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Testimony Concerning APB 23 Exception on Indefinitely Reinvested Earnings

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Senator Levin,

I am pleased to take part in the hearing on the shifting offshore of profits by U.S. multinational corporations and how such activities are affected by the Internal Revenue Code and related regulations. The area I will address is the APB 23 exception to accruing income taxes on foreign earnings, as long as they are intended to be indefinitely reinvested in those jurisdictions.

I would like to first present an overview, then address five questions that the Committee has raised.

Overview: The Importance of Net Income & Its Relation to Cash Flows

Net income is the single most observed indicator of financial performance. Whatever pro forma or non-GAAP variation investors may choose to emphasize or model, those figures will still have their grounding in net income.

Investors perceive net income as a performance measure, and many investors also view it as a predictor of future cash flows. Net income is a figure based not only on cash receipts and disbursements, but it is an accrual amount that includes cash transactions and non-cash transactions that are expected to either convert into cash or result in a use of cash. Net income portrays all transactions affecting a company, whether or not they have been consummated in terms of cash receipt or disbursement, whereas a statement of cash flows summarizes only transactions affected by cash. The statement of cash flows is thus an incomplete portrayal of events affecting a firm, but is popularly perceived as being more difficult to manipulate for producing a desired result. Net income is a more complete accounting of the events affecting a firm, but is rife with judgmental estimates that make it possible to manipulate the level of reported net income. Several simple examples of estimates requiring judgment: the amount of loans or receivables that will not be collected; the depreciable lives of property, plant and equipment; the rate at which pension assets will grow over the lives of employees covered by pension plans; and the warranty expense for products sold.

Net income reporting obviously affects securities prices, but there are other important effects as well. Management compensation is commonly linked to equity instruments, which derive value from a firm's stock market performance, which in turn derives from the firm's net income performance. This situation provides managerial incentives to maximize net income, which may warp the judgment of some managers. Management incentives may also be linked directly to net income (or other income measures) without a linkage to equity performance. For instance, a bonus could be earned for the achievement of a certain percentage increase in net income. Again, the reward is based on a measure that is under the score-keeping influence of the persons being rewarded.

Because net income is so important to investors, both as a performance measure and an indicator of future cash flows, and is full of estimates that are subject to the biases of managers whose well-being is related to the levels of reported net income, investors will view net income with caution. They may compare net income to cash from operations for reasonable relationships, and they may question assumptions underlying the determination of net income. Over the last ten years, for example, investors have become much more cognizant and critical of the earnings rate assumptions used in pension plans. Plan assets might be assumed to return 8% over long periods of time, which may sound reasonable, but may be completely unrealistic in terms of the plan's asset mix. A lower, more depictive rate might be 5%, but this would raise pension costs and depress net income relative to the 8% earnings rate assumption. Keeping the assumed rate of return on pension plan assets unrealistically high is an easy way for managers to produce earnings that meet estimates - yet these kinds of phantom earnings will not produce cash that can be put to use for investors.

(1) Address the potential influence of APB 23 on the shifting of profits to tax haven jurisdictions.

By permitting firms to avoid the recognition of deferred taxes as long as they intend to reinvest earnings indefinitely in foreign jurisdictions, the APB 23 exception creates a scenario for generating this same kind of non-cash income. If a firm earns a dollar before taxes in such a jurisdiction, it's worth a dollar in after-tax net income terms as well - whereas a dollar earned in the United States would be worth only 65 cents. This creates a powerful incentive for firms to invest as much as they can in foreign jurisdictions where they can choose to indefinitely reinvest the earnings; it's a built-in advantage in growing earnings. It also creates a powerful paradox: by choosing to indefinitely reinvest the earnings, the firm's managers assert that the cash resulting from the earnings will remain in those jurisdictions where the earnings originated. The earnings will not naturally turn into cash flows that can be put to use for investors in the United States, as long as the managers are not violating the indefinite reinvestment assertion. Should they choose to violate the assertion, they would be required to accrue taxes on the previously untaxed earnings.

The APB 23 exception for accruing deferred taxes thus creates "look, but don't touch" earnings that will increase consolidated net income and give investors a favorable impression of future cash flows, but that impression may be misleading. When investors view net income, they don't expect the resulting cash flows to be encumbered by the location of origination.

