



THIRD
EDITION

Intermediate ACCOUNTING

IFRS EDITION

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Statement of Cash Flows

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the usefulness and format of the statement of cash flows.
2. Prepare a statement of cash flows.
3. Contrast the direct and indirect methods of calculating net cash flow from operating activities.
4. Discuss special problems in preparing a statement of cash flows.
5. Explain the use of a worksheet in preparing a statement of cash flows.

PREVIEW OF CHAPTER 23

STATEMENT OF CASH FLOWS

The Statement of Cash Flows

- Usefulness of the statement of cash flows
- Classification of cash flows
- Cash and cash equivalents
- Format of the statement of cash flows

Preparing the Statement of Cash Flows

- Illustrations—Tax Consultants Inc.
- Sources of information for the statement of cash flows
- Net cash flow from operating activities—direct method

Special Problems in Statement Preparation

- Adjustments to net income
- Accounts receivable (net)
- Other working capital changes
- Net losses
- Disclosures

Use of a Worksheet

- Preparation of the worksheet
- Analysis of transactions
- Preparation of final statement

Intermediate Accounting

IFRS 3rd Edition

Kieso • Weygandt • Warfield

Statement of Cash Flows

LEARNING OBJECTIVE 1

Describe the usefulness and format of the statement of cash flows.

Primary purpose:

To provide information about a company's cash receipts and cash payments during a period.

Secondary objective:

To provide cash-basis information about the company's operating, investing, and financing activities.

Statement of Cash Flows

Usefulness of the Statement of Cash Flows

Provides information to help assess:

1. Entity's ability to generate future cash flows.
2. Entity's ability to pay dividends and meet obligations.
3. Reasons for the difference between net income and net cash flow from operating activities.
4. Cash and non-cash investing and financing transactions during the period.

Statement of Cash Flows

Classification of Cash Flows

**Operating
Activities**

**Income
Statement Items**

**Investing
Activities**

**Changes in
Investments
and Other Non-
Current Asset
Items**

**Financing
Activities**

**Changes in
Equity and Non
-Current
Liability Items**

Classification of Cash Flows

Operating

Cash inflows

From sales of goods or services.

From returns on loans (interest) and on equity securities (dividends).

Cash outflows

To suppliers for inventory.
To employees for services.
To government for taxes.
To lenders for interest.
To others for expenses.

Income
Statement
Items

ILLUSTRATION 23.1

Classification of Typical
Cash Inflows and
Outflows



Classification of Cash Flows

Investing

Cash inflows

- From sale of property, plant, and equipment.
- From sale of debt or equity securities of other entities.
- From collection of principal on loans to other entities.

Cash outflows

- To purchase property, plant, and equipment.
- To purchase debt or equity securities of other entities.
- To make loans to other entities.

Generally
Long-Term
Asset Items

Financing

Cash inflows

- From sale of equity securities.
- From issuance of debt (bonds and notes).

Cash outflows

- To stockholders as dividends.
- To redeem long-term debt or reacquire capital stock.

Generally
Long-Term
Liability
and Equity
Items

ILLUSTRATION 23.1

Classification of Typical Cash Inflows and Outflows

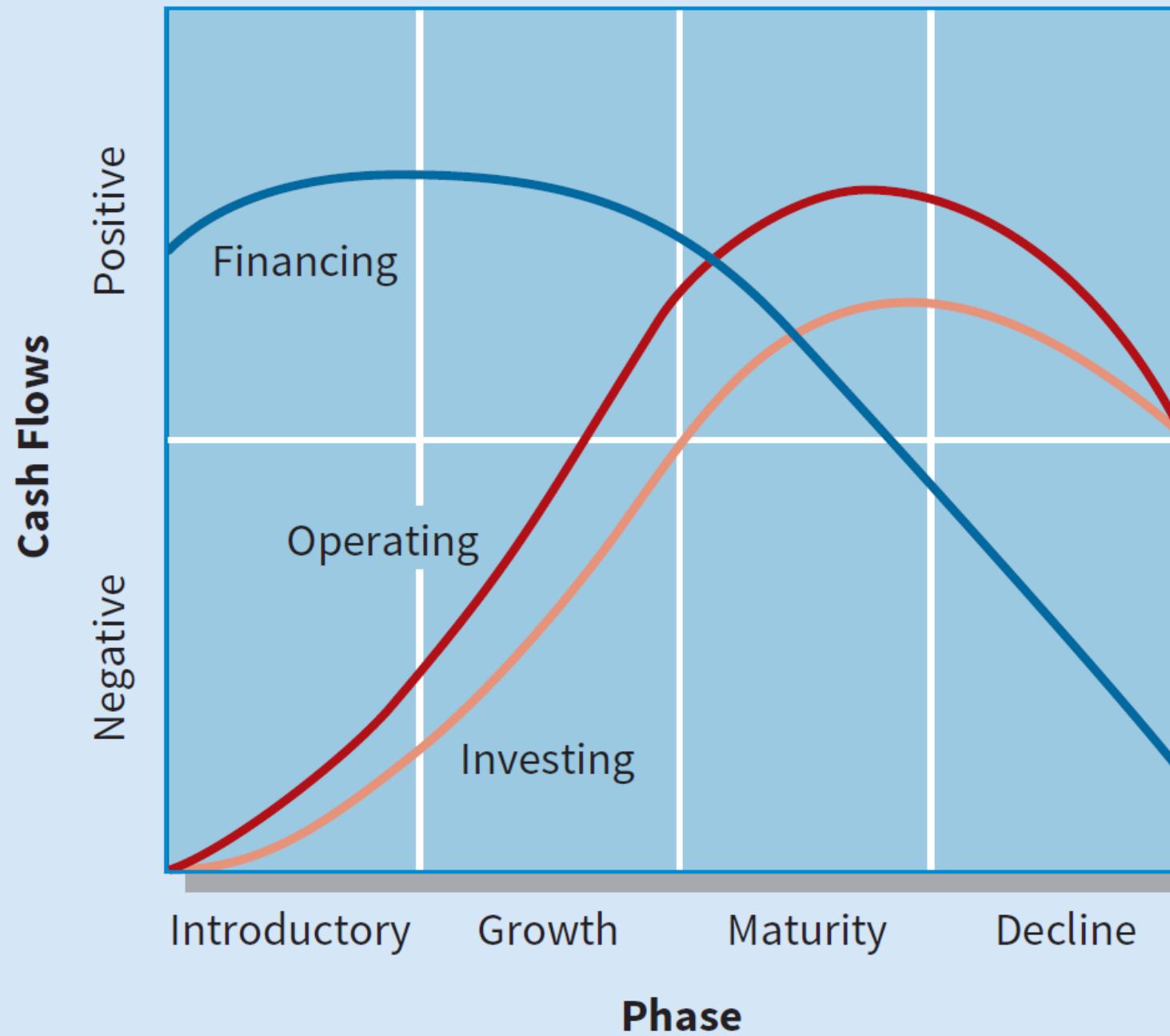
Cash and Cash Equivalents

The basis recommended by the IASB for the statement of cash flows is actually “cash and cash equivalents.” **Cash equivalents** are short-term, highly liquid investments that are both:

- ② Readily convertible to known amounts of cash, and
- ② So near their maturity that they present insignificant risk of changes value in (e.g., due to changes in interest rates).

Generally, only investments with original maturities of **three months or less** qualify under this definition.

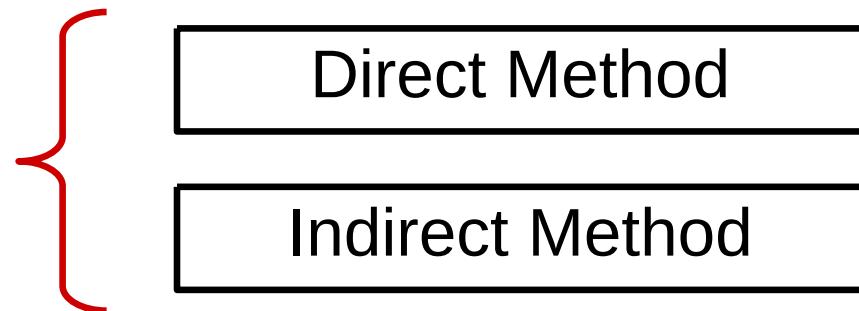
Product Life Cycle



Format of the Statement of Cash Flows

Presentation:

1. Operating activities.
2. Investing activities.
3. Financing activities.



Report inflows and outflows from investing and financing activities **separately.**

My
Notes
& Comp

COMPANY NAME
STATEMENT OF CASH FLOWS
PERIOD COVERED

Cash flows from operating activities

① Net income + Dep Exp

XXX

We (+)
or (-)
مودل

Adjustments to reconcile net income to net

+
-

cash provided (used) by operating activities:

(List of individual items)

XX → XX

Net cash provided (used) by operating activities

XXX

Cash flows from investing activities

(List of individual inflows and outflows)

XX

Net cash provided (used) by investing activities

XXX

Cash flows from financing activities

(List of individual inflows and outflows)

XX

Net cash provided (used) by financing activities

XXX

Net increase (decrease) in cash

(+) we take larger sign

XXX

Cash at beginning of period

(+) sign

XXX

Cash at end of period

=

XXX

ILLUSTRATION 23.2

Format of the Statement of Cash Flows

Preparing the Statement of Cash Flows

LEARNING OBJECTIVE 2

Prepare a statement of cash flows.

