THROUGH A GLASS DARKLY: WHAT CAN WE LEARN ABOUT A U.S. MULTINATIONAL CORPORATION’S INTERNATIONAL OPERATIONS FROM ITS FINANCIAL STATEMENT DISCLOSURES?

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We discuss the accounting rules that apply to reporting a U.S. company’s international operations. We use examples to illustrate diversity in accounting and offer caveats for policy makers, standard setters, analysts, and researchers regarding their interpretation and use of financial accounting information.

Keywords: corporate tax, international tax, tax avoidance, book-tax differences, accounting for income taxes

JEL Codes: H25, H26, M41, M48

I. INTRODUCTION

The growing amounts of foreign income reported by U.S. multinational corporations and the rate of foreign income taxes imposed on such income continue to receive close scrutiny. Although some researchers have access to private data from the Bureau of Economic Analysis, Statistics of Income, and surveys, much of this analysis is based on information reported by corporations in their publicly available financial statements. In this paper, we discuss the accounting rules that apply to reporting a company’s international operations and how such information should be interpreted. We use examples to illustrate diversity in accounting and offer caveats in taking financial accounting data at face value.

As tax policymakers continue to discuss the potential impact of shifting from a system of worldwide taxation to a territorial tax regime or deliberate on whether to impose a
minimum tax on foreign income earned in low tax jurisdictions, we argue that financial accounting statements can provide important information to the debate, provided it is interpreted correctly. We also offer suggestions for improving financial reporting of international operations to enhance its transparency and consistency.

II. ACCOUNTING DISCLOSURES OF INTERNATIONAL OPERATIONS

The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) govern the disclosure of a publicly-traded U.S. company’s international operations in its financial statements.

A. SEC Reporting Requirements

1. Domestic versus Foreign Income

The SEC prescribes the form and content of financial statements filed by publicly-traded companies in Regulation S-X, Form and Content of and Requirements for Financial Statements. REGULATION S-X §210.4-08, General Notes to Financial Statements, provides the disclosures required in a company’s financial statements and notes to the financial statements. In particular, §210.4-08(h)(1), Income Tax Expense, mandates that a company disclose, usually as part of the income tax footnote to the financial statements, the components of income (loss) before income tax expense (benefit) as either domestic or foreign. For this purpose, the SEC defines “foreign income (loss)” as the income (loss) generated from a registrant’s foreign operations, i.e., operations that are located outside of the registrant’s home country. The rules require a U.S. corporation to state separately its foreign income and foreign income taxes applicable to foreign income when foreign income is 5 percent or more of total income before taxes, or foreign taxes are 5 percent or more of total tax expense.

2. Exhibit 21

The SEC also requires registrants to provide certain exhibits to their published financial statements, as described in Regulation S-K. REGULATION S-K §229.601-21 mandates that a registrant include an exhibit that lists all subsidiaries of the registrant, the state or other jurisdiction of incorporation or organization of each, and the names under which such subsidiaries do business (often referred to as “Exhibit 21” to the Form 10-K).

A corporation may omit the names of particular subsidiaries if the unnamed subsidiaries, considered in the aggregate as a single subsidiary, would not constitute a significant

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2 CFR, Title 17, Part 229.
subsidiary as of the end of the year covered by the financial report. The SEC defines a “significant subsidiary” as one whose assets or pretax income from continuing operations exceeds 10 percent or more of the consolidated amount.³

A growing trend has been for multinational corporations to reduce significantly the list of subsidiaries they report in their Exhibit 21. For example, Google Inc. listed 108 subsidiaries in its Exhibit 21 to Form 10-K for 2009, but only two in its Exhibit 21 to Form 10-K for 2011.⁴ The two subsidiaries listed in 2011 were the company’s two Irish subsidiaries, which is consistent with the company’s assertion in its Income Taxes footnote to its financial statements that “substantially all of the income from foreign operations was earned by an Irish subsidiary.”⁵ Similarly, Microsoft Corporation reduced its reported subsidiaries from 28 in 2006 to eight in 2011. Apple Inc. reports only three subsidiaries in its Exhibit 21 to its Form 10-K for 2011, although the company traditionally has reported less than five subsidiaries in its Exhibit 21 for prior years. One possible reason why companies are reducing their disclosure of subsidiaries in tax havens is the growing interest by the media and researchers on the location and number of foreign subsidiaries in such locations (Dyreng and Lindsey, 2009; Balakrishnan, Blouin, and Guay, 2011; Alexander and Whiteaker-Poe, 2011).

B. FASB Reporting Requirements

1. Segment Reporting

The FASB provides additional reporting requirements related to a corporation’s international operations. FASB Accounting Standards Codification (ASC) 280, Segment Reporting, requires that a public company disaggregate its operations based on how management organizes the segments within the entity for making operating decisions and assessing performance. ASC 280-10-50-41 states that a public company shall report the following geographic information unless it is impracticable to do so:

1. Revenues from external customers attributed to the public entity’s country of domicile and attributed to all foreign countries in total from which the public entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately.