For investors, the presence of such earnings is not readily determinable. The only specific disclosure related to the amount of indefinitely reinvested earnings (IRE) is the year end cumulative balance, appearing in the footnotes of the annual report or SEC 10-K filing. There are no required quarterly disclosures. For the 500 firms in the S&P 500 index, which is composed of large multinational firms, Table 1 on the next page shows the accumulated indefinitely reinvested earnings balances by sector from 2006 to 2011. Several observations:

• The total amount of accumulated indefinitely reinvested earnings is $1.542 trillion in 2011, and the technology sector accounts for 24.1% of the total, leading all other sectors. In 2006, the year after firms were allowed to repatriate earnings at a reduced tax rate, the total balance was only $618.5 billion. In the space of five years, the balance of indefinitely reinvested earnings more than doubled, growing at an average rate of 20% per year. Firms had depleted their balances somewhat in 2005, when they were permitted to repatriate earnings at a 5.25% tax rate. Still, firms have added indefinitely reinvested earnings at a remarkable rate in just the last several years: over $450 billion in just 2011 and 2010.

• In 2006, 52% of the S&P 500 firms showed accumulated indefinitely reinvested earnings balances. By 2011, that proportion had increased to 64%. The proportion shift within the technology sector was greater. In 2006, there were 52 technology firms with indefinitely reinvested earnings balances, or 73% of the technology firms; by 2011, there were 65 technology firms with such balances, making that proportion 92%.

Table 1. S&P 500: Accumulated Indefinitely Reinvested Earnings, 2011 Vs. 2006

		# Accumulated IRE Firms:				Year End Balance of Untaxed, Indefinitely Reinvested Earnings:							
($ in billions)	**Total**	**2011**	**2006**	**% 2011**	**% 2006**	**2011**	**% Total**	**2010**	**2009**	**2008**	**2007**	**2006**	**% Total**
Technology	71	65	52	*92%*	*73%*	$371.3	***24.1%***	$285.4	$221.3	$178.0	$124.9	$83.8	***14.2%***
Health Care	52	40	31	*77%*	*60%*	336.1	***21.8%***	284.6	241.6	223.3	183.7	132.0	***10.4%***
Industrials	61	46	37	*75%*	*61%*	198.9	***12.9%***	174.5	153.0	137.1	118.0	84.2	***12.2%***
Consumer Staples	42	30	26	*71%*	*62%*	177.6	***11.5%***	149.7	131.1	109.7	92.4	74.7	***8.4%***
Financials	81	32	29	*40%*	*36%*	152.6	***9.9%***	132.8	112.0	88.2	84.0	61.9	***16.2%***
Energy	43	25	22	*58%*	*51%*	141.4	***9.2%***	123.8	113.8	136.7	124.9	105.6	***8.6%***
Consumer Discretionary	80	48	34	*60%*	*43%*	87.7	***5.7%***	70.6	54.9	47.4	39.1	31.0	***16.0%***
Materials	30	27	22	*90%*	*73%*	70.1	***4.5%***	63.7	57.6	52.8	48.8	40.2	***6.0%***
Utilities	33	4	4	*12%*	*12%*	5.6	***0.4%***	3.9	3.1	3.0	2.4	2.1	***6.6%***
Telecom	7	1	1	*14%*	*14%*	1.5	***0.1%***	1.2	1.1	0.8	0.9	3.0	***1.4%***
Total	500	318	258	*64%*	*52%*	$1,542.8	***100.0%***	$1,290.2	$1,089.5	$977.0	$819.1	$618.5	***100.0%***
	$ Change:					$252.6		$200.7	$112.5	$157.9	$200.6		
	% Change:					*20%*		*18%*	*12%*	*19%*	*32%*		

Source: 10-K filings. S&P 500 composition at 2/29/2012, for companies with financials issued through December 2011.

The technology sector has the greatest amount of untaxed, indefinitely reinvested earnings because the investments needed to conduct their business are the most portable and exportable of all industries. Their asset base is often mostly intangible: research & development, patents, copyrights, and processes, for example. Their most valuable asset base might even be considered biological and completely off-balance sheet: as managers are often fond of pointing out, their most valuable assets are their employees. The health care sector is very close to having the same presence of indefinitely reinvested earnings for mostly the same reasons: most of the indefinitely reinvested earnings in the health care sector relate to pharmaceutical firms, and their asset bases share the portability characteristics of the technology firms. At the other end of the range, notice that telecommunications firms and utilities have the least amount of indefinitely reinvested earnings; their asset base is immobile, even without comparison to the technology or health care sectors.