Flows

Three Sources of Information:

1. Comparative statements of financial position.
2. Current income statement data.
3. Selected transaction data.

Three Major Steps:

- Step 1. Determine change in cash.
- Step 2. Determine net cash flow from operating activities.
- Step 3. Determine net cash flows from investing and financing activities.

Illustrations—Tax Consultants Inc.

Illustration: Tax Consultants Inc. started on January 1, 2019, when it issued 60,000 shares of \$1 par value common stock for \$60,000 cash. The company rented its office space, furniture, and equipment, and performed tax consulting services throughout the first year.

The comparative statements of financial position at the beginning and end of the year 2019 appear in Illustration 23.3. Illustration 23.4 shows the income statement and additional information for Tax Consultants.

ILLUSTRATION 23.3

Comparative Statements of
Financial Position, Tax
Consultants Inc., Year 1

TAX CONSULTANTS INC.
COMPARATIVE STATEMENTS OF FINANCIAL POSITION

Assets:	End Dec. 31, 2019	beg Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$0-	\$36,000 Increase
Cash	<u>49,000</u>	-0-	49,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$0-</u></u>	<i>all increase by \$0</i>
Equity and Liabilities			
Ordinary shares (\$1 par) <i>invest</i>	\$60,000	\$0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	5,000	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$0-</u></u>	

ILLUSTRATION 23.4
Income Statement, Tax
Consultants Inc., Year
1

TAX CONSULTANTS INC.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2019

Revenues	\$125,000
Operating expenses	<u>85,000</u>
Income before income taxes	40,000
Income tax expense	<u>(6,000)</u>
Net income	<u><u>\$ 34,000</u></u>

Additional Information:

Examination of selected data indicates that a dividend of \$14,000 was declared and paid during the year.

بالمليون

$$\text{NI} - \text{RE} = \text{Div}$$
$$34,000 - 20,000 = 14,000$$

;

Illustrations—Tax Consultants Inc.

Step 1: Determine the Change in Cash

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION		
Assets	Dec. 31, 2019	Jan. 1, 2019
Accounts receivable	\$36,000	\$-0-
Cash	49,000	-0-
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>
 Equity and Liabilities		
Ordinary shares (\$1 par)	\$60,000	\$-0-
Retained earnings	20,000	-0-
Accounts payable	<u>5,000</u>	<u>-0-</u>
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>

ILLUSTRATION 23.3

Comparative statements of financial position, Tax Consultants Inc., Year 1

Illustrations—Tax Consultants Inc.

Step 2: Determine the Net Cash Flow from Operating Activities

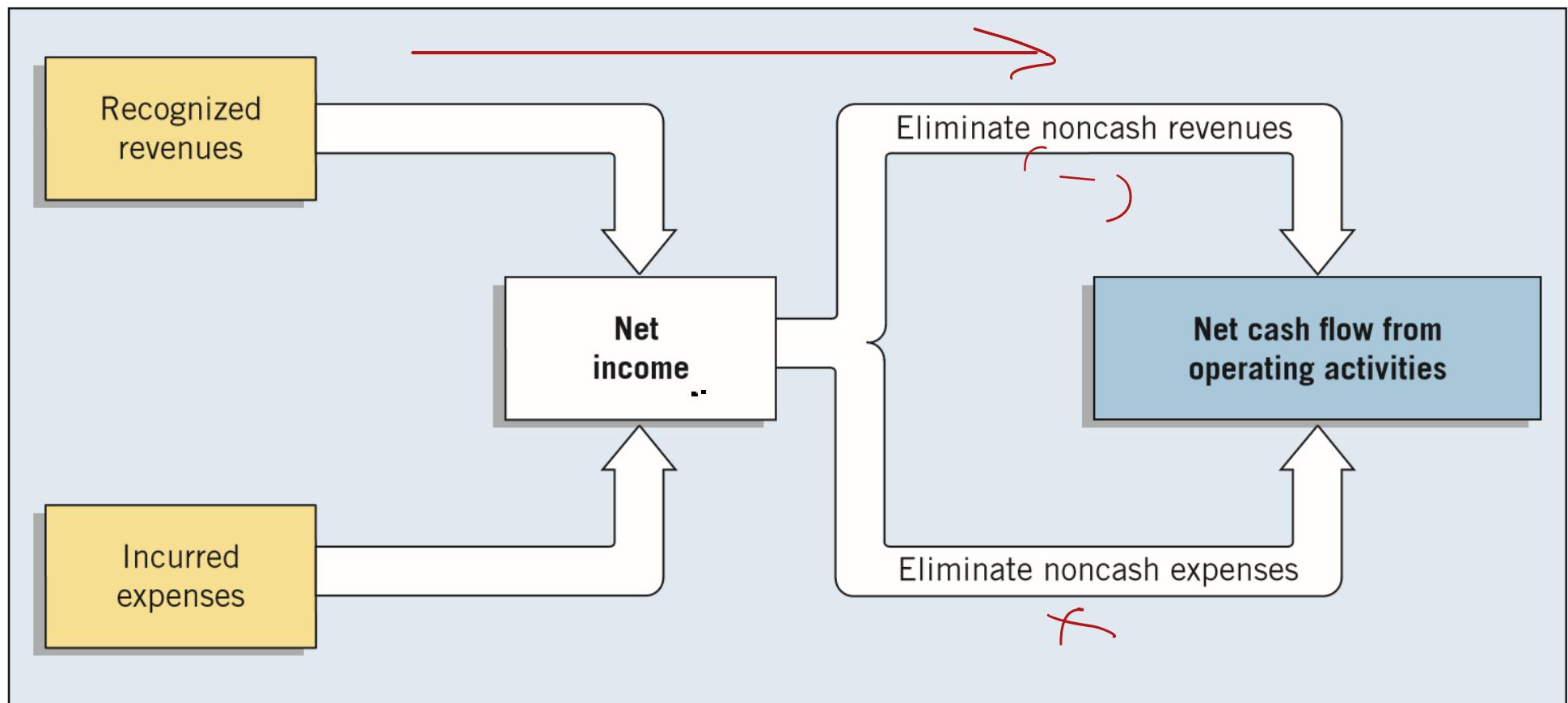
- ② Company must determine revenues and expenses on a **cash basis**.
Conversion
→ ;
- ② Eliminate the effects of income statement transactions that do not result in an increase or decrease in cash. *Dep*
- ② Convert net income to net cash flow from operating activities through either a direct method or an indirect method.

Illustrations—Tax Consultants Inc.

Step 2: Determine the Net Cash Flow from Operating Activities

ILLUSTRATION 23.5

Net Income versus Net Cash Flow from Operating Activities



Illustrations—Tax Consultants Inc.

Increase in Accounts Receivable—Indirect Method

Accounts receivable increased by \$36,000 (from \$0 to \$36,000) during the year. *A/R ↑ → SoC →)*

ILLUSTRATION 23.6

Accounts Receivable

1/1/19 Balance 0	Receipts from customers	89,000
Revenues 125,000		
12/31/19 Balance 36,000		

When the Accounts Receivable balance **increases**, cash receipts are **lower** than revenue earned under the accrual basis.

adj A/R, A/R inventory, revenue

Illustrations—Tax Consultants Inc.

Increase in Accounts Receivable—Indirect Method

ILLUSTRATION 23.6

Accounts Receivable

1/1/19 Balance 0	Receipts from customers	89,000
Revenues 125,000		
12/31/19 Balance 36,000		

The **increase in accounts receivable** is **subtracted** from net income to arrive at net cash provided by operating activities.

ILLUSTRATION 23.7

① Net income	\$ 34,000
<u>Adjustments</u> to reconcile net income to net cash provided by operating activities:	
↑ Increase in accounts receivable (→)	\$(36,000)
↓ Increase in accounts payable (+)	5,000
Net cash provided by operating activities	<u><u>\$ 3,000</u></u>

Illustrations—Tax Consultants Inc.

Increase in Accounts Payable—Indirect Method

Accounts payable increased by \$5,000 during the year.

