8].

2.1 Cash Flow from Operating Activities

Cash flows from operating activities report "on the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make investments without recourse to external sources of financing" (IAS 7). Some of the examples of cash flows from operating activities are:

- Cash received from sale of goods and the rendering of services;
- Cash payments to suppliers for goods and services;
- Cash payments to and on behalf of employees; and
- Cash payments or refunds on income taxes (IAS 7).

2.2 The Direct Method and the Indirect Method

Cash flows from operating activities are reported using either the direct or indirect method. The direct method discloses major classes of cash receipts and cash payments while the indirect

method adjusts the net profit or loss for the effects of non-cash transactions [9;10;11]. Entities are however encouraged to report cash flows from operating activities using the direct method (IAS 7). Below is an example of

reporting cash flows from operating activities using the direct and indirect method given the same data from the income statement and the comparative statement of financial position.

Statement of financial position for ABC as at 31 December 2019

Debits	Dec 2019(\$)	Dec 2018(\$)
Non-current Assets		
Equipment	111 000	99 000
Less: Accumulated depreciation	52 000	34 000
	59 000	65 000
Current Assets		
Inventory	203 000	178 000
Accounts receivable	31 000	27 000
Cash	58 000	39 000
Total Asset	351 000	309 000
Financed by:		
Capital		
Ordinary share capital	194 000	186 000
Capital Reserve	66 000	54 000
Retained Earnings	59 000	29 000
Liabilities		
Income tax payable	9 000	8 000
Accounts payable	23 000	39 000
	351 000	309 000

Income statement for ABC for the year ended 31 December 2019 (\$)

Credit sales	664 000
Less: Cost of goods sold (Purchases of inventory were on credit)	398 000
	266 000
Less: Expenses	
Depreciation expense	18 000
Other operating expenses (paid in cash)	167 000
Income tax expense	14 000
	199 000
Net profit	67 000

Cash flow from operating activities using the direct method

Cash received from customers	660 000
Cash paid to suppliers	(432 000)
Cash paid for other operating expenses	(432 000)
Income tax paid	(13 000)
Net cash provided by operating activities	48 000

Cash flow from operating activities using the indirect method

Net profit	67 000
Increase in inventory	(25 000)
Increase in accounts receivable	(4 000)
Increase in income tax payable	1 000
Decrease in accounts payable	(9 000)
Depreciation Expense	18 000
Net cash provided by operating activities	48 000

From the example above, the direct method distinctly shows specific amounts for the activities that brought cash into the business as cash received from customers (\$660 000) and those that took cash out of the business as payments to suppliers (\$432 000), for other operating expenses (\$167 000) and income tax payments (\$13 000). These figures can be used to compare different financial period results as well as figures from other companies in the same industry. This then gives the users of financial statement relevant figures for their decision-making. On the other hand, the indirect method just reconciles the net profit figure of \$67 000 to the operating cash flows of \$48 000. Users of financial statements might not understand why depreciation of \$18 000 which is an expense is added to the net profit figure. Although both methods result in the same figure of \$48 000 as net cash from

operating activities, the direct method seems to be more user friendly than the indirect method because of its simplicity and understandability [12;10]. The contention map and an argument map below helps to reveal how and why the direct method is better than the indirect method when reporting cash flows from operating activities.

2.3 The Reasons, Sub-reasons and Evidence of the Direct Method

First, considering that the main purpose of financial statements, cash flow statement included, is to provide the financial statement users such as the creditors and investors with the relevant information for decision-making [13], the direct method gives such information to the users [22]. The direct method enhances comparability since the users can compare

