Advances in Accounting, incorporating Advances in International Accounting 34 (2016) 110–116

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

SEC comment letters related to permanently reinvested earnings☆

Lisa Eiler [a], Lisa Kutcher [b,*]

[a] School of Business Administration, University of Montana, Missoula, MT 59812, United States
[b] College of Business, Colorado State University, Fort Collins, CO 80523, United States

ARTICLE INFO

Article history:
Received 14 April 2016
Received in revised form 20 July 2016
Accepted 30 July 2016
Available online 14 August 2016

JEL classification:
G18
G30
K22
M41

Keywords:
Deferred tax liability
Permanently reinvested earnings
Comment letters
Securities and Exchange Commission

ABSTRACT

In this paper, we examine how permanently reinvested earnings (PRE) and disclosure transparency surrounding PRE influences external monitoring from the Securities and Exchange Commission (SEC). Our research is motivated by increased congressional and SEC scrutiny into companies with substantial PRE via their foreign operations. We hypothesize that firms are more likely to receive a PRE-related comment letter if they have large amounts of PRE, a large estimated hypothetical tax on repatriation, increases in PRE, and have less transparent disclosures related to the hypothetical tax on PRE. We find that the estimated hypothetical tax on repatriation and the transparency of PRE disclosures are determinants of receiving a PRE-related comment letter. Further analysis shows that cash-constrained firms with a large estimated hypothetical tax on repatriation are more likely to receive a PRE-related comment letter. Our research contributes to a growing body of research into the external monitoring role of the SEC in the form of comment letters.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

Some analysts estimate that foreign cash balances of US companies are as much as $1.1 trillion (Heller, 2015). Foreign earnings designated as permanently reinvested earnings (PRE) for US multinationals on the Russell 1000 index have grown from approximately $1.1 trillion in 2008 to $2.1 trillion in 2013 (Bank of America, 2014). As a result of growing foreign cash balances and PRE, the foreign operations and tax practices of US multinationals have garnered much attention in the popular press and from members of Congress. Amid concerns that large US multinationals are avoiding US taxes on foreign earnings, senior executives from Hewlett-Packard, Microsoft, and Apple were called to testify before the Permanent Subcommittee on Investigations regarding their tax and financial reporting practices (US Senate Subcommittee on Investigations, 2012, 2013). Although these hearings focused on tax avoidance, scrutiny by the Securities and Exchange Commission (SEC) has focused on registrants with PRE because PRE-related disclosures are one of the few required disclosures about foreign operations. Since PRE-related disclosures alone do not require much detail, the SEC can use its comment letter process to request more in-depth information about foreign operations. Thus, our focus is on understanding comment letters related to PRE.

As noted by Schultz and Fogarty (2009), the information disclosed by US multinational corporations in their 10-K filings related to their foreign operations does not allow users to reasonably estimate or understand the tax implications associated with foreign earnings. While the accounting and disclosure rules around PRE have remained the same since the issuance of APB 23 (AICPA, 1972), the SEC's increased focus on these disclosures through its comment letter process may provide additional information into the disclosure concerns of the SEC. The information contained in a comment letter is often more detailed than the information disclosed in a 10-K filing.

Recent analyses suggest that some of the PRE-related inquiries the SEC makes pertain to (1) the impact PRE has on liquidity by understanding how much of PRE is foreign cash, (2) justifications for asserting the indefinite reinvestment criterion, and (3) information about the incremental tax due if the foreign earnings were repatriated to the US parent as a dividend (Deloitte, 2015). Thus, comment letters provide insight into the rationale for disclosure choices companies make when designating earnings as PRE. Therefore, we examine the determinants of receiving a PRE-related comment letter to provide insights into the inquiries about PRE by the SEC.

We hypothesize that due to the recent political attention on PRE, firms with large amounts of PRE are more likely to receive a PRE-related comment letter. We also hypothesize that firms with a large

☆ We thank Jennifer Howard, Roger Graham (the editor), an anonymous reviewer, workshop participants at the University of Montana and California State University at San Luis Obispo, and the participants of the 2016 AAA Western Region Meeting for helpful comments and discussions.

* Corresponding author at: Department of Accounting, Colorado State University, 1271 Campus Delivery, Fort Collins, CO 80523-1271, United States.
E-mail address: lisa.kutcher@colostate.edu (L. Kutcher).

http://dx.doi.org/10.1016/j.adiac.2016.07.009
0882-6110/© 2016 Elsevier Ltd. All rights reserved.

estimated hypothetical tax on PRE are more likely to receive a PRE-related comment letter. Since Krull (2004) shows that managers utilize PRE as an earnings management tool, we hypothesize that firms with increases in PRE, which is an indicator for earnings management, are more likely to receive a PRE-related comment letter. Additionally, Eiler and Kutcher (2014) show that managers opportunistically use discretion in the disclosure rules when making their disclosures about the estimated tax due upon hypothetical repatriation of PRE. Thus, managers utilize the flexibility in their disclosures surrounding PRE to reduce transparency. As a result, we hypothesize that firms with less transparent disclosures related to PRE are more likely to receive a PRE-related comment letter.

