Discussion of

Noncompliance with Mandatory Disclosure Requirements: The Magnitude and Determinants of Undisclosed Permanently Reinvested Earnings

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Overview of Paper

- **Research Question:** How many firms (do not) comply with the mandatory requirement to disclose PRE & TAX, and what factors are related to the decision to disclose?

- **Importance:** The disclosure of PRE provides information to investors about firm decisions (investment, repatriation, foreign activity), and regulators have recently expressed concern about the transparency related to these disclosures.

- **Finding:** Approximately 12-17% of firms do not disclose PRE, and 73-81% do not disclose the tax associated with PRE. The decision to disclose varies with the level of tax and industry-specific features (litigation risk and competitiveness).
Relevant Literature

- Permanently Reinvested Earnings & Offshore Cash
  - Valuation effects (Collins et al., 2001; Dhaliwal and Krull, 2006; Oler et al., 2007)
  - Earnings management (Krull, 2004)
  - Repatriation (Blouin & Krull, 2009; Graham et al., 2011; Blouin et al., 2012)
  - Investment location (Bryant-Kutcher et al., 2008, Graham et al., 2011)
  - Disclosure (Eiler and Kutcher, WP)

- Noncompliance with Mandatory Disclosure rules
  - Environmental liabilities (Barth et al, 1997; Li et al, 1997; Peters and Romi 2013)
  - Legal liabilities (Chen et al., 2013)
  - Tax contingencies (Gleason and Mills, 2002; Robinson and Schmidt, 2013)
  - Exec compensation (Robinson et al, 2011)
  - Internal control weaknesses (Rice and Weber, 2012)
  - PRE (Bauman and Shaw, 2008)
Strengths of the Paper

- Examines a measure that is commonly used in the literature
- Examines a measure that is related to a very important policy issue facing firms today (foreign earnings and foreign cash holdings)
- Rigorous data collection process
- Careful construction of sample of economically significant firms
Suggestions for Contribution

- Contribution #1: Informs regulators
  - Regulators are already concerned about nondisclosure – recently issued SEC comment letters request information on PRE and foreign cash under Item 303 of Regulation S-K
  - Suggestion: Does this evidence of non-disclosure affect research that uses PRE? Would these results change or affect inferences made in other papers?
Suggestions for Contribution

• Contribution #2: Adds to the literature on mandatory disclosure noncompliance
  
  – Prior papers document non-compliance with other mandatory requirements (environmental liabilities, executive compensation, etc.)
  
  – Observe noncompliance in other tax accounts; for example, 14-18% of firms in years 2004-2011 do not disclose cash taxes paid.
  
  – Recommendation: Discuss further what distinguishes this study of PRE. Consider building off of the potential valuation implications documented in Collins et al. (2001), Oler et al. (2007), and Bauman and Shaw (2008).
Motivation & Hypothesis Development

• Stated assumption that disclosures about PRE and TAX may not be truthful or accurate
  
  – Measurement error for both firms and external users; unclear why measurement error would be lower for external users
  
  – Bauman and Shaw (2008) compare actual repatriation taxes after the AJCA to their estimated tax amounts and find that “disclosed repatriation tax amounts are significantly more accurate than estimated amounts in explaining the actual repatriation taxes due.”
  
  – Suggestion: Consider using actual disclosers to “calibrate” the estimated amounts.
Motivation & Hypothesis Development

- **Selection issue:** unobserved differences disclosers and non-disclosers
  - TAX calculation actually may be “practicable” for firms that disclose; non-disclosers may have more complex tax structures that make it more difficult to estimate TAX (i.e., difference may not just be the decision to disclose).
  - Suggestion: Consider including a measure that attempts to capture “tax complexity” in the analysis (number of subsidiaries in Exhibit 21, haven intensity, etc.). In descriptive statistics, test to see if this variable is significantly different across samples.

- **Economic motivation for relation between PRE and litigation/competition:**
  - What specifically about the decision to disclose PRE would be related to:
    - Litigation risk (example: David Einhorn’s threat to sue Apple to distribute firm’s cash holdings, of which a portion of which likely relates to PRE)
    - Industry competition (example: not reveal proprietary tax structures)
Empirical Execution

• Overview of estimation method for TAX

  
  \[ \text{Tax}_{\text{Estimated}} = \sum \text{Reconciling}_{\text{Foreign}} + \sum \text{Reconciling}_{\text{Non-CurrentPRE}} - \sum \text{Reconciling}_{\text{REPAT}} - \sum \text{Reconciling}_{\text{Reversal}} \]

  
  – My expectation is that firms would under-report PRE and TAX due to valuation implications (not over-report)

  
  – Primary component is derived from ETR reconciliation (current year difference between 35% & FETR)

  
  – ASC 740-30-50-2 requires disclosure of “amount of unrecognized deferred tax liability”, where “deferred tax liability” is measured using the applicable enacted tax rate and provisions of enacted tax law

  • 35% enacted rate

  • Foreign tax credits - estimated in paper by using current foreign effective tax rate

  • Measurement error due to cross-crediting and the difference in foreign rate on distributed earnings (see ASC 740-10-25-39 through- 41) in year of repatriation
Empirical Execution

• Method sums over three years; consider alternative periods

• Use of AJCA: explain further why expect different response in the periods immediately around the AJCA and in later years

• Additional cross-sectional test: effect of political costs on the decision to disclose
  – Motivated effect of political costs in Section 3
  – Measure with press mentions or haven intensity from Exhibit 21 data
Summary

• Interesting paper that examines a popular measure used in prior and existing research

• Important to understand measure and limitations when making inferences on empirical results

• Recommend:
  – Additional motivation for studying the mandatory disclosure test in this tax setting
  – Consider selection issues and the stated assumption that disclosures may not be truthful
  – Review methodology for estimating and consider verification with actual disclosers (as in Bauman and Shaw, 2008)