

Review of the Direct Method Statement of Cash Flows and the Associated Teaching Implications

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FAS 95 permits both the direct and indirect methods of reporting cash flow from operating activities on the statement of cash flows. The academic literature documents several benefits of the direct method. Nevertheless, use of the direct method is now virtually extinct in the U.S. The “indirect-direct” method of preparing the direct cash flow, used by current textbooks, makes the direct method appear more difficult to prepare than the indirect method. Several recommendations are provided to give students a more favorable opinion of the direct method, with the hope of increased U.S. acceptance and adoption.

BACKGROUND INFORMATION

In November 1987, The Financial Accounting Standards Board (FASB) issued FAS 95, Statement of Cash Flows. FAS 95 states: “The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.” (SFAS 95, para. 4). In paragraphs 27 and 28 of FAS 95, and paragraphs 19 of IAS 7 the respective standard setters encouraged entities to use the direct method of reporting cash flow from operations but allowed the indirect method to be used. The direct method requires the listing of the sources and uses of cash for operating activity, while the indirect method reconciles net income to cash flow from operating activities. The example format of the direct and indirect methods, as published in FAS 95, are shown in Appendices 1 and 2, respectively. Note that with both the FAS 95 and IAS 7 standards, entities using the direct method must also continue to provide the indirect method data reconciling net income with cash flow from operating activities. Thus, the true comparison of the usefulness of these methods is not the direct vs. the indirect, but the direct and indirect vs. the indirect alone.

If electing to use the direct method, FASB allowed the direct tracking of this information from the accounting system or adjusting the income statement items by balance sheet changes. The statement passed by a 4-3 vote. Two FAS board members dissented to FAS 95's permitted use of the indirect method of reporting net cash flow from operating activities. "They believe that by permitting the continued use of the indirect method, the Board has foregone the opportunity to make a significant contribution to the quality of financial reporting and to enhance user understanding of cash flows from operating activities." (FAS95, para 34). The stated belief of these two dissenting FAS board members has proven to be prophetic.

ALLOWING INDIRECT METHOD LIMITED THE ADVANCE FROM FAS 95

The statement of cash flows was a significant step forward from the previous financial statement focusing on liquidity, the Statement of Changes in Financial Position. However, allowing the indirect method was a major compromise because the method fails to report relevant information about cash receipts and cash payments within the operating activities category.¹ In addition, the indirect method's manner of reporting cash flows from operating activities is inconsistent with the direct method format used in reporting investing and financing activities. The direct method fulfills the primary purpose of the cash flow statement because it provides relevant cash receipts and cash payments information for the operating, investing and financing activities of an enterprise for the reporting period.

Since FAS 95 was issued in 1987, the direct method was tried by a few U.S. companies. Now the direct method is virtually extinct in the U.S. A review of the statements of cash flow from the S&P 500 revealed only 1 company (0.2%) used the direct method in 2016. (Johnson, 2017) The 0.2% usage in 2016 is down from the 2.5% usage of the direct method reported in the 1991 Accounting Trends and Techniques. Why has the indirect method remained the dominant method employed in preparing the statement of cash flows? Investopedia offers an explanation. "Many accountants prefer the indirect method because it's fairly easy to prepare from the accounts businesses ordinarily maintain as part of the chart of accounts. However, regulators and standards-setting bodies are less in favor of its use as it doesn't offer a clear a picture of cash flows throughout a business." (Investopedia, 2018) Notice that companies are focused on what is relatively easy to produce rather than what provides the most valuable and useful information.

ENHANCED INFORMATIONAL CONTENT OF THE DIRECT METHOD

The direct method statement of cash flows has been reported as easier to understand by non-financial internal management. (Trout et.al., 1993) While this statement came from the context of a case study implementing the direct method cash flow statement, a review of the formats in Appendix 1 and Appendix 2 confirm that this observation can be generalized to other users. Appendix 3 is a list of selected items taken from the indirect statements of cash flow from publicly held companies. It takes a great deal of accounting knowledge to properly interpret items like "excess tax benefit from stock compensation" (or any other of the line items listed in Appendix 3) that reconcile net income to cash flow from operating activities. In contrast, direct cash flow items like cash received from customers and cash paid to suppliers are easy for operating managers to understand. The difficulty to understand the indirect method has been noted in academic literature. For instance, Zhao simply states "The IM (indirect method) has been criticized to confuse readers". (Zhao, 2013, p. 50)

Analysts using cash flow data supported the direct method in the public comment period of FAS95. Wallace reports that out of 154 banks and financial institutions 89% commenting supported the direct method. (Wallace, et.al. 1997). Bradbury notes that Robert Morris Associates, representing more than 15,000 bank loan and credit officers in the United States, adamantly advocated for the direct method. (Bradbury, 2011).

