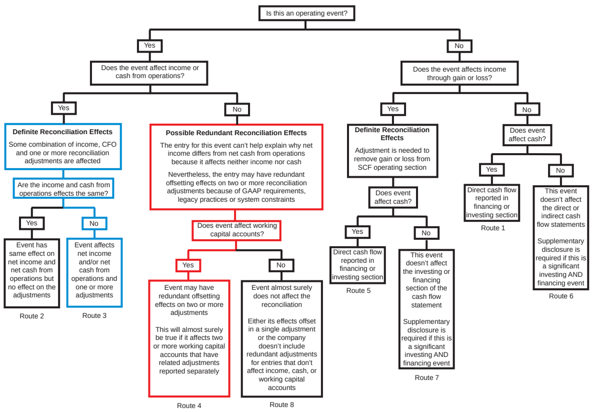
Creating Indirect Cash Flow Statements

WORKING CAPITAL ADJUSTMENTS



Working Capital Accounts

Beginning Balance

Net effect of Period's Operating Entries

Effects of operating entries that **must** be included in the reconciliation adjustments: these entries affect either income or cash from operations

Effects of operating entries that **can** (but need not) be included in the reconciliation adjustments: these entries affect neither income nor cash from operations

Net effect of Period's Non-operating Entries

Example: acquiring other companies

Ending Balance

Step 3

Insider determines net effect of operating entries by deducting the net effect of non-operating entries from net change in account

Step 2

Insider determines net effect of a few **excluded** non-operating entries

Step 1

Insider determines net change in account for period

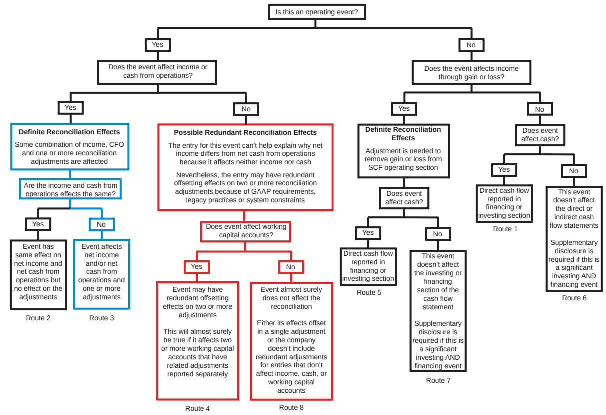
Common Approach for Creating Working Capital Adjustments

Most entries that affect working capital accounts are operating entries. Among these are: (1) entries that affect income or cash from operations, whose effects **must** be included in the reconciliation adjustments, and (2) entries that don't affect either income or cash from operations, but whose effects **can** (but need not) be included in offsetting reconciliation adjustments.

To a far lesser degree, non-operating entries (such as acquiring another company) can also affect working capital accounts. However, because these entries don't affect operations, their effects **can't** be included in reconciliation adjustments, which pertain to the operating section.

The easiest way for companies to create the working capital adjustments is to **exclude** the effects that shouldn't be included — the non-operating entries' effects.

NON-WORKING CAPITAL ADJUSTMENTS



Non-Working Capital Accounts

Beginning Balance

Net effect of Period's Operating Entries

Effects of operating entries that **must** be included in the reconciliation adjustments: these entries affect income but not cash from operations

Effects of operating entries that **can** (but need not) be included in the offsetting reconciliation adjustments: these entries affect neither income nor cash from operations

Net effect of Period's Non-operating Entries

Example: acquiring other companies

Ending Balance

Step 1

Insider determines net effect of a few **included** operating entries

Assumption

As outsiders, absent evidence to the contrary, we will assume companies include the effects of these entries in offsetting reconciliation adjustments when (and only when) the offset is to a working capital account.

An implication of this assumption is that the working capital adjustments reflect the net effects of all operating entries. This is a standard assumption in the exercises.

Common Approach for Creating Non-working Capital Adjustments

Generally, only a few of the entries that affect non-working capital accounts are operating entries. Among these are: (1) entries that affect income, but not cash from operations, whose effects **must** be included in the reconciliation adjustments and (2) entries that don't affect either income or cash from operations, but whose effects **can** (but need not) be included in offsetting reconciliation adjustments.

The easiest way for companies to create the non-working capital adjustments is to **include** the effects that should be included — the effects of operating entries that affect income but not cash from operations.