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## **Recognising deferred tax liabilities in the initial measurement of goodwill**

### **Objective**

1. The objective of this paper is to discuss two issues that arise from recognising deferred tax liabilities (DTLs) in the initial measurement of goodwill and present possible approaches to address these issues. At this stage of the research, this paper does not consider the effects of recognising deferred tax assets as part of goodwill in a business combination.
2. The purpose of the session is to ask EFRAG TEG members whether they agree with the issues and the approaches discussed in this paper, and if so, whether it is something that EFRAG should explore further as part of its work on monitoring the IASB project on Goodwill and Impairment or within its own research project.

### **Note for EFRAG TEG members**

3. In this paper, we examine two issues that arise when DTLs are included in the initial measurement of goodwill. The first issue is the 'day one' impairment when goodwill is tested for impairment immediately after the business combination. The second issue relating to the tracking of the part of goodwill resulting from DTLs.
4. To address the issues, this paper examines four alternative approaches. At this stage, the EFRAG Secretariat would like EFRAG TEG to focus on the advantages and disadvantages of each of the approaches discussed and whether they solve the issues they intend to address.
5. We acknowledge that the mechanics of each approach may need to be further developed to address specific, or more complex scenarios. The interaction with impairment testing would also need to be examined. If there is agreement that the issues are significant in practice and there is tentative support for one or more of the approaches, the EFRAG Secretariat suggests to examine them further for discussion at a future EFRAG TEG meeting.

### **Current projects on goodwill and impairment**

6. Both the IASB and EFRAG are undertaking projects that consider various approaches to the impairment of goodwill.

#### *The IASB's project*

7. The IASB has an active research project that considers improving effectiveness and reducing complexity of the goodwill impairment test in the context of the post-implementation review of IFRS 3 *Business Combinations* (the project or goodwill and impairment project). The biggest challenge lies in achieving an impairment test that is easier for preparers to apply, that is based on a robust model and that provides more relevant information to investors.

*EFRAG research work*

8. EFRAG has a research project to provide input to any future IASB proposals on its goodwill and impairment project. In September 2016, EFRAG published a quantitative study on Goodwill and Impairment that examined the concentration of goodwill and impairments of over 300 European companies over a 10 year period.
9. EFRAG plans to issue a research paper in 2017 that considers some possible approaches to address the subsequent measurement of goodwill as its contribution to the work the IASB is doing on the subject.

**What issues does this paper address?**

10. The EFRAG Secretariat notes that up to now, the primary focus of the IASB's discussions and the EFRAG research work have been on matters relating to the subsequent measurement of goodwill.
11. This paper focuses on issues that arise on the initial measurement of goodwill. The EFRAG Secretariat is of the view that initial measurement is an important aspect of accounting for goodwill which should be considered if the objective is to make the goodwill number more meaningful.
12. There are currently a number of accounting imperfections that potentially obscure the initial measurement of goodwill. In theory, goodwill represents a payment made by an acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. In other words, it should represent future cash flow generation to the acquirer.
13. However, in accounting terms, goodwill includes components such as synergies, intangibles that are not recognised as assets, overpayments, measurement differences (including measurement errors) and the effects of recognising DTLs (and deferred tax assets) as part of goodwill. The first and second component can be justified as properly being part of goodwill as they result from synergies to be gained by the combined entities and identifiable net assets that cannot be recognised under IFRS (such as workforce). The latter three components are more difficult to justify, yet are included in goodwill.
14. This paper focuses only on one of these components – recognising DTLs as part of goodwill- and the issues resulting from this accounting. In summary, the issues discussed in this paper are:
  - (a) Issue 1 – 'Day one' impairment when goodwill is tested for impairment immediately after the business combination; and
  - (b) Issue 2 – Subsequent impairment testing of goodwill resulting from DTLs.
15. These issues are discussed in paragraphs 22 to 37 below.

