

# Accounting Treatment of Contribution to a Cluster Project

*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 (hereinafter referred to as 'the company') is an unlisted public limited company and an auto-ancillary engaged in the business of manufacture of Cast Iron (C.I.), castings and machining of castings automobile parts. The foundry and the machining facilities are located at Kolhapur in the state of Maharashtra.
2. The company requires to use substantial quantity of silica sand in the foundry for making moulds. The sand once used cannot be used again and it becomes waste sand.
3. The disposal of waste sand is becoming difficult due to non-availability of proper place for dumping and on account of environmental issues and stringent restrictions from pollution control department. The problem of disposal of the waste sand is becoming costly and severe day by day.
4. The availability of fresh sand is also diminishing owing to measures being taken by the State Government to protect the environment for silica sand mining, which in turn, has increased the costs of procurement of silica sand.
5. This problem is faced by all the foundries located in and around Kolhapur and for that matter, anywhere in India. To deal with the said problem, the foundries from Kolhapur came together through their association and decided to undertake a cluster project mainly to set-up a sand reclamation plant. The Central and the State Governments have declared incentives and benefits in the form of subsidies for formation of such cluster projects which provide common utilities and services to its members.
6. Accordingly, a cluster project is undertaken by the industrialists of Kolhapur and the company has joined the said cluster project as one of its members. A limited company registered under section 25 of the Companies Act, 1956 is formed as a Special Purpose Vehicle (SPV).
7. The aforesaid cluster project is being set up to provide various services, utilities and facilities to the cluster members and one of the main activities proposed is to set up a sand reclamation plant.
8. The capital cost of the sand reclamation plant is substantially high and the capacity utilisation thereof for one foundry will not be full. Therefore, for an individual foundry owner, it is not viable/feasible to set up such sand reclamation plant on his own.
9. The features of the cluster project are as under:
  - (i) The project will be funded through contributions from members and subsidies from both the Central and State Governments.
  - (ii) Each member of the cluster has to contribute amounts calculated based on its requirement of sand reclamation.
  - (iii) The services of reclamation of sand of such quantity will be assured to the members at reasonable cost.
  - (iv) The other infrastructure and facilities created in the cluster project will also be available to the members of the cluster at reasonable cost.
  - (v) The objectives of the cluster company (i.e., the SPV) are not to make profit.
10. The company is required to pay a non-refundable one-time contribution on the basis of formula for contribution decided by the cluster (ensuring about 700 M.T. of sand reclamation). This formula is decided by the cluster and is mentioned in the scheme for membership circulated by the cluster under the head 'Membership' Sr. No. 3 which reads as under:
 

<b>MEMBERSHIP</b>		
Sl. No.	Member Category	Contribution
1.	Membership-A	Min. ₹ 1.00 Lac

Sl. No.	Member Category	Contribution
2.	Membership-B	Min. ₹25,000/- (B Class members cannot avail the facility of Export-Import House.) Generous Donation/ Contribution are requested from industries once and above the membership etc. *Members will get 25% discount on Testing Facilities.
3.	Sand Reclamation	One time Contribution– ₹6,000 PMT per month. Processing charges: as per actual only. Estimated payback: 2 years

11. The querist has clarified that the company is a general member under 'Sand Reclamation Category'. The contribution for sand reclamation category is one time at ₹6,000/- per metric tonne/per month of sand reclamation requirement. At this rate, the company desires to make one time contribution of ₹42.00 lakhs with a view to book the capacity of 700 tonnes. According to the querist, the sand reclamation benefits are permanent and it is not envisaged that the entitlement would exhaust any time. The mention of the payback period in the Scheme is based on very rough estimation. The above payback period of two years is estimated by the management of the cluster on the basis of saving of about 25 paise per kg/per month, i.e., ₹250/- per month saving for one tonne sand reclamation per month. The one time contribution is ₹6,000/- per tonne. With ₹250/- per month saving, the payback period will be about 24 months i.e. 2 years. The amount of saving per tonne is based on very rough estimation. The actual saving per month will be worked out once the facilities are started, and the more correct estimation of payback period will be worked out to decide the period/years within which the amount of total contribution is to be amortised.

12. The company has paid an advance against its contribution and the balance is required to be paid in five equal installments. The advance paid is shown as advance under long-term loans and advances.

13. The querist has pointed out that it may not be possible to workout the actual saving in the cost of reclamation of sand due to various factors such as no comparative costs being available and various advantages are of qualitative nature such as compliance with environmental issues, etc.

14. The querist has clarified that the company has not received any ownership rights over the SPV and neither the membership nor the benefits can be transferred.

15. The following accounting treatment has been suggested to the company for accounting the expenditure by way of contribution to the cluster project:

- Treat the amount now contributed as an advance till the cluster facility is set up and commences providing the services. Upon such commencement, treat the amount contributed as deferred revenue expenditure and amortise the same over a reasonable period of 3 to 5 years.
- Charge the amortised amount to the statement of profit and loss and balance shall appear in the balance sheet under loans and advances (non-current assets).

## B. Query

16. The querist has sought the opinion of the Expert Advisory Committee as to whether on the basis of above facts, the accounting treatment as suggested in paragraph 15 above is proper and in accordance with the generally accepted accounting principles. If not, then what is the appropriate accounting treatment?

