U.S. CORPORATE CAPITAL EXPENDITURES: CONSCIOUSLY UNCOUPLED FROM FEDERAL TAX INCENTIVES

Bloomberg BNA

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INTRODUCTION

The United States' gross domestic product (GDP) rose by between three and four percent in the last two quarters of 2013, leading many analysts to conclude the nation's economy was, finally, in a recovery from the 2008 recession.

Despite positive indicators, many companies remained conservative spenders. According to Moody's Investors Service, U.S. organizations outside of the finance industry held more than $1.64 trillion in cash reserves by the end of 2013, an historic high and an increase of 12 percent from the year before[1]. Consequently, economists and analysts began to deem 2014 the start of a corporate spending spree, given the cash piles still sitting on balance sheets, rising capacity utilization and aging private assets[2].

The end of 2013, however, also marked the end of an important tax incentive intended to spur business investment. On December 31, 2013, bonus depreciation, a provision that allowed organizations to deduct half the cost of new capital purchases within the first year expired.

In addition, a smaller benefit for smaller businesses was also cut. Expanded expensing levels under Section 179 of the Internal Revenue Code (IRC) fell from $500,000 in first year taxable income on up to $2 million of purchased equipment, to $25,000 on $200,000 worth of purchases.

Bloomberg BNA, provider of expert software for tax and accounting professionals, conducted a roundtable of 100 tax and accounting leaders at firms with average revenues of $7.5 billion to understand how U.S. businesses' capital investment has changed in the years since the recession, and to what degree changes in tax policy actually affect financial decision making at large companies.

SOME OF THEIR KEY FINDINGS:

- 83% of respondents said that the expiration of Section 179 expanded expensing and bonus depreciation has not impacted their organizations' capital expenditures this year.
  - **Implications:** Bonus depreciation and Section 179 expensing, while welcomed by the business community, is not viewed by a majority of that same community as an economic stimulus that drives business decisions.
- By the end of FY 2014, only 37% of respondents expect their organizations' capital expenditures to increase.
  - **Implications:** Companies will continue to hoard cash, skeptical of the market's recent improvements.
- 30% of respondents believe that the current tax policy climate inhibits their firms' willingness to make capital expenditures.
  - **Implications:** Concurrent with the finding that most organizations' capital expenditures haven't been affected by the expiration of bonus depreciation and Section 179 expanded expensing, only a minority of the business community feels that tax policy changes could impact their willingness to invest. Ironically, the tax policies most closely aligned to capital expenditures don't seem to be the ones that would impact businesses.

As Congress continues to debate the future of bonus depreciation and other recently expired tax provisions – most notably through proposed "tax extenders" legislation – the impact these of policies on U.S. businesses, and their investment strategies, remains just as contentious.

From these and another third party analysis, found in a study titled: Bonus Depreciation: Economic and Budgetary Issues, Congressional Research Service, it appears that companies' capital expenditures are largely immune to changes to corporate tax policy in the U.S. tax code. While the revival of bonus depreciation and other tax incentives may leave the House and Senate divided, the corporate world seems united in its collective skepticism of the usefulness of these tax breaks.

TRENDS IN CAPITAL EXPENDITURES

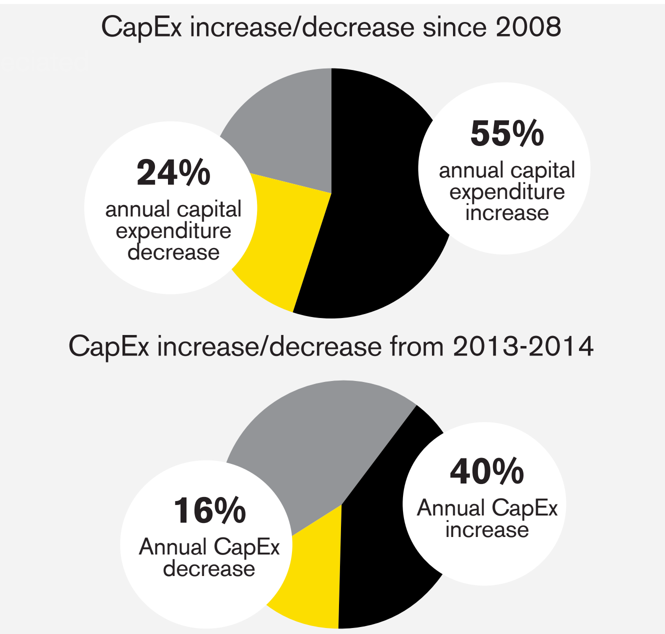
Now six years removed from the 2008 recession, the United States' economy is by any measure in recovery. In June 2014, the federal unemployment rate fell to 6.1%, its lowest since September 2008[3]. At the end of 2013, consumer spending was its highest – $96 dollars per day according to Gallup – since the fall of 2008[4]. Despite a rocky 2013 winter, the Federal Reserve still projects the U.S. economy to grow by approximately 2 percent through the remainder of 2014, and 3 percent in 2015[5].