*Requirements in IFRS Standards*

16. IFRS 3 requires assets acquired and liabilities assumed in a business combination to be measured at their fair value at the acquisition date. IAS 12 *Income Taxes* requires that a deferred tax liability is recognised for all taxable temporary differences, except to the extent that the DTL arises from the initial recognition of an asset or liability. However, this exception does not apply to assets and liabilities acquired in a business combination.
17. A consequence of measuring assets at fair value in a business combination is that it generally results in the recognition of DTLs, and a corresponding increase in goodwill. DTLs arise because some identifiable assets are recognised for the first time in a business combination (such as brands and other intangibles) and increases in the carrying amounts of assets (arising from fair value measurement) are not deductible for tax purposes. Also, under IAS 12, DTLs are not discounted.

*Goodwill – Impact of deferred tax liabilities arising in a business combination*

18. At the date of a business combination, goodwill is determined as the difference between the fair value of the consideration paid and the fair value of the net identifiable assets (including the effects of deferred tax).
19. IAS 36 *Impairment of Assets* allows goodwill to be allocated to either a single cash-generating unit (CGU) or group of CGUs as long as it is not larger than an operating segment as defined by IFRS 8 *Operating Segments*. This means that goodwill can be either allocated to the acquired business, if this represents a separate (single) CGU, or a pre-existing CGU of the acquirer when the acquisition will create synergies from which its pre-existing CGU will benefit.
20. IAS 36 requires a CGU or group of CGUs, to which goodwill has been allocated, to be tested for impairment annually. If some or all of the goodwill allocated to a CGU or group of CGUs was acquired in a business combination during the annual period, that unit must be tested for impairment before the end of the current annual period.
21. IAS 36 also requires that any tax effects are excluded from the estimate of future cash flows used to calculate impairment.

**Issue 1 - 'Day one' impairment**

22. The increase in goodwill, resulting from the recognition of DTLs, together with the impairment requirements under IAS 36, raises the question of whether it creates an immediate 'day one' impairment when goodwill is tested immediately after the business combination.
23. Some respondents advised the IASB during its post-implementation review of IFRS 3 that there are practical difficulties when performing the impairment test on goodwill 'created' by DTLs. They added that although the issue was not directly linked to IFRS 3, it may be useful to address this issue as part of the review. The IASB has so far not considered the issue in its goodwill and impairment project.
24. The issue is illustrated in the example below.

*Example 1 - Fact pattern*

25. On 1 November 2016, Entity A acquires Entity B for €100 million in a transaction that is a business combination. Entity A is taxed at 40%. Entity A has a reporting period as at 31 December 2016. The fair values and tax bases of the identifiable net assets of Entity B are as follows:

	Fair value	Tax base
Trademark	60	nil
Other net assets	20	20

The resulting journal entry is as follows:

	€ million DR	€ million CR
<b>Goodwill</b>	<b>44</b>	
Trademark	60	
Other net assets	20	
DTLs (40% of [(60m+20m) -20m])		24
Cost of the acquisition		100

*Other relevant information*

26. The Trademark is assumed to have a useful life of 10 years. The tax base for the Trademark is zero (meaning that Entity A will not get a tax deduction for tax purposes for the Trademark it acquired in the business combination). Entity A computes the fair value of the Trademark based on the net present value (NPV) of the Trademark. There are no unidentifiable assets. In valuation terms, the NPV is a post-tax number as it considers the discounted net cash flows (including tax) to be derived from the Trademark.
27. A DTL of €24 million arises from the recognition of the Trademark which is recognised in goodwill. Entity A considers the acquired business Entity B to be a single CGU to which it allocates the goodwill for the purpose of impairment testing (Entity B CGU).
28. The fair value of the recognised assets in Entity B CGU is €124 million, but the consideration paid (the cost) is €100 million. This raises the question of whether there should not be an immediate write-down of the assets to €100 million when the entity tests goodwill for impairment immediately after the acquisition.
29. Economically speaking, as no event has taken place that might have affected the entity's enterprise value, no impairment should be recorded. However an impairment test **suggests a 'day one' impairment charge of €24 million**. The amount of the impairment loss corresponds to the DTL recognised in goodwill because, in reality, this portion of goodwill is not backed by future cash flows.
30. Conceptually speaking, one might argue that the portion of goodwill resulting from the DTLs on the date of a business combination has no economic substance, and thus question why it is recognised in the first place. DTLs should reflect liabilities for future income tax payments when the carrying amount of the related asset is recovered, either through use or sale. In example 1, the related asset is the Trademark and not goodwill.
31. In practice, a 'day one' impairment can be avoided. The issue will not arise if the goodwill of **€44 million** was allocated to a pre-existing CGU with a recoverable amount higher than its carrying amount. However, conceptually speaking one should not be 'forced' to make a predetermined allocation simply to avoid an accounting problem.
32. Furthermore, some argue that an immediate write down is unlikely to have been the intention of IAS 36. In their view, the issue can be solved by excluding all tax effects from the CGU to which the goodwill is allocated (Entity B CGU) and reduce the goodwill by the related DTLs in order to test the goodwill for impairment. In this case, a 'day one' impairment would not arise. Supporters of this view argue that this conclusion is consistent with the fact that the goodwill, resulting from the DTLs, that is being recognised as part of the acquisition is a result of a measurement mismatch between IFRS 3 and IAS 36.
33. Neither IFRS 3 nor IAS 36 address impairment created by measurement issues. However IFRS 3 has some exceptions to the basic principle that assets and liabilities be measured at fair value and therefore goodwill will include measurement differences where assets and liabilities are not measured at fair value. Under IFRS 3, deferred tax is measured at its undiscounted amount and not at fair value; which might be significantly lower than the undiscounted amount.
34. Nonetheless, this solution is in conflict with the requirements in IAS 36.

