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.

Goodwill and Impairment
Tax Issues

Objective of this session

1 The objective of this session is to get feedback from EFRAG TEG on tax-related issues and whether to include those issues in the comment letter to the IASB's discussion paper on Business Combinations – Disclosures, goodwill and impairment (DP/2020/1), as follows

(a) Use of post-tax cash flows and post-tax discounts rates in estimating value in use

(b) Impact from deferred tax liabilities recognised in the course of a business combination and their impact on subsequent measurement of goodwill.

2 During the EFRAG TEG discussions leading to the approval of the draft comment letter some of these issues were mentioned but not debated in detail.

Issue 1: Use of post-tax cash flows and post-tax discounts rates in estimating value in use

Background

3 IAS 36 requires entities to use pre-tax discount rate because of a concern that post-tax inputs without specifying the tax attribute (i.e. the tax characteristics attributed to an asset or liability) could cause double counting of some future tax consequences of temporary differences.

4 When developing IAS 36 the IASB Staff considered that the double counting issue can also exist with a pre-tax calculation, although the Basis for Conclusions of IAS 36 explains how to avoid the double count effect. This is because whether a pre-tax discount rate is used with pre-tax inputs or a post-tax discount rate is used with post-tax inputs, the resulting current value is a post-tax vale of the asset (or CGU) being measured.

5 Various stakeholders during the post-implementation review of IFRS 3, including users, commented that a pre-tax discount rate was hard to understand and did not provide useful information because that rate is not observable and is generally not used for valuation purposes. The current value of an asset is regarded as a post-tax measure which is more directly observable. In practice, the impairment test is performed on post-tax basis and the pre-tax discount rate is determined rather for disclosure purposes.

6 To address these concerns, the IASB has tentatively decided and proposed to:

(a) remove the explicit requirement to use pre-tax inputs and pre-tax discount rate to calculate VIU;

(b) require entities to use internally consistent assumptions for cash flows and discount rates; and

(c) disclose the discount rates used in the estimation of VIU.

Review of current accounting requirements

7 IAS 36:55 specifies that the discount rate (or rates) used should be:

(a) a pre-tax rate (or rates);

(b) that reflect(s) current market assessments of:

(i) the time value of money; and

(ii) the risks specific to the asset for which the future cash flow estimates have not been adjusted (but not those for which the cash flows have been adjusted).

8 In the Basis for Conclusions to IAS 36, the IASB explains:

9 [BCZ85 followed by a numerical example not reproduced here] In theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. The pre-tax discount rate is not always the post-tax discount rate grossed up by a standard rate of tax.

10 [BCZ86] IAS 36 requires that the recoverable amount should be based on present value calculations, whereas under IAS 12 an entity determines deferred tax assets and liabilities by comparing the carrying amount of an asset (a present value if the carrying amount is based on recoverable amount) with its tax base (an undiscounted amount).

11 [BCZ87] One way to eliminate this inconsistency would be to measure deferred tax assets and liabilities on a discounted basis. In developing the revised version of IAS 12 (approved in 1996), there was not enough support to require that deferred tax assets and liabilities should be measured on a discounted basis. IASC believed there was still not consensus to support such a change in existing practice. Therefore, IAS 36 requires an entity to measure the tax effects of temporary differences using the principles set out in IAS 12.

12 [BCZ88] IAS 12 does not permit an entity to recognise certain deferred tax liabilities and assets. In such cases, some believe that the value in use of an asset, or a cash-generating unit, should be adjusted to reflect the tax consequences of recovering its pre-tax value in use. For example, if the tax rate is 25 per cent, an entity must receive pre-tax cash flows with a present value of 400 in order to recover a carrying amount of 300.

13 [BCZ89] IASC acknowledged the conceptual merit of such adjustments but concluded that they would add unnecessary complexity. Therefore, IAS 36 neither requires nor permits such adjustments.

14 [BC93] The Board decided that any amendment to the requirement in the previous version of IAS 36 for pre-tax cash flows to be discounted at a pre-tax discount rate should be made only after the Board has resolved the issue of what tax attribute should be reflected in value in use. The Board decided that it should not try to resolve this latter issue as part of the Business Combinations project—decisions on the treatment of tax in value in use calculations should be made only as part of its conceptual project on measurement. Therefore, the Board concluded it should not amend as part of the current revision of IAS 36 the requirement to use pre-tax cash flows and pre-tax discount rates when measuring value in use.

15 [BC94] However, the Board observed that, conceptually, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. The pre-tax discount rate is generally not the post-tax discount rate grossed up by a standard rate of tax.

