

PHILIPPINE DIVIDEND LAW REVISITED: III *

JOVITO R. SALONGA **

THE BALANCE SHEET AND THE PROBLEM OF VALUATION.

As elsewhere stated, one of the most crucial and perplexing problems in the whole subject of dividend regulation, particularly in a balance sheet surplus jurisdiction like the Philippines, is that of valuation. If "net assets" implies the quantity by which the assets of the corporation exceed the aggregate amount of its undischarged debts and liabilities to others than holders of its outstanding shares, the problem immediately comes up: how shall the value of these net assets be determined? In ascertaining the net assets of a corporation, it will be important likewise to find out what are the present assets, and the present debts and liabilities, since 'net assets' refers to the excess of present assets over existing undischarged debts and liabilities. The measurement may be primarily a matter of accounting determination, but the problem cannot be brushed aside summarily.

The reasons are quite obvious. In the first place, some aspects of valuation are not settled by uniform, consistent accounting practice. Accounting, as a technique, is not based on principles that do not change. Thus we find the highly realistic statement of an authoritative body defining the nature and scope of accounting rules and principles in this language:

"Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. An accounting principle is not a principle in the sense that it admits of no variation, nor in the sense that it cannot conflict with other principles."⁹⁸

In the second place, the problem of persuading a particular court to recognize a so-called accepted principle of accounting is ever

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** Professor of Law (Lyceum of the Philippines); LL.B., '46 (U.P.), LL.M., '48 (Harvard); J. S. D., '49 (Yale).

⁹⁸ See Accounting Research Bulletin No. 7 (1940), prepared by the Committee on Accounting Research, American Institute of Accountants. Cf. this statement with SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 5: "The existence of such a body (of 'accepted principles of accounting') does not mean there is only one proper accounting treatment for every situation with which the accountant must deal. For many such situations, there are available a number of treatments which are in accord with the generally accepted principles."

present. And even when a court is so persuaded, there is no assurance that it will give to an accounting concept or rule the meaning and content which an accountant would give, operating on the same facts and under the same circumstances.⁹⁹

There are some minor reasons which may be given. A particular dividend statute may have been so worded as to rule out a certain principle held valid by a great majority of accountants. Likewise, a so-called accepted accounting rule may, for a time, not enjoy the acceptance of the business community, and this factor may well induce a court to hold that the failure of corporate management to adopt it should not expose them to liability.

The economist's division of capital goods into circulating and fixed capital has been carried over to the accounting field. Hence the classification of assets into the fixed and current categories. There is an economic basis for doing so. Current assets represent purchasing power immediately available or which can be made promptly available. Fixed assets are long-term, slowly revolving commitments, quite unavailable as working capital. They are held more or less permanently, such as the physical property and plant which are the basis of its operations, intangible assets like goodwill and investments in subsidiaries held for the purpose of maintaining effective control and ownership of them.¹⁰⁰ The recognition of this distinction is obviously important in the financial administration of a business enterprise.

To distinguish one from the other, it will be necessary to know the degree of liquidity of the particular asset, the normal term, the method of use, the rate of transfer to expense or loss, and the nature of business and intent of management.¹⁰¹

⁹⁹ After reviewing some recent decisions on dividend law, Kripke traces the source of confusion: "Under such decisions, the accountant's traditional balance sheet founded on the cost convention is of slight value in dividend law. And confusion of theories regarding the availability of dividends will persist unless lawyers and accountants are careful to recognize the differences in meaning which they respectively attribute to the same terms." Kripke, *Accountants' Financial Statements and Fact Finding in the Law of Corporate Regulation*, 50 *Yale L. J.* (1941) 1181, 1190.

¹⁰⁰ The assets of a business comprise all its properties or resources. In general, three conditions apply to the listing of items as assets, namely (1) that the business in question owns them; (2) that the business has acquired them at cost; and (3) that they are of value to the business. SANDERS, HATFIELD, AND MOORE, *STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 58. For similar definitions, see PATON, *ESSENTIALS OF ACCOUNTING* (1938) 23; HATFIELD, SANDERS, AND BURTON, *ACCOUNTING PRINCIPLES AND PRACTICES* (1940) 37, 39.