**Issue 2 - Tracking of goodwill 'created' by DTLs**

35. In Example 1, the Trademark is amortised over 10 years resulting in the €24 million DTL being utilised/released to profit or loss over that life.

36. In contrast, if the part of goodwill resulting from the DTL of €24 million is not impaired on the date of the acquisition it will remain in goodwill post-acquisition until it is impaired or derecognised post-acquisition. As explained in paragraph 31, a ‘day one’ impairment will not occur if the goodwill of **€44 million** was allocated to a pre-existing CGU with a recoverable amount higher than its carrying amount.
37. Furthermore, over time, Entity A is likely to ‘lose track’ of the goodwill arising from the acquisition of Entity B, including the related DTL component of €24 million. Similar to issue 1, this raises the question of what the goodwill, resulting from the DTLs on the date of a business combination represents in economic terms.

**Are DTLs significant in a business combination?**

38. The EFRAG Secretariat conducted limited research that focused on a number of European listed companies, in order to understand the potential effects of recognising DTLs in the initial measurement of goodwill.
39. We selected accounting information for all merger/acquisition transactions:
- (a) that occurred between 2008 and 2015;
  - (b) in which the acquiree was located in Europe; and
  - (c) where the total consideration to shareholders was greater than €1 billion.
40. From this list of 207 business combination transactions, the EFRAG Secretariat selected 60 transactions where the acquirer applies IFRS, where the acquiree and acquirer were not related and where the information is publicly available. In 27 of the cases the entity did not provide sufficient detail about DTLs and for this reason were excluded from further analysis.
41. The analysis of the remaining 33 cases provided the following results:
- (a) In 7 cases, the transactions represented bargain purchases or resulted in no (significant) goodwill.
  - (b) In 2 cases, DTLs were recognised for an amount that exceeded the amount of goodwill (on average, the deferred tax liability represented 182% of the goodwill). In these two cases limited goodwill was recognised, resulting in disproportionate amounts of DTLs. However, no reasons were given in the notes for the limited amounts of goodwill.
  - (c) In the remaining 24 cases, DTLs (amounting to € 30.4 billion) were recognised for an amount that **represented an average of 35% of the amount recognised as goodwill** (amounting to € 104.4 billion). The dispersion of the values is presented in the table below:

Range	0-15%	16-30%	31-45%	46-60%	60-100%
# cases	5	8	4	2	5

42. The findings highlight that, in some cases, the amount of DTLs recognised in a business combination results in a significant portion of goodwill.
43. Furthermore, in some cases the amount of recognised goodwill could consist mainly (or solely) of DTLs, particularly in smaller business combination transactions where only a few assets are acquired (including intangible assets) or business combinations involving a strategic asset acquired through a corporate wrapper (single-entity entity), in which the asset could have a significant fair value and a zero tax base. The EFRAG Secretariat notes that the tax base of an asset acquired through a share deal (an entity) might not correspond to its fair value which is used to recognise the asset in the business combination. In contrast, an asset that is

acquired in a separate (asset) transaction could, at least in some European tax regimes, have a tax base equal to the price paid for the asset.

