Operating Cash Flows, Free Cash Flows and the Effect of Income Tax Payments

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Traditionally, a lot of attention is paid to the Income Statement and very little is paid to the Statement of Cash Flows (SCF). Ignoring the SCF may have serious consequences. In the early 1970s, when the SCF was not required, one of the biggest bankruptcies in USA history took place. W.T. Grant, one of the nation's top retailers of that era, showed continuous profits and significant amounts of working capital. However, its operations were not producing enough cash to survive. Even though the SCF has been around since the mid 1980s, auditors, managers and educators still do not place enough emphasis on cash flows. Analyzing the cash flow statement is integral to understanding a company's financial performance and position because it often provides a check to the quality of the earnings shown in the income statement.

Some authors suggest the use of cash flow ratios[i]. In their opinion, cash flow ratios are more reliable indicators of liquidity than balance sheet or income statement ratios such as the quick ratio or the current ratio. Other authors defend the use of free cash flow (FCF)[ii]. Not many companies seem to be interested in discussing cash flow ratios in their annual reports. Auditors have not shown too much interest either. On the other hand, the number of companies presenting and discussing free cash flow information is increasing.

This paper deals with the effect of income tax payment on cash flow from operating activities (CFO) and free cash flow (FCF). It is divided in two parts. In the first part, I look at income tax payments and their effect on CFO, computing what I call the cash-basis effective income tax rate. I compare this rate against the accrual-basis effective income tax rate.

The differences between the amount paid for income taxes and the income tax expense (accrual basis) can be eye-popping. For example, a 2004 study showed that 82 major U.S. corporations paid no federal income taxes at least once in the previous three years, even while they reported more than $100 billion in U.S. profits during those years[iii]. More recently, 2007-

2009, GE paid no income taxes, and in fact received money from the government, even though it reported significant amounts of profits and cash flow from operations. Other companies, however, seem to pay excessive amounts of income taxes. In 2008, Wells-Fargo paid $2.5 billion in income taxes despite having a huge negative cash flow amount and Bank of America paid income taxes equivalent to 54% of its cash flow from operations while the accrual basis figures showed an effective income tax rate of just 9.5%.

A lender's judgment of a borrower's capacity to repay relies on the business' ability to generate and maintain adequate cash flow. By the same token, an investor will be interested in the investee's cash flow. It appears, then, that the amount of cash paid for income taxes is of more relevance than the GAAP-based income tax expense. Obviously, management is also interested in the effect of income taxes in the company's cash flow.

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Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have recognized the importance of income taxes in **all** financial statements. In their October 16, 2008 Discussion Paper, *Preliminary View on Financial Statements Presentation*, the boards suggest that the *Statement of Comprehensive Income* have a separate section for *Income Tax Expense*; the *Statement of Financial Position* present separately all the related income tax assets and liabilities; and the *Statement of Cash Flows* present a separate section for *Income Taxes Paid*.

The second part of this paper looks at free cash flows and the effect of income tax payments on this measure. Some companies seem to be very happy about their free cash flow but, do they know how much of their cash flow is being eaten by income taxes? This paper expects to open their eyes to this issue; resulting, perhaps, in better tax planning.

For this paper, I used the largest 100 corporations in the USA (Fortune 100) and compared the accrual-basis effective income tax rate (already reported by corporations in the notes to the financial statements) and the *cash-basis effective income tax rate*, which is not reported by corporations. The period covered by the study includes the years 2007 to 2009. Because the cash-basis effective rate is not reported by companies, it must be defined and computed in the following manner:

Net cash flow from operations + cash paid for income taxes = net cash flow from operations before income taxes.

$$\frac{\text{Cash paid for income taxes}}{\text{Net cash flow from operations before income taxes}} = \text{Cash-basis effective tax rate}$$

It was expected that the findings will show a significant difference, for most companies, between accrual-basis tax information and cash-basis tax information. In addition to pointing out the importance of income tax payments, another possible contribution of this paper is that accounting and finance studies that use income taxes as a predictive or explanatory variable, could be replicated using the cash-basis tax rate, and the results compared to the original studies.