When accounts payable increase during the year, expenses on an accrual basis exceed those on a cash basis.

Net income	\$ 34,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Increase in accounts receivable	\$ (36,000)
Increase in accounts payable .	5,000
	<u>(31,000)</u>
Net cash provided by operating activities	\$ 3,000

ILLUSTRATION 23.7

Step 3: Determine Net Cash Flows from Investing and Financing Activities

TAX CONSULTANTS INC. Statement of Cash Flows For The Year Ended December 31, 2019

ILLUSTRATION 23.8

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION

ILLUSTRATION 23.3

Assets	Dec. 31, 2019	Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$-0-	\$36,000 Increase
Cash	<u>49,000</u>	-0-	49,000 Increase 
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	
Equity and Liabilities			
Ordinary shares (\$1 par)	\$60,000	\$-0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	<u>5,000</u>	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	

Cash flows from operating activities

Net income

Adjustments to reconcile net income to net
cash provided by operating activities:

Net cash provided by operating activities

Cash flows from financing activities

Net cash provided by financing activities

Net increase in cash

Cash, January 1, 2019

Cash, December 31, 2019

Step 3: Determine Net Cash Flows from Investing and Financing Activities

TAX CONSULTANTS INC. Statement of Cash Flows For The Year Ended December 31, 2019

ILLUSTRATION 23.8

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION

ILLUSTRATION 23.3

Assets	Dec. 31, 2019	Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$-0-	\$36,000 Increase
Cash	<u>49,000</u>	-0-	49,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	
Equity and Liabilities			
Ordinary shares (\$1 par)	\$60,000	\$-0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	<u>5,000</u>	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	

Cash flows from operating activities

Net income

Adjustments to reconcile net income to net cash provided by operating activities:

Net cash provided by operating activities

Cash flows from financing activities

Net cash provided by financing activities

Net increase in cash

Cash, January 1, 2019

Cash, December 31, 2019

49,000

-0-

\$ 49,000

Step 3: Determine Net Cash Flows from Investing and Financing Activities

TAX CONSULTANTS INC. Statement of Cash Flows For The Year Ended December 31, 2019

ILLUSTRATION 23.8

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION

ILLUSTRATION 23.3

Assets	Dec. 31, 2019	Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$-0-	\$36,000 Increase
Cash	49,000	-0-	49,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	
Equity and Liabilities			
Ordinary shares (\$1 par)	\$60,000	\$-0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	5,000	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	

Cash flows from operating activities

Net income

Adjustments to reconcile net income to net cash provided by operating activities:

Increase in accounts receivable	\$(36,000)
---------------------------------	------------

Net cash provided by operating activities

Cash flows from financing activities

Net cash provided by financing activities

Net increase in cash	49,000
Cash, January 1, 2019	-0-
Cash, December 31, 2019	<u><u>\$ 49,000</u></u>

Step 3: Determine Net Cash Flows from Investing and Financing Activities

TAX CONSULTANTS INC.
Statement of Cash Flows
For The Year Ended
December 31, 2019

ILLUSTRATION 23.8

TAX CONSULTANTS INC.
COMPARATIVE STATEMENTS OF FINANCIAL POSITION

ILLUSTRATION 23.3

Assets	Dec. 31, 2019	Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$-0-	\$36,000 Increase
Cash	<u>49,000</u>	-0-	49,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	
Equity and Liabilities			
Ordinary shares (\$1 par)	\$60,000	\$-0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	<u>5,000</u>	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	

Cash flows from operating activities

Net income

Adjustments to reconcile net income to net cash provided by operating activities:

Increase in accounts receivable	\$(36,000)
---------------------------------	------------

Net cash provided by operating activities

Cash flows from financing activities

Issuance of ordinary shares	60,000
-----------------------------	--------

Net cash provided by financing activities

Net increase in cash	49,000
Cash, January 1, 2019	-0-
Cash, December 31, 2019	<u><u>\$ 49,000</u></u>



Step 3: Determine Net Cash Flows from Investing and Financing Activities

TAX CONSULTANTS INC.
Statement of Cash Flows
For The Year Ended
December 31, 2019

*Ex no
invest Act*

ILLUSTRATION 23.8

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION			ILLUSTRATION 23.3
Assets	Dec. 31, 2019	Jan. 1, 2019	Change Increase/Decrease
Accounts receivable	\$36,000	\$-0-	\$36,000 Increase
Cash	49,000	-0-	49,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	
Equity and Liabilities			
Ordinary shares (\$1 par)	\$60,000	\$-0-	\$60,000 Increase
Retained earnings	20,000	-0-	20,000 Increase
Accounts payable	5,000	-0-	5,000 Increase
Total	<u><u>\$85,000</u></u>	<u><u>\$-0-</u></u>	

Cash flows from operating activities		
Net income		\$ 34,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable		\$(36,000)
Net cash provided by operating activities		
Cash flows from financing activities		
Issuance of ordinary shares		60,000
Payment of cash dividends		(14,000)
Net cash provided by financing activities		46,000
Net increase in cash		49,000
Cash, January 1, 2019		-0-
Cash, December 31, 2019		\$ 49,000

TAX CONSULTANTS INC.
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2019
INCREASE (DECREASE) IN CASH

ILLUSTRATION 23.8

Cash flows from operating activities		
Net income		\$ 34,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	\$(36,000)	
Increase in accounts payable	<u>5,000</u>	<u>(31,000)</u>
Net cash provided by operating activities		3,000
Cash flows from financing activities		
Issuance of ordinary shares	60,000	
Payment of cash dividends	<u>(14,000)</u>	
Net cash provided by financing activities		<u>46,000</u>
Net increase in cash		49,000
Cash, January 1, 2019		-0-
Cash, December 31, 2019		<u><u>\$ 49,000</u></u>

Illustration—2020

ILLUSTRATION 23.9
 Comparative Statements
 of Financial Position, Tax
 Consultants Inc., Year 2

TAX CONSULTANTS INC.
COMPARATIVE STATEMENTS OF FINANCIAL POSITION
As of December 31

*following year
they expanded*

	2020	2019	Change
			Increase/Decrease
<u>Assets</u>			
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase
Buildings	200,000	-0-	200,000 Increase
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	-0-	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	\$386,000	\$ 85,000	
<u>Equity and Liabilities</u>			
Share capital—ordinary (\$1 par)	\$ 60,000	\$ 60,000	\$ -0-
Retained earnings	136,000	20,000	116,000 Increase
Bonds payable	150,000	-0-	150,000 Increase
Accounts payable	40,000	5,000	35,000 Increase
Total	\$386,000	\$ 85,000	

Illustration—2020

ILLUSTRATION 23.10

Income Statement, Tax Consultants Inc., Year 2

TAX CONSULTANTS INC. INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2020

Revenues		\$492,000
Operating expenses (excluding depreciation)	\$269,000	
Depreciation expense	<u>21,000</u>	<u>290,000</u>
Income from operations		202,000
Income tax expense		68,000
Net income		<u><u>\$134,000</u></u>

Additional Information

- (a) The company declared and paid an \$18,000 cash dividend.
- (b) The company obtained \$150,000 cash through the issuance of long-term bonds.
- (c) Land, building, and equipment were acquired for cash.

Step 1: Determine the Change in Cash

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31		
Assets	2020	2019
Land	\$ 70,000	\$ 0
Buildings	200,000	-0-
Accumulated depreciation—buildings	(11,000)	-0-
Equipment	68,000	-0
Accumulated depreciation—equipment	(10,000)	-0-
Accounts receivable	26,000	36,000
Prepaid expenses	6,000	-0
Cash	37,000	49,000
Total	<u><u>\$386,000</u></u>	<u><u>\$ 85,000</u></u>

Change
Increase/Decrease

\$ 70,000 Increase
200,000 Increase
11,000 Increase
68,000 Increase
10,000 Increase
10,000 Decrease
6,000 Increase
12,000 Decrease

A handwritten diagram is overlaid on the financial statement. It shows circled amounts for each asset category: Land (\$70,000), Buildings (200,000), Accumulated depreciation-buildings (-11,000), Equipment (68,000), Accumulated depreciation-equipment (-10,000), Accounts receivable (26,000), Prepaid expenses (6,000), and Cash (37,000). Arrows point from the circled amounts to the corresponding columns in the table. A large bracket on the right side groups the circled amounts under the heading 'Change Increase/Decrease'.

ILLUSTRATION 23.9

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31			ILLUSTRATION 23.9
Assets	2020	2019	Change Increase/Decrease
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase
Buildings	200,000	-0-	200,000 Increase
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	-0-	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease 
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	<u>\$386,000</u>	<u>\$ 85,000</u>	

Accounts receivable decreased during the period because cash receipts (cash-basis revenues) are higher than revenues reported on an accrual basis.