**Questions for EFRAG TEG**

44. Does EFRAG TEG agree that issue 1 and issue 2 as described in paragraphs 22 to 37 are significant in practice?

**Analysis of the different approaches**

45. The 'day one' impairment issue discussed above has been addressed in a study<sup>1</sup> reviewing academic literature. It is also considered in professional literature/accounting manuals published by audit and accounting firms. The main approaches discussed in these publications, to solve issues 1 and 2 discussed above, are:
- (a) Approach 1 – Recognise DTLs as an expense in a business combination;
  - (b) Approach 2 – Do not recognise DTLs in a business combination;
  - (c) Approach 3 – Use fair values that reflect tax effects (gross-up approach); and
  - (d) Approach 4 – Separate recognition of goodwill resulting from DTLs.
46. The EFRAG Secretariat believe that approaches 1-3 will address both issue 1 and issue 2. Approach 4 will mainly address issue 2. The approaches are further discussed below.

*Approach 1 – Recognise DTLs as an expense in a business combination*

47. The first proposal is to recognise DTLs arising in a business combination as an expense on the date of the acquisition.
48. This approach can be characterised as a 'quick fix' solution that has conceptual merit by recognising goodwill only to the extent of its economic substance, and thus would solve (or avoid) issue 1 and issue 2 discussed earlier in this paper.
49. However the main disadvantage of Approach 1 is that companies would need to recognise an expense at the date of the business combination. In principle, this expense does not have economic substance and represents an accounting correction that is required by the mechanical recognition of deferred taxes according to IAS 12.
50. The EFRAG Secretariat observes that, under this approach, the expense could also be recognised in other comprehensive income or deducted directly from equity.

*Approach 2 - No recognition of DTLs in a business combination*

51. A more fundamental approach to solve the 'day one' impairment issue could be to not recognise DTLs in a business combination. To support this approach one would argue that the consideration paid to acquire the target reflects the acquirer's expectations with regard to tax cash flows, which would be reflected in the fair value of the net identifiable assets acquired. In other words, the fair value of the assets represents a post-tax NPV.
52. One simple way to implement Approach 2 would be to extend the initial recognition exception in IAS 12 to business combinations.

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<sup>1</sup> Detzen, D, Stork genannt Wersborg, T., Zülch, H., 2016, Impairment of Goodwill and Deferred Taxes under IFRS, Australian Accounting Review, No.78 Vol.26 Issue 3.

*Advantages and disadvantages of this approach*

53. To a certain extent, this reasoning would be consistent with IAS 12 which requires a mechanical *ex post* recognition of deferred taxes, while acquirers include their own expectations regarding tax cash flows. Any unrecognised tax cash flows would be subsumed in goodwill. This approach would address the existing incompatibility between IAS 36 and IAS 12 with regard to business combinations and the consequences on the initial measurement of goodwill.
54. Many argue that the tax effects associated with the assets acquired in a business combination are included in the consideration paid for the acquisition, and thus explain the implications of mechanically recognising DTLs. It is logical that if an entity acquires another entity (Entity B) and needs to 'assume' a DTL, it will factor the DTL into the price it will pay for Entity B (ie the fair value will be a 'net amount' after considering the associated tax effects). In this case, one argue that there is no need to recognise a DTL.
55. For this approach to work, it would need to be assumed that fair value of an asset reflects (includes) the tax effects associated with the asset (ie NPV). A disadvantage of this approach would be that DTLs for assets acquired in a business combination would not be separately recognised in the financial statements.
56. The initial recognition exception in IAS 12 is explained in more detail below.