¹⁰¹ By 'liquidity' we mean ease or speed of conversion into money or purchasing power without serious impairment of value. E.g., a bank account is extremely liquid, while a building or a unit of equipment is commonly a non-liquid asset.

Normal term refers to length of life. Though there is some doubt as to where

I. FIXED ASSETS

a. *Property and Plant Assets.*

Many accounting authorities hold that fixed assets, acquired by purchase, should be carried at cost. Pointed out as the advantage of carrying an asset at cost rather than at an estimated present value is that it is generally capable of objective verification, free from the subjective element that goes with appraisal valuation. Cost, in order to be considered as the proper valuation, must be the outcome of a fair, arm's length transaction. Thus, transactions between a parent and a subsidiary, or sales made to the corporation by promoters or the management should be closely examined, since in many such circumstances shrewd manipulations may produce a cost which is rather fictitious. The true value of the assets rather than the fictitious book value should apply for purpose of dividend accounting when unrealized profits take place between parent and subsidiary or between affiliated companies.¹⁰²

Courts have properly adopted, either expressly or impliedly, the accounting practice of including in the valuation of an asset such items as freight, insurance, and cost of installation necessary to bring it to the point of being an earning asset, since all these enter into the cost of a production unit just as much as the basic purchase price.¹⁰³

the line should be drawn on a time basis, it is generally agreed that to be treated as current an item should expire or mature in less than 2 years, as the outside limit.

Method of use and rate of transfer tests are closely related. Thus a building passes slowly into operating expense whereas a particular stock of supplies is usually held for a comparatively short period. Also, a building or unit of equipment is never consumed physically as are raw materials and supplies.

The nature of the business and intent of the management may likewise have a bearing. For example, land in the hands of a real-estate company may be considered a current asset, whereas land used as a site for a building is clearly a fixed asset. See PATON, *op. cit.* 8, 9.

¹⁰² A very common practice among manufacturing firms is the employment of subsidiaries in the production of basic inventory materials for use at a later stage by the parent. When the transfer is made to the parent, there is an obvious opportunity for a sale which would produce a cost to the parent amounting to merely an inventory write-up. For a detailed illustration of the effect of such practice on dividend availability, see KEHL, *CORPORATE DIVIDENDS* (1941) 86-87.

In one American case, the court did not permit the use of book values in the investment of a corporation in affiliated companies because they included inter-company unrealized profits. The suggestion seems to be that the valuation be made on the basis of the intrinsic worth or net asset value supporting the stock (*Irving Trust Co. v. Gunder*, 152 Misc. 83, 271 N.Y.S. 795 (1934)). See also GRAHAM AND KATZ, *ACCOUNTING IN LAW PRACTICE* (2d ed. 1938) 397; Littleton, *Business Profits as A Legal Basis for Dividends*, 16 *Harv. Bus. Rev.* 51, 59 (1938); SANDERS, HATFIELD, AND MOORE, *STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 30.

¹⁰³ See, e.g. *Hubbard v. Weare*, 79 Iowa 678, 692, 693, 44 N.W. 915 (1890).

Where a plant is acquired in direct exchange for corporate securities, the common practice has been to state the plant at the amount of securities issued therefor, but a number of reputable accounting authorities¹⁰⁴ favor using an amount reached by a reasonable appraisal of the sound value of the property. The reason for this preference is quite persuasive. If the amount-of-securities formula were used, the only justification would be that the nominal value of the securities reasonably comes up to the true value of the plant. The difficulty, however, is that instances are not few when corporations conceal the fact that the securities have been issued at a discount by giving inflated values to the acquired plant.¹⁰⁵ Philippine courts will no doubt strike down this practice, since the corporation statute is clear in its insistence that property acquired in exchange of a corporation's securities should be stated at its 'real fair cash value'.¹⁰⁶ This test should require corporations to carry as an asset excessively valued property only at its fair market value, that is, the price which would result from arm's length negotiation between a willing buyer and a willing seller, each fully acquainted with the conditions and each in the same bargaining position.¹⁰⁷ As indicated before, dividends should not be paid until a sufficient amount has been accumulated out of earnings to cover the differences between the fair market value and the inflated value, thereby eliminating the water.