2. Long-lived assets located in the public entity’s country of domicile and the total assets located in all foreign countries in which the public entity holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

⁴ Data related to a company’s financial statements are available at the SEC’s EDGAR website, http://www.sec.gov/edgar.
⁵ Google Inc. Form 10-K for 2011, Note 15, p. 79.
It is important to note that the definition of foreign revenues as it relates to segment reporting differs from the definition of foreign income as it relates to income tax reporting. For segment reporting purposes, foreign revenue is based on where a company’s customers are located. For income tax accounting purposes, foreign income is based on where the entity selling the product or service is located. A U.S. company selling a product to a Dutch customer would report the revenue as foreign for segment reporting purposes and as domestic for income tax accounting purposes. If the company manufactured the product within the United States and sold the product outside the United States, the income reported on the company’s federal income tax return could be treated as 50 percent U.S. source and 50 percent foreign source under Internal Revenue Code §863(b). This distinction of what constitutes foreign revenues in segment reporting and foreign income for income tax accounting is important to note for persons using financial statements to “uncover” aggressive transfer pricing activities (i.e., the “smoking gun”) (Klassen and Laplante, forthcoming-a, forthcoming-b).

Even the SEC needs reminders of this distinction in its comment letters to registrants. For example, the SEC wrote a comment letter to Microsoft Corporation dated February 10, 2011 asking the following question concerning its fiscal year 2010 Form 10-K:

We note from your income tax and segment disclosures in Notes 13 and 22 on pages 68 and 82, respectively, what appears to be disproportionate relationships among domestic and foreign revenues, pre-tax income and tax rates. From Note 22, “Other countries” revenues were 42%, 44% and 41% of fiscal 2010, 2009 and 2008 total revenues, yet appear to comprise 62%, 72% and 47% of fiscal 2010, 2009 and 2008 “International” income before taxes from Note 13. From Note 13, “Foreign earnings taxed at lower rates” caused a reduction to the fiscal 2010 U.S. statutory rate to effective rate reconciliation of 12% or nearly one-third of the U.S. statutory rate. The disproportionate magnitude of your non-U.S. revenues to non-U.S. pre-tax earnings and related foreign tax rate effects appear to require expanded MD&A disclosures as to how income tax planning has historically impacted or is reasonably likely to impact future results of operations and financial position. We would expect that disclosure should explain in separate detail the foreign effective income tax rates and their importance in understanding U.S. and non-U.S. contributions to your results of operations. Also consider addressing the relationship between the mix of revenue generated in the U.S. and other countries and the U.S. and international components of income before income taxes.

The SEC appears to be focusing on the company’s transfer pricing methodology, noting a seeming disconnect between the company’s percentage of foreign revenue

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and its percentage of foreign pretax income (i.e., why were the company’s foreign profit margins higher for foreign income than for domestic income). Microsoft’s response, dated February 22, 2011, points out the difference in definitional terms as follows:

The basis for our presentation of the mix of U.S. and international revenue in Note 22 differs from the basis for our presentation of the mix of U.S. and international income before income taxes in Note 13. ASC paragraph 280-10-55-22 indicates that, “in determining the revenues attributable to foreign countries, a public entity may allocate revenues from external customers to geographic areas in whatever way it chooses (for example, by selling location, customer location, or the location to which the product is transported, which may differ from the location of the customer), as long as that method is reasonable, consistently applied, and disclosed.” As we disclosed in Note 22, U.S. revenue includes shipments to customers in the United States and licensing to certain OEMs and multinational organizations...In accordance with SEC Regulation S-X, Rule 4-08(h), the presentation of the mix of U.S. and international income before income taxes in Note 13 is based on legal entity status, either U.S. or non-U.S. (foreign legal entity). In addition, our operating expenses vary by geography.\(^7\)

The SEC’s comment letter to Google Inc., dated December 2, 2010, went so far as to ask the company to publish its recently concluded Advance Pricing Agreement (APA) with Ireland to provide even more details on its transfer pricing methodology. Not surprisingly, the company politely declined to provide its investors and competitors with this information (response dated December 13, 2010).

2. Income Tax Accounting

FASB Accounting Standards Codification (ASC) 740, Income Taxes, governs the disclosure rules that apply to income taxes (benefits) associated with a company’s domestic and foreign income. ASC 740-10-50-11 requires a company to provide an income tax “rate reconciliation” between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory federal income tax rate (“hypothetical tax”). For publicly-traded companies, the disclosure should show the estimated dollar amount or percentage of each of the underlying causes for the difference if the amount and nature of the individual reconciling item is “significant.” Under prior SEC reporting rules, a specific reconciling item was

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\(^7\) Microsoft’s response is available at [http://www.sec.gov/Archives/edgar/data/789019/000119312511041864/](http://www.sec.gov/Archives/edgar/data/789019/000119312511041864/)

\(^8\) CFR Regulation S-X, §210.4-08(h).
required to be listed separately if it exceeded 5 percent of the hypothetical tax amount. The 5 percent rule continues to provide a “rule-of-thumb” for many companies.

We illustrate this reconciliation in Table 1 using Google Inc.’s income tax footnote to its financial statements filed in Form 10-K for its year ending December 31, 2011. The company’s “expected” provision at federal statutory tax rate (35 percent) is the “hypothetical” federal income tax Google would owe if all of its pretax book income was reported on its U.S. corporate income tax return. For 2011, Google reported “income before income taxes” of $12,326 million. At a 35 percent tax rate, Google would owe the U. S. government $4,314 million before credits. The actual income tax provision reported by Google on its income statement for 2011 was $2,589 million, for an “effective tax rate” of 21 percent. Items that cause the company’s accounting effective tax rate to differ from the hypothetical tax rate include state and local taxes, taxes related to international operations, permanent differences (e.g., credits, tax exempt interest, non-deductible expenses), and prior period accounting adjustments (e.g., change in valuation allowance). McGill and Outslay (2004) provide a more detailed discussion of the components of the tax rate reconciliation.