A firm's effective tax rate is the income tax provision divided by its pretax income, with these amounts taken from a firm's income statement prepared on a financial reporting basis. The effective tax rate differs from the statutory tax rate in that it shows the effects of all deferred income taxes as well as current tax items. Current tax items will affect a firm's tax return. Chart 1 on the next page shows the median effective tax rate for all of the firms in the S&P 500, the median effective tax rate for the firms in the S&P 500 information technology sector, and also for Hewlett-Packard. (The median tax rates exclude Hewlett-Packard.) The technology sector's median effective tax rate is markedly less than for the S&P 500 as a whole, and the effective tax rate for Hewlett-Packard is less than the median effective tax rate for the technology sector itself. As Table 2 (next page) shows, Hewlett-Packard has significant amounts of indefinitely reinvested earnings balances, which have grown more rapidly than the S&P 500 balances. This may be due to acquisitions of firms with indefinitely reinvested earnings balances of their own.

Judging by the growth of accumulated indefinitely reinvested earnings balances throughout the S&P 500, firms have demonstrated their ability to utilize the APB 23 indefinite reinvestment exception to maximize the amount of earnings that can be sheltered by it.

Chart 1. Effective Tax Rates, 2006 - 2011.

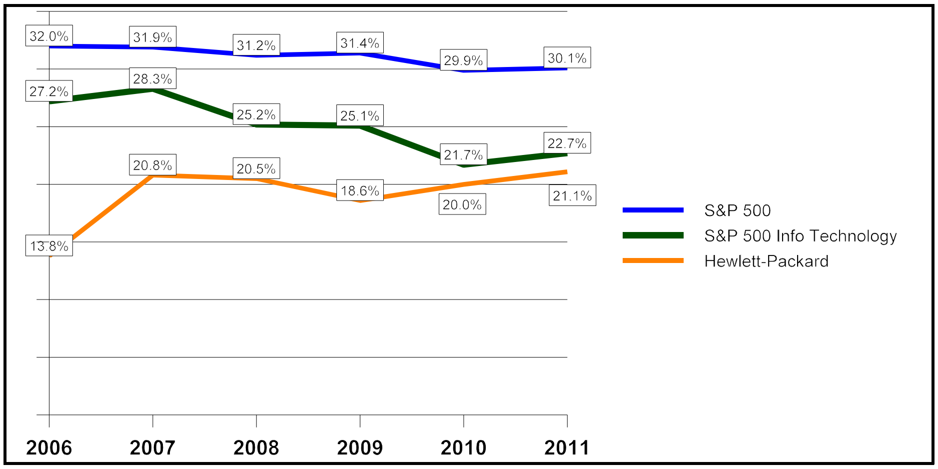

Table 2. Hewlett-Packard IRE

($ in billions)	Accumulated IRE Balance	YTY % Change
2011	$29.1	32.9%
2010	21.9	32.7%
2009	16.5	27.9%
2008	12.9	67.5%
2007	7.7	148.4%
2006	3.1	

Source: 10-K filings

Source: S&P Research Insight database. S&P 500 composition at 2/29/2012,for companies with financials issued through December 2011.

(2) Address whether the procedures under the standard could be used, and may have been used, by companies to manage and improve the appearance of their financial statements.

There are no specific "procedures under the standard." Rather than a strict list of procedures, the standard is much more of a principles-based guideline as to how firms should treat indefinitely reinvested earnings, and similarly, also offers general guidance on the circumstances under which income taxes should be accrued on earnings previously considered to be indefinitely reinvested. The APB 23 exception to deferred tax recognition is intention-based, making it relatively simple to accommodate the needs of managers of multinational firms who might be searching for spare earnings when earnings targets appear to be headed for a shortfall. The intention to reinvest earnings could change in line with the amount of earnings to meet a specific objective. For instance, a firm's managers might intend to reinvest indefinitely a greater amount of foreign earnings if it becomes apparent that it won't otherwise meet Wall Street earnings estimates, or perhaps to meet earnings targets tied to compensation awards. Similarly, the intentions could change so as to *not* recognize income; a firm's managers could elect to recognize some portion of deferred taxes on earnings considered to be indefinitely reinvested, if other earnings sources were performing better than expected.