Step 2: Determine Net Cash Flow from Operating Activities—**Indirect** Method

To convert net income to net cash flow from operating activities, the **decrease of \$10,000** in accounts receivable must be **added to net income**.

Net income

\$134,000

Adjustments to reconcile net income to
net cash provided by operating activities:

Net cash provided by operating activities

ILLUSTRATION 23.11

Computation of Net Cash Flow from Operating Activities, Year 2—Indirect Method

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

ILLUSTRATION 23.9

*Change
Increase/Decrease*

Assets	2020	2019	
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase
Buildings	200,000	-0-	200,000 Increase
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	0	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	<u>\$386,000</u>	<u>\$ 85,000</u>	

When prepaid expenses (assets) increase during a period, **expenses on an accrual-basis income statement are lower than they are on a cash-basis income statement.**

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

To convert net income to net cash flow from operating activities, the **increase of \$6,000 must be deduct from net income**.

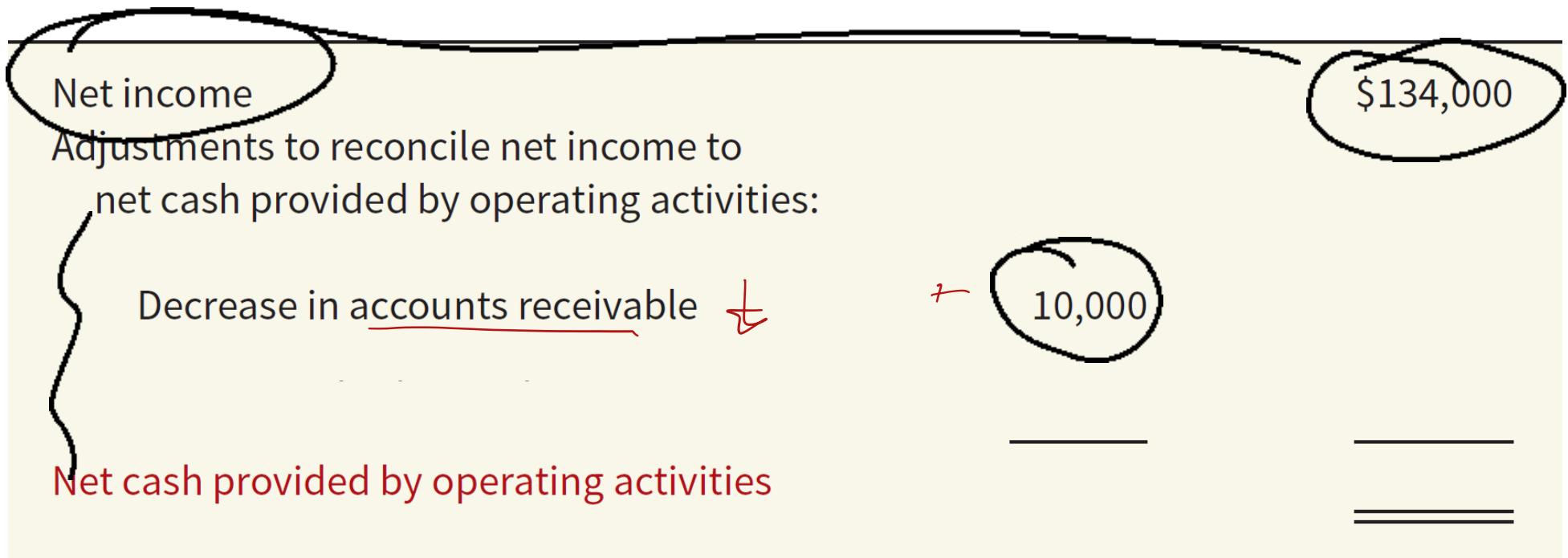


ILLUSTRATION 23.11

Computation of Net Cash Flow from Operating Activities, Year 2—Indirect Method

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31			ILLUSTRATION 23.9
Equity and Liabilities			
Share capital—ordinary (\$1 par)	\$ 60,000	\$ 60,000	\$ -0-
Retained earnings	136,000	20,000	116,000 Increase
Bonds payable	150,000	-0-	150,000 Increase
Accounts payable	40,000	5,000	35,000 Increase
Total	<u>\$386,000</u>	<u>\$ 85,000</u>	<u>\$ 300</u>

When accounts payable increase, the company incurred a greater amount of expense than the amount of cash it disbursed.

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

Tax Consultants must add the 2020 increase of \$35,000 in accounts payable to net income, to convert to net cash flow from operating activities.

Net income	\$134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Decrease in accounts receivable	10,000
Increase in prepaid expenses 	(6,000)
 Net cash provided by operating activities	 <hr/> <hr/> <hr/>

ILLUSTRATION 23.11

Computation of Net Cash Flow from Operating Activities, Year 2—Indirect Method

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

TAX CONSULTANTS INC.

INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2020

ILLUSTRATION 23.10

Revenues

Operating expenses (excluding depreciation)

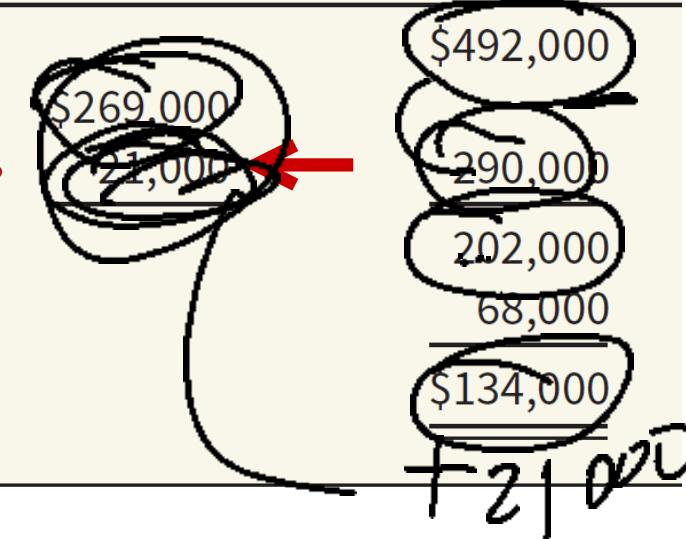
Depreciation expense

Income from operations

Income tax expense

Net income

+ 21,000



Depreciation expense of \$21,000 (also represented by the increase in accumulated depreciation) is a **non-cash charge**.

Step 2: Determine Net Cash Flow from Operating Activities—Indirect Method

Tax Consultants adds depreciation expense back to net income, to arrive at net cash flow from operating activities.

Net income	\$134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable ↑	35,000
Net cash provided by operating activities	60,000

ILLUSTRATION 23.11

Computation of Net Cash Flow from Operating Activities, Year 2—Indirect Method

Step 3: Determine Net Cash Flow from Investing and Financing Activities

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31			ILLUSTRATION 23.9
Assets	2020	2019	Change Increase/Decrease
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase 
Buildings	200,000	-0-	200,000 Increase
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	-0-	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	<u><u>\$386,000</u></u>	<u><u>\$ 85,000</u></u>	

The company purchased land of \$70,000 during the period.

Cash flows from operating activities	
Net income	\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 21,000
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable	35,000
Net cash provided by operating activities	<u>194,000</u>

Cash flows from investing activities

Net cash used by investing activities

Cash flows from financing activities

Net cash provided by financing activities

Net decrease in cash	(12,000)
Cash, January 1, 2020	49,000
Cash, December 31, 2020	\$ 37,000

ILLUSTRATION 23.12

Statement of Cash Flows, Tax Consultants Inc., Year 2

Step 3: Determine Net Cash Flow from Investing and Financing Activities

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31			ILLUSTRATION 23.9
Assets	2020	2019	Change Increase/Decrease
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase
Buildings	200,000	-0-	200,000 Increase 
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	-0-	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	<u><u>\$386,000</u></u>	<u><u>\$ 85,000</u></u>	

Tax Consultants acquired an office building using \$200,000 cash.