*Initial recognition exception in IAS 12*

57. Under IAS 12, if an entity acquires an asset outside of a business combination, it is exempt from recognising deferred tax when it recognises the asset.
58. The EFRAG Secretariat understands that the initial recognition exception was introduced into IAS 12 because the consideration paid for a long-term asset implicitly takes into account the non-deductibility of the asset for tax purposes. In these circumstances, it was inappropriate for an entity to recognise a deferred tax liability for which the related deferred tax expense would have to be either recognised as an expense immediately, added to the cost of the asset, or recognised as a separate asset.
59. However, IAS 12 does not include a similar exception which would apply when an asset is subsequently measured at fair value, and that subsequent remeasurement results in a taxable temporary difference. Neither does it introduce the exception for assets acquired in a business combination.
60. The IASB proposed to eliminate the initial recognition exception in IAS 12 in an exposure draft it published in 2009 on the accounting for incomes tax. The exposure draft proposed that any entity-specific tax effects should not affect the carrying amount of an asset or liability. An entity should separate the asset or liability that results in an initial temporary difference into (i) an asset or liability excluding entity-specific tax effects and (ii) any entity-specific tax effects. Next, a deferred tax asset or liability would be recognised for the temporary difference between the carrying amount of the asset or liability and the tax basis available to the entity. If the consideration paid or received differed from the total recognised amounts of the acquired assets and liabilities (including deferred tax), an entity would recognise the difference as an allowance against, or premium on, the deferred tax asset or liability. If the transaction was a business combination, because any difference between the transaction price and the sum of the recognised amounts would affect goodwill. Many constituents that responded to this exposure draft, including EFRAG, disagreed with this proposal on the basis that it was overly complex to apply.
61. Furthermore, the outcome of the IASB's 2015 Agenda Consultation was that a review of IAS 12 was not considered a priority.

Approach 3 - Use fair values that reflect the tax effects (gross-up approach)

62. Approach 3 proposes that the fair value of assets<sup>2</sup> recognised in a business combination reflects the tax benefits the entity would receive had the asset been tax deductible (also referred to as tax amortisation benefits). In other words, it assumes that an asset acquired in a business combination has the same tax characteristics as one acquired separately by a market participant.
63. In example 1 (see paragraphs 25 and 26), it is assumed that Entity A does not get a deduction for tax purposes for the Trademark it acquired in the business combination. It also assumes that the fair value of the Trademark does not reflect the tax benefits (also referred to as the tax amortisation benefit) had the asset been tax deductible by the entity (or a market participant). This could be because Entity A would pay less for the business combination if the Trademark it is acquiring is not tax deductible. However, as explained in the example below this may not be a correct assumption.
64. Continuing from example 1, if we assumed that the Trademark of €60 million is depreciated over its useful life (10 years) then the DTL relating to that trademark of €24 million will be released to profit or loss over that useful life with the effect that the net amount charged to profit or loss of €36 million (amortisation less DTL) will be the same as if the amortisation charge were tax deductible. In a market-based fair value approach, the fair value is based on market prices for similar assets and the prices will include all the benefits of owning the assets, including any tax effects.
65. The mechanics of Approach 3 are explained in the example below.

Example 2

66. Assume that if the entity in example 1 acquired the Trademark as a separate asset, the Trademark would be fully tax deductible (tax basis is equal to the amount paid for the asset). The same tax basis is available to the entity as to a market participant. Assume also that the tax base is zero if the Trademark is acquired in a business combination.
67. Under Approach 3, the fair value of the trademark will reflect the **undiscounted DTL** of €40 million (€60 million \*40%/60%). The fair value of the Trademark would therefore be €100 million (€60 million/40%). The resulting journal entry is as follows:

Example 2

	€ million DR	€ million CR
<b>Goodwill</b>	<b>20</b>	
Trademark (60m + 40m)	100*	
Other net assets	20	
DTLs (40% of [(100m*+20m) -20m])		40
Cost of the acquisition		100

68. In this case, the gross assets will be recorded at €140 million compared to €124 million in example 1. The increase of €16 results from the recognition of a DTL of €16 million that represents the tax amortisation benefit associated with the trademark (40% of €40 million DTL).

<sup>2</sup> As this paper does not examine the effects of deferred tax assets it also does not consider measurement of liabilities in a business combination.



69. In this example, goodwill results only from the recognition of 'other assets'.

*Advantages and disadvantages of Approach 3*

70. The EFRAG Secretariat believes that this approach has a number of advantages.

71. First, it seems relatively easy to apply. It has the conceptual merit of recognising goodwill only to the extent of its economic substance. This approach solves both issue 1 and issue 2 discussed earlier in this paper.