These optimistic indicators aside, corporate capital expenditures remain underwhelming.

UNDERWHELMING INVESTMENTS IN POST-RECESSION DAYS

Slightly more than half of survey respondents (55%) claim their organizations' annual capital expenditures have increased since the recession, and less than a quarter (24%) have decreased.

This contrast was even more pronounced last year, in which three times as many respondents said that their firms increased versus decreased capital spending (40% v. 16%).



An important comparison to make, especially within the context of tax policy and depreciation incentives, is between asset intensive and non-asset intensive firms.

Asset intensive companies, defined by Bloomberg BNA for this report as organizations in which at least a quarter of all assets are fixed assets, were almost twice as likely to have seen an increase in capital expenditures over the past year than non-asset intensive firms (49% v. 29%). Non-asset intensive companies, in fact, were almost twice as likely to have seen investments decrease over the past year (21% v. 11%).

FY 2014: SLIGHT OPTIMISM OR STATUS QUO?

When asked about the remainder of this fiscal year, most tax and accounting leaders are not betting on a last minute uptick in capital expenditures.

Fifty-one percent of respondents expect their firms' capital investments to remain the same throughout FY 2014, with slightly more than one-third (37%) expecting an increase. This is still more than four times the number of professionals bracing for investments to decline, which was 9 percent.

Both asset intensive companies and companies with a significant amount of depreciable fixed assets on hand are optimistic about capital expenditures rising by the end of FY 2014, suggesting that the expiration of expanded expensing and bonus depreciation (as well as the uncertainty of their renewal) aren't stifling investment plans in the short-term.

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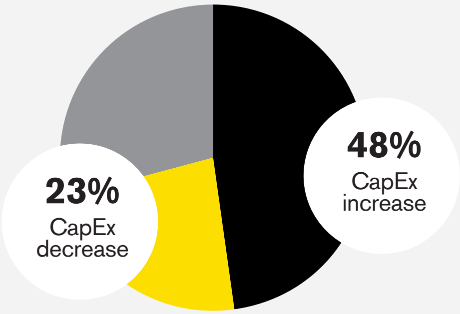
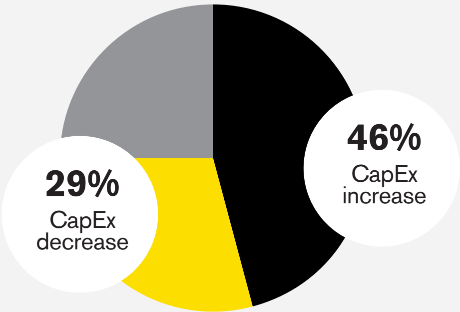
Depreciable asset intensive firms are more than twice as likely to believe that their firms' CapEx will increase by the end of the fiscal year, compared to non-depreciable AI firms (48% v. 23%)



Asset intensive companies are more likely to expect their firms' CapEx to increase by the end of FY2014 (46% v. 29%)



While economic analysts may feel that U.S. companies' recent investment behavior has left something to be desired, only 31 percent of tax and accounting professionals feel that their firms' capital expenditures should be greater than they currently stand. Respondents from asset intensive companies (38%) were more than twice as likely to believe that capital expenditures should be greater, compared to their counterparts at non-asset intensive companies (18%.)

Along those lines, around one-third of surveyed professionals (34%) agree that their organizations have more cash on hand than normal. Representatives from non-asset intensive firms were much more likely to hold this opinion, with 45 percent responding that their cash levels are above average.