ILLUSTRATION 23.12

Cash flows from operating activities	
Net income	\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 21,000
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable	<u>35,000</u>
	<u>60,000</u>
Net cash provided by operating activities	194,000
Cash flows from investing activities	
Purchase of land	(70,000)
	<u> </u>
Net cash used by investing activities	
Cash flows from financing activities	
	<u> </u>
Net cash provided by financing activities	
Net decrease in cash	(12,000)
Cash, January 1, 2020	<u>49,000</u>
Cash, December 31, 2020	<u>\$ 37,000</u>

Step 3: Determine Net Cash Flow from Investing and Financing Activities

TAX CONSULTANTS INC. COMPARATIVE STATEMENTS OF FINANCIAL POSITION AS OF DECEMBER 31			ILLUSTRATION 23.9
Assets	2020	2019	Change Increase/Decrease
Land	\$ 70,000	\$ -0-	\$ 70,000 Increase
Buildings	200,000	-0-	200,000 Increase
Accumulated depreciation—buildings	(11,000)	-0-	11,000 Increase
Equipment	68,000	-0-	68,000 Increase
Accumulated depreciation—equipment	(10,000)	-0-	10,000 Increase
Accounts receivable	26,000	36,000	10,000 Decrease
Prepaid expenses	6,000	-0-	6,000 Increase
Cash	37,000	49,000	12,000 Decrease
Total	<u><u>\$386,000</u></u>	<u><u>\$ 85,000</u></u>	

Tax Consultants acquired equipment using \$68,000 cash.

ILLUSTRATION 23.12

Cash flows from operating activities	
Net income	\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 21,000
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable	<u>35,000</u>
	<u>60,000</u>
Net cash provided by operating activities	194,000
Cash flows from <u>investing activities</u>	<i>outflow</i>
Purchase of land	(70,000)
Purchase of building	<u>(200,000)</u>
	<u> </u>
Net cash used by investing activities	
Cash flows from financing activities	
	<u> </u>
Net cash provided by financing activities	
Net decrease in cash	(12,000)
Cash, January 1, 2020	<u>49,000</u>
Cash, December 31, 2020	<u>\$ 37,000</u>

Step 3: Determine Net Cash Flow from Investing and Financing Activities

TAX CONSULTANTS INC.			ILLUSTRATION 23.9
COMPARATIVE STATEMENTS OF FINANCIAL POSITION			
AS OF DECEMBER 31			
<u>Equity and Liabilities</u>			
Share capital—ordinary (\$1 par)	\$ 60,000	\$ 60,000	\$ -0-
Retained earnings	136,000	20,000	116,000 Increase
Bonds payable	150,000	-0-	150,000 Increase
Accounts payable	40,000	5,000	35,000 Increase
Total	<u>\$386,000</u>	<u>\$ 85,000</u>	

Tax Consultants acquired received \$150,000 from the issuance of bonds.

ILLUSTRATION 23.12

Cash flows from operating activities	
Net income	\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 21,000
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable	<u>35,000</u>
	<u>60,000</u>
Net cash provided by operating activities	194,000
Cash flows from investing activities	
Purchase of land	(70,000)
Purchase of building	(200,000)
Purchase of equipment	<u>(68,000)</u>
Net cash used by investing activities	
Cash flows from <u>financing activities</u> <i>outflow</i>	
Net cash provided by financing activities	
Net decrease in cash	(12,000)
Cash, January 1, 2020	<u>49,000</u>
Cash, December 31, 2020	<u>\$ 37,000</u>

Step 3: Determine Net Cash Flow from Investing and Financing Activities

TAX CONSULTANTS INC.			ILLUSTRATION 23.9
COMPARATIVE STATEMENTS OF FINANCIAL POSITION			
AS OF DECEMBER 31			
<u>Equity and Liabilities</u>			
Share capital—ordinary (\$1 par)	\$ 60,000	\$ 60,000	\$ -0-
Retained earnings	136,000	20,000	116,000 Increase 
Bonds payable	150,000	-0-	150,000 Increase
Accounts payable	40,000	5,000	35,000 Increase
Total	<u>\$386,000</u>	<u>\$ 85,000</u>	

Two factors explain the increase in retained earnings: **(1) net income of \$134,000 increased retained earnings, and (2) dividends of \$18,000 decreased retained earnings.**

ILLUSTRATION 23.12

Cash flows from operating activities	
Net income	\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 21,000
Decrease in accounts receivable	10,000
Increase in prepaid expenses	(6,000)
Increase in accounts payable	<u>35,000</u>
	<u>60,000</u>
Net cash provided by operating activities	194,000
Cash flows from investing activities	
Purchase of land	(70,000)
Purchase of building	(200,000)
Purchase of equipment	<u>(68,000)</u>
Net cash used by investing activities	
Cash flows from financing activities	
Issuance of bonds	150,000
	<u> </u>
Net cash provided by financing activities	
Net decrease in cash	(12,000)
Cash, January 1, 2020	<u>49,000</u>
Cash, December 31, 2020	<u>\$ 37,000</u>

TAX CONSULTANTS INC.
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2020
INCREASE (DECREASE) IN CASH

ILLUSTRATION 23.12

Cash flows from operating activities		
Net income		\$ 134,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	\$ 21,000	
Decrease in accounts receivable	10,000	
Increase in prepaid expenses	(6,000)	
Increase in accounts payable	<u>35,000</u>	<u>60,000</u>
Net cash provided by operating activities		194,000
Cash flows from investing activities		
Purchase of land	(70,000)	
Purchase of building	(200,000)	
Purchase of equipment	<u>(68,000)</u>	
Net cash <u>used</u> by investing activities		(338,000)
Cash flows from <u>financing activities</u>		
<u>Issuance of bonds</u> +	150,000	
Payment of cash dividends (—)	<u>(18,000)</u>	
Net cash provided by financing activities		<u>132,000</u>
Net decrease in cash		(12,000)
Cash, January 1, 2020		49,000
Cash, December 31, 2020		<u>\$ 37,000</u>

Sources of Information for the Statement of Cash Flows

1. Comparative statements of financial position.
2. An analysis of the Retained Earnings account.
3. All changes that have passed through cash or have resulted in an increase or decrease in cash.
4. Write-downs, amortization charges, and similar “book” entries, such as depreciation, because they have no effect on cash.

Indirect Method—Additional Adjustments

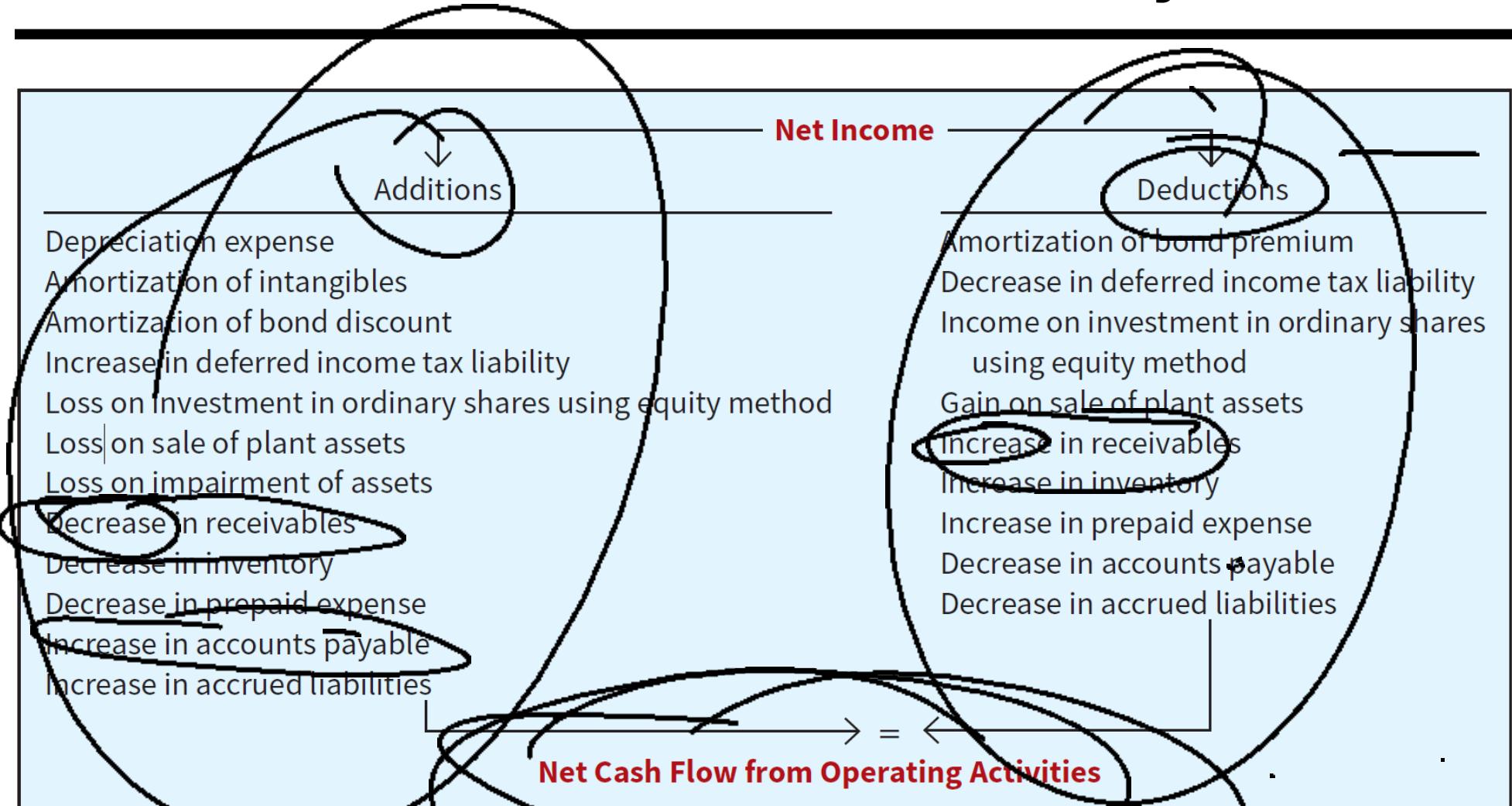


ILLUSTRATION 23.17

Adjustments Needed to Determine Net Cash Flow from Operating Activities—Indirect Method

Net Cash Flow Operating Activities—Direct Method

LEARNING OBJECTIVE 3
Contrast the direct and indirect methods of calculating net cash flow from operating activities.

