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THE CLASSIFICATION OF CASH FLOWS RELATED TO TAXES PAID ON NON-OPERATING ITEMS

EXECUTIVE SUMMARY

The ability of a company to generate sustainable operating cash flow and free cash flow is an important indicator of the company's financial health.

Current treatment of income taxes paid calls for their inclusion in operating cash flow. However, some of these taxes are related to gains on investing or financing items. Their inclusion in operations can cause operating cash flow to be understated.

In this study, we examine 2004 and 2005 financial statements to identify a sample of companies where the effects of taxes on non-operating gains have a material effect on operating cash flow. We found cases where operating cash flow was understated by a significant amount. In one case, the removal of the taxes paid on non-operating gains caused an increase of operating cash flow by nearly forty-five percent. A supplemental table looks at the effects of such taxes on free cash flow with similar findings.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Introduction

Operating cash flow is important in evaluating a company's financial health. It is considered to be sustainable, a useful indicator of a company's future performance, and not as easily manipulated as earnings. In addition, through cash flow we can better understand a firm's debt service capacity and its overall fair market value. However, research has shown that at times operating cash flow includes items that are not related to operations or are non-recurring. Accordingly, it may not accurately portray a firm's sustainable cash generating ability. It is our position that these items should be removed from operating cash flow before it is used in analysis. This is an idea often discussed in the Lab's reports. Examples of previous reports on the topic include *Insurance Proceeds related to PP&E* (June 05), *Interest Paid on Zero Coupon Bonds* (May 05), and *Customer Related Notes Receivable*, *Updated* (April 05).

The purpose of this research report is to discuss how taxes paid on non-operating gains affect operating cash flow rendering it less meaningful and less useful in analysis. Generally accepted accounting principles (GAAP) require that income taxes paid or recovered are to be reported as operating cash flow. According to GAAP, it is not practical to allocate taxes to the operating, investing, and financing sections of the cash flow statement depending on the nature of the item that gave rise to the taxes. It is our position that such an allocation is necessary for operating cash flow to accurately represent a firm's cash generating ability. This report identifies inconsistencies between stated operating cash flow and firm performance due to the classification of taxes paid on non-operating items. In particular, we focus our attention on income taxes paid on net gains on asset sales, including investments and property, plant and equipment.

Cash Flows Related to Taxes:

Taxes create both cash inflows and cash outflows. Cash outflows are more common and are generated from the actual payment of income taxes to taxing authorities. Inflows arise from the reimbursement of taxes previously paid. Such recoveries of taxes previously paid occur when a company incurs a loss and carries it back eliminating past tax payments. When a current loss exceeds taxable income in the two previous years, any excess is carried forward for up to twenty years and used as a deduction against future taxable income.

Corporate income taxes on taxable income are typically paid in quarterly installments, around April 15th, June 15th, September 15th, and December 15th. Companies are required by GAAP to disclose the amount of cash paid for taxes. Usually these numbers can be found at the bottom of the cash flow statement though footnote disclosure is also used. These taxes paid may arise from profits generated by core operations. They may also arise from incidental investing activities, such as the sale of investments or property, plant and equipment, or from such financing activities as early debt retirement or tax benefits received from the exercise of non-qualified stock options. Still, according to GAAP, all such taxes, regardless of origin, are to be classified as operating cash flow.[1]

Tax Related Cash Flows: What is studied

Our objective here is to identify and remove from operating cash flow taxes paid on non-operating items. We focus on taxes paid on non-operating gains because taxes paid can be more accurately traced to their original source than can tax benefits resulting from non-operating losses. Tax outflows typically occur in the same period as their related gain. In contrast, tax benefits resulting from non-operating losses must often be netted against capital gains and may entail carry forwards to future periods. The companies studied provide examples of substantial gains with taxes paid in the same year as the associated gain. In each example, due to the inclusion of income taxes, operating cash flow is understated.

