National Financial Reporting Authority

Auditor -Audit Committee Interactions Series 1 (Part 2)*
Audit of Accounting Estimates and Judgments
Income Taxes - Ind AS 12

**NFRA does not set standards and codes for Corporate Governance, Board of Directors and Audit Committees.*

Introduction

In the course of NFRA's enforcement, review, and monitoring activities, the auditor's communication with those charged with governance (TCWG) (including the audit committees) has been highlighted in various ways. A need has been felt through these activities towards reinforcing the ways and means of communication between the Statutory Auditors and the Audit Committees in particular drawing upon the requirements in the Companies Act 2013 (CA 2013), the two relevant Standards on Auditing (SA 260 (Revised) and SA 265), other related SAs and the Standard on Quality Control (SQC 1).

This Auditor-Audit Committee Interactions Series 1 draws the attention of the auditors to the potential questions the Audit Committees/Board of Directors may ask them in respect of accounting estimates and judgments.

Within that, this communication being the second in this series, includes aspects pertaining to the audit of Income Taxes, in particular, Deferred Tax Assets (DTA) and Deferred Tax Liabilities (DTL) as required by Ind AS 12 Income Taxes. The first series dealt with Expected Credit Loss and can be referenced at https://nfra.gov.in/nfra-auditor-audit-committee-interaction-series-1-accounting-estimates-ecl/.

Companies Act 2013 (CA 2013) and SEBI (LODR) requirements relating to Audit Committee/Board of Directors on review of accounting estimates and judgments

As per Section134 (5) of CA 2013, the Board of Directors (BOD) are required to state in the Directors' Responsibility Statement in the Board's Report, which is part of Annual Report, that they had selected such accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent to give a true and fair view of the state of the affairs of the company.

SEBI LODR also specifically mandates the Audit Committee to review major accounting entries involving estimates based on the exercise of judgment by management.

Accounting Estimates and Judgments

Preparation and Presentation (including Disclosures) of financial statements requires the Management to make estimates and judgements in the recognition/measurement of assets, liabilities, income and expenses. Some of these could be complex requiring special attention by the Preparers, Audit Committees and the Auditors. Ind AS 12 prescribes recognition, measurement and related disclosure requirements of Current Taxes, DTA, DTL and Uncertain Tax Treatments (UTTs).

Understanding Deferred Taxes

As per the detailed guidance in Ind AS 12 a deferred tax liability (DTL) or deferred tax asset (DTA) is created when there are temporary differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Common examples are higher depreciation under tax laws while books of accounts follow a lower depreciation rate, and disallowance of certain expenses under the tax laws, such as warranty estimates under Ind AS 115, Revenue from Contracts with Customers, etc.

Temporary differences are further classified into categories viz. Deductible temporary differences and Taxable temporary differences. Ind AS 12 defines and provides guidance in determining Tax base of an asset or liability.

Deferred Tax Asset

DTA arise from deductible temporary differences, unused tax losses, and tax credits that an entity can utilize to reduce future taxable income under the tax laws. The recognition of DTA in the books of accounts is dependent upon the probability of future taxable profits against which these assets (DTA) can be realized. Companies must carefully assess whether sufficient taxable income will be available in the future to justify recognizing DTA. This assessment involves considering various factors such as projected future profits, the timing and manner of recovery, and provisions of the tax laws, including tax planning aspects.

If, at any point, it becomes unlikely that DTA can be recovered due to a change in circumstances or a re-evaluation of future profitability, the assets must be adjusted accordingly. For instance, deferred tax assets related to carried forward unused tax losses or credits are recognized only when there is convincing evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilized by the entity.

Deferred Tax Liability

DTL represents the future tax payment that an entity expects to make as a result of temporary tax differences.

Measurement

Measurement of deferred tax involves applying the income tax rates and applicable **tax laws that have been enacted or substantively enacted** at the reporting date. Companies must also consider the manner in which the related assets are expected to be recovered.

Consistency in measurement is vital to ensure accurate financial reporting. Furthermore, Ind AS 12 has particular criteria to be used for the recognition of the tax effects of temporary differences arising from ownership interest in investees and subsidiaries and for the accounting related to goodwill from business acquisition.

Companies must disclose the details about the nature of deductible temporary differences, unused tax losses, and tax credits. They must also explain the basis for recognizing deferred tax assets, especially when their recovery is contingent on future profitability. Such disclosures enhance transparency and provide stakeholders with a clear understanding of the entity's financial position.