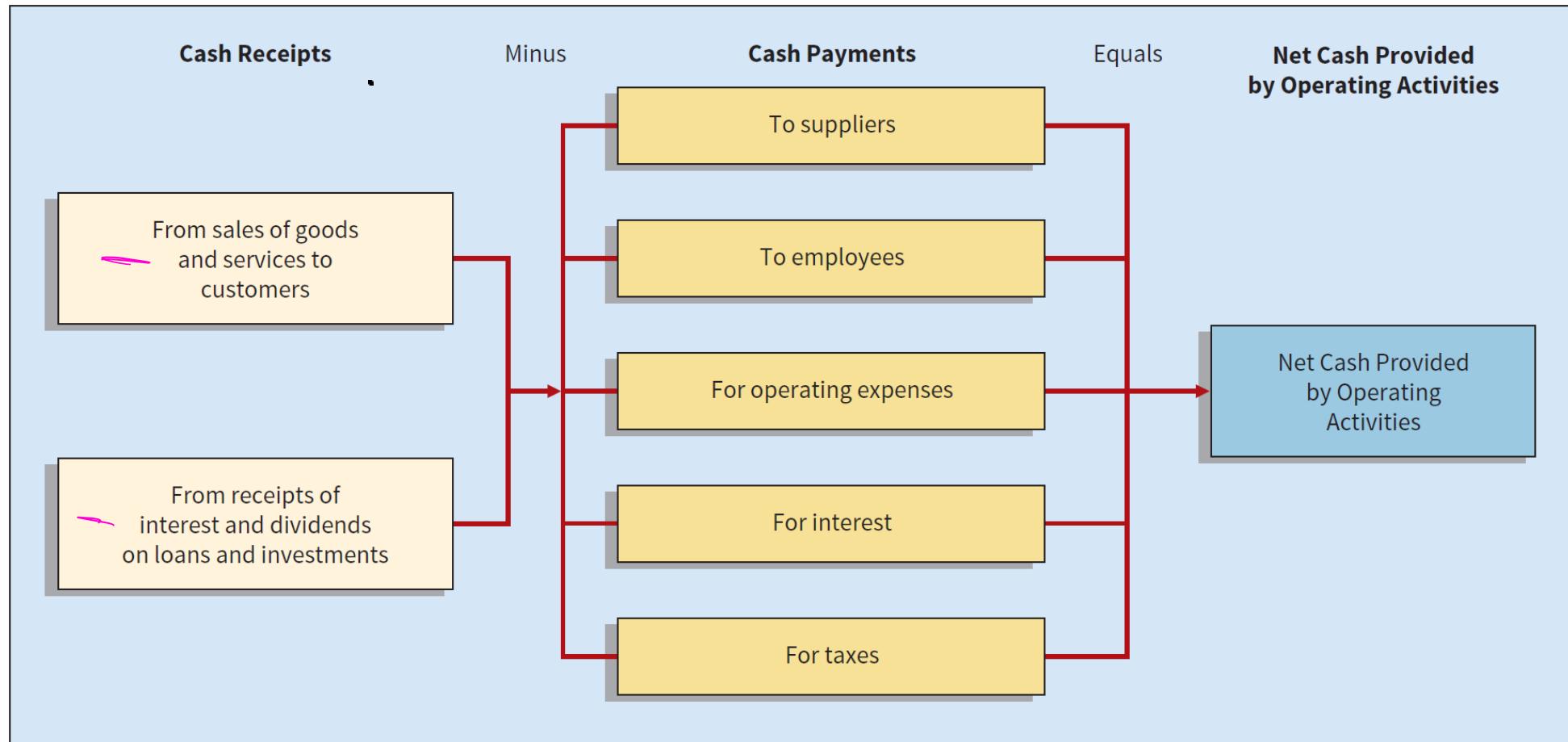


ILLUSTRATION 23.21

Major Classes of Cash Receipts and Payments

Direct Method Example

Drogba SA, which began business on January 1, 2019, has the following selected statement of financial position information.

	December 31, 2019	January 1, 2019
Property, plant, and equipment (net)	€ 90,000	€-0-
Inventory	160,000	-0-
Accounts payable	60,000	-0-
Accrued expenses payable	20,000	-0-
Accounts receivable	15,000	-0-
Prepaid expenses	8,000	-0-
Cash	159,000	-0-

ILLUSTRATION 23.19

Statement of Financial Position Accounts, Drogba SA

Direct Method Example

Drogba's December 31, 2019, income statement and additional information are as follows.

ILLUSTRATION 23.20

Income Statement, Drogba SA

Sales revenue	€780,000
Cost of goods sold	450,000
Gross profit	330,000
Operating expenses	€160,000
Depreciation	10,000
Income before income taxes	170,000
Income tax expense	48,000
Net income	€112,000

Additional Information

- (a) Dividends of €70,000 were declared and paid in cash.
- (b) The accounts payable increase resulted from the purchase of merchandise.
- (c) Prepaid expenses and accrued expenses payable relate to operating expenses. **LO 3**

Operating Activities — Direct Method

Accounts receivable increased €15,000. Thus, ***cash receipts from customers*** are computed as follows.

Illustration 23-22

$$\text{Cash Receipts from Customers} = \text{Sales Revenue} \quad \left\{ \begin{array}{l} + \text{Decrease in Accounts Receivable} \\ \text{or} \\ - \text{Increase in Accounts Receivable} \end{array} \right.$$

Accounts Receivable

1/1/20 Balance 0		Receipts from customers
Sales revenue 780,000		765,000
12/31/20 Balance 15,000		

Operating Activities — Direct Method

Drogba SA reported cost of goods sold on its income statement of €450,000. In 2019, Drogba's inventory increased €160,000. The company computes purchases as follows.

Cost of goods sold €450,000

Add Increase in inventory 160,000

Purchases €610,000

Accounts Payable

	1/1/20	Balance 0
	Purchases	610,000
	12/31/20	Balance 60,000

Operating Activities — Direct Method

Drogba determines ***cash payments to suppliers*** by adjusting purchases for the change in accounts payable.

Accounts Payable

	1/1/20 Balance 0
Payments to suppliers 550,000	Purchases 610,000
	12/31/20 Balance 60,000
adjusting the COGS not cash	yes we

Cash Payments to Suppliers	=	Cost of Goods Sold	$\left\{ \begin{array}{l} + \text{Increase in Inventory} \\ - \text{Decrease in Inventory} \end{array} \right.$	$\left\{ \begin{array}{l} \rightarrow \text{Decrease in Accounts Payable or} \\ - \text{Increase in Accounts Payable} \end{array} \right.$
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ILLUSTRATION 23.23

Formula to Compute Cash Payments to Suppliers

Operating Activities — Direct Method

Drogba reported **operating expenses** of €160,000 on its income statement. To determine the ***cash paid for operating expenses***, it must adjust this amount for any changes in

- ❑ prepaid expenses and
- ❑ accrued expenses payable.

Labs

$$\text{Cash Payments for Operating Expenses} = \text{Operating Expenses} + \begin{cases} \text{Increase in Prepaid Expenses} \\ \text{or} \\ -\text{Decrease in Prepaid Expenses} \end{cases} + \begin{cases} \text{Decrease in Accrued Expenses Payable} \\ \text{or} \\ -\text{Increase in Accrued Expenses Payable} \end{cases}$$

ILLUSTRATION 23.24

Formula to Compute Cash Payments for Operating Expenses

Operating Activities — Direct Method

Prepaid Expenses

	1/1/20 Balance 0
	12/31/20 Balance 8,000

Accrued Expenses Payable

	1/1/20 Balance 0
	12/31/20 Balance 20,000

Operating expenses €160,000

Add: Increase in prepaid expenses 8,000

+

Deduct: Increase in accrued expenses payable 20,000

Cash payments for operating expenses €148,000

Operating Activities — Direct Method

The income statement for Drogba shows income tax expense of €48,000. ***Cash paid for income taxes*** is computed by taking the expense and adjusting by the change in the payable.

