# Issue

# Some Services classify depreciation expense as a non-operating expense on the income statement, while other Services consider depreciation expense an operating expense. Currently the DoD Financial Management Regulation Volume 13 classifies depreciation expense as a non-operating expense. Additionally, Service specific reports that do not need to follow Generally Accepted Accounting Principles (GAAP), use Net Income Before Depreciation and Net Income After Depreciation.

# Research

Below outlines the current treatment on how each service complies and what the regulations, accounting guidance and industry standards are for this area.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Classification and Handling of Depreciation Expense Guidance | Air Force | Army | Navy | Marines |
| Services Depreciation Expense classification | Operating expense | Below the line and therefore uncategorized | Non-operating expense | Operating expense  Because they cannot run the business without the equipment/ assets. |
| FASB 360-10-50-1:  Because of the significant effects on financial position and results of operations of the depreciation method or methods used, all of the following disclosures shall be made in the financial statements or in notes thereto:   1. Depreciation expense for the period 2. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date 3. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date 4. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets. | Follows Alternative Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Current Guidance |
| SEC Staff Views – Staff Accounting Bulletins Official Text  Topic 11: Miscellaneous Disclosure  Depreciation and Depletion Excluded from Cost of Sales:  Facts: Company B excludes depreciation and depletion from cost of sales in its income statement.  Question: How should this exclusion be disclosed?  Interpretive Response: If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation. | Follows Current Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Current Guidance |
| FMR Volume 13, Chapter 5. 050401. Recognition:  NAFIs must recognize costs as an expense in the period that the income with which they are associated is recognized (the matching principle). Cost elements are included in inventory and expensed when the items are sold and income from the sale is recognized. If no connection with income can be established, then the asset’s cost is allocated to the accounting period benefited in a systematic and rational manner. This form of expense recognition involves the expected length of benefit and the relationship and cost of each period (e.g., depreciation of fixed assets, amortization of intangibles, and allocation of rent and insurance). All other costs are recognized in the accounting period in which they are incurred. | Follows Current Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Current Guidance |
| FMR Volume 13, Chapter 5, 050602. Non-operating Expenses (April 2013):  Non-operating expenses are not related to NAFI’s primary operations and consist of depreciation, interest, prior period expenses, and losses. | Follows Alternative Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Alternative Guidance |
| Department of Treasury - U.S. Government Standard General Ledger (USSGL):  USSGL reports a Statement of Net Cost and does not report an Income Statement; therefore, they do not distinguish between operating and non-operating for depreciation expense. | N/A | N/A | N/A | N/A |
| Industry Practice - Disney:  Disney’s consolidated statement of income does not explicitly differentiate between operating and non-operating expenses. However, typical non-operating expenses (i.e. interest income/expense) are separated from depreciation.  *Consolidated Statement of Income:*  Services Revenue  Products Revenue  Total revenues  Cost of services (exclusive of depreciation and amortization)  Cost of products (exclusive of depreciation and amortization)  Selling, general, administrative and other  Depreciation and amortization  Total costs and expenses  Restructuring and impairment charges  Other income/(expense), net  Interest income/(expense), net  Equity in the income of investees  Income before income taxes  Income taxes  Net income | Follows Current Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Current Guidance |
| Industry Practice - Hilton:  Depreciation expense included in operating expenses above operating income calculation.  *Consolidated Statement of Operation:*  Revenues  Owned and leased hotels  Management and franchise fees and other  Timeshare  Total revenues excluding reimbursement revenue  Other revenues from managed and franchised properties  Total revenues  Expenses  Owned and leased hotels  Timeshare  Depreciation and amortization  Impairment losses  General, administrative and other  Total expenses excluding cost of reimbursable expense  Other expenses from managed and franchised properties  Total expenses  Operating income | Follows Current Guidance | Follows Alternative Guidance | Follows Alternative Guidance | Follows Current Guidance |
| DoDI 1015.15, NAFs Available/Projected Usage Report:  This report differs from the Income Statement and is not required to follow GAAP.  FUNDS AVAILABLE  Operating Cash Invested in Central Banking Program  Other Cash Resources/Local Balances:  Local Bank Accounts  Cash on Hand in Change Funds, Petty  Cash Funds, and Conversion Funds  Other Investments (Specify)  Fixed Asset Sinking Funds  Employee Benefit Sinking Funds  Net Income Before Depreciation for Next FY  Total Funds Available |  |  |  |  |

# Discussion

At the time this paper was written, FMR Volume 13 classified depreciation expense as a non-operating expense on the income statement and was not in line with GAAP. FMR Volume 13 also references one of the four principles of accounting, the matching principle. That matching principle matches expenses with revenue it helped create. For example, a rental boat’s depreciation expense would be matched to the rental revenue associated with the boat. Because the boat’s rental revenue is an operating expense, the depreciation expense would match the revenue and be classified as operating.

Service specific reports such as the NAFs Available/Projected Usage report present net income before depreciation. This report is an internal management report and is not required to follow GAAP. The Services are able to present depreciation as an operating expense on the income statement and also generate a separate report that presents net income before depreciation.

# Recommendation

Each Service should follow GAAP and have depreciation expense match the corresponding revenue and present it accordingly on the income statement. **Depreciation expense is primarily associated with operating activities; therefore, we recommend moving depreciation to the operating expense section of the income statement.** Specifically, GLAC 703 Depreciation and Amortization Expense should be moved to the GLAC 500 series with the other operating expenses. Additionally, the following guidance should be revised:

DoDI 1015.15 6.4.2.6. “Depreciation and Amortization” should include additional clarification for the appropriate place to expense depreciation.

Tangible fixed assets, except construction in progress, shall be depreciated over their expected useful lives. Depreciation and amortization shall be established and reported on financial statements. In accordance with the matching principle, depreciation expense should match the corresponding revenue and be presented accordingly on the income statement.

FMR Volume 13, Chapter 2, para 020406.A. “Operating Expenses” be revised to add the depreciation expense (previously in the non-operating expenses section).

# Service Concurrence

|  |  |  |
| --- | --- | --- |
| Service | Concurrence | Reason |
| Air Force | Concurrence on 3/13/2018. **Re-concurred 10/19/2018.** |  |
| Army | Concurrence on 3/13/2018. **Re-concurred 11/2/2018.** |  |
| Marines | Concurrence on 3/13/2018. **Re-concurred 10/31/2018.** |  |
| Navy | Concurrence on 3/13/2018. **Re-concurred 11/2/2018.** |  |

# USD(P&R)/MC&FP Disposition

Revise DoDI 1015.15. 6.4.2.6.

**DFAS Disposition**

Revise FMR Volume 13, Chapter 2, para 020406.

# Forward to DoDIG?

No DoDIG equities.