Where the plant or equipment is constructed by the corporation itself, prudence—often a cogent element in accounting—dictates that only the direct cost of materials and labor, and actual supervision devoted to the work be charged to the asset.¹⁰⁸

(1) *The Problem of Unrealized Appreciation.*—

One fundamental problem in dividend regulation is whether a corporation should be permitted to record plant valuation in conformity to the increase in the price level. These estimated changes in plant value are often denominated 'unrealized appreciation' since they are not a part of the revenue stream resulting from business operation and is not represented by disposable funds. Assume X corpora-

Cf. PATON, *ADVANCED ACCOUNTING* (1941) 217; SANDERS, HATFIELD, AND MOORE, *op. cit.*, 60.

¹⁰⁴ SANDERS, HATFIELD, AND MOORE, *op. cit.* 60.

¹⁰⁵ *Id.*, Consider the fact situation in the *Goodnow* case, *supra*.

¹⁰⁶ Section 16; see also Sec. 9, Philippine Corporation Law.

¹⁰⁷ PATON, *ADVANCED ACCOUNTING* (1941) 323.

¹⁰⁸ SANDERS, HATFIELD, AND MOORE, *op. cit.* 62. These authorities would permit the charging of a reasonable amount of general company overhead, but adds that this should not be done to the extent of relieving the income account of charges which would normally be made against it.

tion to have been organized a year ago. It acquired fixed assets with a fair market value of one million pesos, in exchange for its capital stock of the same amount. Its opening balance sheet should show the following:

<i>Assets</i>	<i>Liabilities</i>
Plant and Equipment 1 million pesos	Capital stock . . . 1 million pesos

A year later, and before any business is transacted, the market value of its plant and equipment is reasonably estimated at 1,250,000 pesos. The question is now posed whether the corporation has a balance sheet surplus of 250,000 pesos available for dividends. Many American courts¹⁰⁹ and respected accounting authorities¹¹⁰ on the subject seem to be agreed it should not be considered available for dividend purposes. Their arguments may be briefly summed up as follows: (1) a corporation does not usually hold its fixed assets for sale. An unrealized gain is merely a factor of the change in the market level and, since it is conceded that fixed assets are not usually put up for sale, should not be considered; (2) to permit a corporation to distribute dividends on the basis of an unrealized appreciation may put it in a financial plight, resulting in serious capital impairment, should the price level decline; (3) if periodical revaluations were allowed and taken up, the acceptability of the balance sheet would be considerably weakened; (4) balance sheet concepts do not involve value, but unexpired cost.

Because of the notable tendency of many a Philippine court to look to New York legislation and judicial pronouncements for guidance in the field of corporation law, more particularly in the area of dividend regulation—since New York adheres likewise to the balance

¹⁰⁹ See *Kingston v. Home Life Ins. Co.* 11 Del. Ch. 258, 101 Atl. 897 (Ch. 1917) aff'd. 11 Dec. Ch. 428, 104 Atl. 25 (1918), where it was held an increase in the value of an office building did not constitute 'surplus or net profits arising from the business'; hence, unavailable for dividend purposes. In *La Belle Iron Works v. U. S.*, 256 U. S. 377, 393, the court said: "There is a logical incongruity in entering upon the books of a corporation as the capital value of property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost but to what probably might be realized by sale in the market. It is not merely that the market value has not been realized or tested by sale made, but that sale cannot be made without abandoning the very purpose for which the property is held."

See also the collection of cases in KEHL, *op. cit.*, 100; and in DODD AND BAKER, *CASES ON BUSINESS ASSOCIATIONS* (1940) 1168.

¹¹⁰ SANDERS, HATFIELD, AND MOORE, *STATEMENT OF ACCOUNTING PRINCIPLES* (1938) 38-40, 63; KESTER, *PRINCIPLES OF ACCOUNTING* (1939) 462, 463; PATON, *ADVANCED ACCOUNTING* (1940) 331, 332.

