

READING**CASH FLOW FORMATS: INDIRECT VS. DIRECT METHOD****Introduction**

The banking industry has evolved to usage of the following two primary formats for cash flow statements and models:

1. In situations where a business provides accountant-prepared financial statements (reviews and audits, in particular, as covered in Level 1 Course 4 of this curriculum), a business banker can utilize a statement of cash flows (SCF) prepared in accordance with SFAS 95, Statement of Cash Flows effective in 1988. As explained in this reading, an SCF usually is prepared using the indirect method
2. In most situations; including accountant prepared reviews and audits, plus customer-prepared financial statements and tax returns; bankers use statement spreading software to create the UCA cash flow model (UCA model). This report is generated using the direct method

Statement of Cash Flows (SCF)—Indirect Method

In SFAS 95, the Financial Accounting Standards Board (FASB) expressed a preference for, but did not require, the use of the direct method. Both the direct and indirect methods 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.

Although both the direct and indirect approaches produce the same subtotal for cash provided from operating activities, the internal composition of the statements differ substantially. A major advantage of the direct method is that the primary sources and uses of cash are listed. A major advantage of the indirect method is that the reasons for the difference between net income and cash generated by operations are detailed.

On the practical side, the indirect approach is used more frequently, partly due to historical convention, and the indirect approach is similar to the statement that was required prior to SFAS 95. Additionally, a firm using the direct approach must provide a schedule that reconciles net income with cash provided by operating activities. This reconciliation essentially consists of the information contained in the indirect approach. Thus, a firm that opts for the direct approach must really provide both methods. Some firms are reluctant to do this, either because additional costs are involved or because they feel that the statement will become too cluttered and, therefore, less informative.

The indirect cash flow method under SFAS 95 will be demonstrated later in this course using the financial data from Dry Supply, a wholesaler of powdered laundry products. The operating activities section of the SCF will be demonstrated from the same financial data, but using the direct method. Because the investing and financing activities sections of the SCF are the same using both methods, they will not be repeated using the direct method.

READING

SURVEY OF USER PREFERENCES

A survey published several years ago by *The CPA Journal* reported that 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. Four possible reasons for the preferred format were (in order of importance):

1. Familiarity with the format, since it more closely resembles the statement of changes in financial position previously required
2. Consistency
3. Seeing changes in accounts receivable and accounts payable, for example, was important. [Seeing actual cash received (from customers, for instance) and cash paid (to suppliers, for instance) was not important]
4. Ability to see the difference between net income and cash from operations

The following trends were found by business type:

- Manufacturing favored the indirect method (85.9%)
- Merchandising (retailers) preferred the indirect method, but by a much lesser percentage than do other business types (63.6%)
- Service businesses preferred the indirect method (76.7%)

The survey did not provide data for agricultural businesses, wholesalers and construction businesses.

UCA Cash Flow Model—Direct Method

Most of the cash flow models developed by bankers have used the direct method, as well as the operating, investing, and financing cash flows categories. The Uniform Credit Analysis (UCA) Model, introduced in The Risk Management Association's training course, *Uniform Credit Analysis*, is perhaps the most popular version and is provided by most of the financial spreading software programs.

Banker-developed models focus on seeing where cash was acquired and expended, rather than simple changes in balance sheet accounts. Most attempt to isolate or exclude interest payments from operating activities, in order to create a cash flow available for debt service number. They also pair the interest paid with scheduled payments on bank debt (current maturities of long-term debt) as a measure of required debt service. Later, when the model presents the overall change in bank debt, the current maturities are excluded from the underlying calculation, since they have already been paid.