For a sample of firms that disclose PRE, we identify firms that receive a PRE-related comment letter and collect information discussed in the comment letters with respect to PRE. Consistent with our hypotheses, we find that the likelihood of receiving a PRE-related comment letter is increasing in the estimated tax on the repatriation of PRE and is decreasing in the transparency of the disclosures around the unrecognized deferred tax liability on PRE. Contrary to expectations, we find that the likelihood of receiving a PRE-related comment letter is negatively related to the amount of PRE. We further partition the sample into firms with high amounts of PRE (i.e., more than $500 million), and find that the negative relation between size of PRE and the likelihood of receiving a PRE-related comment letter is driven by those firms with high amounts of PRE. We find no relation between the likelihood of receiving a PRE-related comment letter and increases in PRE.

One of the concerns around reinvested foreign earnings is that those earnings are “trapped” abroad. In other words, companies cannot repatriate these earnings without potentially incurring a significant US tax upon repatriation. In our sample of PRE-related comment letters, we note that 80% included a request for information regarding liquidity, most likely because of the tax due upon repatriation of PRE. As a result, we include an additional analysis to examine whether cash-constraints are related to the likelihood of receiving a PRE-related comment letter. We find that as the size of the hypothetical tax on PRE grows, liquidity becomes a more important determinant of receiving a PRE-related comment letter.

Our research contributes to two streams of existing accounting literature. First, we contribute to the literature on SEC comment letters. Prior research (e.g., Cassell, Dreher, & Myers, 2013; Johnston & Petacchi, 2014) has examined the determinants and consequences of receiving a generic comment letter. Blouin, Krull, and Robinson (2014) examine the characteristics of firms that report PRE and whether they receive a generic comment letter. Our analysis differs from prior research in that we are interested in examining only those firms where the SEC is specifically seeking information related to PRE. Second, we contribute to the literature on PRE and related disclosures. Prior research (e.g., Eiler & Kutcher, 2014; Krull, 2004; Schultz & Fogarty, 2009) has examined managements' disclosures and incentives surrounding PRE. Our research provides insights into PRE-related disclosure decisions by managers, and PRE-related disclosure concerns of the SEC.

The remainder of this paper is organized as follows. In the next section, we review relevant literature and discuss our hypotheses. The third section outlines our research design. In the fourth section, we discuss our sample selection and results, and the fifth section provides the conclusion of our paper.

2. Literature review and hypothesis development

Broadly speaking, our research bridges the stream of literature examining PRE-related disclosures and literature examining the impact of SEC comment letters, a form of external monitoring, on disclosures. Prior research has examined various aspects of the disclosures related to PRE. Collins, Hand, and Shackelford (2001) find that firm value is lower for firms that disclose a hypothetical tax on PRE. Bryant-Kutcher, Eiler, and Guenther (2008) extend the research of Collins et al. (2001) and find that this result is concentrated in firms with high amounts of excess cash, their proxy for PRE invested in financial assets. This suggests that the market discounts PRE when it is held in financial rather than operating assets. Krull (2004) finds that firms use PRE as a tool to manage earnings.

More recently, Blouin et al. (2014) examine the location of PRE and show that although 25% of PRE is invested in tax havens, nearly 40% of PRE is invested in countries with high growth. However, Blouin et al. (2014) also find that 45% of PRE is invested in financial assets. Finally, Eiler and Kutcher (2014) examine the transparency of tax disclosures related to PRE and find that managers are less transparent when there is greater complexity related to estimating the hypothetical tax on PRE, but that transparency increases as the size of the hypothetical tax on PRE increases. Overall, the results from prior research indicate that PRE has capital market and disclosure implications.

In 2005, the SEC began releasing all comment and response letters between the SEC and its registrants.[1] Thus, a growing body of literature examines the determinants and consequences of SEC comment letters. Cassell et al. (2013) and Johnston and Petacchi (2014) examine the determinants and consequences of 10-K related SEC comment letters. Cassell et al. (2013) find that firms with more complexity and less profitability are more likely to receive a comment letter, and incur greater remediation costs. Johnston and Petacchi (2014) find a reduction in both abnormal returns and trading volume after the comment letter process is complete. Most related to our study, Blouin et al. (2014) document a positive relation between the magnitude of PRE and the likelihood of receiving a comment letter. In this paper, we take the analysis of Blouin et al. (2014) further by focusing on the likelihood of receiving a PRE-related comment letter, rather than a generic comment letter. This refinement allows for a more direct analysis related to disclosures around foreign operations. In addition, our multivariate analysis allows us to control for other variables impacting the likelihood of receiving a comment letter.

Anecdotal evidence suggests the SEC has increased their inquiries into PRE-related disclosures. In their *SEC Comment Letter Series*, Deloitte (2015) makes note of comments made by SEC staff at public speaking engagements, as well as samples from comment letters to registrants. Under ASC 740-30-50, companies must disclose the amount of earnings reinvested permanently and the amount of estimated tax on hypothetical repatriation of such earnings, or a disclosure stating that such an estimate is “not practicable”. Because PRE cannot be accessed domestically without incurring significant tax costs, registrants with high amounts of PRE invested in financial assets may face domestic liquidity issues. Thus, recent comment letters from the SEC have also requested that registrants disclose more information related to their foreign and domestic liquidity needs, including disclosures of foreign cash amounts.