For purposes of this paper, the rate reconciliation item of interest is the “foreign rate differential,” which for 2011 was $2,001 million. Conventional interpretation of this reconciling item would be that Google “saved” $2,001 million in U.S. income tax by earning some part of its reported book income in lower tax rate jurisdictions. In percentage terms, this international “tax savings” reduced Google’s accounting effective tax rate by 16.2 percentage points (0.162=2,001/12,326).

<table>
<thead>
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<th>Year Ended December 31,</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
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<tr>
<td>Expected provision at federal statutory tax rate (35%)</td>
<td>$2,933</td>
<td>$3,779</td>
<td>$4,314</td>
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<td>State taxes, net of federal benefit</td>
<td>302</td>
<td>322</td>
<td>122</td>
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<td>Stock-based compensation expense</td>
<td>63</td>
<td>79</td>
<td>105</td>
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<tr>
<td>Change in valuation allowance</td>
<td>(41)</td>
<td>(34)</td>
<td>27</td>
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<tr>
<td>Foreign rate differential</td>
<td>(1,339)</td>
<td>(1,769)</td>
<td>(2,001)</td>
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<tr>
<td>Federal research credit</td>
<td>(56)</td>
<td>(84)</td>
<td>(140)</td>
</tr>
<tr>
<td>Tax exempt interest</td>
<td>(15)</td>
<td>(12)</td>
<td>(10)</td>
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<tr>
<td>Non-deductible legal settlement</td>
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<td>0</td>
<td>175</td>
</tr>
<tr>
<td>Other permanent differences</td>
<td>14</td>
<td>10</td>
<td>(3)</td>
</tr>
<tr>
<td>Provide for income taxes</td>
<td>$1,861</td>
<td>$2,291</td>
<td>$2,589</td>
</tr>
</tbody>
</table>

Table 1
Google's Tax Rate Reconciliation for 2009–2011 (Form 10-K) ($Million)
In comparison, Microsoft Corporation reduced its accounting effective tax rate by 15.6 percentage points as a result of “foreign earnings taxed at lower rates” for its fiscal year ending June 30, 2011. Based on pretax book income of $28,071 million for 2011, this translates into approximately $4.4 billion of U.S. income tax savings from earning income in lower tax jurisdictions. Apple Inc. reports a reduction in its income tax accounting provision due to “indefinitely invested earnings of foreign subsidiaries” of $3,898 for its fiscal year ending September 24, 2011. These “tax savings” reduced the company’s accounting effective income tax rate by 11.4 percentage points in 2011 (0.114=3,898/34,205). International Business Machines Corporation (IBM) reduced its accounting effective tax rate for 2011 by 10 percentage points due to a “foreign rate differential,” which translates to a reduction in the company’s income tax provision on the income statement of approximately $2.1 billion (pretax book income for 2011 was $21,003 million).

It is important to note that the foreign tax rate differential component of the tax rate reconciliation can contain other items. For example, Google stated in its December 13, 2010 response to the SEC that its foreign rate differential also contained any U.S. tax expense incurred on subpart F income and tax benefits of foreign tax credits used on its U.S. tax return. IBM states in its income tax note that its foreign tax rate reconciliation includes foreign export incentives, U.S. tax impacts of non-U.S. earnings repatriation, any net impacts of intercompany transactions and audit settlements, or changes in the amount of unrecognized tax benefits associated with each of those items.

The reductions reported by these companies in their accounting effective tax rates that are related to their international operations derive primarily from management’s application of Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes — Special Areas* (APB 23), which is now codified in ASC 740-30-25. APB 23 has become the source of much analysis by media, academics, and tax policymakers and is often misunderstood by readers of financial statements. We discuss the accounting issues underlying APB 23, its history, and its application in practice in the next section.

### III. THE ACCOUNTING CONUNDRUM REGARDING INTERNATIONAL OPERATIONS

#### A. The Book/Tax Difference When Foreign Income is Reported

For financial reporting purposes, a U.S. corporation reports current year net income from its international operations in the year such income is earned (“accrued”). Under the U.S. worldwide system of taxation, income from international operations generally is not reported on the U.S. income tax return (i.e., is deferred from U.S. taxation) until such income is repatriated back to the United States as a dividend or other form of payment in compensation for services (e.g., interest, rent, royalty, management fee). The Joint Committee on Taxation (2011) provides a more thorough discussion of the U.S. international tax regime.
repatriation, the U.S. government taxes the remitted income on a residual basis, taxing the income to the extent the U.S. rate exceeds the foreign taxes (income and withholding) paid on the income. For example, if a U.S. multinational company paid foreign taxes of $100 on $1,000 of foreign income and then repatriated the $900 of remaining income as a dividend, the U.S. government would apply an additional tax of $250 to the “grossed up” dividend \((0.35 \times 1,000 – 100\) of foreign taxes paid).

The issue for financial reporting purposes is when should the enterprise record the residual $250 of U.S. tax that would be owed if these currently unrepatriated earnings were remitted back to the United States. The two choices for accounting purposes would be to report the residual U.S. tax in the year the foreign income is reported on the income statement (accrual basis) or defer reporting the residual U.S. tax until the foreign income is actually remitted (cash basis). This question has been the source of discussion and disagreement since 1959.