72. We believe this approach is consistent with the concept of fair value as defined under IFRS 13 *Fair Value Measurement* as it is based on a market participant approach. That is, the fair value of the asset is determined from market prices paid for similar assets which reflect the benefits of owning the assets, including the tax benefits (or tax amortisation benefits). In example 2 above, the same tax basis is available to Entity A as to a market participant if the Trademark is acquired separately. This means that the fair value of the Trademark of €100 million is a market-based value.<sup>3</sup>

73. However, a possible issue relates to the effects of discounting. The approach requires including undiscounted tax benefits in fair value. Conceptually speaking this is not correct, as fair value needs to consider the effects of discounting. This problem could be solved by requiring discounting of the tax benefits, but introduce some complexity in applying the approach, given that discounting of deferred tax is considered to be complex. However, this would create an additional problem because the discounting effect would affect goodwill in a business combination.

74. If accepted, this approach could apply to all acquired assets (and potentially liabilities). The initial recognition exception in IAS 12 would no longer be required, and the accounting for DTL for asset deals and business combinations would be aligned. This has been a source of tension for a long time.

75. The EFRAG Secretariat also notes that this approach is similar to the simultaneous equation method used under US GAAP when the carrying amount of an asset is grossed up. However we have not examined the US GAAP model in detail.

*Approach 4 – Separate recognition of goodwill resulting from DTLs*

76. Approach 4 requires separate recognition of the goodwill resulting from the recognition of DTL. The approach also proposes a special write-off scheme for the DTL-generated goodwill such that the goodwill is reduced at the same pace as the DTLs.

77. This approach would lead to the separation of goodwill into two parts with only 'core' goodwill being tested for impairment and the remainder being amortised, or written-off, by linking it to the reversal of the related DTL. The approach does not fully solve issue 1 discussed earlier in this paper, but solves issue 2.

78. This approach would somewhat reflect current reporting requirements, but provides a more formalised approach to acknowledging that goodwill resulting from DTLs needs to be derecognised/transferred to profit or loss at same point.

79. One argument in support of this approach is that only 'core goodwill' will be recognised as goodwill, and tested for impairment.

80. In Example 1 of this paper (see paragraph 25) the DTL of €24 million will reverse on a straight-line basis as the entity amortises the trademark over its useful life. This approach argues that the part of the goodwill resulting from the DTL needs to be 'reversed' to profit or loss on the same systematic basis, by way of matching, to the

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<sup>3</sup> The EFRAG Secretariat acknowledge that there may be cases when the tax basis for a particular entity and a market participant as discussed in IFRS 13 might be different. We have not considered these cases in this paper.

*Goodwill – Impact of deferred tax liabilities arising in a business combination*

periods to which the DTLs reverse. The rationale is that, unlike ‘core’ goodwill, the part of goodwill resulting from the DTL has a consumption pattern.

*Outcome under each approach*

- 81 When applying the various approaches discussed above to the fact pattern of Example 1, the EFRAG Secretariat reached the following accounting outcomes (ignoring the impact of other net assets):

Million €	Current accounting	Approach 1	Approach 2	Approach 3	Approach 4
<b>Balance sheet</b>					
Goodwill initial measurement	44	20	20	20	44 <sup>(2)</sup>
Goodwill from DTLs	24 <sup>(1)</sup>	-	-	-	24
Trademark	60	60	60	100	60
DTL	24	-	-	40	24
<b>Profit or loss (total over life of Trademark and assuming no impairment of goodwill)</b>					
Depreciation Trademark	-60	-60	-60	-100	-60
Depreciation Goodwill	0	0	0	0	-24
Tax effects <sup>(3)</sup>	24	- <sup>(4)</sup>	-	40	24
<b>Profit or loss</b>	<b>-36</b>	<b>-60</b>	<b>-60</b>	<b>-60</b>	<b>-60</b>

- (1) The goodwill resulting from the recognition of DTL of €24 million is included in the €44 million initial measurement of goodwill
- (2) This value includes €24 million that was triggered by the recognition of DTLs, which will be depreciated in line with the DTL
- (3) The tax effects represents the ‘unwinding’ of the DTL as the Trademark is recovered through use (depreciation)
- (4) In Approach 1, the tax effects represent a tax expense of €24 million on the date of the business combination and an additional amount of €24 million representing the ‘unwinding’ of the DTL as the Trademark is recovered through use (depreciation).