- ! **Contention:** The direct method is better than the indirect method when reporting cash flows from operating activities since the disaggregation of its components suggests more disclosure.
- ↑ Reason: Firstly, considering that the main purpose of financial statements (the cash flow being one of them) is to provide users with relevant information for decision making [13], the direct method gives such to the creditors and investors.
- ⚖ Evidence: The direct method enhances comparability since the users can compare similar types of cash receipts and cash payments across companies at least yearly.
 - Source: [1]
 - Source: [14]
- ⚖ Evidence: Furthermore, the direct method eliminates allocations which are as a result of using different accounting methods such as different depreciation policies.
 - Source: [1]
 - Source: [5]
- ⚖ Evidence: In addition, the direct method clearly shows the users whether cash collection from customers are increasing or decreasing and whether the cash payments to suppliers are also increasing or decreasing.
 - Source: [1]
- ↑ Sub-reason: In support of this, the direct method presents the individual cash inflows and cash outflows from the operating activities, which is clearer and easily understood by users than indirect where the figures are derived from the income statement and have to be reprocessed.
- ⚖ Evidence: Studies have shown that users who might not have substantial accounting knowledge prefer the direct method format than indirect format because it is user-friendly.
 - Source: [12]
 - Source: [1]
- ⚖ Evidence: More so, clarity in presentation enhances readers' understandability of what is being reported. The direct method discloses each major class of gross cash receipts and gross cash payments separately and thus clearer than an adjustment to net income figure.
 - Source: [13]
- ↑ Sub-reason: In the same vein, the format can be easily used for cash flow variance analysis by infusing the cash budget to the report thereby revealing the problematic areas of the cash flow.
- ⚖ Evidence: Operating cash flow information was found to be useful in cash flow forecasts.
 - Source: [15]
 - Source: [14]
- ⚖ Evidence: In addition, cash flow and budgetary variance analysis is useful for predicting future cash flows.
 - Source: [16]

- Source: [17]
- ↑ Reason: Secondly, the direct method improves predictability of future earnings and future operating cash flows.
- ↕ Evidence: The direct method operating cash flow components possess higher predictive ability for future cash flows over aggregate operating cash flow
- Source: [18]
- Source: [19]
- ↑ Reason: Lastly, the direct method is the preferred method by both the IASB and the FASB.
- ↕ Evidence: The accounting standard setters set accounting principles that are to be followed by accountants as they prepare the financial statements. Since the direct method is the preferred method, it means it has good qualities that led to the endorsement of the method.
- Source: [1]
- Source: [2]
- ↑ Objection: On the other hand, the indirect method is a better method than the direct in presenting cash flows from operating activities because it is easier for preparers to create since it uses readily available information from the income statement and balance sheet considering that these statements are prepared on accrual basis.
- ↕ Evidence: The indirect method is the preferred method among the preparers of financial statement because it is less costly and easy to construct.
- Source: [3]
- Source: [1]
- ↕ Counter evidence: Although the income statement and balance sheet feeds directly to the indirect method of cash flows, understandability by the users should be given first consideration than the ease it is to the preparers since financial statements' primary purpose rests with the users. Moreover, being simple does not equate to being relevant and useful.
- Source: [13]
- Source: [2]
- ↑ Objection: The indirect method also highlights differences between net income and net cash from operating activities.
- ↕ Evidence: Since the indirect method focuses on the differences in net income and net operating Cash flow, a useful link to the income statement when forecasting future operating cash flow is then provided.
- Source: [13].
- ↕ Counter-Evidence: However, the reconciliation of net income and net cash from operating activities does not fulfil the main purpose of the cash flow statement which is "to report the historical changes in cash and cash equivalents" and thus providing the users with insight as to how the entity generates and uses cash.
- Source: [1]
- ↕ Counter Evidence: More so, the reconciliation of net income to net cash from operating activities, can be used as a note or an adjustment after a direct method presentation.
- Source: [20]
- ↑ Objection: Finally, the information presented by the indirect method can be used to convert the indirect method to direct method if need be.
- ↕ Evidence: Since the information disclosed by the indirect method is sufficient for the conversion to direct method, then the indirect method is more superior because of dual usefulness of its disclosed information.
- Source: [3]
- Source: [1]
- ↕ Counter evidence: Though conversion to direct method is possible, preparing the direct method cash flow from information derived from the indirect method is however not 100% accurate.
- Source: [21]
- Source: [1]
- ↕ Counter evidence: More so, not all financial statement users are financially literate to be able to convert the information in the indirect method to direct method.
- Source: [13]