B. A Short History of Income Tax Accounting Principles Related to Foreign Earnings

1. ARB 51

The Committee on Accounting Procedure\(^\text{10}\) first addressed this issue when it issued its accounting pronouncement dealing with filing a consolidated financial statement that would include a company’s U.S. and international operations. In Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, issued in 1959, the Committee stated that an enterprise should record U.S. taxes related to foreign earnings “on an estimated basis” when accrued except in cases where the “income has been, or there is evidence that it will be, permanently invested by the subsidiaries” (emphasis ours) (ARB No. 51, p. 46). When the Accounting Principles Board\(^\text{11}\) (APB) first addressed “accounting for income taxes” in APB Opinion No. 11, *Income Taxes*, issued in 1967, the board deferred any modification of ARB 51 pending further study.

2. APB 23

The Accounting Principles Board revisited income tax accounting for unrepatriated foreign earnings in Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes — Special Areas*, issued in 1973. The APB decided that “it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides

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\(^{10}\) The American Institute of Accountants created the Committee on Accounting Procedure in 1936 to set accounting standards in the United States.

\(^{11}\) The Accounting Principles Board was created by the American Institute of Public Accountants in 1959 to issue pronouncements on accounting principles. The APB replaced the Committee on Accounting Procedure. The APB was replaced by the FASB in 1973.
a means by which the investment in a domestic subsidiary can be recovered tax free” (APB Opinion No. 23, p. 446).

In conjunction with this rebuttable presumption of income repatriation, the APB created an “indefinite reversal criteria” (APB Opinion No. 23, p. 447), which stated that the presumption could be overcome and no taxes needed to be accrued if “sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.” Companies were mandated to have specific plans for reinvestment of undistributed earnings of a subsidiary, which could be substantiated by experience or the existence of definite future programs of operations and remittances.

The initial position taken by the company with respect to its unrepatriated earnings could be changed in light of changes in circumstances. The resulting income tax expense or benefit resulting from company’s change in its assertion as to whether its earnings were permanently reinvested is recorded in the current year income tax provision. We discuss this issue in more detail in a later section of the paper.

3. FAS 109

The FASB initiated a project to reconsider all aspects of accounting for income taxes in 1982 (Beresford et al., 1983; Wheeler and Outslay, 1985). As a result of its deliberations, the FASB significantly changed its focus on accounting for income taxes from an income statement approach in APB 11 to a balance sheet approach in Statement of Financial Accounting Standards (FAS) No. 109, Accounting for Income Taxes, beginning in 1993. This change in emphasis changed the focus on unrepatriated foreign earnings. For balance sheet purposes, a company increases its accounting stock basis in its foreign subsidiaries (“outside basis”) by the amount of the subsidiary’s unrepatriated earnings (this is mandated by the equity method of accounting under ASC 323, Investments – Equity Method and Joint Ventures). When a company repatriates the foreign earnings, it reduces the accounting stock basis by the amount of the distribution. For tax purposes, a company does not increase its tax stock basis in its foreign subsidiaries by the subsidiary’s unrepatriated earnings if such earnings are deferred from U.S. taxation.12 This mismatch in the accounting and tax stock basis creates a book/tax balance sheet basis difference, which the FASB decided to treat as a temporary difference.13

In its deliberations leading to the issuance of FAS 109, the FASB concluded that the temporary book/tax difference related to the stock basis of a foreign subsidiary gave

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12 Internal Revenue Code (IRC) § 961.
13 Although unrepatriated foreign earnings are the primary source of the book/tax basis difference related to the stock of a foreign subsidiary, other items, such as foreign currency translation adjustments, can contribute to the difference. For example, Oracle Corporation states in its Form 10-K for the fiscal year ending May 31, 2012, “the amount of temporary differences related to undistributed earnings and other outside basis temporary differences of investments in foreign subsidiaries upon which United States income taxes have not been provided was approximately $20.9 billion and $4.3 billion, respectively.” These other adjustments that create a book/tax stock basis difference also are subject to the APB 23 indefinite reversal criteria.
rise to a recognizable deferred tax liability. They rejected, *in theory*, the principle that an enterprise’s ability to control the timing of events that would cause the temporary difference to reverse (e.g., repatriation) justifies postponing the recognition of the deferred tax liability until the period in which reversal occurs. The Board concluded that such control does not eliminate the existence of the liability at the end of the current year (FAS 109, p. 52).

After much criticism from the practice community, the Board decided to continue the exception to comprehensive recognition of deferred taxes for unrepatriated foreign earnings for three reasons: (1) the complexity of measuring the deferred tax liability for foreign undistributed earnings; (2) the need to compromise; and (3) the omission of discounting (FAS 109, p. 52). The Board recognized that reversing the APB 23 indefinite reversal criteria would be too great a change in practice and concluded that revising the criteria should be treated as an “evolutionary change” that should be implemented gradually. The Board concluded that “recognition of a deferred tax liability for those temporary differences on a prospective basis as required by this Statement is an evolutionary change in practice that results in a significant improvement in financial reporting” (FAS 109, p. 54). The Board has not made any “evolutionary” changes to APB 23 in the 19 years since making that statement.

In its final version, FAS 109 endorsed the indefinite reversal criteria of APB 23. In particular, it stated that a “deferred tax liability is not recognized for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture…that is essentially permanent in duration.” The deferred liability was to be recognized if it became apparent that the temporary difference would reverse in the “foreseeable future” (FAS 109, p. 15).

4. **ASC 740-30**

The FASB’s codification of the pronouncements (FASB Accounting Standards Codification (ASC)) related to accounting for income taxes, effective for annual periods ending after September 15, 2009, combined the principles enunciated in APB 23 and FAS 109 that related to accounting for income taxes associated with unrepatriated foreign earnings. We briefly discuss the application of these principles in the next section.

