This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Recognising deferred tax liabilities in the initial measurement of goodwill

Next steps

Objective

1. The objective of this paper is to ask EFRAG TEG whether it agrees with the proposed next steps on the perceived issues regarding the recognition of deferred tax liabilities (DTLs) in goodwill on the date of a business combination. The issues were discussed at the March 2017 EFRAG TEG meeting.

Background.

2. Both the IASB and EFRAG are undertaking projects on goodwill impairment.

The IASB's project

3. 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 aim of the project is to develop 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

4. 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.
5. 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. A draft of the proposed publication is provided for discussion at this meeting at agenda item 13.

Summary of the issues discussed in March 2017

6. In March 2017 EFRAG TEG discussed a paper (the March paper) that explored two perceived issues, raised by some respondents to the IASB's post-implementation review of IFRS 3, that arise from recognising DTLs in the initial measurement of goodwill. The March paper also set-out some possible approaches that might help address the issues.
7. The March paper focused only on the effects of DTLs, and included limited research that demonstrated that the amount of DTLs recognised in goodwill can be significant. The limited research found that of the business combination cases investigated, DTLs represented an average of 35% of the amount recognised as goodwill.

8. The issues discussed were:

   (a) **Issue 1**– 'Day one' goodwill impairment when goodwill resulting from DTLs is tested for impairment immediately after the business combination; and

   (b) **Issue 2**– Subsequent impairment testing of goodwill resulting from DTLs.

9. Issue 1 related to a potential 'day one' loss when goodwill is tested for impairment immediately after the business combination. The issue could arise in business combinations involving the acquisition of an entity owning only one, or just a few, assets that have a tax base significantly lower than its (their) fair value. Such a business combination would result in a DTL being recognised with a corresponding amount recognised in goodwill. In case the goodwill, including the DTLs, would be allocated to the acquired entity (the relevant cash-generating unit or CGU), a 'day-one' goodwill impairment could occur when applying the impairment requirements under IAS 36 *Impairment of Assets*. The March paper provided an example that illustrated this issue.

10. Issue 2 related to the potential consequential effects that issue 1 could have on the goodwill impairment test in the reporting periods after the date of the business combination. The March paper explained that over time, an entity is likely to 'lose track' of the part of the goodwill that arose from DTLs and that goodwill 'created by DTLs could remain on the balance sheet after the asset(s), that gave rise to the DTLs, had been sold or were fully depreciated. The March paper outlined four possible approaches that might help address the issues. In summary, these were:

    (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 the tax amortisation benefit (gross-up approach); and

    (d) Approach 4 – Separate recognition of goodwill resulting from DTLs.

11. EFRAG TEG members were asked whether they thought that the issues created problems in practice, and if so, whether EFRAG should explore them further as part of its work on monitoring the IASB project on Goodwill and Impairment or within its own research project.

Feedback gathered from EFRAG TEG in March 2017

12. EFRAG TEG members had mixed views on whether the issues were significant in practice. The detailed discussion is available in the minutes for the March meeting (agenda paper 01-01 for this meeting).

13. Overall, EFRAG TEG was not convinced that Issue 1 ('day one' goodwill impairment loss) was a problem in practice, and noted that this issue was not something new. Before EFRAG TEG could discuss the approaches proposed in the paper, the EFRAG Secretariat would need to diagnose the problem more fully. There was also no support from EFRAG TEG to amend the accounting for deferred taxes in IAS 12 *Income Taxes*.

14. When discussing Issue 1, EFRAG TEG members observed that significant judgement is necessary in determining the tax effects on fair value measurement in a business combination. The tax amortisation benefit played an important role in the way fair value was determined, and whether or not it should be reflected in determining fair value would depend on the tax circumstances related to the asset.

15. Referring to the example in the March paper, involving buying a trademark through a business combination where the unit of valuation of the trademark was done on a standalone basis, one would need to consider the market features relevant to the trademark when determining its fair value. The example illustrated a hypothetical

transaction, as it considered that the trademark would be purchased as a standalone asset and the buyer (market participant) would receive a tax amortisation benefit which would be reflected in the fair value amount under IFRS 13. This 'hypothetical transaction' method of valuation is common in practice for fair valuing intangible assets acquired in a business combination.

16. For subsequent impairment testing, separation of DTLs (Approach 4) received some support as it required separate recognition of the part of the goodwill that was 'created' by DTLs.