Tax Rates

In the study we use the cash tax rate to estimate the amount of taxes paid on non-operating gains. For reference, three different tax rates are commonly mentioned when discussing a company's financial performance - the statutory tax rate, the effective tax rate, and the cash tax rate. The statutory tax rate is the combined federal and state corporate tax rate called for by the taxing authorities. Combined they approximate 40 percent of pretax income. The effective tax rate is computed by dividing the total tax provision reported on the income statement by the amount of earnings reported before income taxes. Due to differences between income reported on the income statement and amounts reported for tax purposes, the total tax provision may or may not be actually paid during the reporting period. The cash tax rate represents the actual amount of taxes paid during the reporting period as a percentage of pretax income. This rate is used in the study to estimate the amount of taxes paid on non-operating gains because it is more representative of the actual tax payments associated with the gains.

The Study: Scope, Focus, and Method

The scope of the study included taxes paid on non-operating gains such as gains on sale of investments in public and private companies, available for sale securities, and other assets. Identified in this study were non-financial companies that disclose non-operating gains in their 10-K filings within the past year.

Each 10-K filing was reviewed to make sure that all the gains met the following criteria:

1) The gain itself was related to an investing (non-operating) activity.
2) The company reported positive total earnings before income taxes.
3) The gain itself resulted in the actual payment of income taxes.

[1] There is one exception. According to Statement of Financial Accounting Standards No. 123R "Shared Based Payment," tax benefits received from tax deductions related to non-qualified stock options that exceed the amount of option-related compensation expense charged against income are to be classified as financing cash flows.

After verifying that the identified gains met the above criteria, each was examined to determine their effect on operating cash flow. In order to determine this effect, the cash tax rate was calculated then applied to the gain to get total taxes attributed to the gain. Next, taxes attributed to the gain were added back to operating cash flow so that a percentage change could be computed.

Results

The results are presented in Table 1.

Table 1. Adjustments to Reported Operating Cash Flow for Taxes Paid on Gains Resulting from Sales of Investments and Other Assets. ($ Amounts in 000s).

Company (Year)	Year Ending	Item Resulting in Gain	Reported Operating Cash Flow	Net Gain on Investing Activities	Taxes Paid on Gain	Adjusted Operating Cash	Percent Change
Equifax, Inc.	12/31/2004	Sale of Investment	309,000	36,800	9,764	318,764	3.16%
Insight Enterprises, Inc.	12/31/2004	Sale of Investment	13,247	23,725	5,891	19,138	44.47%
Tekelec	12/31/2004	Sale of Investment	21,158	10,063	4,580	25,738	21.65%
Warwick Valley Telephone Co.	12/31/2004	Sale of Investment	13,786	2,490	776	14,562	5.63%
Brown Forman Corp.	4/30/2005	Sale of Investment	396,000	72,000	26,319	422,319	6.65%
Conagra Foods, Inc.	5/29/2005	Sale of Investment	837,200	185,700	47,580	884,780	5.68%
Escalon Medical Corp.	6/30/2005	Sale of Investment	-3,350	3,412	327	-3,023	9.77%
Franklin Electronic Publishers, Inc.	3/31/2005	Sale of Investment	5,537	1,781	382	5,919	6.90%
The L. S. Starrett Co.	6/25/2005	Sale of Real Estate	2,548	2,794	951	3,499	37.34%

As can be seen in Table 1, the removal of income taxes paid on investing-related gains can have a significant effect on operating cash flow. Two extreme examples of companies with significant reductions in reported operating cash flow due to income taxes paid on investing-related gains include Insight Enterprises and The L. S. Starrett Co. Reclassifying tax payments to the investing section, where the proceeds from sale are reported, resulted in an increase in operating cash flow by 44% and 37%, respectively.

In the example of Escalon Medical the total investing related gain was actually more than total pretax income. As a result, the entire amount of taxes paid could be attributed to the gain. Yet, even though the proceeds from sale are reported as investing cash flow, GAAP requires that the related taxes must be reported in the operating section of the cash flow statement. Reclassifying the tax cash flow to the investing section resulted in an increase in operating cash flow by approximately 10%.