Fig. 1. Contention Map

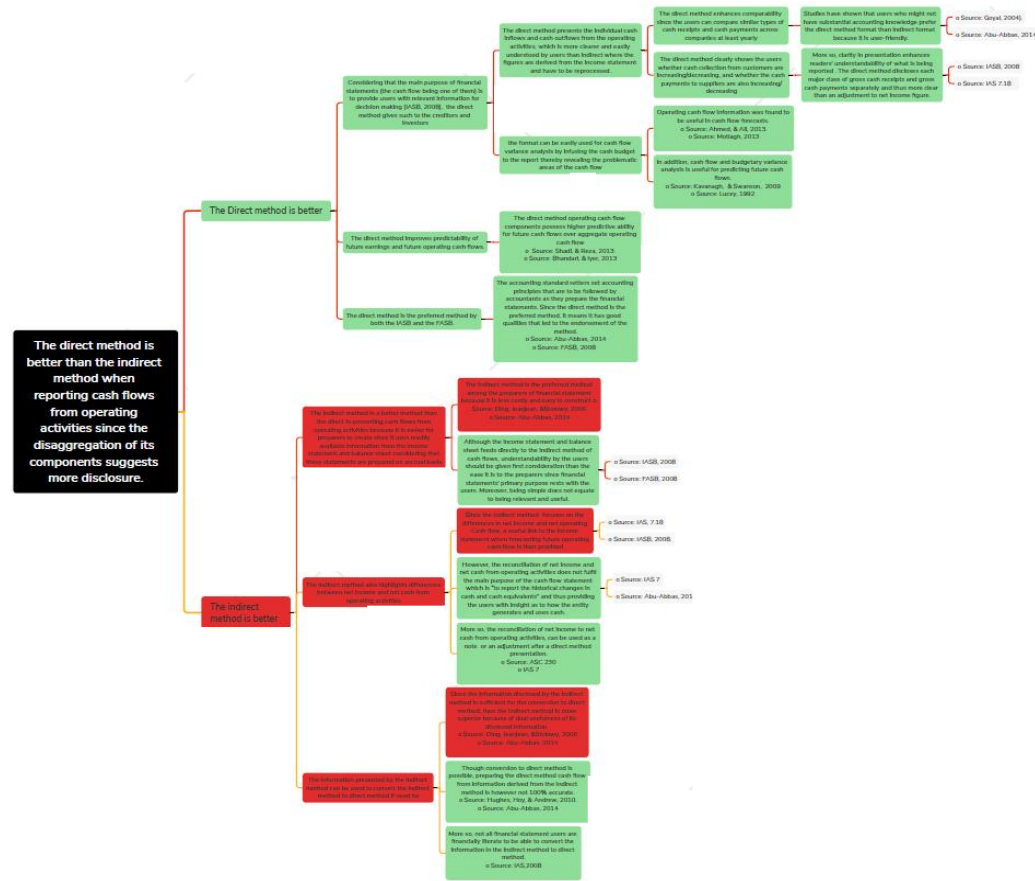


Fig. 2. An argument map

similar types of cash receipts and cash payments across companies at least yearly [1;14]. Comparability being one of the enhancing qualitative characteristic of a quality report [13] that enhances usefulness of financial reports for decision making. The direct method also eliminates allocations which are as a result of using different accounting methods such as different depreciation policies [1;5]. Furthermore, the direct method clearly shows the users whether cash collections from customers are increasing or decreasing and whether the cash payments to suppliers are also increasing or decreasing [1;23]. In support of this, Goyal [12] found the users of financial statements (managers, shareholders, employees, suppliers, and customers) preferred the direct method because of its simplicity, understandability, relevance and reliability. A similar study done by Abdullah, Majed, and Aymen [24] on academic professionals who are professors and associate professors on the preferred method between the direct and indirect method also that the direct method was preferred for its relevance, reliability, and usefulness in decision making. These two study results therefore suggest that the direct method is better than the indirect method to both the users of financial statements and the accounting academicians.

In support of the same point, the direct method presents the individual inflows and cash out flows from operating activities making it more clearer and easily understood by users than indirect method where the figures derived from the income statement have to be reprocessed. Clarity in presentation enhances reader's understandability of the report [13;25]. Moreover, the direct method discloses each class of gross cash receipts and gross cash payments separately (IAS 7.18) and thus more clear than an adjustment to net income figure presented by the indirect method. The direct method therefore becomes more user-friendly to the financial statement users who might not have substantial accounting knowledge [12;1].

In the same vein, the direct method format can be easily used for cash flow variance analysis by infusing the cash budget to the report thereby revealing the problematic areas of the cash flow. In support of this, Ahmed and Ali [15] and Motlagh [14] concluded that operating cash flow information was useful in cash flow forecasts. Since cash flow and budgetary variance analysis is useful for predicting future cash flows [16] the

direct method format make it easier for such analysis.

