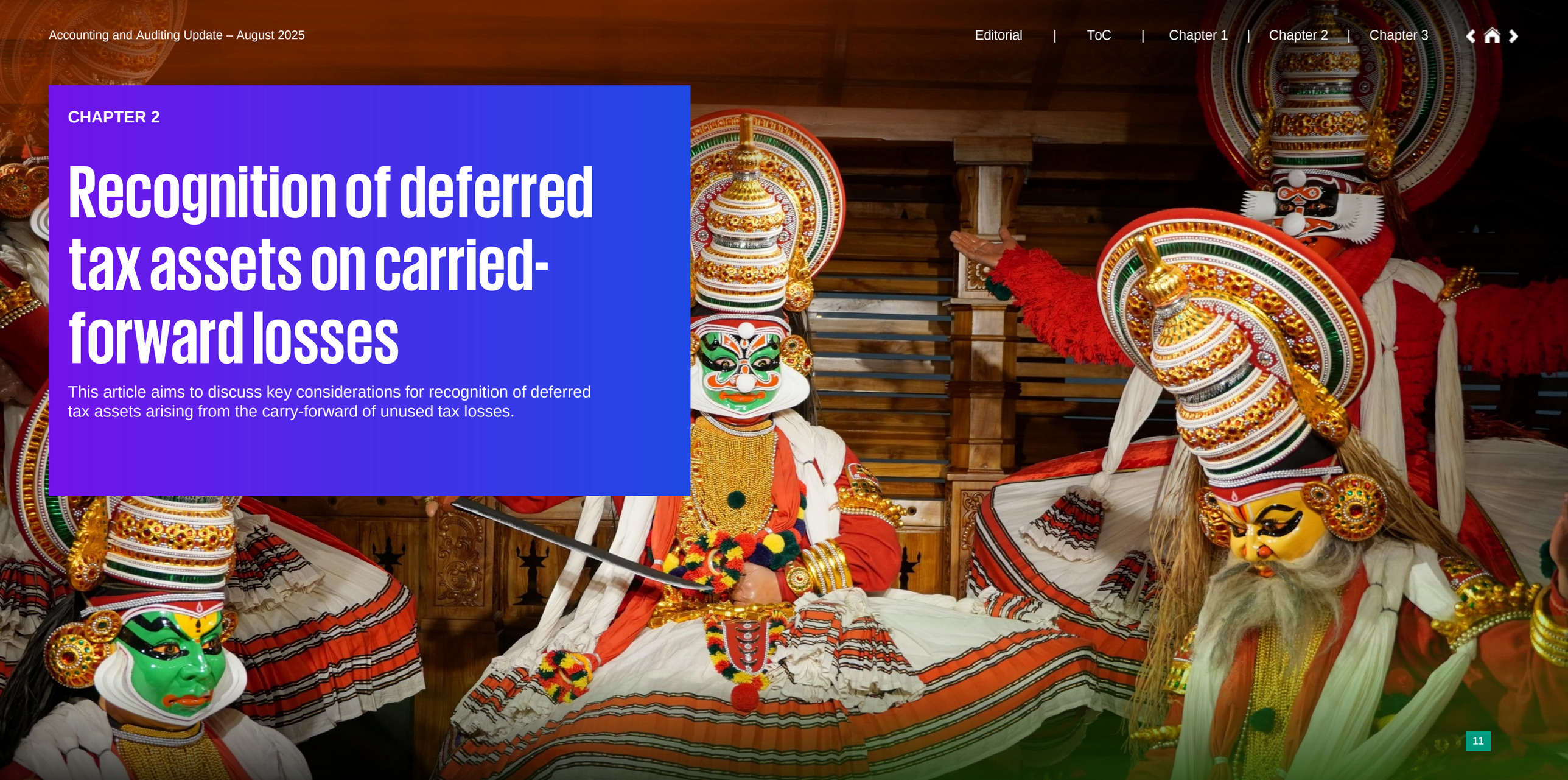
CHAPTER 2

Recognition of deferred tax assets on carried-forward losses

This article aims to discuss key considerations for recognition of deferred tax assets arising from the carry-forward of unused tax losses.



Background

In India's evolving corporate landscape, where financial transparency and regulatory compliance are under growing scrutiny, the recognition of Deferred Tax Assets (DTAs) has emerged as an area of focus. For many Indian companies especially those navigating cyclical industries, grappling with restructuring phases, or are in start-up phase - the question of whether to recognise DTA arising from unused tax losses is far more than an accounting decision. It reflects management's conviction in the entity's future profitability, strategic foresight, and operational resilience.