EFRAG Discussion Paper proposals (2017)

16 When EFRAG published its discussion paper “Goodwill Impairment Test: Can it be improved” in 2017, the issue of pre- vs. post-tax rates was also addressed as follows:

17 [2.61] The inclusion of a choice would simplify the calculation of VIU and reduce the cost when entities only have observable post-tax discount rates for an asset/CGU. Entities usually use WACC as a starting point for determining the discount rate, and the WACC is typically a post-tax rate.

18 [2.62] The relevance of the calculation would not be affected, because both basis should result in the same recoverable amount when the pre-tax rate is adjusted to reflect the timing of creation and reversal of temporary differences.

19 [2.63] However, allowing a post-tax basis could raise some issues. For example, it is unclear if this would have implications on the composition of the CGU and calculation of the amount of tax that should be allocated to the different CGUs. Moreover, since the estimates of future cash flows should include cash inflows or outflows from income tax receipts or payments, a number of practical questions would arise (as noted in paragraphs Z81 to Z84 of the Basis for Conclusions of IAS 36), such as how should deferred taxes be reflected in the future cash flows or if the carrying amount of the CGU should be equally adjusted.

20 [2.64] In this process, entities will have to ensure that the carrying amount of a CGU shall be determined on a basis consistent with the way its recoverable amount is determined. For instance, entities will have to ensure that estimates of future cash flows are aligned with the principles of IAS 12 Income Taxes (e.g. future tax benefits arising from existing deductible differences should be measured consistently with the recognised deferred tax assets).

IASB Discussion Paper proposals (2019)

21 The IASB’s preliminary view is that it should develop a proposal to:

(a) remove the explicit requirement to use pre-tax cash flows and pre-tax discount rates in estimating value in use;

(b) require a company to use internally consistent assumptions for cash flows and discount rates regardless of whether value in use is estimated on a pre-tax or post-tax basis; and

(c) retain the requirement for companies to disclose the discount rates used but remove the requirement that the discount rate disclosed should be a pre-tax rate.

22 This proposal would apply not only to cash-generating units containing goodwill but to all assets and cash-generating units within the scope of IAS 36.

Previous EFRAG discussions

23 EFRAG TEG-CFSS members generally supported removing the explicit requirement to use pre-tax inputs to calculate value in use and to disclose the pre-tax discount rates used at its meetings in April 2018 and in November 2018.

24 The EFRAG User Panel members at its meeting in July 2019 generally supported to use a post-tax discount rate and the use of pre-tax inputs in the calculation of VIU.

25 EFRAG TEG discussed this issue in November 2019. TEG members observed that

(a) the possibility to have post-tax discount rates was positive because market expectations were derived post-tax;

(b) impairment test was usually a post-tax exercise and therefore it was positive to allow post-tax discount rates; and

(c) post-tax rates depend on the tax situation of the owners, which was difficult to analyse.

26 During the EFRAG TEG meetings in March and April 2020, TEG revisited this issue. Members highlighted different aspects of using post-tax rates, e.g. in a situation of a business acquisition where goodwill was the only (additional) non-deductible asset recognised compared to a situation where also deductible assets are recognised; or in a situation where tax loss carry-forwards exist that, while not meeting the recognition criteria in IAS 12, might be included to determine the post-tax rate, which hence gives rise to conceptual differences.

EFRAG Draft Comment Letter

27 [212] EFRAG considers that a pre-tax discount rate could be hard to understand and that it does not provide useful information because this rate is not observable and is generally not used for valuation purposes. The current value of an asset is regarded and understood as a post-tax measure which is more directly observable.

28 [213] Therefore, EFRAG supports the IASB's proposal to remove the explicit requirement to use pre-tax inputs and pre-tax discount rates to calculate value in use. EFRAG considers that this proposal would reduce the cost of the goodwill impairment test; provide more useful information; and make the test more understandable. In addition, using post-tax discount rates and post-tax inputs would be more consistent with other IFRS Standards.

29 [214] EFRAG notes that this proposal would simplify the calculation of value in use and reduce the cost when companies only have observable post-tax discount rates for an asset/CGU. Companies usually use weighted average cost of capital (WACC) as a starting point for determining the discount rate, and the WACC is typically a posttax rate. The relevance of the calculation would not be affected, because both basis (post and pre-tax) should result in the same recoverable amount when the pre-tax rate is adjusted to reflect the timing of the creation and reversal of temporary differences.

30 [215] EFRAG also consulted on this issue in its 2017 discussion paper Goodwill Impairment Test: Can It Be Improved? Almost all respondents supported allowing the use of a post-tax rate.

