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"Trapped Cash" in the Technology Sector: Accounting Disclosures of Permanently Reinvested Foreign Earnings & Foreign Cash Levels

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Permanently reinvested earnings in foreign subsidiaries and cash balances held outside the United States have increased dramatically in the technology sector over the past five years. These values, as well as related unrecognized deferred tax liabilities, are significant to investors, regulators and others. We examine disclosures of the largest technology firms over the 2007 to 2013 period and find that, as a group, the firms have increased the information provided but by fiscal 2013 only four of the ten firms disclosed both foreign held cash and an estimate of the unrecognized deferred tax liability related to permanently reinvested earnings.

INTRODUCTION

Over the past five years, as revenue growth has slowed, the combination of fairly stable earnings and fewer investment opportunities has resulted in increasingly large cash balances at prominent U.S. based technology firms. At these firms, a significant portion of earnings generated relate to the operations of foreign subsidiaries. As overseas earnings have grown, so have foreign held cash balances. At 12/31/2013 Apple, Microsoft, Google, Cisco and Oracle had a combined $386 billion in cash; almost $310 billion of this was held outside the U.S. For perspective, note that combined net income reported by these five firms totaled $92 billion in 2013.

So called "trapped cash" refers to cash and liquid investments held by subsidiaries located outside the United States. The cash is "trapped" overseas because repatriation of the cash would subject it to US Corporate taxes. As explained by the Financial Accounting Standards Board (FASB) in FASB Accounting Standards Codification (ASC) Topic 740, Income taxes: It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity (740-30-25-3) unless sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely (740-30-25-17).

The implication is that if a firm reports that cash is staying overseas, it is not subject to US Corporate Tax. Repatriation of the cash would subject it to US corporate tax rate of 35% less credit for foreign income taxes paid.

SIGNIFICANCE OF THE INFORMATION

The ability to readily identify foreign earnings, cash balances and levels of cash held outside the US is of interest to three distinct groups:

1. Investors
2. Regulators
3. Politicians and others debating U.S. corporate tax policy

The level of cash held outside the U.S. is of interest to equity investors since if the cash is repatriated to the U.S. an additional tax would be due. Thus when valuing firms with significant foreign cash holdings it may make sense to apply a discount to the value of the cash. Such investors may also want to estimate the unrecognized deferred tax liability associated with permanently reinvested earnings since the additional tax due upon repatriation is a function of the difference between the U.S. rate and the rate in the foreign country in which the income was earned.

For the same reasons, regulators such as the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) have an interest in ensuring that financial statements provide sufficient transparency have an interest in disclosure of both potential tax liability and related liquidity issues. For example, if a firm maintains substantially all its cash outside of the U.S. this may be relevant to creditors and others interested in assessing the liquidity of domestic operations.

Legislators and others have vigorously debated corporate tax policy as the levels of foreign earnings and cash balances have risen. The House ways and Means Committee held hearings in June 2013 to examine corporate profit shifting by multinationals. This followed hearings by the Senate Permanent Subcommittee on Investigations in May 2013 which focused on tax strategies at Apple and earlier hearings in September 2012 which focused on Microsoft and Hewlett-Packard. On one side of the corporate tax debate are those pushing tax reform to secure additional tax revenues from firms they argue are manipulating where earnings are recognized and leaving cash overseas in a strategy to avoid paying U.S. taxes. On the other side, are legislators who argue that current US corporate tax rates, among the highest in the world, should be reduced to provide incentives for firms to increase earnings recognized and cash maintained in the U.S.

Despite fairly widespread interest in this information, the financial reporting requirements in the U.S. allow for flexibility on what is reported related to foreign earnings and cash held outside the U.S.

