

## PRINCIPLES OF ACCOUNTING II

### INDIRECT METHOD OF PREPARING CASH FLOWS FROM OPERATING ACTIVITIES

- Start with accrual basis net income for the current period (Income Statement).
- Convert accrual basis net income to cash basis net income with the following adjustments:
  1. Analyze the changes in **current** asset and **current** liability accounts (Balance Sheet) by deducting the prior period balance from the current period balance.
  2. Determine whether the change should be added or deducted from net income using this shortcut:
    - Changes in Assets have the opposite effect on net income
    - Changes in Liabilities have the same effect on net income
    - For example, an **increase** in a current asset account would be **deducted** from net income (opposite effect).
    - An **increase** in a current liability would be **added** to net income (same effect).
  3. Analyze the income statement to identify any non-cash expenses (such as depreciation). Add non-cash expenses to net income.
  4. Analyze the Income Statement to identify any gains or losses. These items have originated from investing activities and should be eliminated from operating activities.
    - Add Losses, Deduct Gains
- Determine the Net Cash Provided <Used> by Operating Activities by combining all the amounts discussed above.

### REVIEW OF ADJUSTMENTS TO NET INCOME

#### To Net Income:

- Add:** Depreciation, amortization, and depletion  
Losses  
Decreases in current assets  
    Decrease in accounts receivable  
    Decrease in inventories  
    Decrease in prepaid expenses  
Increases in current liabilities:  
    Increase in accounts payable  
    Increase in accrued expenses payable  
    Increases in deferred income taxes payable
- Deduct:** Gains  
Deduct increases in current assets  
    Increase in accounts receivable  
    Increase in inventories  
    Increase in prepaid expenses  
Decreases in current liabilities.  
    Decrease in accounts payable  
    Decrease in accrued expenses payable