Of course, the information value of any measurement (ratio or otherwise) depends on the reliability of its components. Although many people extol the virtues of the SCF, the statement is not without its critics. Weiss and Yang[iv] mention what they call problems with the SCF. For example, they say: "the fact that interest paid is treated as an operating activity while dividends paid is treated as a financing activity makes it difficult, if not impossible, to compare the performance of companies that make different financing choices." Another problem is the financing of receivables. Some companies show them as operating activities while other

companies present them as financing activities. Dividends received and interest payments on capital leases are also mentioned.

Siegel[v] identifies what he calls accounting shenanigans that artificially boost reported operating cash flow or present unsustainable cash flows. Stretching out payables and financing payables are but two of these shenanigans.

Nurnberg[vi] calls for a more precise presentation of income taxes in the SCF. He states that some income tax payments relate to gains and losses on investing and financing activities, such as gains and losses on plant asset disposals and early debt extinguishments. As a result, net cash flow from operating activities is contaminated by the income tax effects of investing and financing activities. Nurnberg proposes income tax allocation in the cash flow statement so that the income tax effects of transactions and events would be reported in the same section of the cash flow statement as the transactions and events themselves.

As stated above, the FASB and the IASB are considering changes in the presentation of the financial statements. Some of the issues presented above might be resolved. In the meantime, the present measure of cash flow from operating activities (CFO) will have to do for those who do not have enough information to develop their own measures.

For those same Fortune 100 companies, the second part of the paper analyzes their free cash flows using a similar approach; that is:

Free cash flow + cash paid for income taxes = free cash flow before income taxes.

$$\frac{\text{Cash paid for income taxes}}{\text{Free cash flow before income taxes}} = \text{Free cash flow tax rate}$$

Most companies compute free cash flow (FCF) as the difference between cash flow from operating activities (CFO) and capital expenditures. Therefore, FCF is subject to the same

criticisms pointed at CFO. (Also, see Mills, Bible and Mason for a discussion of other FCF formulas).

Problems in obtaining the Data

Although the annual reports of the companies are readily available, the needed data were not necessarily easy to obtain. Two items in particular required significant effort. The amount of cash paid for income taxes is explicitly presented in the SCF by those companies that use the direct method for reporting cash flow from operating activities. Unfortunately, only two of the 100 companies used the direct method. Those that use the indirect method (98 in this case) must present the amount of cash paid for income taxes. However, the rules do not require a particular form of presentation. Some companies presented it as supplementary information in the SCF, which made it easy to find. However, many companies did not present it that way. Some have a note about cash flows, others present the information in the income taxes note and there were several companies for which it was necessary to use the search (or find) function, finding the information in MD&A or other notes not necessarily concerned with cash flow or income taxes. **I strongly suggest that if the indirect method is going to continue in use, the rules should explicitly require that amount of cash paid for income taxes be explicitly presented in the body of the SCF.**

The second needed item was the effective income tax rate (accrual basis). Companies typically present a note for income taxes. Within that note, many companies present reconciliation between the statutory tax rate (35%) and the effective tax rate. An example follows for CVS Caremark:

	2009	2008	2007
Statutory income tax rate	35.0%	35.0%	35.0%
State income taxes,			
net of federal tax benefit	4.5%	4.1%	4.2%
Other	0.6%	0.5%	0.3%
Federal and net State			
reserve release	-2.8%	-	-
Effective income tax rate	**37.3%**	**39.6%**	**39.5%**

Not all companies, however, present the information in this manner. Again, it was necessary to search for it throughout the annual report. A few companies presented dollar amounts instead of percentages, so the rates had to be computed. **I suggest that the rules require that the effective income tax rate be presented in the income taxes section of the Income Statement.** If it is considered important, it should be clearly presented.

The Cash-Basis Effective Income Tax Rate

For each of the 100 companies, the cash-basis effective income tax rate was computed and compared to the accrual-basis effective tax rate. Several interesting examples are presented here (millions of dollars):

Wal-Mart Stores	2009	2008	2007
Cash Flow from Operating Activities	$ 26,249	$ 23,147	$ 20,642
Cash Paid for Income Taxes	7,389	6,596	6,299
Pretax CF from Operating Activities	$ 33,638	$ 29,743	$ 26,941
Percentage Paid as Income Taxes	**21.97%**	**22.18%**	**23.38%**
Effective Accrual Basis Tax Rate	**34.19%**	**34.19%**	**34.18%**

Wal-Mart is the number 1 company of the 2010 Fortune 100. Its accrual-basis effective tax rate is very close to the statutory rate. However, its cash-basis effective tax rate is only about two thirds of the accrual-basis rate.

