



# SEC Issues & Trends



## SEC focuses on income statement presentation and measures excluding certain costs

October 18, 2017

SEC staff objects to certain gross margin presentations and expense classification in the income statement.

### SEC requires financial statement revisions

The SEC staff is commenting on and requiring financial statement revisions for classification of expenses, allocation of indirect costs and presentation of gross margin.

The SEC staff is asking how companies are complying with Rule 5-03.2 of Regulation S-X, Staff Accounting Bulletin (SAB) Topic 11.B and SAB Topic 14.F in their income statements.<sup>1</sup>

### Required financial statement line items

S-X Rule 5-03 requires companies to state separately net sales and gross revenues, and applicable costs and expenses related to each of the following:

- tangible products sold;
- public utility operating revenues;
- rental income;
- revenues from services; and
- other revenues.

When a company presents in its income statement a subtotal for 'gross margin' or 'gross profit' (generally understood to mean net sales less cost of sales or cost of goods sold), cost of sales must include all costs applicable to sales.

### Depreciation, depletion and amortization

SAB Topic 11.B prohibits companies from presenting a line item for cost of sales in the income statement that omits applicable depreciation, depletion and amortization (DD&A) unless the line item title is modified to disclose that DD&A is excluded.

For example, the separate line item might be titled 'Cost of goods sold (exclusive of depreciation shown separately below)'. In this case, a company could report gross margin or gross profit by also presenting a subtotal that includes depreciation and other costs of sales, thereby avoiding presenting a prohibited measure of income before depreciation.

### Stock-based compensation

SAB Topic 14.F requires companies to allocate stock-based compensation to the same line item as the employee's cash compensation paid.

Similar to the treatment for DD&A in SAB Topic 11.B, a company may present the amount of stock-based compensation related to costs of sales in a separate line item, by modifying the line item title to disclose that stock-based compensation is excluded.

<sup>1</sup> S-X Rule 5-03.2, [Income Statements](#); SAB Topic 11.B, [Depreciation And Depletion Excluded From Cost Of Sales](#); and SAB Topic 14.F, [Classification of Compensation Expense Associated with Share-Based Payment Arrangements](#)

## Example gross margin presentations

In response to comments, some companies have revised their gross margin presentation to more clearly describe how DD&A is reflected in the

measure. Others have stopped presenting the line item gross margin in their income statement because S-X Rule 5-03 does not require that subtotal (although gross margin should be calculable).

### Examples of acceptable presentations that do not state gross margin

#### Example 1:

Total net sales

Costs and expenses:

Cost of materials

Operating expenses (exclusive of depreciation and amortization of \$XXX, \$XXX, and \$XXX, respectively)

General and administrative

Depreciation and amortization

Total costs and expenses

Operating income/(loss)

#### Example 2:

Total net sales

Costs and expenses:

Cost of materials

Operating expenses (exclusive of depreciation and amortization reflected below)

Depreciation and amortization

Total cost of goods sold

General and administrative (G&A) (exclusive of depreciation and amortization reflected below)

Depreciation and amortization

Total costs and expenses

## Non-GAAP financial measures

While not permitted within a company's GAAP income statement, if a company believes that a performance or liquidity measure that excludes DD&A or other expenses is an important metric to the company and investors, it may consider reporting the metric outside of the financial statements (e.g. in Management's Discussion

and Analysis) as a non-GAAP financial measure. That presentation must comply with the SEC's rules and Compliance and Disclosure Interpretations for non-GAAP financial measures, including not labeling the metric the same as, or confusingly similar to, titles or descriptions used for GAAP financial statements (e.g. gross profit).

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