Due to the political scrutiny associated with PRE, firms with large amounts of PRE are likely to be targeted to provide additional information regarding the nature of their PRE. As corporate cash balances and PRE have grown, politicians and tax reform groups have put pressure on US multinationals to reduce the size of foreign cash holdings. Some activists argue that the indefinite reversal criteria in ASC 740 allows managers to avoid recognizing a deferred tax liability on PRE by asserting that foreign earnings are “permanently reinvested”. For example, one proposal by Citizens for Tax Justice suggests imposing a one-time tax on PRE at the corporate rate, after an adjustment for foreign tax credits (Citizens for Tax Justice, 2015). Therefore, consistent with the univariate analysis in Blouin et al. (2014), we expect that firms are more likely to receive a PRE-related comment letter from the SEC as the size of PRE increases. Thus, our first hypothesis is:

Hypothesis 1. The likelihood of receiving a PRE-related comment letter is positively related to the size of PRE.

[1] Until 2012, the SEC could take as long as 45 days following the completion of a review to release all of the letters related to the filing under review. However, as of 2012, the SEC discloses the correspondence within 20 days following the completion of a review.

One of the key issues related to PRE is that these earnings may be considered "trapped" in that repatriation taxes must be paid to access these funds. Thus, another issue is the estimated amount of repatriation tax that would be due on repatriation of PRE. For political reasons and liquidity concerns, the SEC is more likely to request additional information related to PRE from firms that face potentially large repatriation taxes.[2] This leads us to our second hypothesis:

Hypothesis 2. The likelihood of receiving a PRE-related comment letter is positively related to the size of the hypothetical tax on repatriation of PRE.

Krull (2004) shows that firms use PRE as an earnings management tool. Specifically, she finds that for firms where the US tax rate is above the average foreign tax rate, changes in PRE are positively associated with the difference between analyst-forecasted earnings and pre-managed earnings. Because managers do not need to record a deferred tax liability on earnings designated as permanently reinvested, managers can increase net income by increasing the amount of PRE. Thus, the SEC is more likely to issue a comment letter to firms with increases in PRE to ensure that the designation is justified and not an attempt at earnings management. Thus, our third hypothesis is:

Hypothesis 3. The likelihood of receiving a PRE-related comment letter is greater for firms with increases in PRE.

Bozanic, Dietrich, and Johnson (2015) find that firms provide more disclosures (e.g., disclosures with more forward-looking information and more numeric disclosures) after receiving a comment letter from the SEC, although this effect is absent for firms requesting confidential treatment from the SEC. This suggests that firms could reduce the likelihood of receiving a PRE-related comment letter by increasing their disclosure transparency around PRE. Prior research shows that disclosure transparency with respect to the hypothetical tax on PRE is negatively related to the complexity of the calculation. Specifically, Eiler and Kutcher (2014) find that managers are less transparent when there is greater complexity related to estimating the hypothetical tax on PRE. Boone, Linthicum, and Poe (2013) show that accounting standards that require more estimates increase the probability a firm receives a comment letter from the SEC. While the accounting standard related to PRE and the hypothetical tax on PRE is the same for all firms, the complexity of the estimates required under the standard varies across firms. First, managers must estimate the amount of foreign earnings to classify as PRE. Next, an estimate of the nature and timing of a hypothetical repatriation must be made. Finally, managers must make an estimate of the deferred tax liability on the hypothetical repatriation. Due to the numerous estimates required to determine a hypothetical tax on repatriation of PRE, and since Eiler and Kutcher (2014) show that firms with more complexity related to PRE are less transparent, we expect that less transparent firms are more likely to receive a PRE-related comment letter. Thus, our fourth hypothesis is:

Hypothesis 4. The likelihood of receiving a PRE-related comment letter is negatively related to disclosure transparency.

3. Research design

We are interested in examining the determinants of receiving a PRE-related comment letter. Thus, we obtain the disclosures and comment letters from a sample of firms that have PRE. Because firms can receive multiple rounds of comment letters for a single filing, for our analyses, we collapse these rounds into one firm-year observation. We use the following model to test our hypotheses:

$$\begin{aligned} Comment = \alpha + \beta_1 PRE/Assets + \beta_2 PRE_Tax + \beta_3 POS\Delta PRE \\ + \beta_4 Transparent + \beta_5 \ln(Assets) + \beta_6 \%\Delta Sales_F + \varepsilon \end{aligned} \quad (1)$$

where *Comment* equals 1 if the firm received a PRE-related comment letter for that fiscal year and 0 otherwise. Since our dependent variable is dichotomous in nature, we use logistic regression to estimate Eq. (1).[3]

Our first hypothesis examines the relation between the likelihood of receiving a PRE-related comment letter and the size of PRE, *PRE/Assets*. Consistent with prior research (e.g., Blouin et al., 2014; Krull, 2004), we deflate PRE by total assets. If firms with large amounts of PRE face greater scrutiny by the SEC, we expect a positive coefficient on *PRE/Assets* ($\beta_1 > 0$).

Our second hypothesis focuses on whether the estimated repatriation tax on PRE, *PRE_Tax*, impacts the likelihood of receiving a PRE-related comment letter. Our measure of *PRE_Tax* depends on whether or not firms disclose a dollar amount of the estimated tax liability on a hypothetical repatriation of PRE. If the tax footnote includes a disclosure of the dollar amount for the unrecorded deferred tax liability, we use the actual disclosed amount. However, not all firms disclose an estimate of the tax liability on PRE. For firms that do not disclose a dollar amount, we estimate the tax on PRE following the approach in Bauman and Shaw (2008). Specifically, *PRE_Tax* is estimated using the three-year cumulative foreign effective tax rate (ETR_F). If ETR_F exceeds 35%, then *PRE_Tax* is set equal to zero for non-disclosing firms. If ETR_F is less than 35%, then *PRE_Tax* is calculated as $[PRE/(1 - ETR_F)] * (0.35 - ETR_F)$. Once we have calculated the hypothetical tax on repatriation of PRE, we deflate this variable by total assets. We expect that as the estimated tax on PRE increases, the likelihood of receiving a PRE-related comment letter increases ($\beta_2 > 0$).