Since the 1987 issuance of FAS 95, academic literature revealed several studies which support the argument that the direct method of cash flow is a preferred method by many users of accounting information and that the additional information provided is useful for future cash-flow and income predictions of the reporting companies. Some of the academic studies are listed below to demonstrate the usefulness of the direct method. Hales and Orpurt (2013) provide a comprehensive review of these studies.

Goyal (2004) conducted a survey in Australia where 47 of the 100 surveys sent out were returned. Survey respondents were managers, shareholders, employees, suppliers and customers who had significant experience using the direct and indirect cash flow information. At that time Australian standard setters required the use of the direct method, although the indirect method was also disclosed in a required reconciliation of net income to cash flow from operating activities. The majority of all categories

of responding users supported the usefulness of the direct method, indicating that it helps users understanding the cash flow data. Management felt it helped them make decisions on the allocation of resources, make predictions and confirm or correct past evaluations. Shareholders also ranked the direct method higher than the indirect method. They believed it helped them understand cash flow data and satisfied their investment-related decision making needs. Employees, suppliers, and customers also ranked the direct method above the indirect method. However, both the indirect and direct method statements appeared to satisfy their decision-making needs. This study indicates that management and investors, the user groups with the most intense need to utilize cash flows to understand past results and to project future results, favor the direct method for use decision making.

Studies by Orpurt and Zang (2009), and Bradbury (2011) provided evidence that data included on the direct method of cash flow is additional information, not otherwise available to users with only indirect cash flow reports. Attempts to derive the direct method data using income statement and balance sheet items resulted in sizable errors.

Orpurt and Zang extended their study to show that the addition of direct cash flow data resulted in more accurate predictions of future cash flow and earnings that could be used to improve projected valuation of the companies.

Michael Bradbury summed it up succinctly when he stated “. . . the evidence consistently shows the direct method is higher quality reporting.” (Bradbury, 2011, p. 128)

IMPEDIMENTS TO DIRECT METHOD IMPLEMENTATION IN THE U.S.

Two overriding factors prevented the direct method of reporting cash flows from being widely accepted in the U.S. First, the FASB didn't require it. Companies are consistently challenged by required changes to financial reporting and weren't motivated to undergo a voluntary change of enhanced disclosure when the indirect method was allowed and few competing firms provided the additional disclosure required by the direct method.

Financial statement preparers expressed a concern about the cost of preparing the statement of cash flow using the direct method. Preparers of financial statements argued they could not prepare a direct method statement of cash flows without costly accounting system overhauls.

I worked in the accounting department of a company that implemented the direct method statement of cash flow in the early 1990s. Limited resources were consumed by the implementation of the direct cash flow method by my employer. The elapsed time to develop the methodology was two to three months, during which time we were only working part time on the direct cash flow project. Our payment system, which categorized cash disbursements using the general ledger code for the associated expense account, was the main information source. We augmented the direct capture of the cash flow data by deriving certain numbers from a combination of income statement and balance sheet items. We especially faced complexities in determining the cash expended for self-constructed assets. Admittedly, our company's implementation was made simpler due to the fact that the company had only a single small subsidiary for which we did all the accounting. Therefore, we didn't have to coordinate or consolidate our direct cash flow data with many affiliated companies. Nevertheless, being able to provide the enterprise's cash inflows and outflows in summarized line item detail was a much simpler task than required by other accounting and tax calculations. In fact, it can be argued having sufficient internal controls over cash implies the ability to produce an enterprise's cash payment and receipt information. Given reasonable time for implementation by FASB, financial accounting software system providers could focus on capturing this cash flow information.