**IV. APPLICATION OF APB 23 (CODIFIED AS FASB ASC 740-30)**

**A. Mechanics of ASC 740-30**

ASC 740-30-25-3 (p. 6) carries over the rebuttable presumption that “all undistributed earnings of a subsidiary will be transferred to the parent entity.” ASC 740-30-25-17 (p. 9) provides the requirements to rebut the presumption as follows:

The presumption in paragraph 740-30-25-3 that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, for entities and periods identified in the fol-
Multinational International Operations and Financial Statements

Following paragraph if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. These criteria required to overcome the presumption are sometimes referred to as the indefinite reversal criteria. Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity’s representation of indefinite postponement of remittances from a subsidiary.

ASC 740-30-25-18 (p. 9) adds that a deferred tax liability shall not be recognized for an excess of the book stock basis over the tax stock basis in a foreign subsidiary if the difference is “permanent in duration” unless it becomes apparent the difference will reverse in the “foreseeable future.” This paragraph expands the indefinite reversal criteria to all book/tax stock basis differences, e.g., cumulative translation adjustments. ASC 740-30-25-18 has been interpreted to mean that the assertion as to whether the outside basis difference is permanent is not an “all or nothing” assertion (Deloitte, 2011, p. 243; PricewaterhouseCoopers, 2011, pp. 11–21; Ernst & Young, 2011, p. 166); i.e., a corporation can assert the indefinite reversal criteria on all, some, or none of a foreign subsidiary’s undistributed earnings, an issue we will discuss in the next section. In addition, the indefinite reversal criteria only apply to “accumulated” earnings and not current earnings (PricewaterhouseCoopers, 2011, pp. 11–22).

B. Evidence Required to Support the Indefinite Reversal Criteria

ASC 740-30 does not specify the types of evidence that must be provided to support a company’s assertion of the indefinite reversal criteria, other than to state that “experience of the entities and definite future programs of operations and remittances” are examples of the types of evidence that would be “sufficient” to support the assertion.14 As a result, auditing firms have developed their own criteria to “sign off” on a client’s assertion that its undistributed foreign earnings are permanently invested.

For example, one international public accounting firm states in its accounting for income taxes manual that a “mere history of not distributing foreign earnings does not serve as a replacement for specific reinvestment plans” (PricewaterhouseCoopers, 2011, pp. 11–21 and 11–22). This firm lists as “specific plans” the following: (1) long-term and short-term forecasts and budgets of the parent and subsidiary; (2) long-term and short-term financial requirements of both the parent and subsidiary, including projected working capital and other capital needs in locations where the earnings are generated and reasons why any excess earnings are not needed by the parent or another subsidiary somewhere else in the organization; (3) past history of dividend actions; (4) tax consequences of a decision to remit or reinvest; (5) remittance restrictions in a loan

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14 ASC 740-30-25-17, p. 9.
agreement of a subsidiary; (6) remittance restrictions imposed by foreign governments that result in forced reinvestment in the country; and (7) any U.S. government programs designed to influence remittances (e.g., a repatriation holiday similar to §965). The firm notes that the “specific plans for reinvestment must be documented and maintained (PricewaterhouseCoopers, 2011, p. 11–22). Other international public accounting firms have similar documentation requirements (Deloitte, 2011; Ernst & Young, 2011).

C. Disclosure of Permanently Reinvested Foreign Earnings

ASC 740-30-50 (p.11) requires that a company disclose the cumulative amount of the permanently reinvested foreign earnings for which a deferred tax liability was not recorded and the amount of the unrecognized deferred tax liability related to the book/tax stock basis difference in foreign subsidiaries that is asserted to be permanent in duration “if determination of that liability is practicable or a statement that determination is not practicable” (emphasis ours). Companies usually disclose this information in the income taxes footnote.

Apple Inc. provides a disclosure in its income taxes footnote from its 2011 Form 10-K in which determination of the estimated tax liability from recovery of the unrepatriated earnings is “practicable,” as follows:

The foreign provision for income taxes is based on foreign pretax earnings of $24.0 billion, $13.0 billion and $6.6 billion in 2011, 2010 and 2009, respectively. The Company’s consolidated financial statements provide for any related tax liability on amounts that may be repatriated, aside from undistributed earnings of certain of the Company’s foreign subsidiaries that are intended to be indefinitely reinvested in operations outside the U.S. As of September 24, 2011, U.S. income taxes have not been provided on a cumulative total of $23.4 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately $8.0 billion.

Google Inc. provides a disclosure in its income taxes footnote from its 2011 Form 10-K in which determination of the estimated tax liability from recovery of the unrepatriated earnings is “not practicable,” as follows:

We have not provided U.S. income taxes and foreign withholding taxes on the undistributed earnings of foreign subsidiaries as of December 31, 2011 because we intend to permanently reinvest such earnings outside the U.S. If these foreign earnings were to be repatriated in the future, the related U.S. tax liability may be reduced by any foreign income taxes previously paid on these earnings. As of December 31, 2011, the cumulative amount of earnings
upon which U.S. income taxes have not been provided is approximately $24.8 billion. Determination of the amount of unrecognized deferred tax liability related to these earnings is not practicable.