17. Finally, EFRAG TEG was of the view that the EFRAG Secretariat would need to reflect how much progress could be made in this area. This was because EFRAG TEG considered that the issues were not new, and furthermore the current practical solution was to deduct the DTLs from the carrying amount of the CGUs for the purpose of the goodwill impairment test. For this reason, Issue 1 was not a problem in practice.

18. However, given the interaction with 'how' fair value of an asset is determined in a business combination and whether or not it includes tax effects, several EFRAG TEG members suggested to investigate the issues as part of the IASB's Post-implementation Review of IFRS 13 *Fair Value Measurement.* The IASB had started work on the review of IFRS 13 and a Request for Information was expected in May 2017.

Additional information - tax effects when determining fair value

An EY publication

19. Following the March 2017 EFRAG TEG discussion, EFRAG TEG was provided with a copy of an EY publication *Applying IFRS Goodwill Hunting* (EY publication) which illustrates the perceived issue of a 'day one' goodwill impairment. The EY publication is focussed on investment properties and provides an example that involves the acquisition of an entity that owns an investment property, with a tax base significantly lower than its fair value.

20. The example presented is as follows:

Entity A, a property investor, which is taxed at 40%, acquires Entity B for CU180mn in a transaction that is a business combination. The fair values and tax bases of the identifiable net assets of Entity B are, as follows:

	Fair value (CUm)	Tax base (CUm)
Investment property	120	20
Other net assets	40	40

This will give rise to the following consolidation journal:

	(CUm)	(CUm)
Goodwill (balance)	60	
Investment property	120	
Other net assets	40	
Deferred tax[1]		40
Cost of investment		180

[1] 40% of (CU120m- CU20m)

21. In the example, the fair value of the investment property is based on the price of the investment property to a buyer in an asset transaction that <u>assumes the fair value will be deductible for tax purposes.</u> In this case, the fair value of the DTL is CU30m.

22. The goodwill arising on the acquisition is CU60m. This is made up of CU10m arising solely from the recognition difference for the DTL (CU40m recognised minus

CU30m fair value) and CU50m arising from the decision to acquire the business for more than the aggregate of the fair value of its identifiable net assets.

23. EY notes that there are two elements to consider in the example:
    (a) The acquired entity's expected future cash flows arising from the investment property are already built into the fair value of the investment property.
    (b) IAS 36 requires tax cash flows to be *excluded* from the estimate of future cash flows used to calculate any impairment when applying value in use (VIU).

24. The EFRAG Secretariat notes that in this example, the fair value of the investment property includes the 'market' tax amortisation benefit (tax effects) associated with the investment property. This is the case even though entity A will receive a tax deduction for only part of the value of the asset (CU20). The EFRAG Secretariat thinks that including the tax amortisation benefit in the fair value of the investment property partly solves the 'day one' impairment loss issue discussed in paragraphs 8 and 9. In this case, the only amount recognised in goodwill, in respect to the DCL, is CU10 which arises because the DTL is not measured at fair value.

25. EY concludes that this issue is a common theme (which is not unique to property investments) and can be addressed within the current framework of IFRS Standards and the immediate impairment of goodwill would generally not be required.

International Valuation Standards – effects of tax amortisation benefits when determining fair value

26. The International Valuation Standards (2017) published by the International Valuation Standards Council mention tax amortisation benefits in the context of valuation of intangible assets, which in many tax jurisdictions, can be amortised for tax purposes, reducing a taxpayer's tax burden, and effectively increasing cash flows. The guidelines note that, depending on the valuation method used, it may be appropriate to include the value of the tax amortisation benefit in the value of the intangible.

27. The Standards note that for fair value measurement under IFRS Standards, the valuation could assume a hypothetical sale of the intangible asset. For instance, a tax amortisation benefit would generally be included when the income approach is used because a typical market participant would be able to amortise an intangible asset acquired in such a hypothetical transaction.

EFRAG Secretariat conclusion and recommendation

28. On the basis of the feedback provided by EFRAG TEG in March 2017 and the additional information gathered by the EFRAG Secretariat, we agree with EFRAG TEG that there is no strong evidence that the 'day one' impairment issue is a real problem in practice.

29. Given the interaction with 'how' to measure fair value and whether or not fair value included a tax amortisation benefit associated with the asset being valued, the EFRAG Secretariat recommends that this issue is raised as part of the IASB's Post-implementation Review of IFRS 13 *Fair Value Measurement.*

Question for EFRAG TEG

30 Does EFRAG TEG agree with the EFRAG Secretariat recommendation?