Exxon Mobil	2009	2008	2007
Cash Flow from Operating Activities	$ 28,438	$ 59,727	$ 52,002
Cash Paid for Income Taxes	15,427	33,941	26,342
Pretax CF from Operating Activities	$ 43,865	$ 93,668	$ 78,344
Percentage Paid as Income Taxes	**35.17%**	**36.24%**	**33.62%**
Effective Accrual Basis Tax Rate	**47.00%**	**46.00%**	**44.00%**

Exxon Mobil, number 2 in the list, has a very high accrual-basis tax rate. Its cash-basis rate is also high, but 20 per cent lower than the accrual-basis rate.

General Electric	2009	2008	2007
Cash Flow from Operating Activities	$ 24,593	$ 48,601	$ 43,322
Cash Paid for Income Taxes	(2,535)	(3,237)	(2,912)
Pretax CF from Operating Activities	$ 22,058	$ 45,364	$ 40,410
Percentage Paid as Income Taxes	**-11.49%**	**-7.14%**	**-7.21%**
Effective Accrual Basis Tax Rate	**-10.50%**	**5.50%**	**15.60%**

GE, number 4, had CFO before taxes significantly higher than Wal-Mart in 2007 and 2008. Yet it paid no income taxes but received money from the government. The company claims an accrual-basis tax rate of 15.6% in 2007 but received almost $3 billion from the government. In the three years combined, the CFO before taxes was almost $108 billion and the government paid to the company almost $9 billion, increasing its CFO to over $116 billion.

Bank of America	2009	2008	2007
Cash Flow from Operating Activities	$ 129,731	$ 4,034	$ 11,036
Cash Paid for Income Taxes	2,933	4,700	9,196
Pretax CF from Operating Activities	$ 132,664	$ 8,734	$ 20,232
Percentage Paid as Income Taxes	**2.21%**	**53.81%**	**45.45%**
Effective Accrual Basis Tax Rate	**-44.00%**	**9.50%**	**28.40%**

In 2007 and 2008 combined, Bank of America (number 5) had pretax CFO of $29 billion and paid almost $14 billion in taxes (close to 50 per cent). By contrast, in 2009, the company' pretax CFO was an incredible $129.7 billion and paid just under $3 billion in income taxes. What will be more important to investors and creditors, the -44% accrual-basis rate or the 2.21% cash-basis rate?

AT&T	2009	2008	2007
Cash Flow from Operating Activities	$ 34,445	$ 33,656	$ 34,242
Cash Paid for Income Taxes	4,471	5,307	4,013
Pretax CF from Operating Activities	$ 38,916	$ 38,963	$ 38,255
Percentage Paid as Income Taxes	**11.49%**	**13.62%**	**10.49%**
Effective Accrual Basis Tax Rate	**32.40%**	**34.90%**	**34.00%**

Hewlett-Packard	2009	2008	2007
Cash Flow from Operating Activities	$ 13,379	$ 14,591	$ 9,615
Cash Paid for Income Taxes	643	1,136	956
Pretax CF from Operating Activities	$ 14,022	$ 15,727	$ 10,571
Percentage Paid as Income Taxes	**4.59%**	**7.22%**	**9.04%**
Effective Accrual Basis Tax Rate	**18.60%**	**20.50%**	**20.80%**

Verizon Communications	2009	2008	2007
Cash Flow from Operating Activities	$ 31,565	$ 27,557	$ 26,839
Cash Paid for Income Taxes	158	1,206	2,491
Pretax CF from Operating Activities	$ 31,723	$ 28,763	$ 29,330
Percentage Paid as Income Taxes	**0.50%**	**4.19%**	**8.49%**
Effective Accrual Basis Tax Rate	**10.50%**	**20.90%**	**27.40%**

Number 7 AT&T had a cash-basis effective rate equal to about one-third of its accrual-basis effective tax rate while number 10 Hewlett Packard paid in taxes a small percentage of its pretax CFO. A similar situation can be seen with number 13, Verizon.