When asked by the SEC in a comment letter dated December 2, 2010, why the company believed it was not practicable to estimate the liability associated with repatriating its undistributed foreign earnings, Google replied (December 13, 2010) that

We believe it is appropriate not to disclose the potential tax impact to liquidity associated with the repatriation of undistributed earnings of our foreign subsidiaries or the amount of investments currently held by our foreign subsidiaries as we have no intention of distributing any of our cumulative earnings to the parent company in the U.S., and, as such, there will be no tax impact … We respectfully submit that we should not be required to disclose any impact to liquidity as a result of the repatriation of undistributed earnings of our foreign subsidiaries.15

Not disclosing the estimated deferred tax liability associated with unrepatriated earnings is the norm and not the exception. A recent study by J.P. Morgan (Mott and Schmidt, 2011) revealed that 519 of their sample of 880 publicly traded companies (59 percent) disclosed a balance in undistributed foreign earnings. Of those disclosing a balance, 97 companies (19 percent) disclosed an associated deferred tax liability. In a follow-up study, J. P. Morgan found that 11 of the 66 companies (17 percent) with undistributed foreign earnings balances in excess of $5 billion reported an estimated tax liability associated with repatriating those earnings (Mott and Schmidt, 2012). Disclosure of such an amount can lead to increased public scrutiny, as we will illustrate subsequently.

D. How Discretionary is APB 23?

Recent academic research and media attention related to unrepatriated foreign earnings has addressed the degree to which the APB 23 indefinite reversal criteria is “discretionary” and an integral part of a company’s earnings management toolbox. For example Krull (2004) argues that firms use discretion within permanently reinvested earnings (PRE) to manage earnings. Blouin, Krull, and Robinson (forthcoming) imply this discretion in their analysis of whether repatriations are influenced by financial reporting incentives. Hanlon and Heitzman (2010, p. 135) do not dispute Krull’s (2004) supposition, but they note that her conclusion “does not easily square with the observation that

the PRE designation seems to be fixed in many firms.” Their observation is supported by Graham, Hanlon, and Shevlin (2010, 2011), who report that 75 percent of the firms in their survey sample designated 100 percent of their unrepatriated foreign earnings as permanently reinvested. They find that the indefinite reversal criteria provide a powerful incentive in a multinational company’s location and reinvestment/repatriation decisions.

Whether one considers the indefinite reversal criteria to be discretionary depends on how one views a rebuttable presumption. With respect to unrepatriated foreign earnings, ASC 740-30-25-3 (p. 6) presumes that all unrepatriated earnings eventually will be repatriated and a deferred tax liability should be recorded if there is an excess of book stock basis over the tax stock basis. To rebut the presumption, a company must provide “sufficient evidence” that the foreign earnings are permanently reinvested. As one auditing firm notes, this exception “requires a positive assertion of management’s intent to indefinitely reinvest its foreign undistributed earnings. That is, management must have the ability and the intent to indefinitely prevent the outside basis difference of a foreign subsidiary from reversing with a tax consequence” (PricewaterhouseCoopers, 2011, pp. 11–21). A company that chooses not to make such an assertion or provide specific written documentation that supports permanent reinvestment would be required to record a deferred tax liability for the unrepatriated earnings.

The fact that ASC 740-30-25-19 (p.10) permits a company to change its assertion as to whether the unrepatriated earnings are permanently reinvested provides additional “opportunities” to manage earnings through an increase or decrease in the current period tax provision. For example, General Electric Corporation made the following statement in its Form 10-K for 2009:

During 2009, following the change in our external credit ratings, funding actions taken and review of our operations, liquidity and funding, we determined that undistributed prior-year earnings of non-U.S. subsidiaries of GECS, on which we had previously provided deferred U.S. taxes, would be indefinitely reinvested outside the U.S. This change increased the amount of prior-year earnings indefinitely reinvested outside the U.S. by approximately $2 billion, resulting in an income tax benefit of $700 million in 2009.

Based on the quantitative analysis provided, it would appear that the $2 billion of foreign earnings were not subject to any foreign taxation, given that the restored tax benefit is 35 percent of the unrepatriated earnings. As this example illustrates, while auditors might question a client’s use of the indefinite reversal criteria to manage earnings, the fact that there exist alternative means of providing liquidity to the U.S. parent (for example, borrowing rather than repatriating), provides a great deal of flexibility in using the APB 23 exception to affect net income after tax.
E. Importance of APB 23 to a Company’s ETR and EPS

As Blouin, Krull, and Robinson (forthcoming) and Graham, Hanlon, and Shevlin (2010, 2011) have observed, the APB 23 exception for permanently reinvested foreign earnings is valued most by U.S. companies able to locate income in low tax jurisdictions. Perhaps paradoxically, not asserting the APB 23 provides an alternative incentive for U.S. companies earning income in high tax jurisdictions. We explain this paradox below.

