

Treatment of Commission Cost Paid to Agent in Relation to Projects

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 involved in the business of designing, engineering and erection of ethanol, brewery, water and waste water treatment plants. The company caters to both domestic and international markets. The revenue recognition of the company, as per the querist, is governed by Accounting Standard (AS) 7, 'Construction Contracts,' for the above-mentioned line of business. The company has raised this query in relation to inclusion of certain costs as contract cost in terms of paragraphs 15 to 20 of AS 7.
2. The querist has stated that the company executes projects in international and domestic markets for the above-mentioned business. In certain cases, the company appoints agents to undertake the following activities:
 - (i) Generate enquiry from prospective customers.
 - (ii) Support in obtaining the order from the customer and facilitating the execution of the agreement.
 - (iii) Support in technical and commercial discussions and communications with the customer.
 - (iv) Project co-ordination and support, procurement support and local assistance.
 - (v) Overall updation about the status and completion of the project.
 - (vi) Facilitate and arrange advance payment from customer and ensuring timely collections from customer.

The above services rendered by the agent form an integral part of the project right from inception of project till the timely execution and completion of the project. The querist has also clarified that different agents are not deployed for undertaking the above-mentioned activities. Only one agent undertakes all the activities for a particular project right from receipt of order to recovery of last money from the customer for that particular project. The activities of the agent are not limited only to finding the prospective customer and obtaining the contract. The activities involved are right from inception of project till the timely execution and completion of the project. The agent provides various services in the nature of procurement support, vendor short listing, and technical services *etc.*, which are an integral part in the execution work of the project and as such, according to the querist, the costs towards sales commission are specific for that contract and essential for smooth execution of the project. These costs would be incurred only where the project activity is carried out for that particular contract. These are specifically identified for each project and considered in the total estimated cost of the project.
3. The querist has further stated that the company presently pays compensation to these agents for the services rendered in the form of 'sales commission' by entering into individual agreements with them. The sales commission is decided as a percentage of contract value and the same is accrued in the books of account in proportion to contract revenue of respective project. Payment terms are directly linked with specific contract and receipt of amount from customer for the said project. As per normal payment terms, the sales commission is paid to an agent, in proportion to amount received for the project from the customer. In simple words, the commission becomes due (accrued as expense) on the basis of contract revenue and would become payable as and when the company receives money from the customer for the respective project. The querist has also separately clarified that commission for a particular project is payable only on receipt of order from the customer and no commission is payable if the order from the customer does not materialise. In other words, the commission becomes due only when the company receives order for the project. In case, the company does not receive the order for the project, no commission becomes payable to the agent.
4. The querist has also informed that although the commission costs are not explicitly charged to the customer as a separate cost, these form part of the total project cost and are considered while deciding the order value. As such, they are not specifically reimbursable from the customer on one-to-one

basis and there is no separate mention of these costs in the contract entered into with the customer, but the commission cost is included in total order value.

5. The commission paid to the agent is treated as direct cost of the project and included in the total estimated cost of the project as sales commission cost. These costs are included in the project cost as these are directly related to the project and can be separately identified and allocated to the project. For revenue recognition as per AS 7, the sales commission cost is included in the actual cost of project as well as budgeted cost of project to arrive at the percentage of completion. Based on the percentage completion so arrived, the revenue is recognised in the books of account.

B. Query

6. From the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
 - (i) Whether the treatment adopted by the company, of including the commission cost as part of project cost, as explained above is correct.
 - (ii) If the treatment adopted is correct, whether the cost would be classified as direct cost of the project or cost allocable to the project.
 - (iii) If the treatment adopted is not correct, under what head these costs can be classified under indirect expenses.
 - (iv) Whether the treatment adopted by the company to calculate percentage of completion including the sales commission cost and thus complying the revenue recognition as envisaged under AS 7 is correct.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised in the query relate to whether commission paid to agents for the service rendered in relation to projects should be included in contract costs for revenue recognition under AS 7 and if included, whether it should be treated as direct cost or as allocable expenses to the project. Accordingly, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, correctness of using nomenclature 'sales commission' for compensation paid to agents, timing of recognition of commission cost in respect of various nature of activities, etc.

