Applicability of Tax Rate in the Quarterly Financial Results

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company is a central public sector undertaking (CPSU) under the administrative control of the Ministry of Mines, Government of India and is engaged in mining of bauxite, manufacturing of alumina and aluminium, generation of power in captive power plant for use in smelter plant and selling alumina and aluminium both in domestic and international market. It has a capacity to produce 21,50,000 metric tonne (MT) of calcined alumina and 4,60,000 of aluminium metal with 1,200 mega watt (MW) power.
2. Paid-up share capital of the company is ₹1,288.62 crore out of which 81.06% shares are held by the Government of India and 18.94% of its shares are listed in the Bombay Stock Exchange and National Stock Exchange. As per the provisions of clause 41 of the Listing Agreement, the quarterly un-audited financial results are to be furnished to stock exchanges and be published in news papers.
3. The querist has enumerated the Facts of the Case as below:
   (a) Being a listed company, the quarterly financial results of the company are published in the news paper after being taken on record by the board of directors and limited review by the statutory auditors. While computing the quarterly financial results, the company considers provision for tax expenses considering the computed taxable income upto that period based on the applicable tax rate for the said financial year.
   (b) Accounting Standard (AS) 25, 'Interim Financial Reporting' was made mandatory from 01.04.2002 by the Institute of Chartered Accountants of India (ICAI) and was subsequently included in the Accounting Standards notified in the Companies (Accounting Standards) Rules, 2006 under section 211 (3C) of the Companies Act, 1956.
   (c) The principles for recognition and measurement of tax expenses are laid down in paragraph 29(c) of AS 25 which states that the tax expenses in each interim period are to be recognised based on the best estimate of the weighted average annual income tax rate expected for the full financial year. The principle has been illustrated at paragraphs 8 to 16 of Illustration 3 to AS 25.
   (d) As per the practice followed by the company consistently, at every quarter ending day, actual tax expenses are provided based on the financials/performance upto that period (computation of which has been provided by the querist for the perusal of the Committee). According to the querist, guidelines of AS 25 have not been considered as mandatory in respect of limited review of quarterly financial results in terms of clause 41 of the Listing Agreement but only of recommendatory in nature. The company is also in a position to compute actual tax liability upto that period and the company feels it appropriate as compared to estimate of the weighted average annual income tax rate expected for the full financial year as laid down in paragraph 29(c) of AS 25.
   (e) A question has arisen whether the principles mentioned in AS 25, particularly, the principles for recognition and measurement of tax expenses as laid down in paragraph 29(c) of AS 25 would apply to unaudited quarterly financial results prepared to comply with clause 41 of Listing Agreement with the Securities and Exchange Board of India (SEBI) which are subject to limited review by the statutory auditors.
   (f) The question of applicability of above-mentioned principles to quarterly financial results prepared to comply with clause 41 of the Listing Agreement with the SEBI had been laid down in Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', which was published by the ICAI in March 2004 and which, according to the querist, states that the principles of recognition and measurement mentioned in AS 25 would apply to the financial results presented under clause 41 of Listing Agreement even though AS 25 does not apply to financial results presented under clause 41 of Listing Agreement.

(g) However, ASI 27 was not included in AS 25 when AS 25 was notified in 2006 under section 211 (3C) of the Companies Act, 1956. Therefore, it is considered that the principles mentioned in ASI 27 do not have any statutory backing in respect of companies.

(h) Subsequently in 2008, the ICAI has also withdrawn ASI 27 and issued the same as a Guidance Note of recommendatory nature. The Guidance Note on Applicability of AS 25 to Interim Financial Results, issued in 2008 clearly mentions the facts stated above. As per the querist, it has been clarified by the ICAI from time to time that pronouncements with recommendatory authority are neither binding on any entity nor these are binding on the members of the ICAI. Therefore, principles of recognition and measurement laid down in AS 25 are no longer mandatory in case of financial results presented under clause 41 of the Listing Agreement.

(i) Another factor which is required to be considered in connection with financial results being prepared in line with clause 41 of the Listing Agreement over the years is the principle of 'consistency'. The company has been following the accounting for provision for tax expenses on actual income/expenses upto the period over a period of time and as per the querist, will be construed to be giving proper picture of financial results unless the principles are diametrically opposite/ widely variant from Accounting Standards/ generally accepted accounting principles (GAAPs). Besides above, Hon'ble Supreme Court in the case of Excel Industries has given due recognition to the principle of consistency.