While the intention aspects of the standard make it relatively simple to use for managing earnings, it should be noted that it can't be done in a manner that will really have a profound effect on consolidated earnings if there are not sufficient foreign earnings for applying the exception. To have the ability to manage earnings at all, a firm has to have a foreign presence, and therefore, the exception provides an incentive to invest profitably overseas if for no other reason than to avail itself of a possible tool for improving the appearance of earnings. Firms also may be motivated to make such investments because competitors make such investments, and their managers would not want to be at a competitive disadvantage in managing their earnings.

(3) Address the guidance issued by FASB on the portion of APB 23 relating to indefinite reversal criteria.

APB 23 contains one important presumption, one worth emphasizing before a discussion of its exception and its indefinite reversal criteria. Consider it to be the normal route for reporting undistributed earnings of a subsidiary:

"It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity. Accordingly, the undistributed earnings of a subsidiary included in consolidated income shall be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free." (From Accounting Standards Codification 740-30-25-3)

Note that the presumption is that "all undistributed earnings of a subsidiary will be transferred to the parent entity," and these undistributed earnings would have deferred income taxes recognized upon them. That stated presumption implies that in consolidated financial statements, net income is available for the benefit of shareholders because all taxes on earnings due to tax authorities has been accounted for. That implication is compatible with the way investors view net income, as discussed in the overview. Non-recognition of deferred income taxes runs counter to the presumption, and also runs counter to what investors expect net income means for them because some portion will not be available for distribution. In short: investors expect that net income is available to be used for their benefit without encumbrances or restrictions, and the accounting rules governing undistributed earnings of a subsidiary incorporate that same presumption. The APB 23 exception makes net income run counter to investor expectations. As will be discussed later, there is no robust information available to investors to inform them about the amount of indefinitely reinvested earnings behind consolidated net income figures reported to them.

The APB 23 exception as currently framed in the Accounting Standards Codification:

"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 ... 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 ..." (From Accounting Standards Codification 740-30-25-17)

The exception is not a comprehensive set of steps for a firm to follow or a list of missteps to avoid. Rather, it sets out a general guideline or a principle. The burden of proving intention to indefinitely reinvest earnings remains with the managers of the firm making the assertion. Proof of intention to reinvest indefinitely requires the generation of evidence: it might include projection of working capital needs and long-term investment plans for the places where the earnings originate; it may include evidence of why the funds generated from those earnings are not needed at the parent level. The working capital projections and investment plans for the parent may provide this support. Even though there may be past history that demonstrates the intent to reinvest, and other relevant documentary evidence signaling intent, negative market conditions could change those intentions or raise doubts about the ability to continue indefinite reinvestment. Ideally, the evidence would address the stress that could be placed upon the indefinite reinvestment presumption before it might have to change.

Note that this evidence of an intention to indefinitely reinvest earnings must satisfy the firm's auditor. The auditor has a responsibility to obtain sufficient, competent evidential matter in forming an opinion on the financial statements. The auditor's judgment as to the veracity of the indefinite reinvestment assertions and the evidence behind them may be a particularly critical one when a large portion of the earnings (or improvements in earnings) is attributable to indefinitely reinvested earnings.

Another relevant part of the APB 23 exception appears in a later paragraph of the Accounting Standards Codification:

"*If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings shall not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent entity shall adjust income tax expense of the current period; such adjustment of income tax expense shall not be accounted for as an extraordinary item.(From Accounting Standards Codification 740-30-25-19)*

The paragraph above sounds reasonable and prudent: if a firm's managers expect that changed circumstances will require the remittance of earnings to the parent in "the foreseeable future" for some or all of its undistributed earnings, then it should accrue income tax related to the remittance. Again, it's more of a principle than a specific listing of steps; the decision as to when circumstances have changed enough to warrant tax accrual rest with management. The "some or all" part of the paragraph, however, can lead to an interpretation that firms might intend to apply the indefinite reinvestment assertion to only a part of a subsidiary's assertions. An example of this interpretation is found in Ernst & Young's "Financial Reporting Developments, Comprehensive Guide: Income Taxes," (Revised October 2011):

"*Management's decision to indefinitely reinvest foreign earnings is not an all-or-nothing determination. That is, a company can indefinitely reinvest a portion of accumulated foreign earnings while remitting a portion of those earnings.* If a company has both the intent and ability to indefinitely reinvest only a portion of the accumulated and future foreign earnings (i.e., repatriate only a portion the earnings of foreign operations), ASC 740-30-25-19 requires recognition of the deferred tax liabilities on the portion to be remitted in the foreseeable future. In that case, the remaining undistributed foreign earnings (i.e., the indefinitely reinvested portion), would continue to be considered indefinitely reinvested and no deferred tax liabilities would be recognized." (Emphasis added.)

