

# Preparation of the Statement of Cash Flows

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## Abstract

Finance theory and generally accepted accounting principles differ with respect to the proper way to measure cash flows. The accounting technique predominantly used to prepare the statement of cash flows is beset by inconsistencies, measurement errors and complexity. We propose a new technique that breaks down preparation of the statement of cash flows in two stages: the first yields a statement consistent with finance; the second a statement consistent with GAAP. Our proposal has two advantages over the traditional technique: it is simpler and generates a statement useful for business valuation purposes. These are important advantages at a time when accountants face a high demand for business valuation services.

## **1. Introduction**

The purpose of the statement of cash flows (SoCF) is to explain changes in the balance of cash over a period of time. This paper describes a new technique for preparing indirect format statements of cash flows that is general and straightforward to implement. The technique splits the solution of the cash flow problem in two stages: the first produces a statement in which cash flows are measured and classified according to principles of finance; the second stage adapts the previous result to the requirements of GAAP. An important advantage of the two-stage technique is that the statement produced in stage one is appropriate for financial analysis and business valuation. Another advantage is that the adjustments required in stage two can be tailored to accounting environments other than U.S. GAAP. By isolating features of the cash flow statement connected to principles of finance from features imposed by GAAP, we separate that which is logical and permanent from that which is merely conventional or transitory.

## **2. The SoCF Under SFAS No. 95**

The standard procedure for reconciling net income with operating cash flows (this reconciliation is required in cash flow statements according to SFAS No. 95) is to *add non-cash expenses and increases in current liabilities to net income; and subtract non-cash revenues and increases in current assets from net income* (White, Sondhi and Fried 1998, Stickney and Weil 2000; Kieso, Weygandt and Warfield 2001; Stice, Stice and Diamond 2003; Nikolai and Bazley 2003.) However, if we compare the income-to-cash reconciliation presented by almost any publicly traded corporation with the standard reconciliation procedure, several aspects of the published report will appear to be puzzling. For instance, amounts reported as changes in

working capital in the statement of cash flows often differ from the changes reported on the balance sheet (Bahnson, Miller and Budge 1996.) Another example is that the bad debt expense—which does not involve cash—is *not* added back to income (Nurnberg 1996.)

Under SFAS No. 95 the statement of cash flows must classify cash receipts and cash payments as resulting from *investing*, *financing*, or *operating* activities. Two formats are acceptable: direct and indirect. When the direct format is used, every line in the statement is a receipt or disbursement of cash. Under the indirect format every line in the investing and financing sections is cash, but the operating section consists of a series of adjustments to reconcile net income with cash from operations. Firms that choose the direct format must reconcile net income with operating cash flows in a separate schedule. Although the FASB encourages adoption of the direct format, 95% of listed companies in the United States prefer the indirect format (Rue and Kirk 1996; White, Sondhi and Fried 1998.)

According to SFAS No. 95 the three major categories of cash flows are defined as follows:

- *Financing* includes payments received from (or paid to) debt and equity holders, except for interest payments on debt.
- *Investing* includes flows from disposing of (or acquiring) productive assets, debt securities and equity securities.
- *Operating* includes all flows that are not classified as investing or financing.<sup>1</sup>

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<sup>1</sup> The partition of expenditures between operating and investing activities depends on whether they have short or long-term benefits to the firm. Since the strength and consistency of a firm's operating cash flows is an important metric for performance analysis, the blurred distinction between operating and investing flows opens the door to manipulation of the cash flow statement (Mulford 2005.) According to principles of finance and in particular for business valuation, what matters is the sum of operating and investing flows, referred to as free cash flows (White et al. 1998.)

SFAS No. 95 clashes with finance theory in several ways. As a first example, according to finance, interest paid to debtholders contributes to the value of debt securities issued by the firm, and as such should be classified as a financing outflow. Yet, according to SFAS No. 95, interest payments to debtholders are classified as an operating outflow (Nurnberg and Largay 2003.) As a second example, according to finance, the tax shield effect of interest should be treated as a financing benefit to the firm. Yet, according to SFAS No. 95 net income tax payments, and therefore the tax shield effect of interest, are classified as operating cash flows (Nurnberg 1993 and 2003.) As a third example, if a bond is issued and property is acquired with the proceeds, under finance guidelines we should recognize both a financing cash inflow and an investment cash outflow. However, under SFAS No. 95 these cash flow impacts are omitted from the SoCF, being disclosed only as a footnote to the statement. Such differences between the finance and accounting perspectives on measuring and classifying cash flows are important because they can significantly affect estimates of the fair value of a business and conclusions drawn from cash flow patterns over time.