¹¹¹ N.Y. Stock Corporation Law, sec. 58, as enacted by Laws 1923, c. 787.

sheet surplus test¹¹¹ the important case of *Randall v. Bailey*,¹¹² representing as it does the minority rule, may well be examined. The trustee in that case sought to recover on behalf of the corporation dividends paid by defendants as directors between November 22, 1928 and May 2, 1932, aggregating \$3,639,058. At the time of declaration and of payment, the books of the company showed a surplus ranging from \$4,378,554 on December 31, 1927 to \$2,199,486 on April 30, 1932. The plaintiff claimed there was no surplus in fact. He argued, among other things, that it was improper to write-up the land values above cost and thereby take unrealized appreciation into account. The facts showed that the land was written up to 80% of the amount, and if plaintiff's contention be sound, it was conceded that the company undoubtedly had a deficit at all the times involved in an amount exceeding the dividends paid.

Reminiscent of judges that peremptorily brush aside weighty economic and social considerations in an effort to rationalize the result reached, the court said:

"It is to be emphasized at the outset that the question is not one of sound economics, or of what is sound business judgment or financial policy or of proper accounting practice, or even what the law ought to be * * * The question I have to decide is whether or not an existing statute has been violated. The problem is one of statutory construction."¹¹³

Tracing the history of the New York enactment and the court decisions, the court said the terms 'capital' and 'capital stock' appearing in the various New York statutes refer to the amount, i.e., the value of property up to the limit of the number of dollars specified as the par value of paid-up issued shares, or as the stated value of no par shares, and that when the amount, that is, the value of the company's property exceeds that number of dollars, the excess, whether contributed by the stockholders or otherwise obtained, is surplus or surplus profits and may be distributed as dividends until the point is reached where such dividends deplete the assets, i.e., the value of the assets below the number of dollars, specified as the par or stated value of the paid-up issued shares. In short, capital stock or capital is "the sum of the liability to stockholders, and any value which the corporation's property has in addition to that sum is surplus".¹¹⁴ The interpretation of the court left no question that surplus included an appreciation in the value of property purchased, whether realized or unrealized.

¹¹² 23 N.Y.S. 2d 173 (1940), aff'd 288 N.Y. 280, 43 N.E. 2d 43 (1942).

¹¹³ *Id.*, at 179.

¹¹⁴ *Id.*, at 182.

The court concluded, as if in an apologetic gesture, that it could not—

“follow the decisions to the contrary in other states or any contrary view of economists or accounts. If the policy of the law be bad it is for the legislature to change it.”¹¹⁵

Let us grant, for the moment, that the question is purely one of statutory construction. The two problems that must be resolved are:

1. Does the statute impose a value test?
2. If it does, does it include necessarily unrealized appreciation?

The statute reads:

“No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, now while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be.”¹¹⁶

Since, in determining the existence of a capital impairment, one must find out whether the aggregate assets equal all liabilities, including capital, it is obviously necessary to put a figure on the assets. If it be conceded that the statute imposes a value test, the question presents itself: what is the reference of the term ‘value’? The court conceded by implication that value could mean different things in different contexts.¹¹⁷ But normally the reference is to the exchange value, the fair sale value. This was what the court used, and which it justified. Now the issue reduces itself to whether this was what the legislature—whose intention the court was so articulate and enthusiastic in protecting—had in mind in considering value for dividend purposes. The corporation in this case, as is normally the case of many corporations paying out dividends, desired to stay in business; it had no intention of ever selling the terminal property in question. It had to keep that property if it wanted to continue owning and operating the business. Hence, the selling value of the prop-

¹¹⁵ *Id.*, at 183.

¹¹⁶ New York Stock Corporation Law, sec. 58, as enacted by Laws 1923, c. 787. Cf. last paragraph of Section 16, Act No. 1459 (Philippine Corporation Law); par. 3 of Section 18, *id.*

¹¹⁷ “The words to be construed thus are words which have varied and different meanings and express radically different concepts in different connections. Capital means one thing to an economist *** and it still has different meanings to accountants and businessmen.” *Id.* at 179.

erty could not, and should not logically be the criterion in determining the availability of funds for dividend purposes. Besides its utter irrelevance, a write-up of fixed assets may be inadvisable for purposes of dividend distribution, since the corporation would be no better off than it was before the write-up. The consequence might, in many instances, even be disastrous to the corporation as, obviously, the cost of replacement would increase. The corporation may have to pay a smaller dividend as the depreciation reserve will be insufficient for replacement purposes. The observation made by the court in this case that the legislature intended selling value to be the measure for dividend-paying corporations seems far-fetched.