Our third hypothesis focuses on whether the potential for earnings management using PRE attracts more scrutiny from the SEC. We examine the relation between the likelihood of receiving a PRE-related comment letter and changes in PRE. Specifically, we create an indicator variable equal to one if PRE increased (*POSΔPRE*) from the prior year. Because firms avoid recognizing a deferred tax liability on earnings designated as permanently reinvested, we argue that firms with increasing amounts of PRE attract more scrutiny from the SEC. Thus, we predict a positive relation between the likelihood of receiving a comment letter and *POSΔPRE* ($\beta_3 > 0$).

Our fourth hypothesis examines whether transparency in the tax disclosure related to PRE reduces the likelihood of receiving a PRE-related comment letter. Following Eiler and Kutcher (2014), we code *Transparent* equal to one if the 10-K disclosure provides a dollar amount of the estimated tax on PRE or if it states this amount would be zero. *Transparent* is equal to zero if the 10-K disclosure states that estimating the hypothetical tax on PRE is "not practicable" or if no information is provided about the estimated tax on PRE. We expect that as the tax disclosures about PRE become more transparent, the likelihood of receiving a PRE-related comment letter decreases ($\beta_4 < 0$).

Eiler and Kutcher (2014) show that disclosure transparency is inversely related to the complexity of the tax calculation. We do not expect complexity of the tax calculation to be related to the likelihood of receiving a PRE-related comment letter because the SEC's utmost concern is with the transparency of disclosures about PRE and the related hypothetical tax, regardless of the internal challenges managers face in calculating the hypothetical tax related to PRE. However, to address concerns related to potential correlated omitted variables, we examine the three measures of complexity of the tax calculation from Eiler and Kutcher (2014). The first variable, *PRE*, is already included in our analysis to test our first hypothesis. We conduct a sensitivity analysis on the remaining two variables, an indicator variable for low foreign ETR and

[2] Foreign tax credits can be used to offset some or all of the potential tax liability on repatriation of PRE. Additionally, firms that never repatriate their foreign earnings will not incur any US tax on those earnings.

[3] As discussed in greater detail below, we also estimate Eq. (1) based on high versus low amounts of PRE.

Table 1
Variable definitions.

Dependent variable	
Comment	Equals 1 if the company received a PRE-related comment letter from the SEC, and 0 otherwise. *Comment* is based on the fiscal year of the filing under review. Source: EDGAR
Independent variables	
PRE	Permanently reinvested earnings collected from the tax footnote, divided by total assets. Source: 10-K filing
PRE_Tax	The estimated tax liability on *PRE* divided by total assets. This amount is obtained from the 10-K for disclosing firms. For non-disclosing firms, *PRE_Tax* is estimated using the three-year cumulative foreign effective tax rate (ETR_F). If ETR_F exceeds 35%, then *PRE_Tax* is set equal to zero for non-disclosing firms. If ETR_F is less than 35%, then *PRE_Tax* is calculated as $[PRE/(1-ETR_F)]*(0.35-ETR_F)$
POSΔPRE	Equals 1 if $PRE_t - PRE_{t-1}$ is greater than zero, and 0 otherwise
Transparent	Equals 1 if there is an estimate of the unrecognized deferred tax liability on PRE or if the disclosed estimate of the tax liability on PRE is zero, and 0 if it states it is not practicable to estimate the tax on PRE or no information is provided about the unrecognized deferred tax liability. Source: 10-K filing
ln(Assets)	Natural log of total assets. Source: Compustat
$\%\Delta Sales_F$	The percentage change in foreign sales from year $t-1$ to year t. Source: Compustat
Variables in additional analysis	
BigPRE	Equals 1 if PRE is greater than or equal to $500 million, and 0 otherwise
Low_Cash	Equals 1 if observation is in the lowest quintile of cash deflated by total assets, and 0 otherwise

an indicator variable for large book-tax differences, and find they are not significantly different from zero when included in Eq. (1).

We include two additional control variables in our analysis. The first variable, *ln(Assets)*, is included to capture firm size. Consistent with prior research such as Blouin et al. (2014), Cassell et al. (2013), and Kubick, Lynch, Mayberry, and Omer (2016), we expect that larger firms attract more scrutiny from the SEC ($\beta_5 > 0$).[4] Finally, we control for the percentage change in foreign sales, $\%\Delta Sales_F$. We expect that as foreign sales grow by a larger amount over the prior year, the SEC is more likely to issue a comment letter ($\beta_6 > 0$).

Table 1 provides a summary of our variable definitions and calculations.