Procedures for preparing the SoCF under the indirect format begin by posting net income to the operating section of cash and to retained earnings. This entry misestimates operating cash flow because net income contains non-cash revenues, expenses, gains and losses. Consequently, the remainder of the procedure must strive to correct the “error” introduced by posting net income to cash.

It is common, when preparing the SoCF under the indirect format, for non-working capital accounts to be analyzed in much more detail than working capital accounts.<sup>2</sup> For example: when

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<sup>2</sup> Accounts related to transactions with stakeholders, such as dividends payable and current maturities of long term debt, are not considered working capital for purposes of preparing the statement of cash flows.

dealing with property, plant and equipment, analysts consider debits separately from credits; however, when dealing with accounts receivable analysts combine debits with credits into a single entry labeled “net change in accounts receivable.” Why is this so?

There are two reasons. The first is that debits *and* credits caused by routine transactions<sup>3</sup> involving working capital affect only net income and/or operating cash flows. In contrast, debits and credits to non-working capital accounts can affect net income and/or any other category of cash flows. Therefore, a combined entry to working capital can be made to a single section of the SoCF, but a combined entry to a non-working capital account may have to be split up between different sections. Continuing with the example above: acquisition of property affects investing flows, while disposition of property implies an adjustment to net income; however, both sales on account—a non-cash accrual within net income—and collections from customers affect the reconciliation of net income with operating cash flow.

The second reason is that *combined* routine entries to working capital can be interpreted as differences between accruals and cash flows (e.g: increase in accounts receivable = sales on account minus collections from customers.) In contrast, when *separate* debits and credits to working capital are made to the cash account, non-cash components of net income can be easily cancelled out, leading to an operating section of the SoCF under the direct format, instead of under the desired indirect format. Suppose, for example, that both sales on account and collections from customers (instead of simply the net change in receivables) are posted to accounts receivable and to cash. The operating section of the SoCF shows:

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<sup>3</sup> “Routine” excludes businesses acquired, foreign currency translation and changes in accounting principle.

Net Income (+) Collections (-) Sales on Account	instead of simply	Net Income (+) Decrease in Accounts Receivable
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Observe that sales on account are included in net income, but collections are not. By continuing the process started on the left-hand side above, all non-cash accruals within net income (such as sales on account) would be eliminated, leaving in the operating section of the SoCF only cash receipts and disbursements (such as collections.) This would be a statement of cash flows under the direct format.

### 3. A New Technique for Obtaining the Statement of Cash Flows

The proposed technique for obtaining the SoCF under the indirect format is based entirely on a process of posting entries to accounts. As in traditional methods, the initial entry is to debit net income to cash from operations, and to credit net income to retained earnings (or to a master shareholders' equity account.) Since this entry alone would lead to a misstatement of operating cash flow, all subsequent entries that affect income are modified with the objective of reconciling net income with operating cash flow. Towards this end two types of entries are employed: *modified* and *plugging* entries, which are defined respectively as follows:

**Modified Entry:** If a standard bookkeeping entry does NOT affect a temporary account (i.e., an account that is closed periodically to income summary), the associated modified entry is identical to the standard bookkeeping entry. However, if a standard bookkeeping entry does affect a temporary account, the associated modified entry is such that the debits and credits that affect income are posted instead to the operating section of cash.

**Plugging Entry:** The single entry needed to bring a working capital account to its true closing balance, after all entries for non-routine transactions (e.g.: acquisition or sale of businesses, foreign currency translation, and change in accounting principle.) have been posted. The corresponding debit or credit always goes to the operating section of cash.

With these definitions, the proposed technique contains seven steps divided in two stages, as follows:

**(Stage I) Prepare a statement consistent with principles of finance**

▶ **Prepare the SoCF worksheet and post the first entry**

1. Prepare a worksheet with T-accounts for cash, working capital accounts and non-working capital accounts. Record opening and closing balances for each account. Debits and credits posted to cash will be tagged with a descriptive comment, and classified as operating, investing, financing, or other flows.