Under Indian Accounting Standard (Ind AS) 12, *Income Taxes*, companies may recognise DTA on carry forward of unused tax losses and unused tax credits only when it is probable that future taxable profits will be available, or when there is a convincing other evidence that sufficient taxable profit will be available (when there is a history of losses) against which these unused tax losses and unused tax credits can be utilised. The criteria for recognising DTA arising due to unused tax losses and tax credits are aligned with those for recognising DTA from deductible temporary differences. However, Ind AS 12 cautions that existence of unused tax losses is a strong evidence that future taxable profit may not be available.

Thus, recognition of DTAs is inherently complex, highly judgement-driven, and reliant on forward-looking estimates - making it particularly challenging for loss-making entities. It demands a careful balance between optimism and realism, supported by robust evidence and sound forecasting.

This article discusses some of the key considerations for recognition of DTAs arising from the carry-forward of unused tax losses.

Assessing probability of future taxable profits

It is often observed that companies with a recent history of losses have recognised material DTAs, sometimes over a prolonged number of years, without sufficient evidence to support their expectation that taxable profit will be available in future periods against which unused tax losses can be used. In this context, the European Securities and Markets Authority (ESMA) had issued a public statement[1] on IAS 12 ('the Public Statement'), the corresponding international standard to Ind AS 12, emphasising that when evaluating the probability of future taxable profits, companies should consider all available evidence, both negative and positive.

The Public Statement outlined a range of positive indicators that may substantiate the recognition of DTA, particularly in situations where losses were caused by identifiable, non-recurring events, or where the entity has a strong earnings history that excludes the period of loss - provided those losses are not expected to recur. Further evidentiary support may include emergence of new business opportunities, restructuring or disposals that eliminate loss-making operations, credible tax planning strategies, a robust sales backlog or newly secured contracts, and acquisitions that are expected to generate sustainable profit margins within the same tax jurisdiction.

1. ESMA32-63-743 issued by European Securities and Markets Authority dated 15 July 2019

In contrast, the Public Statement also highlighted certain adverse indicators that may suggest that future taxable profits are not probable. These include:

- A recent history of tax-related operating losses
- The entity being in its start-up phase
- Significant deviations between actual results and business forecasts
- Loss of major customers or contracts, and
- Uncertainties surrounding the entity's ability to continue as a going concern.

Additional concerns may arise in situations involving repeated restructuring without a return to profitability or emerging from a bankruptcy, expectations of continued losses in the near future, or a consistent pattern of unused tax losses and credits expiring unutilised. Losses arising from core business activities raise significant concerns over availability of future taxable profits as these may reoccur in the future.

Given these considerations, it is imperative that companies adopt a balanced, evidence-driven approach when evaluating the recognition of DTAs. The decision must rest on a holistic assessment, where both positive and negative factors are weighed with equal rigour to ensure that the recognition is not only compliant with applicable accounting standards but also reflects a credible, realistic, and supportable expectation of future taxable profits.

Availability of convincing evidence

While Ind AS 12 places considerable emphasis on the need for convincing other evidence to support the recognition of DTAs, it does not define the term convincing other evidence explicitly. This absence necessitates a meticulous evaluation of the nature and extent of evidence which supports the conclusion. Such convincing evidence should be objectively verifiable to support the recognition of DTAs. For instance, a forecast or budget in itself does not provide such convincing evidence. The assumptions underlying these projections should be supported by reliable evidence.

The Public Statement issued by ESMA highlights that preparation of future business projections generally requires significant judgement. Accordingly, management should exercise caution when incorporating one-time events that are beyond their control and remain highly uncertain as such events may undermine the credibility of the projections and contradict the requirement for convincing evidence to support the recognition of DTAs. Further, management must ensure the reasonableness of their business plan and its impact on future taxable profits. This includes their historical ability to accomplish their stated plans, consistency with relevant industry data and trends, and consistency of assumptions compared to prior periods. Assumptions should also be coherent with those used in other financial statements estimates for comparable elements such as goodwill impairment. Although impairment testing and budget planning should be based on consistent underlying assumptions, their distinct objectives naturally may lead to some key differences in approach and outcomes.

Some of above principles are illustrated by way of case studies.

Case Study 1:

Company A (the Company) was established one year ago and is in its start-up phase. In its first year of operations, the Company has a loss of INR700 Lakh for tax purposes. It does not have any taxable temporary differences. Further, the management of the Company expects that the Company will be profitable by its third year of operations and expects to utilise all tax losses by the end of its sixth year of operations.