The importance of this interpretation is that it gives management another tool for adding or subtracting a desired amount of indefinitely reinvested earnings in its mix of total earnings. Subsidiaries' indefinitely reinvested earnings can be a malleable pool of earnings to be sliced as finely as needed to meet earnings estimates with pinpoint precision.

Though the Accounting Standard Codification does not speak to it, the assertion is one that's made when earnings are reported; it's not a lifetime assertion. In practice, this means that a firm's managers may change that assertion when they report. The assertions regarding indefinite reinvestment would still need support, but it also means that a firm's managers have flexibility to change that assertion as their circumstances dictate what would be most beneficial for them to report.

(4) Address potential loopholes created by the way in which the accounting standard is written and interpreted.

The entire APB 23 exception is a way to manipulate the rules to achieve an outcome the rules were intended to discourage. Income tax accounting in financial reporting is supposed to provide for deferred income taxes on earnings, and this exception specifically nullifies that provision. The rule itself is a loophole, and its potential for flexible interpretation (partial application and continuous reassertion of assumption, for example) make it even more inviting to use as a tool for financial earnings management.

A simple example: suppose a firm creates an overseas subsidiary with the intention to indefinitely reinvest its earnings. Assume it's profitable from the start, earning $200, but the firm does not want to show 100% of the untaxed earnings from it in Year 1, so it accrues income taxes at 35% on the full earnings of the foreign subsidiary. The subsidiary thus contributes $130 to the consolidated income of $1,000 in Year 1. Investors valuing those earnings expect no encumbrances upon them. As far as their availability for use to benefit shareholders, there are no encumbrances. Wall Street earnings estimates for the following year are that the firm will report $1,100 of net income. In Year 2, the foreign subsidiary's earnings are repeated, but the domestic operations will not reach the $970 needed to meet earnings estimates. To remedy the shortfall, the parent's managers intend to indefinitely reinvest 80% of the subsidiary's foreign earnings and will no longer accrue income tax upon them. The $160 of untaxed earnings enables the firm to report consolidated net income of $1,100, enabling it to meet Wall Street estimates. Observations from this example:

• Management is freely able to change its assertion regarding the proportion of earnings that will be untaxed. While it may have to justify its assertion to its auditors through forecasts and investment plans, those forecasts and plans can easily be modified to justify the change in assertions.

• This will increase the proportion of indefinitely reinvested earnings in the consolidated earnings from zero in Year 1 to 14.5% in Year 2.

• Investors will see that there is $1,100 of net income and assume that as it subsequently converts into cash, $1,100 of earnings will be available for dividends, share repurchases, or capital investment anywhere in the world. Only $940 of it is freely available, because $160 of it is committed to reinvestment in the foreign subsidiary. In Year 1, none of it was committed to reinvestment.

• The company may be forthcoming about the shortfall in domestic operations, but may imply that overseas operations have taken up the slack, which has in fact occurred. The important factor, though, is that the overseas operations have improved only because of a change in management intention. The foreign subsidiary earned $200 in both years, but the change in assumption about reinvestment - from zero reinvestment to 80% reinvestment - is what made the after-tax earnings $160 compared to $135 in the previous year.

Earnings management possibilities are magnified when there are more overseas operations involved. The APB 23 exception provides enormous potential to call up earnings as needed - or postpone them - in a large multinational operation.

This exception is often referred to as the “APB 23 indefinite reinvestment assumption.” In 2004, as part of the convergence projects between the FASB and the IASB, revocation of the assumption was studied because the IASB tax accounting standard did not have a similar exception. In the end, the IASB standard was modified to conform more closely to the APB 23 exception. Convergence was achieved, but not the way it was intended. APB Opinion 23 was issued in 1972, and when the FASB overhauled income tax accounting in 1992, it carried forward the APB 23 indefinite reinvestment assumption, without substantive modification. The history of the exception goes much farther back than 1972, however. It has been a part of accounting standards since 1959, with the issuance of Accounting Research Bulletin No. 51. From paragraph 16:

... Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. <u>There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation.</u> (Emphasis added.)