(Examples A-J below are based on Wendy’s Financial Statements for 2002, included below as Appendices 1 through 4. Monetary values in the examples are in \$ millions. )

2. Post net income to retained earnings and to the operating section of cash.

Example A: In 2002 Wendy’s generated net income of \$218.8. The first entry posted to the SoCF worksheet for Wendy’s is:

Cash, from Operations .....	\$ 218.8
Retained Earnings .....	218.8

▶ **Entries affecting working capital accounts**

3. Post modified entries for non-routine transactions that affect working capital.

Example B: In 2002 Wendy’s acquired the Baja Fresh chain of Mexican food restaurants. This transaction affects both working and non-working capital accounts. The standard bookkeeping entry posted by Wendy’s could have been:

Working Capital.....	\$ 3.3
Other Assets, net.....	298.5
Other Liabilities, net .....	14.4
Cash, to Investments .....	287.4

Observe that the same entry is posted to the SoCF worksheet because no temporary accounts are involved: the modified entry in this case is identical to the standard entry.

Example C: In 2002 Wendy’s had operations abroad and its accounts were affected by foreign exchange fluctuations. This non-routine transaction affects both working and non-working capital accounts. The standard bookkeeping entry posted by Wendy’s could have been:

Working Capital.....	\$ 7.2
Other Assets, net.....	9.9
Cash, Other Flows .....	0.4
Other Liabilities, net .....	13.5
Shareholders’ Equity .....	4.0

Once again the same standard entry is posted to the SoCF worksheet because no temporary accounts are involved.

4. Post plugging entries to bring working capital accounts to their actual closing balances.

Example D: After entries for all non-routine transactions that affect working capital of Wendy’s have been posted, some working capital accounts still have not reached their actual closing balances. A simple plugging entry is made to achieve those balances:

Cash, from Operations .....	\$ 49.6
Net Working Capital .....	49.6

► **Entries NOT affecting working capital accounts**

5. Post modified entries to all non-working accounts. Classify flows strictly according to principles of finance. Continue until all actual ending balances have been obtained.<sup>4</sup>

Example E: The standard bookkeeping entry for depreciation is:

Depreciation Expense .....	\$ 142.8
Accumulated Depreciation .....	142.8

To prepare the SoCF, we post this modified entry to the worksheet:

Cash, from Operations .....	\$ 142.8
Accumulated Depreciation .....	142.8

Notice that in the standard entry the debit is made to a temporary account. In the modified entry that debit is made instead to cash from operations. This entirely mechanical modification produces the well known depreciation adjustment of net income.

Example F: The standard bookkeeping entry for interest incurred is:

Interest Expense .....	\$ 41.5
Interest Payable .....	41.5

The modified entry posted to the SoCF worksheet is:

Cash, from Operations .....	\$ 41.5
Interest Payable .....	41.5

Interest expense is added back to income because it is an accrual, not a cash flow, just as in the case of depreciation. Observe that interest payable is *not* considered to be a working capital item when preparing the SoCF, even if the payment is due in the short term. This is because interest is paid to a

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<sup>4</sup> Often the data needed to provide a full explanation of changes in the balance of an account is unavailable to external analysts. In such cases the analyst should try to make reasonable assumptions to obtain the ending balance.

stakeholder. For the same reason dividend payable is also excluded from working capital.

Example G: The standard bookkeeping entry to recognize interest paid is:

Interest Payable.....	\$ 41.5
Cash .....	41.5

The entry posted to the SoCF worksheet classifies interest as a *financing* activity:

Interest Payable.....	\$ 41.5
Cash, from Financing.....	41.5

No modification of the standard entry is needed here because no temporary account is involved.

Example H: The standard bookkeeping entry for disposition of property is:

Cash .....	\$ 25.1
Loss (proceeds minus carrying value of asset) .....	2.6
Property, net.....	27.7

The entry posted to the SoCF worksheet removes proceeds from operations and includes it in the investments section. It also adds back the cost of the asset sold to net income:

Cash, from Investments .....	\$ 25.1
Cash, from Operations .....	2.6
Property, net.....	27.7

Example I: The standard bookkeeping entry for a new capital lease that does not affect cash is:

Leasehold.....	\$ 8.3
Lease Obligation .....	8.3

The entry posted to the SoCF worksheet reflects the cash impact on the lessor, even though Wendy’s cash account is bypassed. This is consistent with the finance principle that, in order to measure the value of debt correctly (and therefore the value of the firm), all cash flows to or from the debtholder must be included. Thus:

Cash, from Financing.....	\$ 8.3
Leasehold .....	8.3
Lease Obligation .....	8.3
Cash, to Investments .....	8.3

► **Tax allocation**

6. Calculate the tax implications of interest on debt and of gains or losses in the disposition of assets. Transfer those amounts from operations to the financing or investing sections of cash, as recommended by principles of finance.