1. APB 23 and Low Tax Jurisdictions

For a U.S. company earning income in a low tax foreign jurisdiction, the assertion that foreign earnings are permanently reinvested allows the company to avoid recording a deferred U.S. tax liability (and deferred foreign tax liability if withholding taxes would be imposed on the repatriation). For example, assume a U.S. corporation earns $200 in a low-tax jurisdiction with a tax rate of 10 percent and pays $20 of foreign income tax. Repatriation of the after-tax earnings would attract a residual U.S. tax of $50 (200 x (0.35–0.10)), assuming no withholding tax is imposed on the repatriation. Asserting APB 23 allows the company to record only the $20 foreign tax in its income statement, leading to an effective tax rate on this income of 10 percent. The presentation of the “tax savings” from earning the income in a low-tax jurisdiction would appear as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hypothetical tax expense (at 35%)</td>
<td>70</td>
<td>35</td>
</tr>
<tr>
<td>Foreign tax rate differential</td>
<td>(50)</td>
<td>(25)</td>
</tr>
<tr>
<td>Tax expense</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

2. APB 23 and High Tax Jurisdictions

For a U.S. company earning income in a high tax foreign jurisdiction, the assertion that foreign earnings are not permanently reinvested allows the company to record a tax benefit from the foreign tax credit that would be allowed to offset the deferred U.S. tax liability, potentially lowering the company’s effective tax rate to 35 percent. For example, assume a U.S. corporation earns $200 in a high-tax jurisdiction and pays $100 of foreign income tax. Repatriation of the after-tax earnings would attract a residual U.S. tax of $0 and leave the company with an excess foreign tax credit of $30 (200 x (0.3–0.5)). Not asserting APB 23 allows the company to record the $30 excess foreign tax credit as a deferred tax asset in its balance sheet, leading to an effective tax rate on this
income of 35 percent. The journal entries to record this deemed repatriation would be as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit ($)</th>
<th>Credit ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Tax Expense (Foreign)</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Deferred Tax Expense (precredit U.S.)</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Taxes Payable (Foreign)</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Deferred Tax Liability (U.S.)</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Deferred Tax Asset (U.S. FTC)</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Deferred Tax Benefit</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

The presentation of the future tax benefit from the excess foreign tax credit on the high-tax earnings would appear as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hypothetical tax expense (at 35%)</td>
<td>70</td>
<td>35</td>
</tr>
<tr>
<td>Foreign tax rate differential</td>
<td>(0)</td>
<td>(0)</td>
</tr>
<tr>
<td>Tax expense</td>
<td>70</td>
<td>35</td>
</tr>
</tbody>
</table>

Not surprisingly, it is customary for U.S. multinational companies to assert APB 23 on low-tax earnings and not assert APB 23 on high-tax earnings. This is not always the case, however. Microsoft did not assert APB 23 until 2002 even though it had significant foreign earnings in low-tax jurisdictions. Not asserting APB 23 kept the company’s Generally Accepted Accounting Principles (GAAP) ETR near 35 percent during that period of time. As we illustrate later in the paper, Apple made the APB 23 assertion on only half of its foreign earnings for 2011.

3. Growing Impact of Asserting APB 23 on EPS and ETR

We present some empirical data for Microsoft, IBM, Apple, and Google in Figures 1 through 5. We chose these companies because a significant and growing component of their total income comes from low-tax jurisdictions. As a result, the ability to assert APB 23 to their PRE has a substantial impact on their accounting effective tax rates (ETR) and earnings per share (EPS). The metrics provided in Figures 1 through 4 are the company’s GAAP ETR, Cash ETR, Structural ETR (GAAP ETR without discrete items), GAAP ETR without an APB 23 assertion, and ETR without a non-APB 23 assertion over the time period 1997–2011. In addition, the company’s gross profit (GP) percentage also is included. This time period coincides with the introduction of the “check-the-box” regulations that greatly facilitated the cross-border transfer
Figure 1
Importance of APB 23 to ETR/EPS: Microsoft

Figure 2
Importance of APB 23 to ETR/EPS: IBM
Figure 3
Importance of APB 23 to ETR/EPS: Apple

Figure 4
Importance of APB 23 to ETR/EPS: Google
of intellectual property and intercompany payments such as interest, rents, royalties, and dividends. For each company we compare their metrics to the weighted average of S&P North American Technology Sector Index as a benchmark. Figure 5 presents a comparison of the growing importance of the assertion of APB 23 on EPS over the same time period.

For each company, it is clear that APB 23 allowed these companies to reduce their GAAP ETR significantly over time and consequently, increase their EPS. It is also apparent that what drives the impact of APB 23 is the company’s profit margin (GP%). Companies that have a high proportion of intangible assets such as intellectual property have more profit to transfer to low tax jurisdictions than capital intensive companies that have lower profit margins and less residual income to transfer after allocating profit across their supply chains. This observation is consistent with Grubert (2012), who finds that profits rather than sales are being shifted outside the United States.

V. A CASE STUDY USING APPLE INC.

We illustrate the application of APB 23 and how to analyze financial statement disclosures of foreign earnings and the associated taxes using information provided by Apple Inc. in its 2011 Form 10-K for the year ending September 24, 2011. We chose Apple because of the recent media scrutiny of its financial statement disclosures related to its
international operations (Duhigg and Kocieniewski, 2012; McIntyre, 2012; Sullivan, 2012, 2011; Pender, 2011).

In its Form 10-K for 2011, Apple disclosed the following information about its worldwide operations:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before income taxes</td>
<td>34,205</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>8,283</td>
</tr>
<tr>
<td>Cash paid for income taxes, net</td>
<td>3,338</td>
</tr>
</tbody>
</table>

Apple’s worldwide effective tax rate for 2011 was 24.2 percent and its cash tax rate was 9.8 percent (using profit before income taxes as the denominator for both ratios). Included in the provision for income taxes was a deferred tax expense of $3,927 million related to the current year’s unrepatriated foreign earnings for which an APB 23 assertion was not made. The deferred tax liability not recorded under APB 23 related to the current year’s unrepatriated foreign earnings was $3,898 million. If Apple had asserted APB 23 on its entire foreign earnings, its effective tax rate for 2011 would have been 12.7 percent (($8,283 – $3,927)/$34,205).\(^\text{16}\)

Apple provided the following information with respect to its international operations:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign pretax earnings</td>
<td>24,000</td>
</tr>
<tr>
<td>Provision for foreign income taxes</td>
<td>602</td>
</tr>
</tbody>
</table>

If the company had recorded a full current and deferred tax on these foreign earnings at the U.S. tax rate of 35 percent, the total income tax provision recorded in the income statement would have been $8,400 million. The residual U.S. tax, assuming no foreign withholding taxes, would have been $7,798 million (8,400–602). This residual tax was partially recorded in the provision ($3,338) and partially recorded in the income tax footnote as the tax that would have been paid if the current year addition to the company’s permanently reinvested earnings had been recorded ($3,898).