While this issue is relevant for all sectors, it is particularly relevant in the technology sector since a relatively large portion of earnings are recognized outside of the U.S. and foreign cash balances have skyrocketed over the past five years. In this paper we examine the information provided by ten major technology firms in SEC disclosures of foreign earnings and cash balances held outside the U.S. We examine the period 2007 through 2013. We find that the level and detail of information on permanently reinvested foreign earnings, related deferred tax liabilities and cash held outside of the U.S. has increased over this period.

REPORTING REQUIREMENTS

The FASB and SEC are both involved in disclosure requirements. The FASB has required the reporting of information on permanently reinvested earnings (PRE) since 1993. Since the financial crisis it has also encouraged (see: Proposed ASU, Financial Instruments (Topic 825), Disclosures about Liquidity Risk and Interest Rate Risk) discussion of liquidity and capital resources. More recently the SEC has begun encouraging increased transparency on foreign earnings and cash holdings and has questioned some firms about the liquidity implications of permanently reinvested earnings. Certainly investors are also interested in enhanced disclosure particularly at firms with significant earnings in foreign subsidiaries. Correspondingly, there have been significant changes in what is reported in annual reports and 10Ks related to PREs and foreign held cash balances. At a number of firms, the reporting has changed over the 2007 to 2013 period. As required, all firms report PRE, some also report cash held outside of the US and some attempt to quantify the, albeit difficult to estimate, deferred tax liability associated with the PREs. This has led to confusion and some published reports and online financial news sources have mistaken undistributed earnings for cash. The PRE disclosures can be found in the tax note where the firm may also opt to provide an estimate of associated deferred tax liability should the funds be repatriated. Firms may choose to disclose the level of foreign cash and, when provided, this is typically found in the discussion of liquidity and capital resources in the Management Discussion & Analysis. For example, Apple has been fairly transparent about foreign cash balances and estimates of the related deferred tax liability reporting foreign cash as early as 2002 while Microsoft began disclosing cash held by foreign subsidiaries only in 2011. IBM was still not disclosing this information in 2011, leading to the SEC to suggest to IBM that it consider providing enhanced disclosure on this topic. Despite the request, as of 2013, IBM has not disclosed foreign cash in its annual reports or 10K filings.

DISCLOSURE LANGUAGE

To show the range of disclosures on the topic consider the information provided below by IBM and Apple in 2013 10K filings.

Management Discussion of Liquidity from Page 66 of IBM's 2013 10K

> "The company does earn a significant amount of its pre-tax income outside the U.S. The company's policy is to indefinitely reinvest the undistributed earnings of its foreign subsidiaries, and accordingly, no provision for federal income taxes has been made on accumulated earnings of foreign subsidiaries. The company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable. While the company currently does not have a need to repatriate funds held by its foreign subsidiaries, if these funds are needed for operations and obligations in the U.S., the company could elect to repatriate these funds which could result in a reassessment of the company's policy and increased tax expense."

Tax Note from Page 123

> "The company has not provided deferred taxes on $52.3 billion of undistributed earnings of non-U.S. subsidiaries at December 31, 2013, as it is the company's policy to indefinitely reinvest these earnings in non-U.S. operations. However, the company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable."

Management Discussion from Page 35 of Apple 2013 10k

> As of September 28, 2013 and September 29, 2012, $111.3 billion and $82.6 billion, respectively, of the Company's cash, cash equivalents and marketable securities were held by foreign subsidiaries and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.

Tax Note from Page 64

> The foreign provision for income taxes is based on foreign pre-tax earnings of $30.5 billion, $36.8 billion and $24.0 billion in 2013, 2012 and 2011, respectively. The Company's consolidated financial statements provide for any related tax liability on undistributed earnings that the Company does not intend to be indefinitely reinvested outside the U.S. Substantially all of the Company's undistributed international earnings intended to be indefinitely reinvested in operations outside the U.S. were generated by

subsidiaries organized in Ireland, which has a statutory tax rate of 12.5%. As of September 28, 2013, U.S. income taxes have not been provided on a cumulative total of $54.4 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be approximately $18.4 billion.