Example J: In 2002 the tax shield on interest for Wendy’s is about \$16.6 million (based on a presumed marginal tax rate of 40 %.) The tax shield inflow is a benefit related to financing, and therefore must be transferred from operations to financing. This is accomplished by posting the following entry to the SoCF worksheet:

Cash, from Financing.....	\$ 16.6
Cash, from Operations .....	16.6

- At this point we can prepare a statement of cash flows consistent with *principles of finance* from all the entries posted to the cash account. (See Exhibit 5, column labeled “Stage I.”)

**(Stage II) Prepare a statement consistent with GAAP**

7. Make all necessary entries to adapt the result of Stage I to the requirements of SFAS No. 95, and disclose the corresponding transactions as supplemental information:

- Transfer cash credits for interest and taxes paid from the financing and investing sections back into operations.
- Reverse entries for investing and financing transactions that bypass cash.

- At this point we can prepare a statement consistent with *U.S. GAAP* from all entries posted to the cash account. (See Exhibit 5, column labeled “Stage II.”)

A flowchart of the proposed technique is given in Exhibit 6.

**Discussion**

Preparing a statement of cash flows under the indirect format can be described as making an “incorrect” entry—debiting the firm’s net income to its cash account<sup>5</sup>—and then trying to fix that “error” by making a series of entries to adjust net income to a cash flow. The revision that we propose improves upon the traditional technique in three important ways: (1) it creates a statement that is consistent with principles of finance before preparing a statement that is

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<sup>5</sup> This entry is said to be incorrect not because it should be avoided (it *is* the right entry to make if the goal is to prepare the SoCF in the indirect format), but in the sense that net income is not a cash flow and therefore is not debited to cash under standard bookkeeping practice.

consistent with GAAP; (2) it makes it clear that within working capital we must deal separately with routine operating flows and non-routine flows, such as those caused by acquisitions, foreign currency translation and changes in accounting principles; and (3) it introduces a purely mechanical identification of expenses and revenues that do not affect cash.

In the proposed technique the idea of a modified entry is conceptually equivalent to the traditional rule of adjusting net income for non-cash revenues and expenses. But the proposed technique applies modified entries automatically, without exception, to all non-routine transactions that affect working capital accounts and to all transactions that affect non-working capital accounts. Routine transactions in working capital are simply plugged. The modified entry idea implies, for example, that in the proposed technique interest expense is added back to income and interest paid is treated as a financing activity. The reasons for adding back depreciation and interest expense to net income are the same (neither is a cash outflow) and therefore the proposed technique treats them similarly. Of course the treatment of depreciation complies with SFAS No. 95, but the treatment of interest does not. Both treatments are, however, entirely consistent with finance theory. (Ref: Examples E, F and G.)

Example H shows a well known adjustment that complies with both finance and U.S. GAAP: the deduction of the gain on the sale of an asset from net income. The proposed technique highlights the fact that even though the treatment of the gain (proceeds minus cost) is similar to the treatment given to depreciation, two types of adjustments are performed simultaneously when the gain is subtracted from income. The “cost” component of the gain is added back to income because it does not imply a cash outflow (like depreciation.) The “proceeds” component of the gain is subtracted from income not because it is not cash (it is cash), but because it belongs within investing, not operating activities. Examples E-H show that adjustments to income in the first stage of the new method are purely mechanical transformations of standard bookkeeping

entries. This makes the proposed technique easy to explain and suggests a simple way to implement cash flow statements in accounting software.

As an example of differences between cash flow statements produced under the two alternatives—finance theory based and GAAP based—Exhibit 5 presents data for Wendy’s International, Inc. in 2002 (amounts in millions.) During 2002 Wendy’s generated net income of \$218.8 and the balance of cash increased by \$60.8. Under the finance theory based measurement of cash flow, we attribute the increase in cash to: operations \$468.8; investments (\$611.8); financing \$203.4; and a foreign exchange effect of \$0.4. Under the U.S. GAAP measurement of cash flow, the explanation for the increase in cash is: operations \$444.3; investments (\$603.5); financing \$220; and the same foreign exchange effect. Thus, when compared with cash flow measurements prescribed by finance theory, the statement of cash flows published by Wendy’s:

- understates operating inflow by \$24.9, being the net result of removing a \$41.5 interest payment from operations, but leaving there a \$16.6 benefit from the interest tax shield;
- understates investing outflow by \$8.3, because the effect of acquiring an asset under a new capital lease is offset against the increase in lease obligations, with the result that neither is shown on the statement of cash flows; and
- overstates financing inflows by \$16.6 because the financing section omits the new lease of \$8.3, the interest payment of \$41.5, and the tax shield on interest of \$16.6.