AUSTRALIA'S EXPERIENCE PROVIDES A LARGE SUCCESSFUL PILOT STUDY FOR THE DIRECT METHOD

In 1991, the Australian Accounting Standards Board, AASB, required the direct method be used on the statement of cash flows. Jones (1997) surveyed Australian financial statement preparers and found

support for the direct method and statistically insignificant results to the question of whether the direct method was more costly than the indirect method. Nevertheless, in 2007, the AASB changed its cash flow statement requirements and allowed the indirect method in order to conform to IFRS and U.S. standards. Interestingly, a study by Bond found that only a few companies changed to the indirect method in the following three years. Of the companies changing to the indirect method, most were engaged in operations in countries where the indirect method was the norm. (Bond, et.al., 2012). In order determine if Australian companies continued to use the direct method, Johnson (2017) viewed the statement of cash flows of the companies on the ASX 200, an index of 200 Australian firms, and found 93.5% used the direct method. Continued voluntary use of the direct method by Australian firms nine years after the AASB no longer required it provides additional evidence U.S. companies' concerns about the cost of using the direct method were overstated.

ACCOUNTING CURRICULUM POSES ANOTHER BARRIER TO DIRECT METHOD IMPLEMENTATION

The opinion that the indirect statement of cash flows is difficult to understand is supported by the fact that its preparation is taught so late in principles of accounting texts. In our curriculum, we don't cover it until the second term of accounting. Some colleges don't cover the preparation of the statement of cash flows at all at the principles level.

Going from industry to academia in 2006, I was pleased that the direct method was covered in current accounting texts, but I was struck by way the direct method is taught in the U.S. accounting curriculum. Rather than assume that accounting systems provide the numbers needed to calculate the direct method cash flow, principles level and intermediate accounting textbooks indirectly calculate the direct method cash flow by taking income statement line items and adjusting them by balance sheet changes. This method has been termed by some as the indirect-direct method. Appendix 4 shows an example of a direct cash flow problem found in a textbook using this method. This method of computing the direct cash flow is great for pedagogical reasons, teaching students to convert from the accrual to the cash basis. However, students are left with the impression this is only way the direct cash flow can be calculated. Students complain that the direct method is harder to prepare than the indirect method due to the indirect manner of calculating the line items. Further, by the time students learn the direct method, they have already learned the indirect method and the differences in handling the balance sheet changes is confusing.² The academic presentation of the direct cash flow has created a generation of accountants who believe the direct method is more difficult to prepare than the indirect method.

The FASB has not given up on the direct method. As recently as July 1, 2010, the Staff Draft prepared for the Financial Accounting Board's joint financial statement project includes a proposal to require a direct method statement of cash flows and a reconciliation of income or loss from operating activities to cash flow from operating activities as an integral part of the statement of cash flows.

TEACHING IMPLICATIONS

In addition to teaching students how to account using prevalent practices in use, accounting faculty have an obligation to support best practices in financial reporting such as the direct method cash flow. Several actions could be taken by faculty to support the direct method.

Faculty could discuss the benefits of the direct method statement of cash flow. In summary, the benefits are providing more useful information to users in a format that is more understandable to non-financially trained management. One way to demonstrate the direct method's improved understandability is by showing students direct and indirect statements of cash flows side-by-side for the same company and asking them which format better communicates the relevant information about the cash receipts and cash payments of the enterprise. While doing this, the faculty member can remind the students that financial statements are to provide data which provide both predictive and confirmatory value to users.

Faculty could ask students whether they would expect that companies' financial systems would be able to summarize the company's cash receipts and cash payments. In an Intermediate Accounting course, the students could be asked to brainstorm how the financial accounting system could accumulate or derive this cash flow data.