American International group	2009	2008	2007
Cash Flow from Operating Activities	$ 18,584	$ (122)	$ 32,792
Cash Paid for Income Taxes	(226)	(617)	(5,163)
Pretax CF from Operating Activities	$ 18,358	$ (739)	$ 27,629
Percentage Paid as Income Taxes	**-1.23%**	**83.49%**	**-18.69%**
Effective Accrual Basis Tax Rate	**13.80%**	**8.30%**	**15.60%**

Wells Fargo	2009	2008	2007
Cash Flow from Operating Activities	$ 28,613	$ (4,788)	$ 9,286
Cash Paid for Income Taxes	3,042	2,554	3,719
Pretax CF from Operating Activities	$ 31,655	$ (2,234)	$ 13,005
Percentage Paid as Income Taxes	**9.61%**	**-114.32%**	**28.60%**
Effective Accrual Basis Tax Rate	**30.30%**	**18.50%**	**30.70%**

American International Group (number 16) paid in 2008 three times as more taxes as in 2009, even though its pretax CFO was negative in 2008 and positive in 2009. Its 2008 cash-basis tax rate was a whopping 83.5 per cent. Something similar but with much larger dollar amounts, happened to Wells Fargo (number 19). Note the -114.3 per cent cash-basis tax rate.

Summary of All Companies

The 300 observations (100 companies, three years) for the years 2007 to 2009 show that the majority (57%) of the companies reported an accrual-basis effective income tax rate greater than 30%, (see table below). More than a third reported a rate greater than 35% and only one

fourth reported an effective rate lower than 25%. The story with the cash-basis effective income tax rate was significantly different. Only one fifth of the companies had a rate greater than 35% and almost 50% had a rate lower than 25%. In fact, dividing the total cash paid for income taxes (300 payments, net of negative taxes) by the total pretax CFO (300 periods), the companies had a weighted-average cash-basis rate of 22%. Thus, while the typical Fortune-100 company reports an accrual-basis effective tax rate greater than 30%, it pays income taxes equal to 22% of its pretax cash flow from operating activities.

Cumulative Percentages		
	Accrual Effective	Cash Effective
Greater than:	Rate	Rate
40%	12%	8%
35%	36%	21%
30%	57%	36%
25%	74%	51%
20%	85%	86%

The information content, and the usefulness, of the accrual-basis effective income tax rate has never been very clear to preparers, auditors and analysts of financial statements. Some scholars consider **taxable income** a better measure of performance and a better predictor of future performance than book income[vii]. The cash-basis effective tax rate could provide information about how the company manages the effect of income taxes on its cash flow from operations. Yet, many companies might not be aware of this effect, or at least they do not care enough to provide that information to the users of financial statements. The amount of cash paid for income taxes is usually buried in a note in the annual report. **I suggest that, whether the direct method or the indirect method is used, the SCF presents the net cash flow from operating activities as follows:**

Cash flow from operating activities before payment of income taxes	$XXXX
Cash paid for income taxes	XXXX
Net cash flow from operating activities	$XXXX

Effect of Income Tax Payments on Free Cash Flows

Not many companies discuss free cash flow (FCF) in their annual reports, but those that do, seem to be strong believers of this measure. Let's see five examples:

Walmart:

> Our free cash flow performance continues to be impressive, closing the year with $14.1 billion in free cash flow. Our goal is also to continue to produce significant free cash flow to drive our ROI performance and deliver greater shareholder value. Management believes that free cash flow, which measures our ability to generate additional cash from our business operations, is an important financial measure for use in evaluating the company's financial performance.

Procter & Gamble:

> The company views free cash flow as an important measure because it is one factor in determining the amount of cash available for dividends and discretionary investment. Free cash flow is also one of the measures used to evaluate senior management and is a factor in determining their at-risk compensation.

IBM (2008 annual report):

> You need to know, in this time of turmoil, that your company is well positioned to continue delivering strong results, as we have been doing and did again in 2008—achieving record revenue, record pre-tax earnings, record earnings per share and record free cash flow. Our business model has allowed us to generate more than $84 billion in free cash flow over the past nine years.

Johnson and Johnson:

> The Company believes investors gain additional perspective of underlying business trends and results by providing free cash flow [*and other measures*].

Disney

> The strength of our businesses enables us to deliver strong free cash flow even while we invest in opportunities with attractive growth potential.