The bottom line for business valuation purposes is that Wendy’s SoCF under GAAP understates free cash flow in 2002 by about 8% (\$16.6.)

## **5. Summary**

The classification and measurement of cash flows under SFAS No. 95 differs in important respects from the classification and measurement of cash flows recommended by principles of

finance. As a result of these differences, the technique predominantly used by accountants to prepare the statement of cash flows is beset by inconsistencies (e.g., depreciation is added to income but interest expense is not), measurement errors (e.g., free cash flows are understated because interest paid is treated as an operating flow), and unnecessary complexity. The existence of discrepancies between accounting and finance-based measurement rules for cash flows is especially troublesome at a time when accountants face a high demand for business valuation services (AICPA 2005.)

We propose breaking down the process that produces a GAAP-compliant statement of cash flows in two stages: the first yields a statement consistent with principles of finance; the second adapts the statement to GAAP. The first stage requires no more than standard bookkeeping entries modified by a straightforward rule that holds without exception. The second stage requires detailed knowledge of differences between the finance and accounting conceptions of cash flows. Our proposal has two advantages over the standard approach: it is simpler and it generates, as a by-product, a statement useful for business valuation purposes.

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**Exhibit 1**  
**Wendy's International, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows (As Published)**  
**Years ended 12/29/2002, 12/30/2001 and 12/31/2000**

<b>(in thousands)</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Cash flows from operating activities</b>			
Net income	<b>\$218,781</b>	\$193,649	\$169,648
Adjustments to reconcile net income with net cash provided by operating activities			
Depreciation and amortization	<b>142,773</b>	123,238	113,491
Deferred income taxes	<b>17,941</b>	250	2,319
(Gain) loss from property dispositions, net	<b>2,623</b>	-1,832	17,330
Net reserves for receivables and other contingencies	<b>-109</b>		1,340
Changes in operating assets and liabilities, net of effects of acquisitions and dispositions of restaurants			
Accounts and notes receivable	<b>-5,061</b>	-7,313	-12,226
Inventories and other	<b>-4,594</b>	-5,335	-613
Accounts payable and accrued expenses	<b>59,218</b>	7,509	8,680
Increase in other assets	<b>-18,971</b>	-3,974	-2,472
Effect of exchange rates on cash	<b>392</b>	-2,329	-868
Tax benefits on stock options	<b>15,243</b>	5,534	2,715
Other, net	<b>16,020</b>	-4,201	2,872
Net cash provided by operating activities	<b>444,256</b>	305,196	302,216
<b>Cash flows from investing activities</b>			
Proceeds from property dispositions	<b>25,122</b>	29,961	37,979
Capital expenditures	<b>-330,811</b>	-301,054	-275,675
Acquisition of franchises	<b>-2,316</b>	-2,278	-1,555
Acquisition of Baja Fresh	<b>-287,405</b>		
Proceeds from sale of Conference Cup	<b>19,959</b>		
Principal payments on notes receivable	<b>19,751</b>	14,121	5,738
Investments in joint venture and other	<b>-43,126</b>	-14,103	
Other investing activities	<b>-4,630</b>	-8,575	-6,247
Net cash used in investing activities	<b>-603,456</b>	-281,928	-239,760
<b>Cash flows from financing activities</b>			
Proceeds from issuance of senior notes, net of issuance costs	<b>223,037</b>	197,138	
Proceeds from employee stock options exercised	<b>77,737</b>	40,207	21,982
Repurchase of common stock	<b>-49,401</b>	-287,308	-93,435
Principal payments on long-term obligations	<b>-4,274</b>	-5,078	-4,554
Dividends paid on common and exchangeable shares	<b>-27,076</b>	-26,824	-27,516
Net cash provided by (used in) financing activities	<b>220,023</b>	-81,865	-103,523
<b>Increase (decrease) in cash and cash equivalents</b>	<b>60,823</b>	-58,597	-41,067
<b>Cash and cash equivalents at beginning of period</b>	<b>111,121</b>	169,718	210,785
<b>Cash and cash equivalents at end of period</b>	<b>\$171,944</b>	\$111,121	\$169,718