4. Sample selection and results

We construct our sample by first identifying firms with PRE. We use a text analysis search of 10-K filings to identify firms with variations on the phrases "permanently reinvested", "indefinitely reinvested", "undistributed earnings", and "unremitted earnings". Next, we read each 10-K to determine the amount of PRE and the related tax disclosure. We initially identify 3208 firm-years that report positive PRE from 2004 to 2013. After identifying necessary data, we have a final sample of 2891 firm-year observations. Panel A of Table 2 describes the various data requirements. Panel B of Table 2 provides the industry composition of our sample. The largest industries represented in our sample are manufacturing (29%) and business equipment (30%).

We next identify whether our sample firms received a PRE-related comment letter. Specifically, we first determine if any correspondence took place between the SEC and the firm. Next, we search each comment letter using the same phrases noted above. Of our 2891 firm-years, we find that 120 received a PRE-related comment letter. As shown in Panel C of Table 2, most of the comment letters generated occurred in the later years of our sample. Specifically, of the 120 firm-years with PRE-related comment letters, 91% of those letters related to fiscal years 2010–2013.[5]

In untabulated analyses, we note that the SEC raised a variety of issues for our sample of comment letters. For example, 80% were asked about their liquidity position as a result of having PRE. This often resulted in the registrant responding in the comment letter response or in a subsequent filing with the amount of foreign cash. Thirty percent of comment letters requested additional information on the reason for the PRE designation. That is, the SEC asked these registrants to justify the indefinite reinvestment assumption. The most common responses were that foreign earnings were needed for foreign acquisitions, foreign growth, and/or

Table 2
Sample description.

Panel A: Sample selection	
Observations with positive PRE identified using 10-K Wizard text search in the 10-K	3208
Observations with insufficient Compustat data	(4)
Observations with insufficient segment data	(162)
Observations without data to calculate estimated tax on PRE	(85)
Observations without data to calculate the change in PRE	(66)
Observations with all required data available	2891

Panel B: Industry composition	Frequency	Percent
Consumer non-durables	245	8.47
Consumer durables	123	4.25
Manufacturing	845	29.23
Oil, gas, and coal extraction and products	98	3.39
Business equipment	865	29.92
Telephone and television transmission	20	0.69
Wholesale, retail, and some services	149	5.15
Health	262	9.06
Utilities	1	0.03
Other	283	9.79
Total	2891	100.00

Panel C: Sample distribution by year

		Comment letter	
Year	*N*	Yes	No
2004	295	1	294
2005	309	0	309
2006	316	0	316
2007	299	2	297
2008	290	2	288
2009	288	6	282
2010	280	57	223
2011	277	22	255
2012	274	22	252
2013	263	8	255
Total	2891	120	2771

[4] Cassell et al. (2013) show that lower profitability, higher complexity, and employing a non-Big 4 auditor are positively associated with receiving a comment letter for any reason. Since our analysis focuses on firms that have PRE, we have a relatively homogenous set of firms. For example, because our firms have PRE, by definition all of our firms have foreign operations (a common measure to capture complexity). Additionally, 95% of firms in our sample are audited by a Big 4 auditor.

[5] Due to the frequency of observations occurring later in the time period examined, we conduct a sensitivity analysis focusing on the 2010 to 2013 time period. The inferences related to our hypotheses remain unchanged, except for Hypothesis 1. In Table 5, we find the coefficient on PRE/Assets is marginally significant; however, in this post-2009 analysis, we find the coefficient on PRE/Assets is not significantly different from zero.

Table 3
Descriptive statistics.

Panel A: Descriptive statistics for the full sample ($N = 2891$)

Variable	Mean	SD	P25	Median	P75
PRE/Assets	0.17	0.16	0.06	0.13	0.24
PRE_Tax	0.03	0.04	0.00	0.01	0.04
POSΔPRE	0.77	0.42	1.00	1.00	1.00
Transparent	0.16	0.37	0.00	0.00	0.00
ln(Assets)	8.26	1.88	7.01	8.17	9.59
%ΔSales$_F$	0.21	4.49	−0.01	0.09	0.20
BigPRE	0.48	0.50	0.00	0.00	1.00

Panel B: Means of independent variables by comment letter samples

	Comment = 1 ($N = 120$)	Comment = 0 ($N = 2771$)	*p*-value for test of difference in means
PRE/Assets	0.218	0.170	0.001
PRE_Tax	0.041	0.026	0.000
POSΔPRE	0.833	0.768	0.095
Transparent	0.117	0.165	0.158
ln(Assets)	8.889	8.234	0.000
%ΔSales$_F$	0.130	0.210	0.847
BigPRE	0.608	0.474	0.004

Table 5
Determinants of receiving a PRE-related comment letter.

	Predicted sign	(1) Full sample	(2) *BigPRE* = 0	(3) *BigPRE* = 1
PRE/Assets	+	−1.313	1.676	−3.062
		(0.076)	(0.117)	(0.009)
PRE_Tax	+	7.399	−6.359	14.820
		(0.022)	(0.147)	(0.001)
POSΔPRE	+	0.130	−0.011	0.494
		(0.320)	(0.488)	(0.144)
Transparent	−	−0.625	−0.225	−0.969
		(0.038)	(0.372)	(0.005)
ln(Assets)	+	0.146	0.179	0.228
		(0.003)	(0.110)	(0.008)
%ΔSales$_F$	+	−0.001	−0.001	−0.093
		(0.467)	(0.423)	(0.450)
Constant		−6.857	−6.445	−6.177
		(0.000)	(0.000)	(0.000)
Year fixed effects?		Yes	Yes	Yes
Observations		2266	1116	897
Pseudo R-squared		0.184	0.139	0.189

p-values based on robust standard errors (clustered by firm) are reported in parentheses and are one-tailed when there is a predicted sign and two-tailed otherwise. All variables as defined in Table 1.

foreign working capital needs. Surprisingly, six firms stated that foreign earnings were indefinitely reinvested because of the tax consequences associated with remittance of foreign earnings. The last common inquiry related to the foreign ETR with 23% of our sample being asked for additional detail. These inquiries revolved around the location and components of foreign taxes in the ETR reconciliation table.