Forbes Magazine and Motley Fool are strong believers of FCF. Regarding Microsoft, Forbes emphasized its continued strong free cash-flow generation[viii] while Motley Fool stated that "the one factor that I think really gives Microsoft a substantial advantage over the competition is its tremendous financial resources, namely free cash flow."[ix]

The first issue with FCF is how to define it, for there are several definitions, for example[x]:

- Cash provided by operations less capital expenditures
- Cash provided by operations less capital expenditures and dividends paid
- Net income plus depreciation less capital expenditures
- EBITDA less capital expenditures
- Earnings before interest and taxes (EBIT) multiplied by 1 minus the tax rate, plus depreciation and amortization less changes in operating working capital and less capital spending.

Walmart recognizes a limitation to its definition of FCF:

> Additionally, our definition of free cash flow is limited and does not represent residual cash flows available for discretionary expenditures due to the fact that the measure does not deduct the payments required for debt service and other obligations or payments made for business acquisitions. Therefore, we believe it is important to view free cash flow as supplemental to our entire statement of cash flows.

Since most companies that measure FCF use the first definition, I use that one as well, in the interest of uniformity. There is no single definition, however, that can suit every company. The one I am using has significant drawbacks. All the shortcomings attributed to CFO are

automatically attributed to FCF. Also, a firm can "manage" FCF by increasing or reducing capital expenditures; that is, shenanigans are also possible with respect to FCF.

Those companies that measure and report FCF do not consider the effect of income tax payments. It can be said, then, that they are using an after-tax measure. I believe that both a before-tax and an after-tax measure should be reported so that a user can see how much of what could have been free cash flow was "eaten" by income taxes. Let's look at the largest firm, Walmart:

Wal-Mart Stores	2009	2008	2007
Cash Flow from Operating Activities	$ 26,249	$ 23,147	$ 20,642
Capital Expenditures	(12,184)	(11,499)	(14,937)
Free Cash Flow	**$14,065**	**$11,648**	**$ 5,705**
Cash Paid for Income Taxes	7,389	6,596	6,299
Free Cash Flow Before Income Taxes	**$21,454**	**$18,244**	**$12,004**
Percentage Paid as Income Taxes	**34.44%**	**36.15%**	**52.47%**

The amount of cash paid for income taxes is added back to the FCF to compute FCF before income taxes. Dividing the amount paid for income taxes by the FCF before taxes results in what could be called the FCF tax rate. Note that in 2007, income taxes consumed 52.5% of what otherwise would have been FCF. Income taxes also "ate" a good portion in 2008 and 2009.

Exxon presents an interesting case:

Exxon Mobil	2009	2008	2007
Cash Flow from Operating Activities	$ 28,438	$ 59,727	$ 52,002
Capital Expenditures	(22,491)	(19,318)	(15,387)
Free Cash Flow	$ 5,947	$ 40,409	$ 36,615
Cash Paid for Income Taxes	15,427	33,941	26,342
Pretax Free Cash Flow	$ 21,374	$ 74,350	$ 62,957
Percentage Paid as Income Taxes	**72.18%**	**45.65%**	**41.84%**

While the 2009 CFO was less than half of the 2008 CFO, Exxon had more capital expenditures in 2009 and, even though it paid significantly fewer taxes, the percentage was much higher. It should be noted that Exxon does not report FCF in its annual report.

Chevron does not report FCF either. It consistently spent close to $20 billion in capital expenditures, regardless of CFO, so the tax percentage in 2009 was almost 107. Exxon and Chevron could be used as examples that not every company cares about the concept of FCF. While some companies use FCF to measure performance, other companies are satisfied with different measures.

Chevron	2009	2008	2007
Cash Flow from Operating Activities	$ 19,373	$ 29,632	$ 24,977
Capital Expenditures	(19,843)	(19,666)	(16,678)
Free Cash Flow	$ (470)	$ 9,966	$ 8,299
Cash Paid for Income Taxes	7,537	19,130	12,340
Free Cash Flow Before Income Taxes	$ 7,067	$ 29,096	$ 20,639
Percentage Paid as Income Taxes	**106.65%**	**65.75%**	**59.79%**

Conoco Philips, like Exxon and Chevron, is more interested in having a healthy amount of capital expenditures than in measuring FCF.