B. Query

4. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether calculation of tax expenses based on "best estimate of the weighted average annual income tax rate expected for the full financial year" as laid down under paragraph 29(c) of AS 25 is mandatorily applicable for quarterly financial results being published in compliance to clause 41 of the Listing Agreement with the SEBI.

(ii) Whether the existing practice of recognising provision for tax expenses considering the computed taxable income for the relevant period based on applicable tax rate is in contravention of the provisions of AS 25.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to applicability of paragraph 29(c) of AS 25 to the quarterly financial results as per clause 41 of the Listing Agreement with the SEBI and recognition of provision for tax expenses. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, other disclosure requirements as per clause 41 of the Listing Agreement, etc.

6. The Committee notes sub-clause IV (f) of clause 41 of the Listing Agreement and paragraphs 1, 2, 27 and 29 of AS 25, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') as follows:

Listing Agreement

"IV (f) The quarterly and year to date results shall be prepared in accordance with the recognition and measurement principles laid down in Accounting Standard 25 (AS 25 - Interim Financial Reporting) issued by the Institute of Chartered Accountants of India (ICAI)/company (Accounting Standards) Rules, 2006, whichever is applicable."

AS 25

"1. This Standard does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator."

"Recognition and Measurement

Same Accounting Policies as Annual

27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the

measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis."

"29. To illustrate:

...

(c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

From the above, the Committee notes that clause 41 of the Listing Agreement specifically requires that quarterly and year-to-date results should be prepared in accordance with the recognition and measurement principles laid down in AS 25. The Committee also notes that the Guidance Note on applicability of AS 25 to Interim Financial Results, issued by the ICAI does not lay down any new accounting principle and is only providing guidance on the application of a mandatory Standard (viz., AS 25). Therefore, the Committee is of the view that the company should follow the requirements of AS 25 as explained in the Guidance Note and should apply the recognition and measurement requirements as contained in paragraph 29(c) of AS 25 to the interim financial results presented under clause 41 of the Listing Agreement. Thus, whether or not the Guidance Note is binding or is recommendatory in nature is not relevant as the relevant requirements of the Standard are binding on the company. The Committee further notes that paragraph 29(c) of AS 25 requires that income tax expense should be recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year, application of which is also illustrated in paragraphs 8 to 11 and 14 to 15 of Illustration 3 to AS 25, notified under the Rules, as reproduced below:

"8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Standard. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns ₹150 lakhs pretax profit in the first quarter but expects to incur losses of ₹50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in ₹ Lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	5th Quarter
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0"

"Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax

benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carryforwards

15. A deferred tax asset should be recognised in respect of carryforward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate."

7. The Committee notes from the Facts of the Case that while computing the quarterly financial results, the company considers provision for tax expenses considering the computed taxable income upto that period based on the applicable tax rate for the said financial year. On the basis of the above, the Committee is of the view that the accounting practice of the company to provide for tax expenses at the quarterly / interim periods results based on the applicable tax rate for the said financial year would be correct provided such tax rate is the rate that would be applicable to the expected total annual earnings of the company for the whole year, that is, the estimated average annual effective income tax rate. In this regard, the Committee wishes to point out that the tax expense for each interim period is not to be determined on the basis of average of estimated annual tax expense rather it is to be determined on the basis of estimated average annual effective income tax rate applied to the portion of income earned in the interim period. Thus, if in an interim period, there is a profit but in other interim periods, there are losses resulting into nil taxable income for the financial year, tax expense in each interim period will be provided for by applying estimated average annual effective income tax rate to the income (profit or loss) of those interim periods. In other words, if there are profits in the first quarter, the company has to provide tax liability in the first quarter at the appropriate estimated average annual effective income tax rate, which would get reversed in subsequent quarters if there are losses. For the purpose of calculating the estimated average annual effective income tax rate, guidance may also be taken from the Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25, issued by the ICAI.

D. Opinion

8. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 4 above:

(i) Paragraph 29(c) of AS 25 is mandatorily applicable for quarterly financial results being published in compliance to clause 41 of the Listing Agreement with SEBI, as discussed in paragraph 6 above.

(ii) The existing practice of recognising provision for tax expenses considering the computed taxable income for the relevant period based on applicable tax rate for the said financial year would be correct provided such tax rate is the rate applicable to the expected total annual earnings of the company for the whole year, that is the estimated average annual effective income tax rate.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on September 5, 2014. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty two volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.