The exception may have seemed like a good idea at the time. Its financial reporting effects indicate it needs to be re-examined.

(5) Address the potential impact of the indefinite reversal exception of APB 23 on financial statement reporting, including transparency relating to earnings, and all investors’ ability to understand the financial condition of the reporting entity.

Indefinitely reinvested earnings matter to investors for the following reasons:

• In estimating future earnings, investors could be mistaken about the source of earnings growth or decay without an understanding of how much a firm’s total earnings are driven by indefinitely reinvested earnings.

• The cash produced by differentially-taxed foreign operations is trapped in those countries due to management’s intentions regarding deployment. Even if investors had a clear picture of the contribution of indefinitely reinvested earnings, it’s even harder to forecast “management intention.”

• Firms may also issue debt at the foreign subsidiary level and use the proceeds to make intracompany loans within the firm as a means of freeing trapped cash without violating the letter of the law regarding repatriation and reinvestment. De facto distributions may abound, but investors have no idea.

• Total firm leverage may increase as a way of "liberating" cash, but investors may not really understand why a firm is taking on more debt. They may attribute it to standard asset funding practices. Investors would certainly be interested in the interplay between "trapped cash," taxes paid, and financial leverage.

• In assessing dividend prospects, investors may be misled by the amount of trapped cash flow and assets. They may be expecting dividend increases based on observed financial strength in the consolidated financial statements - but the strength may be less than depicted. Not every dollar of cash on the balance sheet has the same degree of accessibility.

As important as the subject may be for investors, the disclosure requirements are slim. The only quantitative disclosure requirement for indefinitely reinvested earnings is that the accumulated balance be disclosed each year. There is no requirement that firms present the balance on a year-to-year comparative basis. Worse, there is no requirement for firms to disclose the annual effect of indefinitely reinvested earnings on net income. (Nor is there any similar requirement for quarterly earnings reports.)

Investors can only roughly estimate the amount of indefinitely reinvested earnings in a company's earnings for a particular year. The simplest way is to subtract the previous year's accumulated balance of indefinitely reinvested earnings from the current year's balance. The difference represents the amount of the current year's estimated foreign earnings, upon which a firm neither paid nor accrued any income taxes. The problem with this "net" approach is that it can't account for transactions that could affect the estimate.

For example, suppose a firm disposes of a subsidiary with an accumulated indefinitely reinvested earnings balance. The accumulated balance figures are reported only on an annual basis, without a comparable prior year balance, so there wouldn't even be a revised prior year balance available for calculating the current year results from the two balances. Disposal of a unit and its related accumulated indefinitely reinvested earnings balance would make a light estimate of current year indefinitely reinvested earnings, perhaps even showing a loss where none occurred. Similarly, acquiring a subsidiary in the current year with an indefinitely reinvested earnings balance could skew the estimate the other way. The current year balance would be higher for reasons that had nothing to do with earnings, making the current year estimated earnings look higher than in reality. Another scenario: suppose a firm repatriates some earnings without disclosing its actions. There's no disclosure requirement regarding repatriations, so this is not a far-fetched scenario - but it would again distort the net change between years, which is assumed to be the current year indefinitely reinvested earnings.

To reiterate, the financial reporting standards are so poor in this area that investors are forced to work with only primitive disclosures, and they must assume that firms do not radically change their business portfolios containing indefinitely reinvested earnings each year. In fact, the disclosures are so poor that most investors are not aware of any net income effects of the APB 23 indefinite reversal assumption.

An example with Hewlett-Packard illustrates the mechanics involved - and the severe limits placed on investors who are trying to understand the sources of a firm's earnings. Table 3 shows the accumulated balance of untaxed, indefinitely reinvested earnings for each year. The annual growth in the balances is striking: the smallest annual change occurred in 2009, a net growth of $3.6 billion, and 27.9% more than the 2008 balance. The difference between each year can be considered a rough proxy for the untaxed, indefinitely reinvested earnings in a given year.

Table 3. Hewlett-Packard Indefinitely Reinvested Earnings Compared to Net Income, 2006 - 2011.