When introducing the direct method to students, faculty could use a problem like that shown in Appendix 5. This could be done at the principles level at the end of the coverage of accounting cycle or later as an introduction on the chapter dealing with preparation of the statement of cash flow amounts. This problem provides students with the cash flows for each line item of the direct cash flow explaining that the information came from the accounting system. Students will use this data to create a direct statement of cash flows. Assigning problems like these will teach the students the format of the statement of cash flows and require them to correctly categorize items into operating, investing and financing activities. After this introduction, the indirect method will be introduced. Faculty should explain that the preponderance of U.S. companies use the indirect method and that a reconciliation from net income to cash flow from operating activities is also provided by the direct method. When the indirect-direct method is introduced, faculty should remark that this is an acceptable but not required way to prepare the direct method statement of cash flows. Students should understand that using the indirect-direct method allows them to convert an accrual-basis income statement to a cash-basis income statement and is important for their understanding of the interrelatedness of the financial statements. Done in this order, students are exposed to the enhanced understandability of the direct method and will not be left with the conclusion that the direct method is necessarily more difficult to prepare than the indirect method.

SUMMARY AND CONCLUSION

The direct method of reporting cash flow from operating activities provides useful information that is otherwise not available to financial statement users. FASB's decision to allow enterprises to report using the indirect method has resulted in almost no U.S. companies using the direct method. However, as recently as 2010, the FASB staff still expressed support for the direct method. This is very important because with the use of the direct method nearly extinct in the U.S., it will require FASB's mandated use for the method to become widely adopted. Although estimates of the cost of implementing and maintaining the direct method are not available, the survey results of Australian entities using the direct method and Australian firms' overwhelming continued use of the direct method after it ceased to be required by the AASB, provides evidence the cost of the direct method is not unreasonable.

To their credit, principles level and intermediate texts include instruction on the direct method despite the small minority of U.S. firms using the method. However, for pedagogical reasons, the texts focus on the indirect-direct method of computing the direct cash flow which creates the impression that the direct method is more difficult than the indirect method. This impression creates an additional obstacle to widespread adoption of the direct method.

Accounting faculty have an obligation to support best practices such as the direct method statement of cash flows. Faculty should express this support when the opportunity exists through FASB public comment. Another way to support the method is to demonstrate to students how much easier it is to understand for non-financially trained management. It is also important for accounting faculty to indicate that the indirect-direct method, the method predominately used in textbooks to introduce the direct method, is not the only way to do the direct method. That in fact, accounting systems can and should be developed to routinely provide information on cash receipts and disbursements by summary line items.

ENDNOTES

1. Except interest and income taxes which are required disclosures of the indirect method according to FAS 95 paragraph 121.
2. When adjusting net income, a source of cash, by balance sheet changes using the indirect method, increasing current assets and decreasing current liabilities are negative adjustments to net income, while decreasing current assets and increasing current liabilities are positive adjustments. With the direct method, when adjusting individual income statement items, both cash sources and uses are adjusted, so the above methodology doesn't work universally. The student must consider the balance sheet change effect on each individual item.

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APPENDICES

**APPENDIX 1
FORMAT OF STATEMENT OF CASH FLOWS USING THE DIRECT METHOD**

COMPANY M
Consolidated Statement of Cash Flows
For The Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Cash received from customers	\$13,850	
Cash paid to suppliers and employees	(12,000)	
Dividends received from affiliates	20	
Interest received	55	
Interest paid (net of amounts capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received	15	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		\$1,365
Cash flows from investing activities:		
Proceeds from sale of facilities	600	
Payment received on note for sale of plant	150	
Capital Expenditures	(1,000)	
Payment for purchase of Company S, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligations	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends Paid	(200)	
Net cash provided by financing activities		<u>875</u>
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		<u>600</u>
Cash and cash equivalents at end of year		<u>1,665</u>

APPENDIX 1 CONTINUED

Reconciliation of net income to net cash provided by operating activities:		
Net Income		\$760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Company S:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		<u>605</u>
Net cash provided by operating activities		\$1,365
Supplemental schedule of noncash investing and financing activities:		
The company purchased all the capital stock of Company S for \$50. In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired	\$1,580	
Cash paid for the capital stock	(950)	
Liabilities assumed	\$630	
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest (net of amount capitalized)		\$220
Source: FAS 95, Statement of Cash Flows, November, 1987, paragraph 131.		

