Note by Christopher Nobes on the Definition of 'Revenue' in the IASB's Exposure Draft of 2011

The definition of 'revenue' in Appendix A is:

Income arising in the course of an entity's ordinary activities.

I suggest that this definition is seriously flawed in a number of ways, as now explained. I do not reply to the specific questions in the ED. I believe that it would be premature to do so. It is not possible to give good answers to questions of recognition and measurement while it remains quite unclear what it is that we are supposed to be recognising and measuring.

Problem 1

Income is defined (in Appendix A) as increases in economic benefits. As pointed out elsewhere by Richard Barker, an increase in benefits is a *debit*, whereas income is a *credit*. That is, income (and therefore revenue) should instead be defined as the increases in equity that result from increases in benefits.

Problem 2

The definition of revenue rests on the concept of 'ordinary activities'. This is unsatisfactory because the term is no longer defined in IFRS. When it was defined (in IAS 8 of 1993), it was a very wide concept:

any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from these activities. (para. 6)

That is, virtually all income was ordinary, so virtually no income was extraordinary. In IAS 1 (from 2003 onwards), the concept of 'extraordinary activities' is irrelevant because no income must be *presented* as extraordinary. However, the IASB implies (in BC 64 of the 2007 version of IAS 1) that the concept still exists with a similar very narrow meaning.

Consequently, to take the example of a stores group (e.g. Tesco), the sale of a shop is an ordinary activity. Therefore, according to the ED, income from the sale of a shop is revenue. I presume that the IASB does not intend this result.

Similarly, when Tesco receives interest income or dividends, these meet the definition of revenue (because they are ordinary). Again, presumably this is not intended.

¹ Barker, R. (2010) 'On the definitions of income, expenses and profit in IFRS', *Accounting in Europe*, Vol.7, No.2, pp.147-158.

The IASB suggests (BC 30 and 36) that its hands are tied because of the 'description' of revenue in the Framework. However, this is incorrect. In the Framework (para.4.29), income is divided into revenue and gains. Gains are defined residually as income other than revenue. However, since gains 'may, or may not, arise in the course of ordinary activities' (para. 4.30), it is clear that some ordinary income is revenue and some is not. Therefore, the ED's definition does not follow from the Framework, because it implies that all ordinary income is revenue.

Problem 3

Connected to the above issue, the concept of 'gains' seems to have been almost eliminated, as now explained. Assuming that most entities in most years have no extraordinary activities (see the discussion above), then the following appears to apply to such entities:

- 1. No income is from extraordinary activities.
- 2. Therefore, all income is from ordinary activities.
- 3. Income from ordinary activities is revenue (from ED on Revenue).
- 4. Therefore, all income is revenue (from 2 and 3).
- 5. Gains are any income that is not revenue (from the *Framework*).
- 6. Therefore, there are no gains (from 4 and 5).

Problem 4

Appendix A of the ED defines 'customer' as a party contracted to receive the output of the entity's 'ordinary activities'. Given the above discussion about the wide scope of ordinary activities, this means that Tesco's customers would include an entity which bought a shop from Tesco, an investee which paid a dividend to Tesco, and a bank which bought Tesco's receivables. Presumably this is not intended. The word 'customer' appears in a number of other definitions, so they are also flawed.

Problem 5

Unlike IAS 18, the ED does not tell us whether revenue is a net or a gross concept. I believe that it should tell us. I presume that a gross concept is intended. This, however, also creates a problem.

Suppose that an entity buys inventory for ≤ 10 and later sells it for ≤ 8 . There are two ways of looking at this when trying to identify revenue: (i) considered net, the transactions do not involve an increase in equity (or a net increase in assets) but a decrease, so the ≤ 8 is not income, and therefore not revenue; or (ii) considered gross, we should concentrate on the sale only, so the ≤ 8 is an increase in equity and in assets (and the ≤ 10 separately becomes a decrease, i.e. an expense). I take it that interpretation (ii), the gross one, is intended.

Suppose, now, that an entity buys inventory for €10 and later sells it for €12 on credit. There is a gross increase in equity of €12 caused by the rise in receivables (ignoring the fall in the asset

inventory). So, there is revenue of €12. In the next period, the customer pays €12 cash. This is also a gross increase in equity of €12 caused by the rise in cash (ignoring the fall in the asset receivables), and it appears to meet the definition of revenue. Similarly, if Tesco sells its receivables to a bank, that would meet the definition of revenue. Presumably, none of this is intended.

Problem 6

The ED (para. 2) states that it does not deal with 'revenues arising from other transactions or activities (for example...the changes in the values ofassets)'. Indeed, the ED is entitled 'Revenue from Contracts with Customers', implying that there are other sorts of revenue. The Basis for Conclusions of the ED states that 'revenue would continue to be recognised from changes in value of biological assets, investment properties ...' (para. BC 29). However, to take the example of investment properties, there is no suggestion in IAS 40 that increases (let alone decreases) in fair value are 'revenue'. Furthermore, in practice, companies (even those whose main business is running investment properties) do not show such items as 'revenue'. Instead, such items (which are not gross inflows) are shown as gains rather than as revenue.

Conclusion

The combination of all the above problems of definition seems to me to be a fatal flaw in the ED, which needs to be resolved before publishing a Standard. Improvements could include:

- (i) Defining income and revenue in terms of increases in equity not increases in benefits.
- (ii) Removing the term 'ordinary activities' form the definitions of 'revenue' and 'customer'.
- (iii) Removing the suggestions that increases in fair value are revenue.
- (iv) Explaining that revenue is a gross concept.
- (v) Explaining that revenue is a measure of the increase in equity achieved by work done for customers.

At first sight, suggestion (v) does not help much, because it merely pushes the problem on to the word 'customer' rather than the word 'ordinary'. However, this can be resolved by requiring each entity to identify and disclose what it regards as its revenue-earning activities. Other income would be gains. For many entities, this would be simple enough. For Tesco, such revenue-earning activities include selling baked beans but not selling shops, receiving dividends or selling receivables.

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² For example, British Land has 'Net rental and related income' as the first line of its income statement. The fair value changes on investment properties are shown six lines later after administrative expenses (Annual Report, 2011, p.134 and note 6).