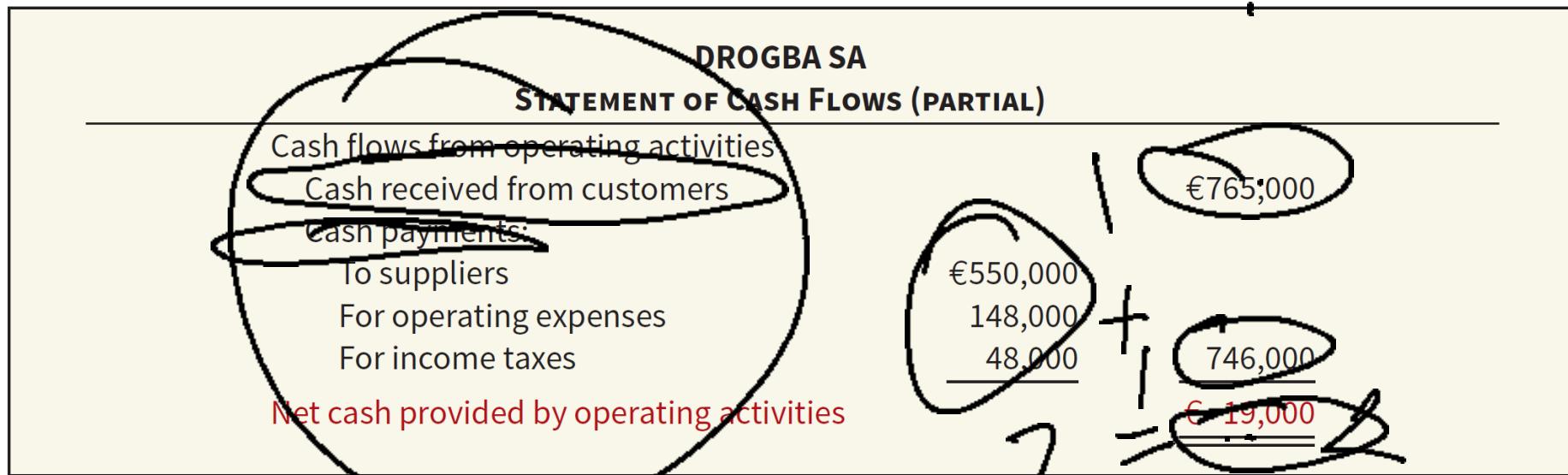
Income Tax Payable

	1/1/20 Balance 0
Payments for income tax 48,000	Income tax expense 48,000
	12/31/20 Balance 0

ILLUSTRATION 23.25

Accrual Basis to Cash Basis

	Accrual Basis	Adjustment	Add (Subtract)	Cash Basis
Sales revenue	€780,000	- Increase in accounts receivable	€ (15,000)	<u>€765,000</u>
Cost of goods sold	450,000	+ Increase in inventory - Increase in accounts payable	160,000 (60,000)	550,000
Operating expenses	160,000	+ Increase in prepaid expenses - Increase in accrued expenses payable	8,000 (20,000)	148,000
Depreciation expense	10,000	- Depreciation expense	(10,000)	-0-
Income tax expense	48,000			48,000
Total expense	<u>668,000</u>			<u>746,000</u>
Net income	<u>€112,000</u>	Net cash provided by operating activities		
				<u>€ 19,000</u>


ILLUSTRATION 23.26

Operating Activities — ~~Direct~~ Method

When companies use the direct method they **are required to** provide in a separate schedule the reconciliation of net income to net cash provided by operating activities.

ILLUSTRATION 23.27

DROGBA SA RECONCILIATION	
Net income	€112,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	€ 10,000
Increase in accounts receivable	(15,000)
Increase in inventory	(160,000)
Increase in prepaid expenses	(8,000)
Increase in accounts payable	60,000
Increase in accrued expense payable	20,000
Net cash provided by operating activities	€ (93,000)
	€ 19,000

Calcutta 22/22

Catch
V.S.
Disc

19000

T

Special Problems in Statement Preparation

LEARNING OBJECTIVE 4

Discuss special problems in preparing a statement of cash flows.

Adjustments to Net Income

Depreciation and Amortization

- ❑ Amortization of limited-life intangible assets.
- ❑ Amortization of bond discount or premium.

NON CASH
GXP

+

Postretirement Benefit Costs

- ❑ Company must adjust net income by the difference between cash paid and the expense reported.

Adjustments to Net Income

Changes in Deferred Income Taxes

- ❑ Affect net income but have no effect on cash.

ExP.

Equity Method of Accounting

- ❑ Net increase in the investment account does not affect cash flows.
- ❑ Company must deduct the net increase from net income to arrive at net cash flow from operating activities.

20 - 50%.

30%

Cash
Div.

Adjustments to Net Income

Loss and Gains

- ② A loss is added to net income to compute net cash flow from operating activities because the loss is a noncash charge in the income statement.

- ② Company reports a gain in the statement of cash flows as part of the cash proceeds from the sale of equipment under investing activities, thus it deducts the gain from net income to avoid double-counting—once as part of net income and again as part of the cash proceeds from the sale.

Adjustments to Net Income

Share-Based Compensation

100

+

- ❑ Cash is not affected by recording the expense.
- ❑ The company must increase net income by the amount of compensation expense from share options in computing net cash flow from operating activities.

Special Problems in Statement

Preparation

Accounts Receivable (Net)

Indirect Method

Because an increase in Allowance for Doubtful Accounts results from a charge to bad debt expense, a company should add back an increase in Allowance for Doubtful Accounts to net income to arrive at net cash flow from operating activities.

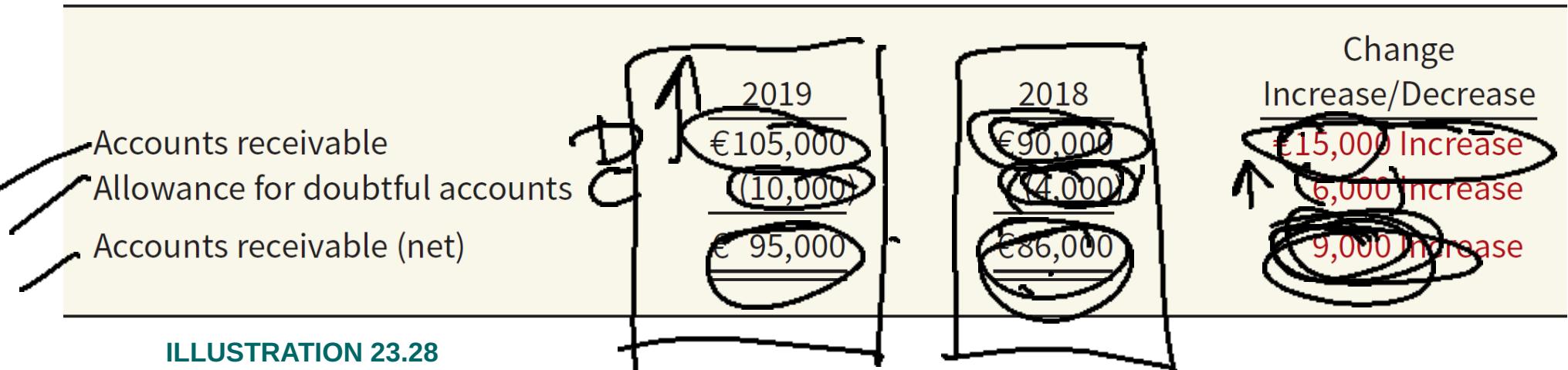


ILLUSTRATION 23.28

Accounts Receivable (Net)

Indirect Method

One method of presenting this information
in the statement of cash flows:

ILLUSTRATION 23.29
Presentation of Allowance
for Doubtful Accounts—
Indirect Method