Table 3 provides descriptive statistics for our sample in total. PRE is approximately 17% of total assets for the full sample. As reported in Panel A, the estimated tax on hypothetical repatriation of PRE is 3% of assets on average. Seventy-seven percent of observations in the sample involve years where PRE increased from the prior year (*POSΔPRE* = 1).

Panel B provides the means of our variables of interest for firms that received a comment letter (*Comment* = 1) and those that did not receive a comment letter (*Comment* = 0), and provides univariate tests of our hypotheses. We hypothesize that the likelihood of receiving a PRE-related comment letter is increasing in the size of PRE, the hypothetical tax on PRE, and increases in PRE. The results reported in Panel B of Table 3 are consistent with hypotheses 1 and 2 that the size of PRE and the hypothetical tax on PRE are larger for firms receiving a PRE-related comment letter (*p*-values < 0.01). For our third hypothesis, a larger percentage of firms that receive a PRE-related comment letter have an increase in PRE; however it is only marginally statistically significant (*p*-value = 0.095). Additionally, while we find a smaller percentage of firms that receive a PRE-related comment letter are transparent (consistent with Hypothesis 4), this is not statistically significant (*p*-value = 0.158). Overall, the univariate results reported in Table 3 provide mixed evidence to support our hypotheses.

Table 4 reports Pearson (Spearman) correlation coefficients for the full sample. On average, the correlation coefficients are consistent with the results reported in Table 3. Specifically, *PRE/Assets* and *PRE_Tax* are positively correlated with our dependent variable, *Comment* (*p*-values < 0.01). While *POSΔPRE* is positively correlated with *Comment* and *Transparent* is negatively correlated with *Comment,* they are not significantly different from zero.

Table 5 reports coefficient estimates and *p*-values from our primary regression analysis. As reported in Panel C of Table 3, we did not identify any firms that received a PRE-related comment letter in 2005 or 2006. As a result, our regressions are based on 2266 observations. The first column provides results for our base model and provides support for two of our four hypotheses. Specifically, contrary to our first hypothesis that the likelihood of receiving a PRE-related comment letter is positively related to the size of PRE, the coefficient on *PRE/Assets* is negative and marginally significant (*p*-value = 0.076), However, the coefficient on *PRE_Tax* is positive and significant (*p*-value = 0.022), consistent with our hypothesis that as the size of the hypothetical tax on repatriation of PRE increases, firms are more likely to receive a PRE-related comment letter. Inconsistent with our third hypothesis that firms with increases in PRE are more likely to receive a PRE-related comment letter, the coefficient on *POSΔPRE* is positive but not significant (*p*-value = 0.320). Finally, the coefficient on *Transparent* is negative and significant (*p*-value = 0.038). This result supports our fourth hypothesis and suggests that firms with more transparent disclosures about PRE are less likely to receive a PRE-related comment letter. We also find a positive and significant coefficient on *ln(Assets)* (*p*-value = 0.003), suggesting that larger firms are more likely to receive a PRE-related comment letter.

We expect it is possible that the SEC may utilize different methodologies to determine which firms to issue PRE-related comment letters

Table 4
Correlation matrix ($N = 2891$).

Spearman (upper) Pearson (lower) correlation matrix

	Comment	*BigPRE*	*PRE/Assets*	*PRE_Tax*	*POSΔPRE*	*Transparent*	*ln(Assets)*	*%ΔSales$_F$*
Comment		**0.054**	**0.072**	**0.079**	*0.031*	−0.026	**0.066**	0.013
BigPRE	**0.054**		**0.435**	**0.373**	**0.123**	**0.071**	**0.746**	**−0.084**
PRE/Assets	**0.062**	**0.397**		**0.644**	**0.264**	***−0.038***	**0.104**	**−0.121**
PRE_Tax	**0.076**	**0.361**	**0.769**		**0.272**	**0.142**	**0.194**	−0.011
POSΔPRE	*0.031*	**0.123**	**0.198**	**0.203**		−0.006	**0.052**	**0.152**
Transparent	−0.026	**0.071**	**−0.057**	**0.083**	−0.006		**0.128**	−0.006
ln(Assets)	**0.069**	**0.702**	**0.064**	**0.123**	**0.061**	**0.132**		**−0.049**
%ΔSales$_F$	−0.004	−0.025	−0.028	−0.017	−0.025	−0.010	−0.003	

All variables are as defined in Table 1. Bold correlation coefficients indicate significance with a *p*-value of less than 0.01. Correlation coefficients in bold and italics (italics only) indicate significance with a *p*-value of less than 0.05 (0.10).

based on the size of PRE. Given the increased scrutiny into firms with high amounts of PRE, we code the variable *BigPRE* equal to one if PRE is greater than or equal to $500 million, and zero otherwise.[6] Column (2) reports results for firms with smaller amounts of PRE (i.e., $BigPRE = 0$) while column (3) reports results for firms with the largest amounts of PRE (i.e., $BigPRE = 1$).