Disclosures of Cash, Cash Held Outside the U.S. & Accumulated Foreign Earnings

The different disclosures and a general lack of familiarity with related reporting requirements have led to confusion. In fact some published reports in print and online financial news sources have confused undistributed earnings and cash. See for example, the following from CNBC.

"Correction: An earlier version of this story stated that undistributed foreign earnings were a reliable indicator of the amount of cash U.S. corporations hold in their foreign subsidiaries. However, the JPMorgan report points out that some investors use undistributed foreign earnings balances as a proxy for foreign cash. Furthermore, there is a weak relationship between foreign earnings and foreign cash balances." http://www.cnbc.com/id/43152232

Perhaps because of this and the importance of foreign earnings and cash levels on valuation, the SEC has taken steps to encourage fuller disclosure. Blouin, Krull & Robinson (2014) provide the following example of a 2011 SEC request to IBM and IBM's response.

From the SEC to IBM

> "While we note that you intend to permanently reinvest such funds outside of the U.S. and that these funds are not considered a main source of liquidity for funding U.S. operations, we believe you should consider providing enhanced liquidity to disclose the amount of cash held by foreign subsidiaries that would be subject to the potential tax impact associated with the repatriation of undistributed earnings of foreign subsidiaries. In this respect, this disclosure would illustrate that some cash is not presently available to fund domestic operations such as the payment of dividends, corporate expenditures or acquisitions without paying a significant amount of taxes upon their repatriation. As part of your response, please quantify the amount of cash and cash equivalents held in foreign subsidiaries to which you intend to permanently reinvest earnings" (Correspondence between SEC and IBM, September 7, 2011, File No. 001-02360).

From IBM to the SEC

> "As indicated in the company's June 28, 2011 response, the company discloses on page 108 of its 2010 Form 10-K that its policy is to indefinitely reinvest the earnings of its foreign subsidiaries, and that it periodically repatriates a portion of these earnings only to the extent that it does not incur an additional U.S. tax liability. It is important to note that the undistributed accumulated foreign earnings of the company's foreign subsidiaries do not necessarily represent cash and marketable securities. At December 31, 2010, total cash and marketable securities was $11,651 million, of which $7,677 million was held in the U.S. and $3,974 million was held by the company's foreign subsidiaries. As stated in our prior response, in addition to dividend repatriation, the company has several liquidity options available when the company may have additional cash requirements in the U.S. These options include the ability to borrow funds at reasonable rates, utilizing the company's committed global credit facility, repatriating high-taxed foreign earnings and recalling intercompany loans that are in place with certain foreign subsidiaries"
> (Correspondence between SEC and IBM, September 7, 2011, File No. 001-02360).

Disclosures in the Technology Sector 2007 Through 2013

We examined 10K filings for the largest ten technology firms in 2007, 2010 and 2013. We selected 2007 to begin our analysis since this was pre financial crisis and liquidity concerns were significantly different in the post crisis period; our results follow.

TABLE 1
RELEVANT DISCLOSURES FOR FISCAL YEAR 2007

Firm	Cash Equivalents & Investments	Cash Outside the U.S.	Permanently Reinvested Earnings (PRE)	Unrecognized Deferred Tax Losses (DTL) related to PRE	Auditor
Apple	15.4	6.5	2.4	not disclosed	KPMG
Cisco	22.3	17.5	16.3	not disclosed	PWC
Dell	12.4	7.9	2.4	2.4	PWC
Ebay	4.2	4.0	3.8	not disclosed	PWC
Google	14.2	not disclosed	3.9	not disclosed	Ernst & Young
Hewlett Packard	11.3	not disclosed	7.7	not disclosed	Ernst & Young
IBM	16.1	not disclosed	18.8	not disclosed	PWC
Intel	19.3	not disclosed	6.3	not disclosed	Ernst & Young
Microsoft	23.4	not disclosed	6.1	0.001	Deloitte & Touche
Oracle	7.0	5.0	5.7	1.4	Ernst & Young