Key Considerations for the Audit Committees

Recognition and Measurement of DTAs: Significant judgment is involved in assessing the likelihood of realizing DTAs. The audit committee should be informed about the methodology used to determine the recoverability of DTAs, the impact of any changes in business operations, tax laws, or economic conditions on the recoverability of DTAs and the management's process for reviewing and updating the valuation of DTAs.

Recognition and Measurement of DTLs: The measurement of DTLs is generally less complex than DTAs. However, the audit committee should be informed about the consistency of the methodology used in calculating DTLs.

Disclosure: The audit committees review the adequacy of disclosures related to DTAs, DTLs and UTTs in the financial statements. The disclosures should include:

- The significant accounting policies used in determining DTAs, DTLs and UTTs.
- The reconciliation of the beginning and ending balances of DTAs and DTLs.
- The nature and amount of significant temporary differences.
- Any uncertainties regarding the realization of DTAs.

- In case of UTTs, judgments and assumptions made in determining tax bases, unused tax losses, tax credits etc.[1]

Internal Controls: Robust internal controls are essential to ensure the accuracy and reliability of the accounting for DTAs, DTLs and UTTs. The committee should be informed about the existence and effectiveness of controls over the identification, measurement, and disclosure of DTAs, DTLs and UTTs.

What are some of the potential questions that the Auditors may expect from the Audit Committees in respect of Income Taxes related estimates and judgments under Ind AS 12? (Illustrative only)

- ❖ Has the auditor properly identified the relevant Income Tax Laws enacted or substantively enacted at the reporting date? What were the criteria adopted for determining 'substantially enacted' laws? Has this been done by members of the engagement team with adequate knowledge and experience in tax laws or have other specialists been involved?
- ❖ Have there been any significant changes in tax laws, relevant interpretations/decisions or regulations that could impact the valuation of DTAs and DTLs? How have these changes been considered?
- ❖ What was the tax rate adopted for the measurement of current taxes and deferred taxes? Was this rate based on the rate expected at the time of reversal of temporary differences?
- ❖ What are the key reconciling items reflected in the effective tax rate reconciliation prepared by the Company? Has the auditor reviewed these and is the auditor satisfied that these are appropriate and reasonable in context of the applicable tax regulation and computation of current tax provision prepared by the Company? Has the auditor evaluated effectiveness of internal controls over computation of current tax and deferred tax?
- ❖ Is the computation of current tax provision prepared by the Company in order?
- ❖ How has the auditor ensured that the tax rate and the tax base are consistent with the expected manner of realization of the asset? e.g. the carrying value of an asset can be realized through usage or sale or a combination of both.
- ❖ Has the auditor noticed any revalued non-depreciable assets carried at fair value? If so, what were the special considerations applied?
  - ❖ What was the basis for identifying the taxable temporary differences for DTL and deductible temporary differences for DTA? Has the management instituted robust controls around such identification?
  - ❖ Has the auditor noticed any initial deferred tax recognised on assets and liabilities acquired in a business combination? If so, whether such deferred tax is recognised as an adjustment to goodwill or any gain on bargain price?
  - ❖ What was the process followed by the company to calculate and measure DTA and DTL?

    Generally, the following process is followed for such measurements.

    1. Identification of temporary differences
    2. Identification of exceptions
    3. Identification of unused tax losses or tax credits
    4. Calculation and measurement of DTA and DTL
    5. Limitations on recognition of DTA.
  - ❖ How does the auditor ensure the completeness of identified temporary differences?
  - ❖ Have unused tax losses or tax credits been identified by the Company and DTA recognised for them after an assessment of the probability of utilization of these amounts?
  - ❖ Has the auditor independently verified the assumptions underlying these calculations? Does the company have a robust process in place for such identification?
  - ❖ How has the auditor assessed the probability of future taxable profits against which the DTA can be utilized?
    - ❖ This involves evaluation of the Company's business plans and projections to verify assumptions of future profitability and taxable profits. Here, the Auditor expects that the Audit Committee is aware of the future business plans, significant assumptions, and tax implications. The Audit Committee may cross-verify the Auditor's understanding of the business plans and its impact on availability of future taxable income for recognition of DTA. **It is not enough to simply consider future profitability of the entity**

[1] Para A4 of Appendix C to Ind AS 12

but future *'taxable Income'* as there could be material difference in these amounts.