8. The Committee notes paragraphs 15, 19 and 20 of Accounting Standard (AS) 7, 'Construction Contracts', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as stated below:

"15. Contract costs should comprise:

- (a) *costs that relate directly to the specific contract;*
- (b) *costs that are attributable to contract activity in general and can be allocated to the contract; and*
- (c) *such other costs as are specifically chargeable to the customer under the terms of the contract."*

"19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

- (a) general administration costs for which reimbursement is not specified in the contract;
- (b) selling costs;
- (c) research and development costs for which reimbursement is not specified in the contract; and
- (d) depreciation of idle plant and equipment that is not used on a particular contract."

"20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period."

From the above, the Committee notes that contract costs include the costs directly related to a specific contract as well as the costs that are attributable to contract activity in general and can be allocated to the specific contract. However, as per paragraph 19 of AS 7, general administration costs that are not specifically reimbursed in the contract and selling costs are excluded from the costs of a construction contract since these can neither be attributed nor allocated to the 'construction

activity'. As per paragraph 20 of AS 7, the costs which are incurred in securing the contract are included as part of the contract costs only if they can be separately identified and measured reliably and its probable that the contract will be obtained. Accordingly, the Committee is of the view that whether commission payable to agent is a contract cost or not depends on the nature of activity for which commission is being paid.

9. The Committee notes from the Facts of the Case that so far as the activities of the agent related to execution of the contract activity, such as procurement support, project coordination and other technical services are concerned, the Committee is of the view that these activities are directly related to the construction contract and therefore, costs pertaining to these activities should be treated as costs that relate directly to the specific contract. Similarly, activities of the agent related to finding the prospective customer and obtaining the contract, *etc.* can also be treated as directly related to the contract as in the extant case, the costs pertaining to these activities are payable only on obtaining the contract. The Committee further notes that since commission payable in respect of such activities can be identified separately and can also be measured reliably (commission being charged as a specified percentage of contract value), it can be included as part of contract costs. However, the Committee notes from the Facts of the Case that the agent, in the extant case, not only provides services in relation to securing of the contract, procurement support and other technical services relating to execution of the project, but also facilitates and arranges advance payments from the customer and ensures timely collections from them. The Committee is of the view that activities relating to the facilitation and arrangement of advance payments and final collections from the customer and other similar activities are of the nature of administration costs, which cannot be considered as attributable to construction activity and accordingly, cost of these activities should not be treated as the cost directly related or that attributable to a construction contract as per the principles of AS 7. Therefore, the Committee is of the view that if the commission cost paid to the agents is a composite commission, the company should assess whether the latter activities and the cost in respect thereof are material and if it is so, attempt should be made to estimate the cost pertaining to

these activities considering the factors, such as, the cost that would have been incurred had the agent performed only these activities, *etc.* Accordingly, the cost incurred on selling and administration activities should not be included in contract cost.

10. As regards including the commission cost for determining the stage of completion, the Committee notes paragraph 30 of AS 7, notified under the 'Rules,' which is reproduced as below:

"30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and
- (b) payments made to subcontractors in advance of work performed under the subcontract."

From the above, the Committee is of the view that only those contract costs that reflect work performed should be included in costs incurred upto the reporting date. However, as per the Facts of the Case (paragraph 3 above), related commission is accrued in proportion to contract revenue. In other words, such costs are not being recognised considering the performance of related service rather the same is being recognised on the basis of contract revenue. Accordingly, the Committee is of the view that inclusion of commission on this basis is not correct; rather, it should be recognised considering the performance of related service provided the commission so determined is 'contract cost', as discussed in paragraph 9 above.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6 above:

- (i) The treatment adopted by the company of including the commission cost as part of project cost would be correct only in respect of the commission cost paid to the agents to

the extent it is directly related to contract and such activities are in relation to construction activity and further, it is not in the nature of administration and selling cost, as discussed in paragraph 9 above. Commission cost to the extent it is incurred on selling and administration activities, if material, should not be included in contract cost.

- (ii) and (iii) Subject to (i) above, the cost may be classified as direct cost of project, as discussed in paragraph 8 above. However, if it does not meet the criteria as laid in (i) above, it cannot be treated as a contract cost. The nature of such expense should be considered to determine the head of the expense.
- (iv) Subject to (i) above, the treatment adopted by the company to calculate percentage of completion would be correct provided the commission cost is recognised considering the performance of related service as per the principles of AS 7, as discussed in paragraph 10 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 3 rd September, 2013. 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 .