The results in column (2) do not support any of our hypotheses. For firms with the smallest amount of PRE, the coefficients on *PRE/Assets*, *PRE_Tax*, *POSΔPRE*, and *Transparent* are not significantly different from zero. For firms with the largest amount of PRE, our results presented in column (3) provide evidence consistent with that presented in column (1). One interesting result in column (3) is that firms with the largest amounts of PRE are less likely to receive a PRE-related comment letter as the size of PRE increases (p-value = 0.009). This result is surprising and contrary to Hypothesis 1.

One interpretation of the results in column (3) is that for firms with the greatest amount of PRE, the SEC is less concerned about the size of PRE, since all of these firms have substantial amounts of PRE. That is, once a firm has large amounts of PRE, the SEC uses other benchmarks to determine whether or not to issue a PRE-related comment letter. Specifically, as the size of the hypothetical tax on repatriation of PRE increases, the SEC is more likely to issue a PRE-related comment letter. Thus, for firms with large amounts of PRE, the magnitude of the tax on PRE is one of the main determinants of the SEC's decision to issue a PRE-related comment letter. Finally, firms with the largest amounts of PRE can reduce the likelihood of receiving a PRE-related comment letter by providing more transparent disclosures. Thus, less transparent disclosures bear the cost of increased SEC scrutiny.

As noted above, a common issue brought up by the SEC in their PRE-related comment letters related to liquidity information, suggesting that PRE and foreign cash are inexplicably intertwined. That is, as PRE grows, foreign cash balances may also grow. To the extent PRE is invested in operating assets, it could result in a reduction in foreign cash. On the other hand, a firm with PRE invested in financial assets and limited domestic cash could face domestic liquidity issues. Given anecdotal evidence of the SEC's concerns about liquidity for multinationals with large amounts of PRE (Deloitte, 2015), we include an additional analysis to examine whether cash-constraints affect the likelihood of receiving a PRE-related comment letter. In particular, as the estimated tax on a hypothetical repatriation of PRE increases, firms may be constrained in their ability to pay this tax. As a result, cash-constrained firms facing high potential repatriation taxes are likely to garner the attention of the SEC. Therefore, we supplement Eq. (1) with an interaction term that captures cash-constraints and *PRE_Tax*. Our measure of cash-constraints, *Low_Cash*, is an indicator variable equal to 1 for observations in the lowest quintile of cash deflated by total assets and 0 otherwise. Table 6 presents the results of this analysis. Column 1 restates the regression results from Eq. (1) initially presented in Table 5. Column 2 includes the *Low_Cash* indicator variable and column 3 includes the interaction term between *Low_Cash* and *PRE_Tax*. The interaction term is positive and significant, indicating that cash-constrained firms with a high estimated tax associated with PRE are more likely to receive a PRE-related comment letter. This is consistent with the SEC seeking additional information from firms whose liquidity may be of concern.

[6] We choose $500 million as our cutoff based on legislation under the America Jobs Creation Act (hereafter AJCA) that provided a one-time tax holiday on repatriations of foreign earnings. Specifically, the AJCA allowed US multinationals to repatriate foreign earnings using a one-time 85% dividends received deduction, resulting in an effective US tax rate of 5.25%. Additional restrictions required the dividend be "extraordinary" by exceeding dividends paid during a base period. The amount of eligible dividends was further limited to the greater of (1) $500 million, (2) the amount of earnings reported on the most recent financial statements as permanently reinvested, or (3) if permanently reinvested earnings were not disclosed on the most recent financial statements, but a tax liability on those earnings was disclosed, the amount of that tax liability divided by 0.35.

Table 6
Effect of cash holdings on determinants of receiving a PRE-related comment letter.

	Predicted sign	(1)	(2)	(3)
PRE/Assets	+	−1.313	−1.286	−1.308
		(0.076)	(0.080)	(0.079)
PRE_Tax	+	7.399	7.014	6.078
		(0.022)	(0.028)	(0.057)
POSΔPRE	+	0.130	0.118	0.143
		(0.320)	(0.337)	(0.307)
Transparent	−	−0.625	−0.618	−0.627
		(0.038)	(0.040)	(0.037)
ln(Assets)	+	0.146	0.150	0.155
		(0.003)	(0.003)	(0.002)
$\%\Delta Sales_F$	+	−0.001	−0.0002	0.002
		(0.467)	(0.495)	(0.421)
Low_Cash	?		−0.220	−0.483
			(0.455)	(0.169)
*Low_Cash*PRE_Tax*	?			9.915
				(0.065)
Constant		−6.857	−6.831	−6.854
		(0.000)	(0.000)	(0.000)
Year fixed effects?		Yes	Yes	Yes
Observations		2266	2266	2266
Pseudo R-squared		0.184	0.184	0.187

p-values based on robust standard errors (clustered by firm) are reported in parentheses and are one-tailed when there is a predicted sign and two-tailed otherwise. All variables as defined in Table 1.