<b>(in thousands)</b>	<b>2002</b>	2001	2000
<b>Supplemental disclosures of cash flow information:</b>			
Interest paid	<b>\$41,456</b>	\$29,570	\$28,721
Income taxes paid	<b>69,392</b>	97,818	85,163
Capital lease obligations incurred	<b>8,311</b>	11,553	5,025
Notes receivable from restaurant dispositions			553
<b>Non-cash investing and financing activities:</b>			
\$2.50 Term Collectible Securities, Series A, converted and redeemed	<b>\$200,000</b>		

**Exhibit 2**  
**Wendy's International, Inc. and Subsidiaries**  
**Consolidated Statements of Income and Comprehensive Income (As Published)**  
**Years ended 12/29/2002, 12/30/2001 and 12/31/2000**

**Consolidated Statements of Income**

<b>(in thousands)</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Revenues</b>			
Retail sales	<b>\$2,187,438</b>	\$1,925,319	\$1,807,841
Franchise revenues	<b>542,823</b>	465,878	429,105
	<b>2,730,261</b>	2,391,197	2,236,946
<b>Costs and expenses</b>			
Cost of sales	<b>1,383,665</b>	1,229,277	1,140,840
Company restaurant operating costs	<b>459,141</b>	406,185	382,963
Operating costs	<b>118,643</b>	91,701	86,272
General and administrative expenses	<b>241,438</b>	216,124	208,173
Depreciation and amortization of PP&E	<b>139,101</b>	118,280	108,297
International charges			18,370
Other expense, net	<b>6,905</b>	1,722	5,514
Interest expense	<b>41,454</b>	30,175	28,859
Interest income	<b>-5,985</b>	-9,647	-13,779
	<b>2,384,362</b>	2,083,817	1,965,509
<b>Income before income taxes</b>	<b>345,899</b>	307,380	271,437
<b>Income taxes</b>	<b>127,118</b>	113,731	101,789
<b>Net income</b>	<b>\$218,781</b>	\$193,649	\$169,648

**Consolidated Statements of Comprehensive Income**

<b>(in thousands)</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Net income</b>	<b>\$218,781</b>	\$193,649	\$169,648
<b>Other comprehensive income (expense)</b>			
Translation adjustments	<b>4,040</b>	-21,621	-12,690
Pension liability (net of taxes of \$9,617)	<b>-16,183</b>		
	<b>-12,143</b>	-21,621	-12,690
<b>Comprehensive income</b>	<b>\$206,638</b>	\$172,028	\$156,958

**Exhibit 3**  
**Wendy's International, Inc. and Subsidiaries**  
**Consolidated Balance Sheets at 12/29/2002 and 12/30/2001 (As Published)**

(in thousands)	2002	2001
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$171,944	\$111,121
Accounts receivable, net	86,416	83,603
Notes receivable, net	11,204	11,295
Deferred income taxes	13,822	15,000
Inventories and other	47,433	45,334
	<b>330,819</b>	<b>266,353</b>
<b>Property and equipment, net</b>	<b>1,851,266</b>	<b>1,647,985</b>
<b>Notes receivable, net</b>	<b>20,548</b>	<b>32,694</b>
<b>Goodwill, net</b>	<b>272,325</b>	<b>41,214</b>
<b>Deferred income taxes</b>	<b>48,966</b>	<b>36,175</b>
<b>Intangible assets, net</b>	<b>47,393</b>	<b>18,171</b>
<b>Other assets</b>	<b>96,044</b>	<b>41,458</b>
	<b>\$2,667,361</b>	<b>\$2,084,050</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable	\$134,208	\$112,245
Accrued expenses		
Salaries and wages	44,932	34,014
Taxes	77,956	59,113
Insurance	42,898	40,719
Other	55,308	46,386
Current portion of long-term obligations	4,773	4,210
	<b>360,075</b>	<b>296,687</b>
<b>Long-term obligations</b>		
Term debt	627,053	401,511
Capital leases	54,626	49,735
	<b>681,679</b>	<b>451,246</b>
<b>Deferred income taxes</b>	<b>108,906</b>	<b>82,287</b>
<b>Other long-term liabilities</b>	<b>68,096</b>	<b>24,051</b>
<b>Commitments and contingencies</b>		
<b>Redeemable preferred securities</b>		200,000
<b>Shareholders' equity</b>		
Common stock	10,895	13,271
Capital in excess of stated value		467,687
Retained earnings	1,498,607	1,377,840
Accumulated other comprehensive expense	-60,897	-48,754
	<b>1,448,605</b>	<b>1,810,044</b>
Treasury stock, at cost		-780,265
	<b>1,448,605</b>	<b>1,029,779</b>
	<b>\$2,667,361</b>	<b>\$2,084,050</b>