31 [216] However, the discussion paper also highlighted that allowing a post-tax basis could raise some issues. For example, it would be unclear if this would have implications for the amount of tax that should be allocated to the different CGUs. Moreover, since the estimates of future cash flows should include cash inflows or outflows from income tax receipts or payments, a number of practical questions would arise (as noted in paragraphs BCZ81 to BCZ84 of the Basis for Conclusions of IAS 36), such as how deferred taxes should be reflected in the future cash flows or if the carrying amount of the CGU should be adjusted.

EFRAG Secretariat analysis

32 The EFRAG Secretariat observes that the use of post-tax discount rates was generally supported in previous discussions at EFRAG TEG. However, during these discussions, several concerns were raised. The following paragraphs provide an analysis of potential issues that the use of post-tax discounts rates may have against the background of BCZ85 which requires that "the post-tax discount rate [should be] adjusted to reflect the specific amount and timing of the future tax cash flows."

33 The composition of a CGU is not necessarily identical to the taxable entity. Subject to local tax regimes, several branches can be taxed on a consolidated basis if an entity elects to do so, or the CGU may consist of several individually taxable entities. As a result, the post-tax rate for a particular CGU may either be merely hypothetical or differ from a blended post-tax rate derived on a more aggregate or disaggregated level and may depend on choices an individual entity has made for tax purposes.

34 Another issue may arise in the context of loss carry-forwards in relation to a CGU. This is because the actual post-tax rate may be impacted when utilising a loss carry-forward. However, a loss carry-forward would generally not be considered for determining the VIU of a CGU if the loss carry-forward does not relate to the tax-deductibility of the assets within the CGU. In other words, an entity cannot assume that the post-tax and pre-tax discount rate would be the same because no taxes would be paid because of the entities' tax losses and instead would have to make assumptions about taxation (see EY, International GAAP 2019, p.1484).

35 While a loss carry-forward will have impacts on the actual post-tax rate, it may not meet the recognition criteria in IAS 12. This would give rise to conceptual differences and effectively result in accounting, if considered for impairment testing, for a "hidden" asset that has accounting consequences only for the purpose of impairment considerations while, for purposes of IAS 12, recognition is not permitted and hence the recognition threshold in IAS 12 might effectively be circumvented for the purposes of measuring impairment (see also EFRAG DCL, paragraph 218).

36 Some jurisdictions apply particular tax requirements which foresee a different determination of the tax bases between several elements of income tax. An example is the German municipality tax that forms part of the overall tax rate of an entity and has broadly the same tax base as the general corporate income tax. However, particular elements of expenses are added back to the tax base, e.g. lease payments or financing expenses, while other items reduce the tax base, e.g. a defined percentage of the value of real estate property. In addition, the rates differ between municipalities and the tax base may need to be allocated between several municipalities where the taxable entity has taxable operations.

37 As a result, the applicable post-tax rate may need to be determined at a level that does not reflect the composition and asset allocation of the CGU, and hence may give rise to additional complexity or require the use of simplifications or assumptions.

38 EFRAG Secretariat observes that, when testing VIU in practice, the actual post-tax rate is not applied. This is because the VIU relates to the asset or CGU that is tested for impairment.and hence should not give consideration of entity-specific facts and circumstances that go beyond the respective unit of assessment.

39 According to published guidance, "a post-tax discount rate is based on certain assumptions about the tax-deductability of the asset and not the actual tax cash flows. […] If the entity calculates post-tax VIU, it will also make assumptions about taxation and not base the calculation on the actual cash flows." (EY, International GAAP 2019, p. 1484).

40 Furthermore, an entity has to consider "the allocation of tax cash flows to CGUs, because the actual tax return is normally calculated on the basis of legal entities; the timing of tax cash flows because those are subject to the discounting effect; and the asset's tax base." (KPMG, Insights into IFRS 16th Ed. 2019/2020, p. 755)

41 The outcome of using pre-tax or post-tax inputs should give rise to a consistent impairment outcome. In doing so, several common pitfalls can be observed in practice that do not give the correct VIU according to IAS 36 and relate to how the cash flows are imputed and discounted (see PWC, Manual of Accounting 2017, Vol. 1., p.24068).

42 Hence, in order to achieve consistency in outcomes, careful consideration needs to be given to how VIU inputs interrelate and how they are reflected in respect of

(a) the discount rate (pre- vs. post-tax),

(b) the approaches used to determine cash flows (adjusted vs. actual tax base approaches; need for iterative computations),

(c) the carrying amounts to be considered (in particular in respect of including or excluding of deferred tax liabilities, depending on the approach taken for determining cash flows), and

(d) application of particular methods to impairment losses

(see for an illustration KPMG, Insights into IFRS 16th Ed. 2019/20, p. 743.).