APPENDIX 2
FORMAT OF STATEMENT OF CASH FLOWS USING INDIRECT METHOD

COMPANY M
Consolidated Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Net Income		760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Company S:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		<u>605</u>
Net cash provided by operating activities		1,365
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital Expenditures	(1,000)	
Payment for Purchase of Company S, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash Flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends Paid	(200)	
Net cash provided by financing activities		<u>875</u>
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		<u>600</u>
Cash and cash equivalents at end of year		1,665

APPENDIX 3
EXAMPLES OF INDIRECT CASH FLOW STATEMENT RECONCILING ITEMS OF
NET INCOME TO CASH FROM OPERATING ACTIVITIES

Note: The indirect method of reporting cash from operating activities starts with net income and reconciles to cash flow from operating activities. Reconciling items from net income to cash from operating activities often are arcane and very difficult for non-financial managers to interpret. Below are some examples of especially difficult-to-interpret reconciling items found in 25 selected companies' year 2017 statements of cash flows.

Reconciling Item	Company, Year
Customer Financing valuation cost/(benefit)	Boeing (2017)
Net (gains) losses of consolidated investment entities	Ameriprise Financial (2017)
Accretion related to purchase accounting	Tomkins Financial Corporation (2017)
Unrealized foreign exchange (gains) losses	Synnex Corporation (2017)
AFS securities losses (gains), net	CIBC (2017)
Client Incentives	Visa Inc. (2017)
Excess tax benefit from stock-based compensation	Hormel Foods Corporation (2017)
Right to recover for covered losses recorded in equity	Hormel Foods Corporation (2017)

APPENDIX 4
TYPICAL DIRECT CASH FLOW PROBLEM FOUND IN ACCOUNTING TEXTS

The Dairy Company's income statement and comparative balance sheets as of December 31, 2016 and 2015 follow:

Dairy Company
Income Statement
For the Year Ended December 31, 2016

Sales revenue		\$700,000
Cost of Goods Sold	\$460,000	
Wages and other operating expenses	95,000	
Depreciation Expense	22,000	
Goodwill amortization expense	7,000	
Interest Expense	10,000	
Income Tax Expense	36,000	
Loss on bond retirement	<u>5,000</u>	<u>635,000</u>
Net Income		<u>\$65,000</u>

Dairy Company
Balance Sheets

Assets	<u>12/31/2016</u>	<u>12/31/2015</u>
Cash	\$22,000	\$18,000
Accounts Receivable	43,000	28,000
Inventory	103,000	129,000
Prepaid Expenses	12,000	10,000
Plant Assets	360,000	336,000
Accumulated Depreciation	(87,000)	(84,000)
Goodwill	<u>43,000</u>	<u>50,000</u>
Total Assets	<u>\$496,000</u>	<u>487,000</u>
Liabilities and Stockholders' Equity		
Accounts payable	32,000	26,000
Interest payable	4,000	7,000
Income Tax payable	6,000	8,000
Bonds payable	60,000	100,000
Common Stock	252,000	248,000
Retained Earnings	<u>142,000</u>	<u>98,000</u>
Total Liabilities and stockholders' Equity	<u>\$496,000</u>	<u>\$487,000</u>

During the year, the company sold for \$17,000 cash old equipment that had cost \$36,000 and had \$19,000 accumulated depreciation. New equipment worth \$60,000 was acquired in exchange for \$60,000 of bonds payable. Bonds payable of \$100,000 were retired for cash at a loss. A \$21,000 cash dividend was declared and paid. All stock issuances were for cash.

Required:

- a. Compute the change in cash that occurred in 2016.
- b. Prepare a statement of cash flows using the direct method.

**APPENDIX 4 CONTINUED
SOLUTION**

a. Cash, December 31, 2016 \$22,000 Cash, December 31, 2015 (\$18,000)

Cash increase during 2016 \$ 4,000

b. Supporting computations:

Cash received from customers:

\$700,000 sales - \$15,000 accounts receivable increase = \$685,000

Cash paid for merchandise purchased:

\$460,000 cost of goods sold - \$26,000 inventory decrease - \$6,000 accounts payable increase = \$428,000

Cash paid for wages and other operating expenses:

\$95,000 wages and other operating expenses + \$2,000 increase in prepaid expenses \$97,000

Cash paid for interest:

\$10,000 interest expense + \$3,000 decrease in interest payable = \$13,000

Cash paid for income taxes:

\$36,000 income tax expense + \$2,000 decrease in income tax payable = \$38,000

Sale of equipment: \$17,000 given in problem data.