**Exhibit 4**  
**Wendy's International, Inc. and Subsidiaries**  
**Consolidated Statements of Shareholders' Equity (As Published)**

(in thousands)	Common stock at par	Capital in excess of par	Retained earnings	Accumulated comprehensive earnings	Treasury stock, at cost	Shareholders' equity
Balance on Jan. 2, 2000	\$11,941	\$398,580	\$1,068,883	(\$14,443)	(\$399,522)	\$1,065,439
Net income			169,648			169,648
Other comprehensive income				(12,690)		(12,690)
Exercise of stock options (*)	133	24,564				24,697
Purchase of treasury stock					(93,435)	(93,435)
Retirement of treasury stock						
Dividends paid			(27,516)			(27,516)
Conversion of securities						
Balance on Dec. 31, 2000	12,074	423,144	1,211,015	(27,133)	(492,957)	1,126,143
Net income			193,649			193,649
Other comprehensive income				(21,621)		(21,621)
Exercise of stock options (*)	226	45,514				45,740
Purchase of treasury stock					(287,308)	(287,308)
Retirement of treasury stock						
Dividends paid			(26,824)			(26,824)
Conversion of securities	971	(971)				
<b>Balance on Dec. 29, 2001</b>	<b>13,271</b>	<b>467,687</b>	<b>1,377,840</b>	<b>(48,754)</b>	<b>(780,265)</b>	<b>1,029,779</b>
<b>Net income</b>			<b>218,781</b>			<b>218,781</b>
<b>Other comprehensive income</b>				<b>(12,143)</b>		<b>(12,143)</b>
<b>Exercise of stock options (*)</b>	<b>355</b>	<b>92,625</b>				<b>92,980</b>
<b>Purchase of treasury stock</b>					<b>(49,401)</b>	<b>(49,401)</b>
<b>Retirement of treasury stock</b>	<b>(3,488)</b>	<b>(755,240)</b>	<b>(70,938)</b>		<b>829,666</b>	
<b>Dividends paid</b>			<b>(27,076)</b>			<b>(27,076)</b>
<b>Conversion of securities</b>	<b>757</b>	<b>194,928</b>				<b>195,685</b>
<b>Balance on Dec. 29, 2002</b>	<b>\$10,895</b>		<b>\$1,498,607</b>	<b>(\$60,897)</b>		<b>\$1,448,605</b>

Note: Exercise of stock options includes tax benefits in the column for "Capital in Excess of Par".

**Exhibit 5**  
**Wendy's International, Inc. and Subsidiaries**  
**Fiscal Year Ended December 29, 2002**  
**Cash Flows for Financial Analysis Purposes and According to U.S. GAAP**  
**- Pro-forma, prepared by the authors with the proposed technique. -**