($ in millions)	**2011**	**2010**	**2009**	**2008**	**2007**	**2006**
Cumulative IRE balance	$29,100.0	$21,900.0	$16,500.0	$12,900.0	$7,700.0	$3,100.0
% Change in cumulative IRE balance	*32.9%*	*32.7%*	*27.9%*	*67.5%*	*148.4%*	
Estimated annual indefinitely reinvested earnings	$7,200.0	$5,400.0	$3,600.0	$5,200.0	$4,600.0	
Net income from continuing operations	$7,148.0	$8,870.0	$7,738.0	$8,329.0	$7,264.0	
Estimated IRE/Income from Continuing Ops.	**100.7%**	**60.9%**	**46.5%**	**62.4%**	**63.3%**	

Sources: IRE balances, 10-K filings; Net income from continuing operations, S&P Research Insight (2009-11 adjusted to include earnings attributable to non-controlling interests).

Notice the impact of the estimated annual untaxed, indefinitely reinvested earnings on net income: in the last five years, they comprise anywhere between 46.5% to 100.7% of net income from continuing operations. This is an estimate, however. If a firm has an unchanging portfolio of operating subsidiaries, the net yearly balance change should represent the untaxed, indefinitely reinvested earnings. That is unlikely however, because firms engage in acquisitions constantly. Hewlett-Packard, for instance, made a large acquisition of Autonomy in 2011, which may have increased the cumulative IRE balance without being related to earnings. There's no description of how acquisitions or disposals affected the balance; none is required.

The effects on net income may be exaggerated by undisclosed effects on the balance, but several certainties exist. The effect of untaxed, indefinitely reinvested earnings is not zero, and the size of the balance suggests that the investments that encourage this source of earnings growth are increasing, whether by acquisition or by growth.

The cash flow statement is also affected by untaxed, indefinitely reinvested earnings. Investors often focus on cash generated by operations, which is presented in the cash flow statement as a series of steps beginning with net income. There is no adjustment for cash that is trapped in foreign subsidiaries due to management intention, however. The consolidated cash generated by operations figure carries the same message to investors as net income: it's unencumbered and freely available for use. As with net income, it's not conveying an accurate message.

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The most important points to understand regarding the APB 23 exception:

• It erodes and undermines the meaning of net income as understood by investors.

• It provides a powerful, flexible tool for managers to shape their earnings forecasts without real changes in underlying economics, solely through changes of intention. That may lead to incentive problems.

• To the extent that the indefinite reversal exception distorts earnings reporting, it introduces inefficiencies into the capital allocation process of markets. If these earnings influence investors to favor securities of such companies, they may not be getting what they expect - and they may have forgone other opportunities.

• The idea of intending to indefinitely reinvest earnings to avoid accruing income tax is absurd. Heavy industries continually reinvest in capital projects to obtain accelerated depreciation benefits and reduce their current income tax burden. They accrue deferred income taxes even though they intend to indefinitely reinvest their earnings this way. Would anyone suggest that they should not accrue deferred income taxes?

• The extent to which the indefinite reinvestment exception affects any given company's earnings is not disclosed. Investors do not have a clear idea of how much this kind of encumbered income comprises net income and have little idea of how it will affect future earnings and cash flows.

• The exception benefits a relatively few firms: the ones with the most portable assets and the greatest global footprint. Of the $1.542 trillion of accumulated indefinitely reinvested earnings in the S&P 500, 72% of the amount belonged to only 50 companies - only 16% of the 318 firms with such balances. Note that there were 182 firms in the S&P 500 that showed no accumulated indefinitely reinvested earnings.

• The exception dates back to at least 1959. What may have been a minor distortion in financial reporting at that time has grown tremendously in a era of global markets, instant communications, and the ability to move cash around the world in seconds.

• Standard setters have not served investors well in that they had a chance to remedy it in 2004 but did nothing. Likewise, the SEC has done some letter-writing to individual companies, but has done nothing in terms of setting standards of disclosure on the matter. Disclosure is not the solution, but greater disclosure would at least bring attention to the problem.

Accounting rules shape management behavior. This rule, or rather, this *exception* to the rule, encourages firms to make investments that produce one kind of "special" income that really isn't, in substance, very special at all. It may encourage firms to take on more complex management tasks than they really need to take, in order to show a kind of earnings pattern that may be more of an optical illusion than anything - while serving to buffer them from critical market scrutiny.