Second, the direct method is better than the indirect method because it improves predictability of future earnings and future operating cash flows [22]. In their studies, Shadi and Reza [18] and Bhandari and Lyer [19] found that the direct method operating cash flow components possess higher predictive ability for future cash flows over aggregate operating cash flow. This therefore makes it a better method than the indirect method.

Lastly, the fact that the direct method is the preferred method by both the IASB and the FASB shows that it has better qualities than the indirect method [1;13]. Accounting standard boards being independent organisation that set accounting principles and standards that are to be followed by accountants as they prepare the financial statements, their view that the direct method is better than the indirect method is likely to be unbiased hence confirming that the direct method is a better method than the indirect method.

2.4 The Objection, Evidence and Counter Evidence of the Direct Method

Although the direct method is a better method than the indirect method, the indirect method has its proponents as well. First, they argue that the indirect method is easier to prepare since it uses readily available information from the income statement and balance sheet. As an example, the figures for net income, depreciation, loss or gain on sale of assets are directly shown in the income statement hence need no additional calculations. Unlike the direct method where the cash receipt figure is found by adjusting the sales figure with the increase/decrease in accounts receivable and the cash payment for purchases is the cost of sales figure adjusted to the changes in inventory and accounts payable. This makes the indirect method the preferred method among the preparers of financial statements [3; 1]. While the indirect method may seem easy to the preparers, understandability by the users should be prioritized since the main objective of preparing financial statements rests with the users not the ease it is to the preparers. Moreover, being simple does not equate to being relevant and useful which one of the fundamental qualitative characteristics to be found in financial statements [13;2]. This therefore leaves the direct method still a better method than the indirect method.

Second, the proponents claim that the indirect method highlights differences between the net income and the net cash from operating activities thereby providing a useful link to the income statement when forecasting future operating cash flow [13]. Although a useful link to the income statement is provided by the indirect method, the net income reconciliation to net cash flow from operating activities does not fulfill the overall objective for cash flow statement preparation which is “to report the historical changes in cash and cash equivalents” and thus providing the users with insight as to how the entity generates and uses cash [1]. Moreover, the reconciliation of net income to net cash from operating activities can be presented as a note or an adjustment after a direct method presentation [20] hence refuting the raised point.

Lastly, they also argue that the information disclosed by the indirect method can be used to convert the indirect method to direct method if need be hence making the indirect method superior because of this dual usefulness of its disclosed information [3;1]. Despite the dual usefulness of its disclosed information, the direct method is still better than the indirect method because the derived figures are not 100 percent accurate [21;1]. This then makes the derived statement inferior because it then fails to fulfill one of the fundamental qualitative characteristics of useful financial information, which is ‘faithful representation’. Faithful representation implying completeness, neutrality and freedom from error. More so, not all financial statement users are financially literate to be able to convert the information from the indirect method to direct method [13]. This again leaves the direct method still better than the indirect method when reporting cash flows from operating activities.

3. CONCLUSION

After weighing the two views, the direct method is still a better method of reporting the cash flows from operating activities. This is so because the direct method clearly presents to the users information which is relevant for economic decision making. The information presented does not need re-processing and is also useful for cash flow variance analysis so as to reveal the problematic areas of the cash flow. Furthermore, studies have shown that the direct method improves predictability of future earnings and future operating cash flows [17;12]. Finally, the direct method is the preferred method by both the IASB and the FASB. On the other hand, the

proponents for the indirect method favor it because it is easier to prepare, it highlights differences between net income and net cash from operating activities and the information presented can be converted to direct method if need be. In spite of these cited advantages for the indirect method, their arguments are less convincing because they compromise understandability, relevance, faithful representation and also fail to fulfill the overall purpose of preparing cash flow statements. More so, not all financial statement users have substantial accounting knowledge to be able to convert the information disclosed by the indirect method to direct method if need be. This therefore leads to the conclusion that the direct method is better than the indirect method when reporting cash flow from operating activities.

4. RECOMMENDATION

The debate on which method is better than the other is still ongoing. The standard setters have also not agreed to the mandatory presentation of cash flow from operating activities using the direct method. Therefore, the possibility of using both methods in one statement could be explored.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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