43 EFRAG Secretariat understands that common practice is usually to apply an approach that does not consider deferred tax liabilities and to apply a general post-tax rate (i.e. no actual entity-specific rate).

44 EFRAG Secretariat observes that, even if consistent inputs are used, conceptual differences in approaches will remain due to the discounting of cash flows for the purposes of VIU while deferred taxes are not discounted (BCZ86, see also for an example KPMG, p. 750).

45 EFRAG Secretariat further observes that many practical application issues will not disappear if the IASB decided to grant an accounting policy choice between using pre- and post-tax discount rates under final amendments. This is because EFRAG Secretariat works under the assumption that, regardless of which accounting policy is selected, the outcome of applying pre-tax or post-tax discount rates should still be consistent, and impairment losses should be recognised as appropriate.

46 Hence, the statement in BCZ85 remains valid in that "[i]n theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows." However, as can be seen already from the previous paragraphs, application in practice still requires an entity to make several assumptions and to carefully implement reasonable approaches that do not lead to double-counting of inputs and effects while conceptual challenges remain.

47 EFRAG Secretariat seeks input from EFRAG TEG whether to address this issue in the comment letter. If so, EFRAG Secretariat suggests encouraging the IASB to clarify and provide guidance how "post-tax rate" is defined in the context of IAS 36 and how it interrelates with the respective inputs that are considered for the purpose of VIU and impairment testing. This should also include a clarification, as already identified in BC94, on the tax attributes which should be reflected in value in use.

48 Against the background of the challenges in practice in applying the current guidance and the numerous interrelations of inputs and approaches used, the key objectives for application guidance should be to avoid double-counting of effects

and inputs, achieving consistency of the outcome when using pre-tax or post-tax rates and also consistency in how impairment testing is applied in practice.

Questions for EFRAG TEG/CFSS/User Panel/Board

49 Does EFRAG TEG agree with the observations of the EFRAG Secretariat?

50 Which is the practice for considering tax effects when determining VIU that EFRAG TEG members observe in their environment, in particular whether general post-tax rates are adjusted to reflect CGU or asset-specific tax attributes?

51 Does EFRAG TEG support inclusion of the issue in the comment letter of the discussion paper?

52 Does EFRAG TEG have further comments?

Issue 2: Impact from deferred tax liabilities recognised in the course of a business combination and their impact on subsequent measurement of goodwill

EFRAG Draft Comment Letter

53 EFRAG's draft comment letter includes a discussion and questions to constituents on the effect of effects of deferred tax liabilities and other tax implications as follows:

54 [258] Paragraph 19 of IAS 12 states that "[w]ith limited exceptions, the identifiable assets acquired, and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired, and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill."

55 [259] This means that a portion of goodwill may result from the effects of deferred tax liabilities. This portion of goodwill does not represent the "core goodwill", i.e. the fair value of the going concern element of the acquiree's existing business and the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses (see BC313-BC318 of IFRS 3). This portion of goodwill is only due to an accounting mismatch arising from the fact that deferred taxes are not recognised at fair value in business combinations.

56 [260] It may be argued that, after the business combination, the portion of goodwill resulting from the effects of deferred tax liabilities should be reduced over time (i.e. reversed to P&L) to reflect the reduction of the deferred tax liabilities that originated that portion of goodwill.

57 [261] Is the portion of goodwill resulting from the effects of deferred tax liabilities significant compared with the goodwill recognised in your financial statements/in your jurisdiction (e.g. >10% of recognised goodwill)?

58 [262] Would you support a change in the goodwill accounting (along the lines of paragraph 260 above), such that the portion of goodwill resulting from the effects of deferred tax liabilities, is subsequently measured at an amount that reflects the deferred tax liabilities that originated that portion of goodwill? Please explain. The IASB is proposing in this DP to allow for the adoption of post-tax inputs for the calculation of the value in use. How would such a proposal interact with the issue described in the above paragraphs (i.e. goodwill originated by an accounting mismatch due to effect of deferred tax liabilities? Please explain.

EFRAG Secretariat analysis

59 In case of a business combination, IFRS 3 requires recognition of previously unrecognised assets such as internally generated intangibles at fair value.

60 This results in recognition of a related deferred tax liability because the initial recognition exemption in IAS 12[1] does not apply if an asset is initially recognised in the course of a business combination.