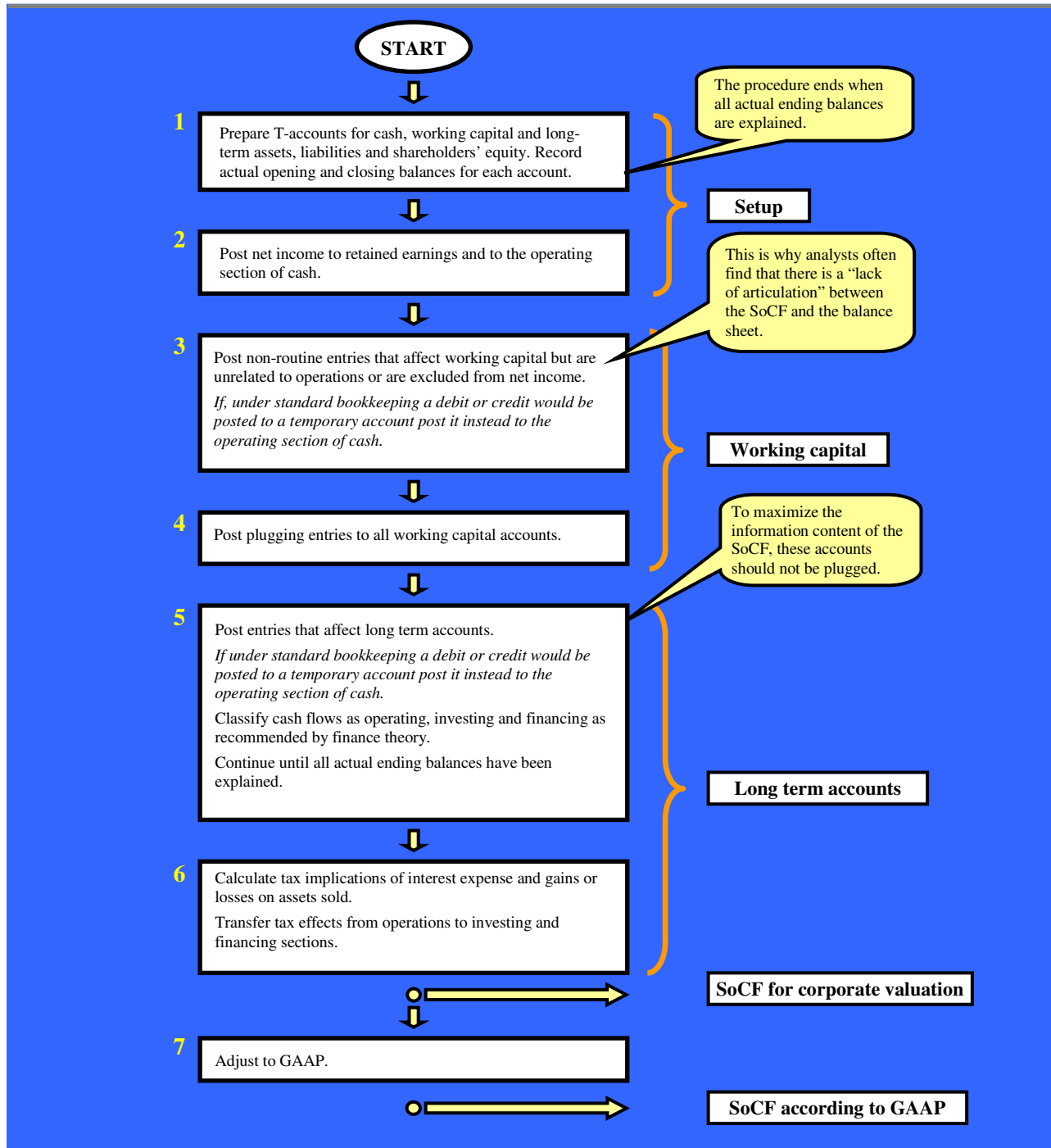
(in millions)	Stage I FSA and Valuation	Stage II U.S. GAAP	I-II
Net income	\$218.8	\$218.8	
Depreciation and amortization	142.8	142.8	
Loss from property dispositions, net	2.6	2.6	
Decrease in working capital	49.6	49.6	
Tax benefits on stock options	15.2	15.2	
Other adjustments, net	39.8	14.9	24.9
Net cash provided by operating activities	468.8	443.9	24.9
Proceeds from property dispositions	25.1	25.1	
Proceeds from sale of Conference Cup	19.9	19.9	
Capital expenditures	(330.8)	(330.8)	
Net acquisition of businesses	(289.7)	(289.7)	
Principal payments on notes receivable	19.7	19.7	
Investments in joint venture and other	(43.1)	(43.1)	
Other investing activities	(4.6)	(4.6)	
Asset acquired under new capital lease	(8.3)		(8.3)
Net cash used in investing activities	(611.8)	(603.5)	(8.3)
Net borrowings	218.7	218.7	
Proceeds from employee stock options exercised	77.7	77.7	
Dividends paid and repurchase of common stock	(76.4)	(76.4)	
Capital lease obligations incurred	8.3		8.3
Interest paid	(41.5)		(41.5)
Interest tax shield (40% tax rate)	16.6		16.6
Net cash provided by financing activities	203.4	220.0	(16.6)
Effect of exchange rate fluctuation on cash	.4	.4	
Increase in cash and cash equivalents	\$60.8	\$60.8	

The following supplemental disclosures are given in 2002:

Interest paid .....	\$ 41.5
Income taxes paid.....	69.4
Capital lease obligations incurred .....	8.3
\$2.50 term convertible securities type A, converted and redeemed.....	200.0

Wendy's 2002 annual report overstates financing cash flows (and understates free cash flows) by \$16.6 because: (1) a new capital lease is excluded; and (2) both the interest paid and the tax shield on interest expense are classified as operating items.

## Exhibit 6 Proposed Technique to Prepare the Statement of Cash Flows: Indirect Format



The proposed technique breaks the cash flow problem in two stages: (I) produce a statement that complies with finance; (II) produce a statement that complies with GAAP. This separates features of the SoCF that are logical and permanent from features that are conventional or transitory.