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Should APB 23 Indefinite Reinvestment Be Repealed?

By J. Richard Harvey Jr.



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Policy during the drafting and implementation of the Tax Reform Act of 1986. He was also the first expert witness at the May 2013 Senate hearing on Apple Inc.'s international tax planning. All views expressed are solely his own.

In this article, Harvey explains why Accounting Principles Board Opinion No. 23 should not be repealed. He argues that the Financial Accounting Standards Board should provide more application guidance on several issues. Without that guidance, aggressive multinational corporations may continue to assert indefinite reinvestment when in fact they are likely to repatriate some portion of their low-taxed foreign earnings.

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In a recent letter to the Financial Accounting Standards Board,¹ six law school professors, one retired Joint Committee on Taxation revenue estimator, and one retired CPA strongly advocated for the repeal of Accounting Principles Board Opinion No. 23's assumption of indefinite reinvestment.² The letter argues that APB 23 undermines account-

ing credibility, contributes to bad tax policy, invites conflicts of interest, and so on.

Although some of these assertions may be true, this does not mean that APB 23 should be repealed. Rather, FASB should provide more application guidance.³

Why Should FASB Take Action?

For years, if not decades, many U.S. multinational corporations (MNCs) have aggressively shifted income into low-tax jurisdictions. Once the tax savings were obtained, the question became how much financial statement benefit to record. As a retired Big Four accounting firm partner who worked extensively with APB 23, this author can attest that the lack of application guidance effectively allowed U.S. MNCs to make whatever APB 23 assertion they desired. In the vast majority of cases, U.S. MNCs assumed that 100 percent of their low-taxed foreign earnings were indefinitely reinvested.

Although MNCs have been able to sustain this strategy for an extended period, it appears the day of reckoning could be approaching. If U.S. tax law is not changed, many MNCs may need their foreign earnings to continue paying dividends and funding stock buybacks.

Without guidance on the issues discussed later in this article, there will continue to be uncertainty and diversity of practice. More importantly, aggressive MNCs will continue to assert indefinite reinvestment when in fact they will likely repatriate some portion of their low-taxed foreign earnings. Thus, FASB should provide guidance. If FASB will not do this on its own, the SEC should intervene.⁴

Is APB 23 a Reasonable Accounting Model?

The short answer is yes, but first a detour. Conceptually, U.S. deferred tax liabilities (DTLs) on unremitted foreign earnings should be recorded using a net present value (NPV) approach. Under this approach, the timing of future dividends

¹The letter is dated August 31, 2015, and is signed by Patrick Driessen, J. Clifton Fleming Jr., Jeffery M. Kadet, Edward D. Kleinbard, David L. Koontz, Robert J. Peroni, Daniel N. Shaviro, and Stephen E. Shay.

²With the 2009 codification of accounting standards, APB 23 is now Accounting Standards Codification (ASC) 740-30-27-17. However, this article will nevertheless refer to it as APB 23.

³If the United States adopts a territorial tax system, the importance of APB 23 should decrease substantially. However, if less than 100 percent of foreign dividends are exempt, the concept may remain relevant.

⁴When there was diversity of practice surrounding tax reserves, the SEC reportedly convinced FASB to issue FASB Interpretation No. 48.

COMMENTARY / VIEWPOINT

should be estimated and the resulting tax discounted to arrive at an NPV. Although the NPV approach is conceptually appealing, FASB and its predecessors⁵ have rightly rejected it because of the significant uncertainties surrounding when foreign earnings will be repatriated.

As an alternative, accountants developed an accounting model for when to recognize — or not recognize — a DTL on unremitted foreign earnings. The recognition question is a common problem that accountants must address for many assets and liabilities, including tax reserves in FASB Interpretation No. 48 and DTL valuation allowances in Financial Accounting Standard No. 109.

Because it is unclear whether the earnings of foreign subsidiaries will ever be repatriated, it seems reasonable to conclude that there are cases when a DTL should *not* be recorded. Two examples are when foreign earnings will never be repatriated and when they will be repatriated so far in the future that the NPV of the liability is immaterial.

Thus, this author believes that the APB 23 indefinite reinvestment model is a reasonable one. However, there are major practical problems because the accounting literature provides very little guidance on the meaning of the term “indefinite reinvestment.”

Practical Problems

U.S. MNCs are generally able to support whatever APB 23 assumption they desire because of the following uncertainties:

- *The time frame for indefinite is not clear.* The dictionary definition of “indefinite” is “lasting for an unknown or unstated length of time.”⁶ More specifically, does indefinite mean (i) forever, (ii) not in the foreseeable future,⁷ or (iii) something else? Could it include a situation in which it is unclear whether unremitted foreign earnings will be repatriated in year 3 or year 4? Given the lack of a specific time frame, U.S. MNCs have plenty of wiggle room to argue whatever position best suits them.
- *Can U.S. MNCs assume foreign operations will generate future income?* Assume a U.S. MNC is certain that at some point it will need cash from its low-taxed foreign subsidiaries. Nevertheless, suppose the U.S. MNC wants to continue its APB 23 assumption. One solution is to

argue that future earnings, rather than prior earnings, will be used to fund repatriations. Also, the U.S. MNC may be able to continue using the assumption until repatriation finally occurs.