- There are positive and negative factors which may be evaluated in reaching a conclusion as to the amount of the deferred tax asset to be recognised.

  1. Evidence of sufficient future taxable income to realise the benefit of DTA.
  2. Evidence of sufficient future taxable income arising from the reversals of existing taxable temporary differences (DTL) to realise the benefit of the DTA.
  3. Evidence of sufficient taxable income in the prior year(s) available for the realisation of an operating loss carryback under existing statutory limitations.
  4. A cumulative recent history of accounting losses. Depending on the extent and length of time over which losses were experienced, this could reduce the assessment of the likelihood of realisation below the important "probable" threshold
  5. A history of operating losses or of tax operating loss or credit carryforwards that have expired unused.
  6. Losses that are anticipated in the near future years, despite a history of profitable operations.

- Has the auditor noticed any change in previous estimations regarding the recoverability of DTA? If so, how robust were the underlying assumptions used by the Company?
- If the recoverability of DTA is based on management expert's valuation reports or certificates, has the auditor verified the professional competence, objectivity and independence of that expert as well as the data used by the expert to form his opinion?
- Auditor's assessment of any valuation allowance or reduction required in opening DTAs that may not be recoverable due to change in circumstances. The Audit Committee may enquire about the circumstances that changed between the previous assessment of DTA and the current assessment.
- If the auditor flagged certain uncertainties regarding Company's basis of Going Concern, how do such uncertainties impact future profitability to recover DTA?
- In case of assessment orders received from the income tax authorities during the current year, has the Company appropriately reflected the impact on current tax provision of the relevant financial year? Has the Company assessed the impact of the same on provision for current tax (outstanding in the books of accounts) for other financial years and appropriately reflected the impact thereon? Were necessary adjustments on DTA/DTL (where applicable) considered?
- What are the key areas relating to the computation of the current tax provision for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law?
- For such uncertain tax treatments, how has the Company determined the probability of the taxation authority accepting the tax treatment?
- Has the Company involved an expert to assist with the determination of such probability? If yes, was the auditor satisfied with the competence of the expert and also, does the auditor agree with the conclusions drawn by the expert?
- Which method has the Company used to reflect the effect of the uncertain tax treatments – most likely amount method or the expected value method?
- Has the Company made consistent judgements and estimates for both current tax and deferred tax (where applicable)?
- Has the Company reassessed its judgements or estimates made in relation to uncertain tax treatments in prior periods?
- Contingent liabilities and contingent assets may arise due to unresolved disputes with Taxation Authorities. Has the auditor evaluated the adequacy and appropriateness of disclosure of tax-related contingencies in the light of requirements of Ind AS 37[2]?
- Has the auditor considered the tax disputes shown under "Contingent Liabilities" and determined that the treatment of such matters is consistent with the positions taken in recording DTA and DTL?

Key Standards on Auditing (SAs) that are relevant to accounting estimates and judgments

There are number of areas that involve accounting estimates and management judgments[3]. Therefore, there are certain SAs that deal with auditor's responsibilities regarding accounting estimates. Following are the key SAs that would be of interest to Auditors & Audit Committees.

SA 540[4] which lays down audit requirements of risk assessment procedures and guidance on the nature accounting estimates, indicators of possible management bias and audit work paper documentation. This SA expands on how the requirements of SA 315[5] and SA 330[6] have to be applied in the audit of accounting estimates.

SA 701[7] deals with the auditor's responsibility to communicate key audit matters (KAM) in the auditor's report. One of the three items included as a KAM relates to areas that involve significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty. The auditor is required to report the reason and rationale for considering it as a KAM and how the matter was addressed during the course of the audit.

SA 260 (Revised)[8] requires the auditor to communicate with those charged with governance about the qualitative aspects of the accounting practices, policies and disclosures. The rationale behind such a communication is that the views of the auditor would be particularly relevant to those charged with governance to discharge their responsibilities for oversight of the financial reporting process.

[3] Also refer para A6 and A7 of Standard on Auditing (SA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
[4] Standard on Auditing (SA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
[5] Standard on Auditing (SA) 315, *Identifying and Assessing Risk of Material Misstatement*
[6] Standard on Auditing (SA) 330, *The Auditors' Responses to Assessed Risks*
[7] Standard on Auditing (SA) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
[8] Standard on Auditing (SA) 260 (Revised), *Communication with Those Charged with Governance*

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