5. Conclusion

In this paper, we examine how PRE and disclosure transparency surrounding PRE influences external monitoring from the Securities and Exchange Commission (SEC). Specifically, for firms with PRE, we examine the determinants of receiving a PRE-related comment letter from the SEC. While prior research such as Cassell et al. (2013) has examined the determinants of receiving an SEC comment letter, little research has been conducted on SEC comment letters specifically related to tax disclosures. Kubick et al. (2016) find that firms with greater tax avoidance are more likely to receive an SEC comment letter and that these firms subsequently reduce their levels of tax avoidance. Prior research of Krull (2004) demonstrates that managers use PRE to manage earnings to meet a benchmark. Furthermore, Eiler and Kutcher (2014) find that managers exercise discretion in their disclosure transparency related to the unrecognized deferred tax liability on hypothetical repatriations of PRE. Thus, managers utilize flexibility in their disclosures decisions surrounding PRE to meet earnings benchmarks and reduce transparency.

We hypothesize that firms with larger amounts of PRE, larger estimated hypothetical tax on PRE repatriation, increases in PRE, and less transparent disclosures related to the unrecognized tax on PRE are more likely to receive a PRE-related comment letter. We find that the likelihood of receiving a PRE-related comment letter is increasing in the size of the estimated hypothetical tax on PRE repatriation and decreasing in the transparency of the disclosures related to the tax on PRE. While we find that these results exist on average, they are strongest for firms with the largest amounts of PRE. We also examine the impact of cash-constraints on the likelihood of receiving a PRE-related comment letter. We find that cash-constrained firms with a large estimated hypothetical tax due on repatriation are more likely to receive a PRE-related comment letter. This is consistent with anecdotal evidence suggesting the SEC is concerned about whether firms have liquidity issues related to PRE. Those liquidity issues could arise because foreign cash is tied up in foreign assets and thus not accessible, or liquidity concerns could result from the potential lack of sufficient cash available to cover the US tax upon repatriation in the event PRE are needed for domestic operations. Overall, our research suggests that the implications of PRE to legislators extend beyond concerns of tax avoidance and include potential liquidity issues for firms with PRE.

References

American Institute of Certified Public Accountants (AICPA) (1972,). Accounting for income taxes—Special areas. *Opinions of the Accounting Principles Board No. 23. (April)*. New York, NY: AICPA.

Bank of America Merrill Lynch (2014). "Indefinite reinvestment": An accounting election with a big impact. Available at http://corp.bankofamerica.com

Bauman, M. P., & Shaw, K. W. (2008). The usefulness of disclosures on untaxed foreign earnings in firm valuation. *Journal of the American Tax Association*, *30*(2), 53–77.

Blouin, J. L., Krull, L. K., & Robinson, L. A. (2014). The location, composition, and investment implications of permanently reinvested earnings. *Working paper*. University of Pennsylvania, University of Oregon, and Dartmouth College.

Boone, J. P., Linthicum, C. L., & Poe, A. (2013). Characteristics of accounting standards and SEC review comments. *Accounting Horizons*, *27*(4), 711–736.

Bozanic, Z., Dietrich, J. R., & Johnson, B. A. (2015). *The SEC comment letter process and firm disclosure*. Working paper: The Ohio State University.

Bryant-Kutcher, L., Eiler, L., & Guenther, D. A. (2008). Taxes and financial assets: Valuing permanently reinvested foreign earnings. *National Tax Journal*, *61*(4), 699–720.

Cassell, C. A., Dreher, L. M., & Myers, L. A. (2013). Reviewing the SEC's review process: 10-K comment letters and the cost of remediation. *The Accounting Review*, *88*(6), 1875–1908.

Citizens for Tax Justice (2015). $2.1 trillion in corporate profits held offshore: A comparison of international tax proposals. Available at: http://ctj.org

Collins, J. H., Hand, J. R. M., & Shackelford, D. A. (2001). Valuing deferral: The effect of permanently reinvested foreign earnings on stock prices. In J. R. (Ed.), *International taxation and multinational activity*. Chicago: University of Chicago Press.

Deloitte (2015, October). *SEC comment letters — Including industry insights*. Deloitte Foundation LLC.

Eiler, L., & Kutcher, L. (2014). Disclosure decisions surrounding permanently reinvested foreign earnings. *Journal of the American Tax Association*, *36*(2), 101–116.

Heller, M. (2015). Corporate cash hoard hits a record $1.73 trillion. Available at: http://cfo.com

Johnston, R., & Petacchi, R. (2014). Regulatory oversight of financial reporting: Securities and Exchange Commission comment letters. *Working paper*. Rice University and MIT.

Krull, L. K. (2004). Permanently reinvested foreign earnings, taxes, and earnings management. *Accounting Review*, *79*(3), 745–767.

Kubick, T. R., Lynch, D. P., Mayberry, M. A., & Omer, T. C. (2016). The effects of regulatory scrutiny on tax avoidance: An examination of SEC comment letters. *The Accounting Review*. http://dx.doi.org/10.2308/accr-51433 (in press).

Schultz, T. D., & Fogarty, T. J. (2009). The fleeting nature of permanent reinvestment: Accounting for the undistributed earnings of foreign subsidiaries. *Advances in Accounting*, *25*, 112–123.

U.S. Senate (2012, September 20). *Permanent Subcommittee on Investigations. offshore profit shifting and the U.S. tax code—Part 1 (Microsoft and Hewlett-Packard), hearing.*

U.S. Senate (2013, May 21). *Permanent Subcommittee on Investigations. Offshore profit shifting and the U.S. tax code—Part 2 (Apple Inc.), hearing.*