In the given instance, the following factors serve as negative evidence, indicating that future taxable profits may not be sufficient:

- The company is in the start-up phase and expects to incur loss for another year
- Unavailability of sufficient taxable temporary differences
- Absence of secured contracts to support that the Company will be profitable by its third year of operations.

Accordingly, in the absence of convincing evidence that future taxable profits will be available, the Company should not recognise DTA in respect of tax losses.

(Source: Adapted with modifications from KPMG Insights into IFRS, 21st Edition 2024/25)

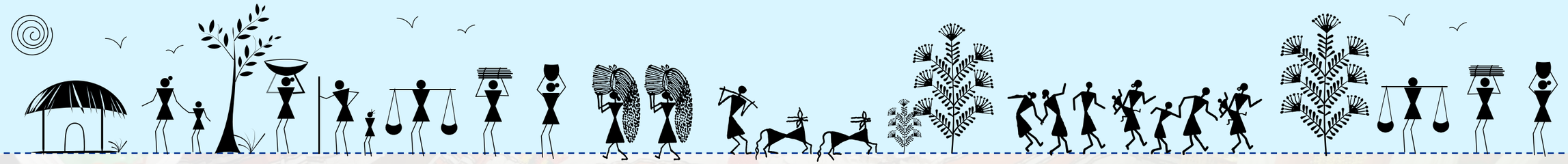
Case Study 2:

Company B (the Company) is a biotech company with one already commercialised biosimilar (B1) and multiple other products under development. Since its incorporation in the year 2013, the Company has incurred tax losses and has negative equity. Tax losses in the jurisdiction can be utilised only for a period of 8 years. In its consolidated financial statements for the year ended 31 March 2025, the Company stated that there is a material uncertainty regarding its ability to obtain funding, which may cast significant doubt upon its ability to continue as a going concern. In its business projections for the years ended 31 March 2023 to 31 March 2025, based on a 10-year budget, the Company anticipated most of its cash flows from B1 from the US, despite lacking regulatory approval as at 31 March 2025. The Company has immaterial taxable temporary differences.

In the given instance, the only positive factor that the Company may consider is that it has several business opportunities supported by products in various stages of development, supporting the assessment that it is probable that sufficient future taxable profits will be available. However, there are several factors indicating that future taxable profits may not be sufficient, constituting negative evidence, such as:

- A recent history of operating losses for tax purposes
- The Company seems akin to a start-up business since it is at an early stage still developing most products
- Existence of material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern
- Losses are related to the core activity of the Company and thus could recur in the future
- Forecasts are based upon a 10-year period, whereas the common market practice is to take future taxable profits over the next two to five years. Longer-term projections are generally viewed as less reliable
- Cash flow projections incorporate a future event - regulatory approval in the US - which is beyond the Company's control
- Tax losses in accordance with the applicable tax legislation has an expiry period.

Given that negative factors outweigh positive evidence regarding the potential availability of sufficient taxable profit, Company B should not recognise DTA in respect of tax losses.



(Source: Adapted decision ref EECS/0126-03 with modifications from ESMA, 30th Extract from the EECS's Database of Enforcement, Reference No. ESMA32-193237008-9182, dated 27 June 2025)

Key takeaways

In conclusion, DTA recognition under Ind AS 12 is far more than a technical accounting exercise – it is a nuanced, judgement-intensive process that calls for a robust, evidence-based approach. Companies must go beyond mere compliance and demonstrate convincing evidence in their assessment of future taxable profits. When building these forecasts, management should be conscious of the below:

- Forecasts should be realistic, achievable, and not excessively long-term. Longer the forecast horizons, greater the uncertainty - demanding stronger supporting evidence.
- Avoid assumptions based on future events beyond the company's control. The mere expectation that the company will continue as a going concern is not, by itself, sufficient to justify the recognition of DTA.
- Deviations between actual and projected outcomes warrant closer scrutiny.
- Consider the company's stage of growth and prevailing market trends.
- Distinguish between one-off events and recurring issues tied to core operations. Losses from core operations (e.g. poor margins or demand) require stronger offsetting evidence than losses from isolated events.
- Ensure alignment with other financial statement assumptions and estimates.

However, recognition alone is not sufficient. Equally important is the quality of disclosures accompanying DTA recognition. Disclosures should be company-specific, not boilerplate, and must reflect the facts and circumstances surrounding the recognition of DTAs by the company. The level of detail should be proportionate to the materiality of the assets and the degree of uncertainty and judgement involved.

Companies must ensure that their accounting practices and related disclosures are not merely compliant with accounting standards but also transparent, specific, and aligned with the principles of fair presentation.