REDMARK AG
STATEMENT OF CASH FLOWS (PARTIAL)
FOR THE YEAR 2019

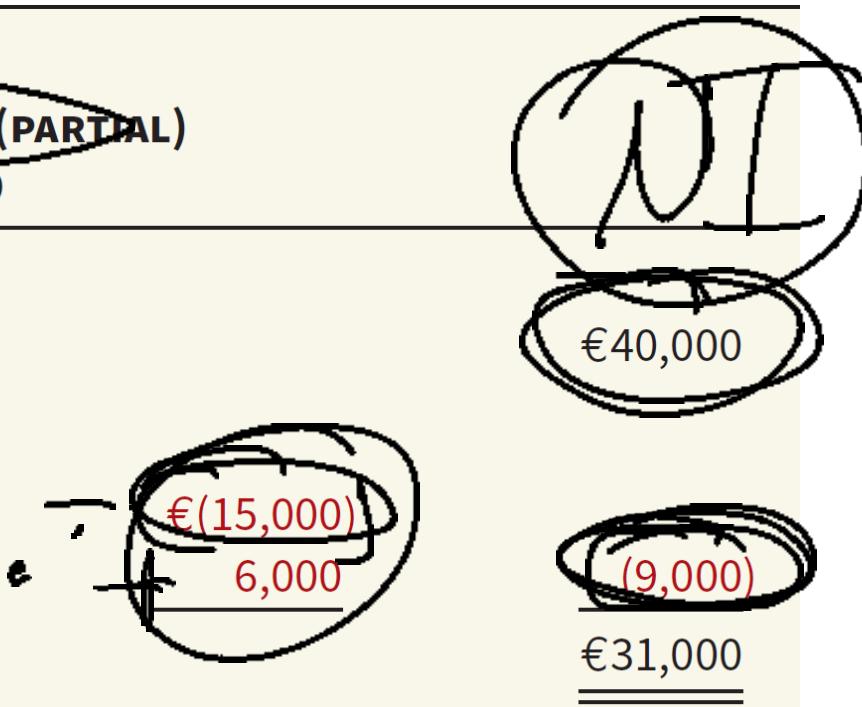
Cash flows from operating activities

Net income

Adjustments to reconcile net income to net
cash provided by operating activities:

Increase in accounts receivable

Increase in allowance for doubtful accounts



Accounts Receivable (Net)

Indirect Method

Alternate method (net approach) of presenting this information in the statement of cash flows:

ILLUSTRATION 23.30
Net Approach to Allowance for Doubtful Accounts—Indirect Method

REDMARK AG
STATEMENT OF CASH FLOWS (PARTIAL)
FOR THE YEAR 2019

Cash flows from operating activities

Net income €40,000

Adjustments to reconcile net income to

net cash provided by operating activities:

Increase in accounts receivable (net)



(9,000)
€31,000

Accounts Receivable (Net)

Direct Method

Company ~~should not net~~ Allowance for Doubtful Accounts against Accounts Receivable.

ILLUSTRATION 23.31
Income Statement,
Redmark AG

REDMARK AG	
INCOME STATEMENT	
FOR THE YEAR 2019	
Sales revenue	€100,000
Expenses	
Salaries	€46,000
Utilities	8,000
Bad debts	6,000
	<u>60,000</u>
Net income	€ 40,000

Accounts Receivable (Net)

Direct Method

Company **should not net Allowance** for Doubtful Accounts against Accounts Receivable.

ILLUSTRATION 23.31

REDMARK AG INCOME STATEMENT FOR THE YEAR 2019		
Sales revenue		€100,000
Expenses		
Salaries	€46,000	
Utilities	8,000	
Bad debts	6,000	
Net income		€ 60,000
		€ 40,000

REDMARK AG
STATEMENT OF CASH FLOWS (PARTIAL)
FOR THE YEAR 2019

ILLUSTRATION 23.32
Bad Debts—Direct
Method

Cash flows from operating activities	
Cash received from customers	€85,000
Salaries paid	€46,000
Utilities paid	8,000
	54,000
Net cash provided by operating activities	€31,000

Cash sales should be reported at **€85,000** ($€100,000 - 9,000 - 6,000$).

Increase in Accounts Receivable

Special Problems in Statement

Preparation

Other Working Capital Changes

Some changes in working capital, although they affect cash, do not affect net income.

- ❑ Purchase of short-term non-trading equity securities.
- ❑ Issuance of a short-term non-trade note payable for cash.
- ❑ Cash dividend payable.

Special Problems in Statement

Preparation

Net Losses

Illustration: If the net loss is £50,000 and the total amount of charges to add back is £60,000, then net cash provided by operating activities is £10,000.

Net income (loss)	£(50,000)
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation of plant assets	£55,000
Amortization of patents	5,000
	<u>60,000</u>
Net cash provided by operating activities	£ 10,000

ILLUSTRATION 23.33

Computation of Net Cash Flow from Operating Activities—Cash Inflow

Significant Non-Cash Transactions

Common noncash transactions that a company should report or disclose:

1. Acquisition of assets by assuming liabilities (including finance lease obligations) or by issuing equity securities.
2. Exchanges of non-monetary assets.
3. Refinancing of long-term debt.
4. Conversion of debt or preference shares to ordinary shares.
5. Issuance of equity securities to retire debt.

Use of a Worksheet

LEARNING OBJECTIVE 5

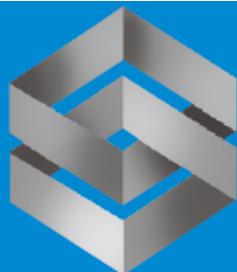
Explain the use of a worksheet in preparing a statement of cash flows.

A worksheet involves the following steps.

Step 1. Enter the statement of financial position accounts and their beginning and ending balances in the statement of financial position accounts section.

Step 2. Enter the data that explain the changes in the statement of financial position accounts and their effects on the statement of cash flows in the reconciling columns of the worksheet.

Step 3. Enter the increase or decrease in cash on the cash line and at the bottom of the worksheet. This entry should enable the totals of the reconciling columns to be in agreement.

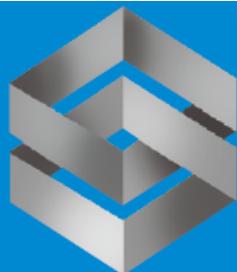


GLOBAL ACCOUNTING INSIGHTS

LEARNING OBJECTIVE 6

Compare the statement of cash flows under IFRS and U.S. GAAP.

As in IFRS, the statement of cash flows is a required statement for U.S. GAAP. In addition, the content and presentation of a U.S. GAAP statement of cash flows is similar to one used for IFRS. However, the disclosure requirements related to the statement of cash flows are more extensive under U.S. GAAP.

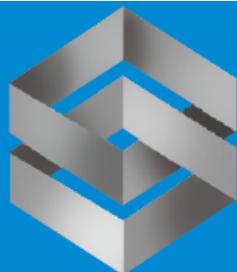


Relevant Facts

Following are the key similarities and differences between U.S. GAAP and IFRS related to the statement of cash flows.

Similarities

- Both U.S. GAAP and IFRS require that companies prepare a statement of cash flows.
- Both U.S. GAAP and IFRS require that the statement of cash flows should have three major sections—operating, investing, and financing—along with changes in cash and cash equivalents.
- Similar to U.S. GAAP, the cash flow statement can be prepared using either the indirect or direct method under IFRS. For both U.S. GAAP and IFRS, most companies use the indirect method for reporting net cash flow from operating activities.



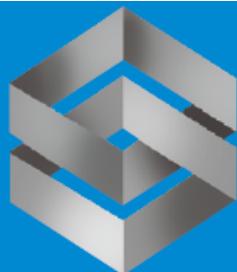
Relevant Facts

Similarities

- The definition of cash equivalents used in U.S. GAAP is similar to that used in IFRS.

Differences

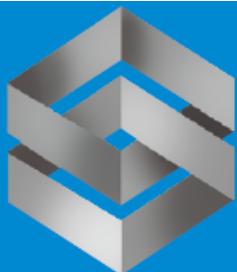
- Under U.S. GAAP, bank overdrafts are classified as financing activities. A major difference in the definition of cash and cash equivalents is that in certain situations, bank overdrafts are considered part of cash and cash equivalents under IFRS.



Relevant Facts

Differences

- Under U.S. GAAP, companies may present non-cash investing and financing activities in the cash flow statement. IFRS requires that non-cash investing and financing activities be excluded from the statement of cash flows. As indicated in the chapter, these non-cash activities should be reported elsewhere. This requirement is interpreted to mean that non-cash investing and financing activities should be disclosed in the notes to the financial statements instead of in the financial statements.
- One area where there can be substantive differences between U.S. GAAP and IFRS relates to the classification of interest, dividends, and taxes. U.S. GAAP requires that except for dividends paid (which are classified as a financing activity), these items are all reported as operating activities. IFRS provides more alternatives for disclosing these items.



On the Horizon

Presently, the IASB and the FASB are involved in a joint project on the presentation and organization of information in the financial statements. With respect to the cash flow statement specifically, the notion of cash equivalents will probably not be retained. The definition of cash in the existing literature would be retained, and the statement of cash flows would present information on changes in cash only. In addition, the IASB and FASB favor presentation of operating cash flows using the direct method only.

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