Overwhelmingly, survey participants' responses reveal that what many have considered to be an anemic period for capital investment could instead be the new normal. More moderation in capital spending presents both short-term benefits and long-term challenges. Rather than fuel capital expenditures, some businesses may dedicate current cash reserves to paying dividends and buying back stock shares. This particular tactic has increased stock value for a number of organizations, Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, noted earlier this year.[6]

At the same time, failing to invest in new facilities and equipment may stifle businesses in terms of innovation, production and, consequently, competition. As Laurence Fink, Chairman and CEO of global investment management firm BlackRock, Inc., warned in a March 2014 open letter to leaders of companies in Standard & Poor's 500 index:

"Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy … when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns."[7]

As developing economies in Western Europe and Asia ramp up capital investments, U.S. companies that default to slow spending today could likely be first to lose their competitive edge in the global market – with suffering sales and a smaller customer base to show for it.

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POLICY INFLUENCE

For U.S. businesses, December 31, 2013, marked the end of bonus depreciation and, simultaneously, a sharp reduction in expanded expensing levels under Section 179 of the tax code. More than six months later, it seemed reasonable to find out precisely how businesses are coping in this post-incentive environment and how the changes have impacted corporate investments – if at all.

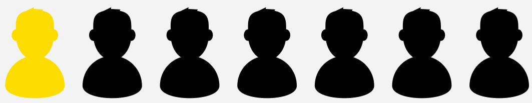
A “NICE TO HAVE,” NOT “NEED TO HAVE”

The majority of survey respondents’ organizations (83%) have historically applied bonus depreciation to qualifying assets.

Despite the widespread use of bonus depreciation, 83 percent of respondents feel that the expiration of both bonus depreciation and expanded expensing have not had an impact on their organizations’ current capital expenditures. Asset intensive firms did report a greater effect: they were twice as likely to believe that the 2013 expirations had reduced investment (19% versus 9%), although this was still the minority view overall.

83%

feel that the expiration of bonus depreciation/expanded expensing has not impacted CapEx



14%

of respondents feel that the expiration of each incentive has affected CapEx

TAX POLICY & CAPITAL EXPENDITURES: FAR FROM MUTUALLY EXCLUSIVE

Diving deeper into the relationship (or lack thereof) between federal tax policy and corporate investments, survey respondents were asked how much more their firms would funnel into capital expenditures if they were able to offset costs through bonus depreciation and expanded expensing.

WHO CARES? (ABOUT TAX POLICY)

Tax and accounting executives and controllers feel that, on average, 50% of their firms’ assets are in use after being fully depreciated. Respondents at the manager and director level report that 44% remain in use.

67% of tax and accounting professionals who don’t feel that depreciation impacts their jobs believe that tax policy has a negligible impact on their firms’ willingness to make capital expenditures, compared to 40% of respondents who feel that their jobs are impacted by depreciation.

55% of respondents at asset-intensive companies feel that their jobs are impacted by change in depreciation regulations, compared to 38% of those at non-asset intensive firms.

Fifty-six percent claim that their firms’ capital expenditures would not increase, even if the tax break reduced their total cost of capital by 10 percent. Interestingly, respondents from asset intensive firms cited that if they could lower their total cost of capital by 10 percent, they would invest five percent more into capital expenditures. By comparison, non-asset intensive firms would only invest two percent more under the same circumstances.

Survey respondents made it clear that capital expenditures stand far outside the overall tax policy’s realm of influence. Only 30 percent of tax and accounting leaders feel that the current U.S. tax policy climate inhibits their firms’ willingness to make capital expenditures. Similarly, nearly half (45%) believe that the tax policy has a limited impact on investment behaviors.

In retrospect, very few organizations exerted notable effort to make use of bonus depreciation in its final days. Nineteen percent of respondents claim that their firms purposefully invested more in assets that received favorable depreciation treatments in 2013. Moving forward, **only 10 percent of corporate tax and accounting leaders believe that the expiration of bonus depreciation and expanded expensing will reduce their companies’ capital expenditures in 2014.**

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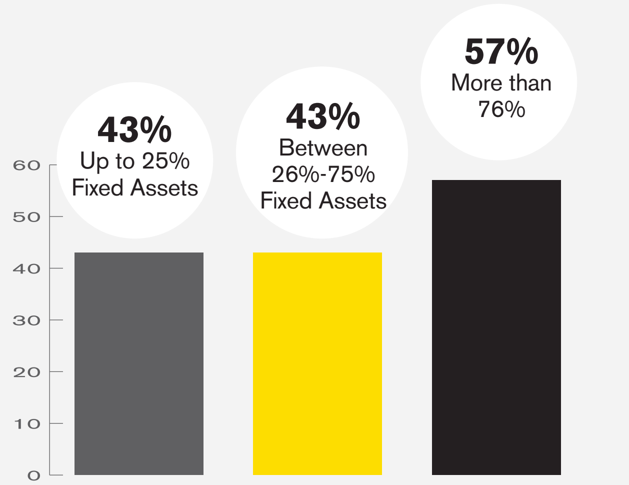
LOOKING AHEAD

As Congress continues to debate the merits of bonus and accelerated depreciation, it's clear many firms are disinterested in the proceedings. In a recovering economy, nothing Congress does seems to have any impact on how firms choose to depreciate their assets. It does seem, however, that executives are dutifully concerned about earning a return on assets beyond their useful lives.