- *Can APB 23 apply when tax is the only reason for leaving earnings overseas?* In practice the answer seems to be yes, as long as the U.S. parent can demonstrate it has the financial liquidity to survive for some period of time without repatriating the foreign earnings. This is the case even though it may make absolutely no long-term economic sense to leave the earnings overseas. In large part, this issue is intertwined with the lack of a time frame and the ability to project future earnings that can be repatriated.
- *No probability standard.* In FIN 48, there are probability thresholds for both the recognition and measurement analysis. Even FAS 5 has some thresholds. However, there is no probability standard in APB 23. Thus, unless a U.S. MNC’s assertion is unreasonable, it is very difficult for an external auditor to challenge a client’s assertion.
- *Minimal disclosure requirements.* The only disclosure requirements surrounding APB 23 are the cumulative amount of indefinitely reinvested earnings and, if practicable, the additional tax that would be incurred on repatriation. There is no disclosure requirement for how a U.S. MNC interprets indefinitely reinvested — including, for example, what time frame it is using, what its confidence level is that the earnings will not be repatriated in that time frame, and whether it is assuming that it will repatriate any future foreign earnings. This disclosure could be valuable to readers of the financial statements.

As stated previously, the cumulative effect of the above uncertainties is that U.S. MNCs can pretty much make whatever APB 23 assertion that best suits their needs. Given the general presumption in APB 23 that foreign earnings will be repatriated, it is questionable whether U.S. MNCs should have so much flexibility.

FASB Response to U.S. Senate Questions

In its written testimony to the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations in September 2012, FASB acknowledged that U.S. generally accepted accounting principles do not define the term “indefinitely.”⁸ FASB defended the lack of a definition

⁵The indefinite reinvestment assumption was first adopted in 1959 by the American Institute of Certified Public Accountants in Accounting Research Bulletin No. 51. APB 23 was issued by the APB in 1973, and FASB has reconsidered APB 23 on at least two occasions.

⁶See the *Oxford American English Dictionary*.

⁷ASC 740-30-25-18 and 19 both refer to the foreseeable future.

⁸Despite FASB’s testimony, FAS 142, par. 10 states “indefinite does not mean infinite.”

by arguing that principles-based standards may be more appropriate than rules-based standards.

Although this author generally supports principles-based statements, FASB needs to explain the meaning of various terms. For example, FIN 48 provides substantial guidance on when a tax reserve should or should not be recorded. FAS 109 provides guidance on when a deferred tax asset valuation allowance should or should not be recognized. Both sets of guidance rely heavily on probability analysis.

Recommendations

Given the importance of APB 23 to the reported earnings of many U.S. MNCs, FASB should provide additional guidance. Also, because the general presumption in APB 23 is that unremitted foreign earnings will be repatriated, an assertion that avoids recording a DTL should meet a relatively high standard. Assuming FASB or the SEC agree that additional guidance is needed, the following recommendations should be considered:

- *Indefinite time frame is unclear.* Although some might argue that *indefinite* should mean that the earnings are reinvested forever, a better answer would be to pick a specific period of time. Forever is a long time, and in business it is very difficult to generate accurate long-term projections. Thus, a period of at least 10 years might be reasonable.

If it is agreed that, conceptually, an NPV approach is preferred, one could use NPV concepts to support whatever period FASB selects.⁹ For example, assume a U.S. MNC estimates it will need to repatriate foreign earnings in 10 years and that the U.S. tax on those earnings in year 10 will be approximately \$100 million. If a 7 percent discount rate is assumed, the failure to record a \$100 million DTL means that a DTL with an NPV of approximately \$50 million was not recorded. Said differently, once the NPV of the unrecorded DTL exceeds 50 percent of the undiscounted DTL, this indicates that a DTL should probably have been recorded.

- *No probability standard.* Given there are probability standards for tax reserves in FIN 48 and valuation allowances in FAS 109, it is surprising that there is no probability standard for APB 23. At a minimum, the standard should be probable (that is, generally interpreted by accountants to be at least 70 to 75 percent). Given

the general presumption that foreign earnings will be repatriated, a higher standard could also be considered.

- *Can U.S. MNCs assume foreign operations will generate future income?* This is an interesting question, and reasonable accountants could have different views, especially for those who remember that FAS 96 was revised to allow the projection of future income when FAS 109 was issued. My suggestion is that for purposes of evaluating the APB 23 indefinite reinvestment assumption, U.S. MNCs should be allowed to project future income only from their U.S. operations.

Thus, U.S. MNCs should not be allowed to support an indefinite reinvestment assumption by projecting repatriation of future income from their foreign operations. If this position is viewed as too harsh, one approach may be to require the increased footnote disclosure suggested below.

- *Minimal disclosure requirements.* Whether disclosure should be enhanced depends in large part on whether FASB decides to accept some version of the three preceding recommendations. If those recommendations are accepted, no additional disclosure may be needed. However, if FASB decides not to issue substantive guidance clarifying indefinite reinvestment, disclosure needs to be enhanced.

For example, U.S. MNCs should be required to disclose what they mean by indefinitely reinvested, including the time frame used, their confidence level that the earnings will not be repatriated in that time frame, and whether they are assuming they will repatriate any future foreign earnings.

Summary

A recent letter to FASB suggested that APB 23 should be repealed. Although there is a clear lack of application guidance surrounding APB 23, repeal is not justified. Instead, FASB should address several practical uncertainties that have effectively allowed U.S. MNCs to make whatever APB 23 assumption best suits their needs.

Given that many U.S. MNCs have shifted substantial amounts of income to low-tax foreign jurisdictions and may need those foreign earnings back in the U.S. relatively soon, it is important for FASB to address these issues. If not, aggressive MNCs may continue to assert indefinite reinvestment when in fact they are likely to repatriate some portion of their low-taxed foreign earnings.

⁹This does not mean that DTLs should be recorded at their NPV.