\(^{16}\) It is interesting to note that when Apple announced it would pay a dividend for the first time, the company’s CEO said that the company would only use domestic cash to pay the dividend because “repatriating cash from offshore would result in significant tax consequences for the company” (Apple, Inc., 2012); see http://thehill.com/blogs/hillicon-valley/technology/216725-apple-refuses-to-bring-foreign-cash-back-to-the-us-blames-tax-law.
Apple’s tax rate reconciliation supports this analysis (emphasis added):

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computed expected tax</td>
<td>$11,973</td>
<td>$6,489</td>
<td>$4,223</td>
</tr>
<tr>
<td>State taxes, net of federal effect</td>
<td>552</td>
<td>351</td>
<td>339</td>
</tr>
<tr>
<td>Indefinitely invested earnings of foreign subsidiaries</td>
<td>(3,898)</td>
<td>(2,125)</td>
<td>(647)</td>
</tr>
<tr>
<td>Domestic production activities deduction</td>
<td>(168)</td>
<td>(48)</td>
<td>(36)</td>
</tr>
<tr>
<td>Other</td>
<td>(9)</td>
<td>(117)</td>
<td>36</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>$10,461</td>
<td>$6,560</td>
<td>$5,924</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>24.2%</td>
<td>24.4%</td>
<td>31.8%</td>
</tr>
</tbody>
</table>

Using the income tax note information, one can compute Apple’s effective tax rate on its foreign earnings for 2011 as 2.5 percent (0.025 = 602/24,000). This is the approach often taken by the media in their analysis of U.S. multinational corporations (Drucker, 2010). Because the components of a company’s tax provision (current and deferred) can contain adjustments that do not reflect current period taxes paid or deferred (McGill and Outslay, 2004), a more precise calculation is available where the company reports the deferred tax that would be paid on the permanently reinvested earnings if repatriated. In its income taxes footnote for 2011, Apple reports total permanently reinvested earnings (PRE) of $23.4 billion and discloses that a residual U.S. tax of $8 billion would be paid on repatriation of such earnings. The following formula can be used to compute the foreign tax rate imposed on the PRE

\[
\frac{(\text{PRE}+Z) \times 0.35}{\text{PRE}} - Z = 8,000,
\]

where \(Z\) is foreign taxes paid on PRE and where PRE equals $23,400. Solving yields \(Z=292\), which can be used to solve for foreign ETR of 1.2 percent, or

\[
\text{Foreign ETR} = \frac{292}{(23,400 + 292)} = 0.012.
\]

It is not surprising that U.S. multinational corporations that locate significant amounts of income in low tax jurisdictions are reluctant for political cost reasons to report the residual tax that would be due on repatriation of their PRE.

VI. CAVEATS AND OBSERVATIONS

Our goal in writing this paper is to provide policymakers, researchers, analysts, and the media with some insights on how to analyze and interpret a U.S. multinational company’s financial statement disclosures of its international operations. Several observations are in order.
For tax policymakers, it is important to understand that PRE does not represent a U.S. multinational corporation’s dividend paying capacity. Crafting a tax repatriation holiday or deemed repatriation tax based on accounting metrics (as was done with the first repatriation holiday in 2004) likely will erode the quality of financial reporting. Form 5471 already provides more accurate information regarding a company’s dividend paying capacity (current and accumulated earnings and profits).

For accounting standard setters, perhaps it is time to “evolve” in how income taxes related to PRE are recorded and disclosed. There is still too much discretion in how companies record or do not record their tax liabilities related to unrepatriated foreign earnings. Applying a window for anticipated repatriations, e.g., five years, may serve as a compromise between schools of thought that would favor recording a deferred tax liability on the entire amount of unrepatriated foreign earnings and those that would favor a cash taxes paid approach. Eliminating the “not practicable” exception to recording an estimated deferred tax liability in the tax footnote also would eliminate much of the diversity in practice that now exists. Requiring a company to segregate its cash taxes paid by jurisdiction (United States, state and local, and foreign) would mitigate the speculation that finds its way into the media regarding a U.S. company’s tax burden (Christians, 2012; Sloan, 2011). We urge the FASB to revive its project to reconsider the whole topic of accounting for income taxes.

Finally, academic researchers who rely on financial statement data (e.g., Compustat), should acknowledge the limitations and diversity of practice with respect to financial statement disclosure of international operations, and should not accept Compustat at face value (Earnes and Luttman, 2010).

ACKNOWLEDGMENTS AND DISCLAIMERS

We are grateful to George Plesko for inviting us to participate in the 2012 National Tax Association Spring Symposium. We also thank Casey Schwab for his constructive remarks as our discussant. We cannot thank Tim Gibbs sufficiently for his valuable insights into helping us understand the nuances and application of APB 23.

REFERENCES