TABLE 2
RELEVANT DISCLOSURES FOR FISCAL YEAR 2010

Firm	Cash Equivalents & Investments	Cash Outside the U.S.	Permanently Reinvested Earnings (PRE)	Unrecognized Deferred Tax Losses (DTL) related to PRE	Auditor
Apple	51.0	30.8	12.3	4.0	KPMG
Cisco	39.9	33.2	31.6	not disclosed	PWC
Dell	15.1	10-20%	11.3	3.7	PWC
Ebay	7.8	5.1	8.3	not disclosed	PWC
Google	35.0	16.7	17.5	not disclosed	Ernst & Young
Hewlett Packard	10.9	not disclosed	21.9	not disclosed	Ernst & Young
IBM	11.7	not disclosed	31.1	not disclosed	PWC
Intel	21.5	not disclosed	11.8	not disclosed	Ernst & Young
Microsoft	36.8	not disclosed	29.5	9.2	Deloitte & Touche
Oracle	18.5	16.6	13.0	3.6	Ernst & Young

TABLE 3
RELEVANT DISCLOSURES FOR FISCAL YEAR 2013

Firm	Cash Equivalents & Investments	Cash Outside the U.S.	Permanently Reinvested Earnings (PRE)	Unrecognized Deferred Tax Losses (DTL) related to PRE	Auditor
Apple	146.8	111.3	54.4	18.4	Ernst & Young
Cisco	50.6	40.4	48.0	not disclosed	PWC
Dell	15.3	100%	19.0	6.2	PWC
Ebay	12.8	9.7	14.0	not disclosed	PWC
Google	58.7	33.6	38.9	not disclosed	Ernst & Young
Hewlett Packard	12.5	not disclosed	38.2	not disclosed	Ernst & Young
IBM	11.1	not disclosed	52.3	not disclosed	PWC
Intel	20.1	11.3	20.0	not disclosed	Ernst & Young
Microsoft	77.0	69.6	76.4	24.4	Deloitte & Touche
Oracle	32.2	28.2	26.2	8.0	Ernst & Young

CONCLUSION

Permanently reinvested earnings in foreign subsidiaries and cash balances held outside the United States have increased dramatically in the technology sector over the past five years. Overall, cash held by the ten technology firms examined, increased over 200% between 2007 and 2013. At December 2013, Apple alone held more cash than all ten firms combined had in 2007. Permanently reinvested earnings have increased by 427.8% over the 2007-2013 period. We find that as a group, the firms have increased the information provided but by fiscal 2013 only four of the ten firms disclosed both foreign held cash and an estimate of the unrecognized deferred tax liability related to permanently reinvested earnings. Since these values are significant to investors, regulators and others, we recommend that the SEC and FASB continue to work to promote greater transparency and more consistent disclosure.

APPENDIX

The following example has been provided by Ernst & Young in Young "Financial reporting developments: A comprehensive guide Income taxes", Revised September 2013 to demonstrate disclosure.

Illustrative financial statement note disclosure (updated September 2013)

The following example illustrates ASC 740 financial statement note disclosures for a public company.

> Undistributed earnings of certain of the Company's foreign subsidiaries amounted to approximately $5 million at 31 December 20X2. Those earnings are considered to be indefinitely reinvested; accordingly, no provision for US federal and state income taxes has been provided thereon. Upon repatriation of those earnings, in the form of dividends or otherwise, the Company would be subject to both US income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred US income tax liability is not practicable due to the complexities associated with its hypothetical calculation; however, unrecognized foreign tax credit carryforwards would be available to reduce some portion of the US liability. Withholding taxes of approximately $400,000 would be payable upon remittance of all previously unremitted earnings at 31 December 20X2.

REFERENCES

Blouin, Krull & Robinson (2014). The Location, Composition, and Investment Implications of Permanently Reinvested Earnings. Working paper available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154662