Changes in Working Capital in Free Cash Flow FCF

There are many variations of **free cash flow** but recently I've been asked a couple of times why I don't include changes in working capital. So let me go through why I don't believe including changes to working capital is necessary to the free cash flow calculation or for **stock valuation** for that matter.

But first, a discussion on working capital..

Working Capital and Changes in Working Capital

By definition:

> *working capital = current assets – current liabilities*

Working capital is useful to show the operating liquidity of a company and how the company manages its business.

When we look at the assets of the balance sheet, accounts receivables is listed under assets but when you start thinking about working capital it should actually be under the liabilities section.

The reason why it should be considered as a liability is that the amount of accounts receivables is really just an interest free loan to the customer. The company has not received the cash for the bills. It is only when accounts receivables decreases that cash flow increases. This is what the term "changes in working capital" refers to. The working capital change on the balance sheet impacts the cash flow statement.

For more information, I've explained this phenomenon in the analysis of cash flow statements.

Inventory is another major component of working capital and can also be considered to be a liability while accounts payable will add to positive cash flow because it's money that you owe but haven't paid yet. So it's like an interest free loan that increases your cash flow.

Working Capital and Free Cash Flow

So people ask me why I don't include changes in working capital to the FCF equation in the **stock analysis tools** because clearly accounts receivables does not represent an increase in cash. Inventory also doesn't bring in cash if it is sitting on the shelf.