Free Cash Flow

Free cash flow is calculated by subtracting capital expenditures from operating cash flow. Free cash flow measures the amount of cash available for discretionary purposes such as dividends, stock buybacks, investments and acquisitions, after necessary disbursements on debt service and infrastructure maintenance and growth have been made. When computing free cash flow, proceeds from the sale of property, plant and equipment are typically netted against capital expenditures. As such, income taxes paid on such asset sales should also be included in free cash flow calculations. They serve to reduce the net proceeds received from the sales of the assets.

Sales of investments are different, however, in that investments are typically not subtracted from operating cash flow in computing free cash flow. Unlike capital expenditures, which are made to build infrastructure for the purpose of generating free cash flow, investments are generally considered to be a discretionary use of free cash flow. Accordingly, because the proceeds from sales of investments are not considered to be a source of free cash flow, taxes paid on their sale should not be subtracted when computing free cash flow. Thus, our objective here is to add taxes paid on gains arising from investment sales back to free cash flow to derive a more meaningful measure.

All of the firms in our study reaped gains from sales of investments and other assets, which are not assets included in the calculation of capital expenditures. In Table 2, we add taxes paid on these gains to free cash flow and calculate an adjusted free cash flow amount.

Table 2. Adjustments to Free Cash Flow for Taxes Paid on Gains Resulting from Sales of Investments and Other Assets. ($ Amounts in 000s).

Company	Reported Operating Cash Flow	Capital Expenditure Net	Reported Free Cash Flow	Taxes Paid on Gain	Adjusted Free Cash Flow	Percent Change
Equifax, Inc.	309,000	16,500	292,500	9,764	302,264	3.34%
Insight Enterprises, Inc.	13,247	20,705	-7,458	5,891	-1,567	78.99%
Tekelec	21,158	18,278	2,880	4,580	7,460	159.04%
Warwick Valley Telephone Co.	13,786	4,906	8,880	776	9,656	8.74%
Brown Forman Corp.	396,000	49,000	347,000	26,319	373,319	7.58%
Conagra Foods, Inc.	837,200	453,400	383,800	47,580	431,380	12.40%
Escalon Medical Corp.	-3,350	104	-3,454	327	-3,127	9.47%
Franklin Electronic Publishers, Inc.	5,537	970	4,567	382	4,949	8.37%
The L. S. Starrett Co.	2,548	6,848	-4,300	951	-3,349	22.12%

The effects of removing taxes paid on gains related to sales of investments and other assets from free cash flow is similar to those of removing taxes from operating cash flow. The percent change ranges from Equifax's approximate 3½% to Tekelec's extreme example of nearly 160%. In addition, the example of Insight Enterprises is also quite significant. Insight *consumed* $7,458 in reported free cash flow (reported operating cash flow less capital expenditures). Once adjusted for taxes paid on investment sales, adjusted free cash flow was also a use of cash, but was greatly reduced to -$1,567.

Conclusion

Our research uncovered many examples of substantially understated operating cash flow and free cash flow due to taxes paid on investing-related gains. In these cases, cash flow amounts may be misleading and may not be an accurate representation of a firm's financial performance. Before using operating cash flow in analysis, investors, creditors and other users of financial statements should consider adjustments for income taxes paid on non-operating items.

GAAP calls for the income statement to be presented in a way that reports the effects of income taxes on the items to which they relate.[2] It calls for the matching of income and expenses with

[2] Statement of Financial Accounting Standards No 109 "Accounting for Income Taxes" 1992.

the related tax effects of various categories such as continuing operations, discontinued operations and extraordinary items. When it comes to classifying cash flows to the operating, investing and financing sections, however, such intraperiod tax allocation is not employed. Our research indicates that users of financial statements may be well served if intraperiod tax allocation for the cash flow statement were reconsidered.