61 When determining fair value, a so-called tax amortisation benefit (TAB) is considered (see International Valuation Standards Council: IVS 210 Intangible Assets, paragraph C35)The TAB reflects the cost savings from the tax deduction of an asset's amortisation charges and hence increases the fair value of the underlying asset and, with it, the amount of the related deferred tax liability.

62 This may be perceived being counter-intuitive, as the deferred tax liability is recognised because the underlying asset is only recognised in the course of the business combination and not recorded for tax purposes, which gives rise to temporary differences. In other words, it may be unclear how the tax amortisation benefit will actually be realised if the asset is not recognised for tax purposes at all.

63 However, two concepts have to be distinguished: The first is the concept of fair valuation in IFRS 13 that relies on a market participant's perspective, and the second is the concept of deferred taxes based on temporary differences between accounting and taxation carrying amounts.

64 The TAB only relates to the first concept, i.e. arises when determining fair value. This is because the benefits of it can be realised by more than one possible acquirer or could be achieved if the asset is acquired in a separate purchase. Hence, the way underlying asset is acquired (asset vs. share deal) is not considered when determining the fair value of the asset – in other words: if a TAB *could* be realised by any market participant in any transaction, it is considered for the purposes of fair valuation.

65 In contrast, the recognition of a deferred tax liability applies based on the particular facts and circumstances of an entity, i.e. without taking a third-party perspective.

66 When recognition of an asset at fair value in the course of a business combination gives rise to temporary differences to its tax carrying amount, recognition of a deferred tax liability ('DTL') takes place mechanically.

67 As required by IAS 12, the DTL is not discounted while the TAB is when fair value is determined, applying usually a post-tax rate.

68 The goodwill recognised in the course of a business combination is therefore impacted by the following two effects:

(a) Recognition of previously unrecognised assets at fair value (which is increased by TAB), discounted based on a post-tax rate; this effect gives rise to a lower goodwill;

(b) Recognition of a deferred tax liability on undiscounted basis; this effect increases goodwill.

69 **In a business combination, this latterincrease of goodwill does not necessarily related to economic benefits acquired.** The effect is further increased because the deferred tax liability is not discounted.

[1] If a deferred tax liability arises from the initial recognition of an asset or a liability in a transaction which is not a business combination, no deferred tax liability is recognised in accordance with IAS 12.15(b).

70 EFRAG Secretariat observes that this situation does not change if entities were permitted to use post-tax discount rates rather than pre-tax discount rates for the purposes of impairment testing as proposed in the discussion paper.

71 One possible approach to address the increase in goodwill could be to discount deferred taxes, which is currently neither permitted under IAS 12 nor proposed in the discussion paper.

72 EFRAG Secretariat observes that in the particular case where a TAB is considered for asset measurement, it may be possible to identify tax payments for particular periods together with a detailed scheduling of the expected timing of the reversal of every temporary difference. However, this may not be possible in other circumstances and hence will impair comparability of deferred tax balances between entities and even within an entity, depending on the trigger of deferred taxes.

73 However, as the deferred tax liability reverses, the respective DTL-related portion of goodwill could be reversed accordingly over time. Assuming the reversal of temporary differences in relation to the underlying asset occurs on a straight-line basis, equivalent amortisation of the DTL-related part of goodwill could be justified in that this portion of goodwill results rather from the mechanical application of accounting requirements rather than representing economic benefits.

74 Amortisation of the DTL-related part of goodwill would be in conflict of the current impairment only approach under IAS 36 that applies to the entire goodwill.

75 If entire goodwill would be amortised as alternatively proposed in the discussion paper, this would also relate to the DTL-related part of goodwill. However, differences will remain if the amortisation pattern is different to the reversal of temporary differences that caused recognition of the DTL.

76 EFRAG Secretariat observes that, when discussing pros and cons of impairment only vs. amortisation of goodwill, the latter approach would at least mitigate the issue of DTL-related goodwill, which might be reflected in EFRAG's comment letter accordingly. EFRAG Secretariat therefore seeks input from EFRAG TEG on whether this issue should be addressed in the comment letter accordingly.

Questions for EFRAG TEG/CFSS/User Panel/Board

77 Do EFRAG TEG members observe that a tax amortisation benefit (TAB) is not considered when determining fair value?

78 Does EFRAG TEG agree that the issue of DTL-related goodwill is an argument in favour of amortisation of goodwill?

79 Does EFRAG TEG support inclusion of the issue in the comment letter of the discussion paper?

80 Does EFRAG TEG have further comments?