## C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to accounting treatment of the contribution made by the company to a cluster project for a sand reclamation plant through a Special Purpose Vehicle company. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, legal interpretation of Memorandum and Articles of Association of the SPV (supplied by the querist for the perusal of the Committee), implications of the recommended accounting treatment for income-tax purposes, etc. Since the querist

has mentioned that the company has not received any ownership rights over the SPV, the Committee proceeds on this premise.

18. The Committee notes that as stated in paragraphs 5 and 6 above, a Special Purpose Vehicle (SPV) has been set up by the industrialists in the Kolhapur region in the form of a not-for-profit section 25 company under the Companies Act, 1956, to undertake a cluster project to set up a sand reclamation plant for the benefit of its members including the company. Each member of the SPV company is required to contribute a non-refundable amount towards the cost of setting-up the sand reclamation plant based on its monthly requirement of sand reclamation. The question now arises is whether such contribution can be capitalised as an asset or should be expensed.
19. The Committee notes that Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. In this context, the Committee notes the definitions of the terms 'intangible asset' and 'asset' given in paragraph 6 of AS 26 and meaning of 'control' dealt with in paragraph 14 thereof as reproduced below:

***"6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes."***

***"6.2 An asset is a resource:***

***(a) controlled by an enterprise as a result of past events; and***

***(b) from which future economic benefits are expected to flow to the enterprise."***

"14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control.

However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way."

20. The Committee notes from the above that an item can be classified as an intangible asset only if it fulfills all the three conditions: (a) it is identifiable, (b) the enterprise has control over the resource, and (c) it is expected that future economic benefits will flow to the enterprise. The Committee notes that in the extant case, the contribution entitles the company the service of reclamation of sand upto 700 M.T. per month and various other services, utilities and facilities provided by the SPV at a reasonable cost. Thus, contribution made by the company gives rise to a membership right in the SPV for the company, which is identifiable and from which future economic benefits are expected to flow to the company. Further, with regard to control, the Committee notes that to the extent of its entitlement for sand reclamation of 700 M.T. per month, the company enjoys unrestricted services. Thus, although the company does not get any ownership right over the SPV, the company has the control over sand reclamation entitlement and other benefits attached with the membership rights. Accordingly, the Committee is of the view that the membership right received as a consideration of the total contribution of ₹42 lakh made by the company to the cluster project should be recognised as an intangible asset. In view of this, the accounting treatment proposed by the company to treat the contribution as deferred revenue expenditure is not appropriate. However, till the time such right is not available for its intended use due to cluster project being in progress and other factors, the contribution made by the company should be treated as an advance.
21. With regard to the amortisation of the intangible asset, the Committee notes paragraph 63 of AS 26, notified under the Rules, which requires as below:

***"63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten***

*years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.”*

The Committee notes from the above that as the future economic benefits embodied in an intangible asset are consumed over time, the cost of the asset should be systematically allocated over the asset's useful life. In this regard, the Committee notes the definition of the term 'useful life' as per paragraph 6.9 of AS 26, notified under the Rules, which provides as follows:

**“6.9 Useful life is either:**

- (a) the period of time over which an asset is expected to be used by the enterprise; or**
- (b) the number of production or similar units expected to be obtained from the asset by the enterprise.”**

From the above, the Committee notes that useful life is the period of time for which the asset is expected to be used by the enterprise.

The Committee is of the view that useful life is different from the pay-back period, which is merely an estimate of the period over which the cost incurred (contribution towards the cluster project) will be recovered. In the extant case, since the economic benefits of membership right would be available to the company even after the pay-back period, the useful life should be determined considering the period over which the economic benefits are expected to arise from the use of the membership right. Further, the Committee is of the view that for determining the useful life of an intangible asset, various factors, such as, the expected usage of the asset, the period of control over the asset and legal or similar limits on the use of the asset etc., as indicated in paragraph 64 of AS 26, need to be considered. Accordingly, the contribution made by the company to the cluster project should be amortised over its useful life rather than the pay-back period or a period of 3-5 years, considered reasonable by the company, as proposed in paragraph 15

above. In this context, the Committee also notes that the amortisation method should be in accordance with paragraph 72 of AS 26, notified under the Rules, as reproduced below:

***“72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.”***

22. With regard to the querist's contention that the sand reclamation benefits are permanent and it is not envisaged that the entitlement would exhaust any time, the Committee further notes paragraphs 67 and 68 of AS 26, notified under the Rules, which state as below:

“67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

- (a) amortises the intangible asset over the best estimate of its useful life;
- (b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and
- (c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset. ...”

“68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.”

From the above, the Committee is of the view that an intangible asset may have a useful life longer than ten years but it is always finite. The company should disclose the reasons if the

presumption of useful life of 10 years is rebutted and the factor(s) that played a significant role in determining the useful life of the asset. Thus, keeping in view the facts and circumstances of each case, the useful life of an intangible asset has to be determined.

## D. Opinion

23. On the basis of the above, the Committee is of the opinion that as explained in paragraph 20 above, the membership right received as a consideration of the total contribution of ₹42 lakh made by the company to the cluster project should be recognised as an intangible asset. In view of this, the accounting treatment proposed by the company to treat the contribution as deferred revenue expenditure is not appropriate. However, till the time such right is not available for its intended use due to cluster project being in progress and other factors, the contribution made by the company should be treated as an advance. Further, such intangible asset should be amortised over the estimated useful life as explained in paragraphs 21 and 22 above.

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 July 24, 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 <a href="mailto:eac@icai.in">eac@icai.in</a> .