Acquisition of equipment in exchange for bonds payable:

\$60,000 given in problem data; this is a noncash investing and financing activity.

Retirement of bonds payable:

\$100,000 beginning bonds payable + \$60,000 bonds payable increase from acquisition of equipment —

\$60,000 ending bonds payable + \$5,000 loss on bond retirement = \$105,000

Issuance of common stock:

\$252,000 ending common stock — \$248,000 beginning common stock = \$4,000

Payment of dividends: \$21,000 given in problem data

Other analysis:

Equipment increased by \$24,000, which is the difference between the \$60,000 increase from equipment acquired for bonds payable and the \$36,000 decrease from the cost of equipment sold.

Accumulated depreciation increased by \$3,000, which is the difference between the \$22,000 increase from depreciation expense and the \$19,000 decrease from the sale of equipment.

Goodwill decreased by \$7,000, which is the amount of goodwill amortization expense.

Retained earnings increased by \$44,000, which is the difference between the net income of \$65,000 and the dividends declared of \$21,000.

APPENDIX 4 CONTINUED

DAIRY COMPANY Statement of Cash Flows FOR YEAR ENDED DECEMBER 31, 2016	
Cash flow from operating activities:	
Cash received from customers	\$685,000
Cash paid for merchandise purchased	(\$428,000)
Cash paid for wages and other operating expenses	(97,000)
Cash paid for interest	(13,000)
Cash paid for income taxes	<u>(38,000)</u>
Cash provided by operating activities	109,000
Cash flow from investing activities:	
Sale of equipment	17,000
Cash flow from financing activities:	
Retirement of bonds payable	(105,000)
Issuance of common stock	4,000
Payment of dividends	<u>(21,000)</u>
Cash used by financing activities	<u>(122,000)</u>
Net increase in cash	4,000
Cash at beginning of year	18,000
Cash at end of year	<u>\$ 22,000</u>
<u>Schedule of Non-Cash Investing and Financial Activities:</u>	
<u>Acquisition of equipment in exchange for bonds payable</u>	60,000

Source: Managerial Accounting for Undergraduates, First Edition, Theodore Christensen, L. Scott Hobson, and James Wallace, Cambridge Business Publishers. Published with permission from Cambridge Business Publishers.

APPENDIX 5
EXAMPLE INTRODUCTORY DIRECT METHOD CASH FLOW PROBLEM

CTX Inc. is a retailer with a beginning cash balance of \$6,000. CTX's accounting system reported the following cash receipts and expenditures for the year ended December 31, 2016:

Cash Paid for Compensation	\$18,000
Cash Paid for Dividends	6,000
Cash Paid for Debt Repayment	12,000
Cash Received from Debt Issuance	3,000
Cash Paid for Income Taxes	11,130
Cash Paid for Interest	16,000
Cash Paid for Inventory Purchases	153,300
Cash Paid for Plant, Property and Equipment	15,000
Cash Received from Sales	249,300
Cash Paid for Vendors for Operating Expenses	\$11,000

Required: Prepare a statement of cash flows for CTX Inc. for 2016 using the direct method.

SOLUTION

CTX Inc.

Statement of Cash Flows

For the year ending December 31, 2016

Cash Flow from/(used in) operating activities:	
Cash Received from Sales	\$249,300
Cash paid for Inventory Purchases	(153,300)
Cash Paid for Compensation	(18,000)
Cash Paid to Vendors for Operating expenses	(11,000)
Cash Paid for Interest	(16,000)
Cash Paid for Income Taxes	(11,130)
Total Cash from/(used in) Operating Activities	<u>\$39,870</u>
Cash Received/(Paid) for Investing Activities:	
Purchase of Plant, Property and Equipment	(15,000)
Total Cash Received/(Paid) for Investing Activities	<u>(\$15,000)</u>
Cash Received/(Paid) for Financing Activities:	
Cash Paid for Dividends	(6,000)
Cash Paid for Debt Repayments	(12,000)
Cash Received from Debt Issuance	3,000
Total Cash Received/(Paid) for Financing Activities	<u>(\$15,000)</u>
Net Change in Cash	\$9,870
Beginning Cash	<u>6,000</u>
Ending Cash	\$15,870