Summary of the approaches

	Approach 1	Approach 2	Approach 3	Approach 4
<b>Advantages</b>	Easy to apply	Easy to apply	Relatively easy to apply	Relatively easy to apply
	Does not recognise goodwill resulting from DTLs	Does not recognise goodwill resulting from DTLs	Does not recognise goodwill resulting from DTLs  Recognises a DTL separately in the financial statements which (more transparent)	Amortises goodwill resulting from DTL on a systematic basis (so over time there will be no goodwill resulting from DTLs)
			Overall relatively conceptually sound  Can be applied to all acquired assets	Somehow reflects current requirements
<b>Disadvantages</b>	DTLs recognised as an expense in PL on date of acquisition  Lacks conceptual merits	Does not recognise DTLs in a business combination (potential loss of transparency)  Lacks conceptual merits	Discounting effects in fair value	Recognises goodwill resulting from DTLs – so does not fully solve issue 1

**Feedback from the EFRAG User Panel**

83. At its February 2017 meeting, the EFRAG User Panel had an initial discussion about the recognition of DTLs when accounting for business combinations and the issues discussed in this paper. However, the paper presented at the EFRAG User Panel meeting examined only approach 2 (no recognition of DTLs in a business combination) as a possible solution to the issues.
84. EFRAG User Panel members generally supported investigating the issues further. Regarding applying approach 2, some EFRAG User Panel members were reluctant to accept no recognition of DTLs in case a DTL existed in practice, which they would prefer to see in the financial statements. Further research was needed to understand this better.
85. Some EFRAG User Panel members expressed concerns with the accounting for deferred taxes in general, and the meaning of a DTL. Overall, User Panel members supported improving disclosures on deferred tax liabilities recognised when accounting for a business combination in order to have information any goodwill resulting from the recognition of DTLs on the date of the business combination and in periods after the acquisition.

**EFRAG Secretariat recommendation on next steps**

86. The EFRAG Secretariat thinks that Approach 3 has several merits. This approach has the potential to eliminate issue 1 and issue 2 discussed in this paper, is relatively easy to apply and relatively conceptually sound. However, as discussed in

paragraph 73 a decision would be needed on whether to include or exclude the discounting effects relating to the tax amortisation benefit.

87. We also believe that Approach 2 has practical merits. However, extending the initial recognition exception in IAS 12 to business combination transactions would raise conceptual issues as there is no convincing conceptual basis for this exception. However, its good points are that it avoids DTLs being recognised in goodwill. Also, it would align DTL accounting for asset acquisitions and business combinations, which some might welcome.
88. Regarding Approach 4, we believe that separate recognition of the part of goodwill relating to DTL with subsequent amortisation, might raise conceptual concerns as it would involve 'amortising' goodwill resulting from DTLs.
89. The EFRAG Secretariat notes that expensing the DTL on the date of the business combination (Approach 1) would probably not have much support.

*Next steps*

90. The EFRAG Secretariat observes that the following next steps could be considered to stimulate the debate on the issues discussed in this paper and the approaches to address them:
  - (a) Bring a paper to a future ASAF meeting to gather initial views on the issues and on some (or all) of the alternative approaches discussed in this paper. Based on the support of the ASAF, we could further develop the paper and publish an EFRAG Short Discussion Series paper.
  - (b) Publish a Short Discussion Series paper without consulting with ASAF.
  - (c) Include a discussion of these issues in the EFRAG's forthcoming research paper that considers some possible approaches to improve goodwill impairment testing.
91. On next steps, the EFRAG Secretariat supports (a) – developing a paper to discuss at a future ASAF meeting.
92. The paper could include a discussion on all four approaches mentioned in paragraph 45.

**Questions for EFRAG TEG**

- 93 Does EFRAG TEG object to any of the approaches presented in paragraph 45? Or there other approaches you support?
- 94 Does EFRAG TEG agree with the EFRAG Secretariat proposal on next steps (paragraph 91)?
- 95 Does EFRAG TEG have any other comments on the matters discussed in this paper?