ConocoPhilips	2009	2008	2007
Cash Flow from Operating Activities	$ 12,479	$ 22,658	$ 24,550
Capital Expenditures	(10,861)	(19,099)	(11,791)
Free Cash Flow	$ 1,618	$ 3,559	$ 12,759
Cash Paid for Income Taxes	6,641	13,122	11,330
Free Cash Flow Before Income Taxes	$ 8,259	$ 16,681	$ 24,089
Percentage Paid as Income Taxes	**80.41%**	**78.66%**	**47.03%**

Procter & Gamble, as we already know, measures and reports FCF. Income tax payments appear to be reasonable in relation to pretax FCF.

Procter & Gamble	2009	2008	2007
Cash Flow from Operating Activities	$ 14,919	$ 15,008	$ 13,410
Capital Expenditures	(3,238)	(3,046)	(2,945)
Free Cash Flow	$ 11,681	$ 11,962	$ 10,465
Cash Paid for Income Taxes	3,248	3,499	4,116
Free Cash Flow Before Income Taxes	$ 14,929	$ 15,461	$ 14,581
Percentage Paid as Income Taxes	**21.76%**	**22.63%**	**28.23%**

Summary of all Companies

For the 300 periods (100 companies, three years), the Fortune 100 companies paid cash for income taxes that was approximately one third of the companies' combined pretax FCF. The distribution was as follows:

Cumulative Percentages	
	Tax Pmts as % of
Greater than:	FCF
50%	18%
40%	26%
35%	36%
30%	48%
25%	57%
20%	76%
10%	90%
0%	

A little over one third of the companies paid taxes in excess of 35% of the would-be FCF, while 43% of them paid taxes under 25% of the would-be FCF.

It is very difficult to draw conclusions from FCF data. The measure is a hybrid between operating activities (CFO) and investing activities (capital expenditures). If a company were to finance its capital expenditures with operating cash flows, perhaps the measure will make more sense. However, many companies use debt or equity (financing activities) to finance their capital expenditures. Notwithstanding the enthusiasm of some companies, it is hard for me to see the usefulness of FCF and how it can be used to measure performance and determine compensation of managers and executives.

Companies that use FCF to measure performance **should consider using pretax FCF**, since the amount of income taxes a company pays depends upon many factor, some of which cannot be controlled by the managers whose performance is being measured.

Conclusion

As a result of this study it is recommended that:

1. Companies be required to explicitly present the amount of cash paid for income taxes in the body of the statement of cash flows, whether using the direct method or not. The suggested presentation is:

Cash flow from operating activities before payment of income taxes	$XXXX
Cash paid for income taxes	XXXX
Net cash flow from operating activities	$XXXX

This suggestion does not rule out allocation of income tax payments to operating, investing and financing activities as Nurnberg proposes.

2. The effect of income tax payments on free cash flow should be explicitly reported by those companies that use FCF as a measure of performance. Because income tax payments are not always controlled by managers, pretax FCF should be used for performance measurement and managers compensation.

[i] See for example, *The Power of Cash Flow Ratios* by Mills and Yamamura. **Journal of Accountancy**. October 1998.
[ii] *Defining Free Cash Flows: Lack of Consensus Calculation* by Mills, Bible and Mason. **The CPA Journal**. January 2002.
[iii] See http://articles.latimes.com/2004/sep/23/business/fi-biztax23
[iv] *The Cash Flow Statement: Problems with the Current Rules*. **The CPA Journal**. March 2007.
[v] *Accounting Shenanigans on the Cash Flow Statement: Metrics Might Change, but Corporate Behavior Does Not*. **The CPA Journal**. March 2006.

[vi] *Income Taxes in the Cash Flow Statement: A Proposal for More Precise Presentation*. **The CPA Journal**. June 2003.

[vii] See for example, *Taxable Income as a Performance Measure: The Effects of Tax Planning and Earnings Quality* by Ayers, Jiang and Laplante. **Contemporary Accounting Research**. Spring 2009; and *What Can We Infer about a Firm's Taxable Income from Its Financial Statements?* Hanlon. **National Tax Journal.** December 2003.

[viii] http://www.forbes.com/2005/07/18/microsoft-earnings-cash-flow-0718markets21.html

[ix] http://www.fool.com/portfolios/rulemaker/1999/rulemaker990824.htm

[x] Weiss and Yang. Id.