Indeed, a large number of companies are keeping assets in service well beyond the IRS's definition of "Useful Life." 34 percent of respondents said that over half of their companies' assets are used after being fully depreciated. Congress might consider slowing down the cost of recovery or depreciation of certain fixed assets to better match their actual lifetimes.

Firms that are classified by the software segment of Bloomberg BNA as "asset intensive" are even more likely to keep assets in play long after they've depreciated entirely. Perhaps firms that rely heavily on fixed assets know full well the true useful lives of their investments and keep them in play correspondingly longer.

THE MORE ASSET-INTENSIVE A FIRM, THE MORE ASSETS ARE STILL IN USE AFTER BEING FULLY DEPRECIATED



TOMORROW'S CHALLENGES: MISCALCULATIONS AND MORE AUDITS

That firms are maintaining assets beyond their useful lives belies another important fact: executives believe their accounting departments are incorrectly depreciating a sizeable portion of their fixed assets.

One-third (32%) of companies feel that 1-10% of their companies' assets are not depreciated correctly. On average, tax and accounting leaders feel that almost six percent of their companies' assets are not depreciated correctly.

To illustrate the potential scope of this problem, in the tax year 2011, the IRS reported that active corporations held more than $10 trillion in depreciable assets[8]. If six percent of those assets are depreciated incorrectly, roughly $600 billion in assets are vulnerable to improper accounting practices.

Finally, especially among firms with more assets, there appears to be a sense of foreboding over auditor scrutiny. Thirty-nine percent of respondents feel that auditor scrutiny has increased around their firms' accounting of capital assets. Understandably, 42% of asset intensive firms share this concern, compared to 32% of non-asset intensive companies.

This appears in keeping with the Obama Administration's reticence to raise taxes, while promising to expand the tax base by removing a variety of benefits, loopholes and deductions.

CONCLUSION

Through a survey of 100 tax and accounting leaders at U.S. businesses with revenues of $500 million and above, Bloomberg BNA discovered that corporate America operates under a veil of conscious uncoupling where tax policy and capital expenditures are concerned.

While other economic indicators have crept up into the green in the years since the Recession, capital expenditure levels remain relatively low. According to tax and accounting professionals, this is no cause for alarm. With less than a third of respondents wishing their firms' investments were higher, businesses are not rushing into spending sprees anytime soon. Yesterday's sluggishness is becoming today's standard.

It would be incorrect, however, to attribute slow-moving investment levels to tax policy. Survey respondents expressed that while incentives such as bonus depreciation are useful, they're not critical. For that reason, the expiration of these breaks has left large U.S. businesses unfazed, and relatively indifferent toward Congress's push for extensions.

These findings echo a theme supported by a variety of recent analyses claiming bonus depreciation (and its revival) as an ineffective economic stimulus. Congressional Research Service reports from July 2013[9] and July 2014[10] round up a number of insights suggesting that bonus depreciation has been a less effective stimulus than other temporary tax cuts and spending increases.

If tax policy isn't a top of mind concern for tax and accounting leaders, internal accounting treatments are. Incorrectly depreciated assets add up, even for multimillion dollar revenue corporations. Auditors are turning a more critical eye towards in-house asset accounting and minor errors can result in major consequences.

Rather than become embroiled in the very public, federal fight around the tax extenders legislation, U.S. businesses would be smart to refocus on internal operations. During this continued period of moderate capital expenditures, companies should ensure that the assets they do hold are accounted for appropriately.

METHODOLOGY

In June 2014, the software segment of Bloomberg BNA conducted phone interviews with CFOs, controllers and tax directors of companies whose revenues exceeded $500 million dollars per year. A mix of "asset intensive" and less asset intensive industries were polled by The Blackstone Group. The results were analyzed and reported in July 2014.

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