The point here suggested is that fixed assets should be valued at cost for dividend purposes, since that is the value of the property to the corporation. The statute is, of course, ambiguous concerning what method of valuation should be used. Precisely because of that ambiguity, the court should be guided by considerations of policy, having due regard for the socio-economic implications of the problem. The bold disregard of what economists and accountants consider to be an advisable method of valuation for purposes of dividend regulation seems unwarranted.

In the latter part of the court's opinion, the learned judge treated the appraisal by an engineering company and increased earning power as evidence of increased value for dividend purposes.¹¹⁸ One may therefore ask whether increase in reproduction cost, or valuation by the method of capitalizing earnings should be employed in determining the valuation of a plant or fixed asset.

It seems clear that if the reproduction cost valuation were used by a corporation, it would be able to pay out in dividends more than what it earns or has earned. The undesirable impact of such a valuation on the community, particularly on the interests of various groups in the corporation who stand to be affected, cannot be overstated. Short-term creditors are interested in the current assets of the corporation. If the current ratio, i.e., the ratio of current assets to current liabilities, is not sufficiently sound,¹¹⁹ the payment of dividends on the basis of reproduction cost valuation will make the situation worse, particularly since the usual manner of paying dividends is in the form of cash. Bondholders and long-term creditors are in-

¹¹⁸ *Id.* at 187, 188.

¹¹⁹ Ordinarily, the standard minimum ratio of current assets to current liabilities is two to one. The working capital, i.e., the excess of current assets over current liabilities, should at least equal the amount of current liabilities, as creditors cannot be expected to have more at risk in the current assets of a business unit than have the owners of the business. See KESTER, *op. cit.*, 31.

terested in the maintenance of a financial policy which will enable the corporation to pay their debts at maturity. To be able to refund the bonds, the corporation must be able to show good earning power. But the scheme of paying dividends on the basis of reproduction cost valuation will hurt earning power considerably, since it permits the corporation to sell necessary assets or borrow from other sources in order to pay dividends. Stockholders of a corporation do not stand to gain in the long run, although temporarily the scheme works to their advantage. But since the earning power of the corporation will suffer due to the minimization of working capital, the distribution of dividends on the basis of this valuation will eventually hurt them beyond repair. The investing public, because not usually sophisticated, would be led to buy corporate securities enjoying unjustified marketability. Unless they have adequate access to all the facts concerning the nature of the dividend and the environmental circumstances attending its payment, the public would probably be deceived by this appearance of prosperity.

The valuation of a plant on the basis of earning power, currently employed in reorganization proceedings, presents the same problem posed by reproduction cost valuation. It is submitted that for purposes of dividend regulation, the method of capitalizing earnings should not be employed for it would permit a corporation to pay out in dividends more than what it has earned. To be more concrete, a hypothetical case may serve as an illustration. Let us take a corporation, with assets at a historical cost of 10 million pesos. The earnings for the last three years amount to 2 million pesos. If these earnings were capitalized at 10 per cent, or a times earning ratio of 10.0, the corporation will have an extra ten million pesos to pay out in dividends. The disastrous consequences of such an action upon the corporation, the stockholders, the creditors, and the public may well be imagined.

It is not clear whether the court in *Randall v. Bailey* entirely rejected this test, since greater reliance was put on the plaintiff's compromise with the taxing authorities as to the value of the property in question, and on the reproduction cost valuation which it termed satisfactory.¹²⁰

The many who attach value to conservatism in the preparation of financial statements naturally oppose write-ups.¹²¹ But it is not

¹²⁰ *Id.* at 188.

¹²¹ See, e.g., SANDERS, HATFIELD, AND MOORE, *op. cit.*, 38, 39, 40. "The experience of the last twenty years indicates that such revaluations inject a disturbing element into accounts; they destroy comparisons and tend to reduce the acceptability

that element alone that has aroused hostility towards the scheme of recording unrealized appreciation. There is the increasing number of flagrant overvaluations which have justly evoked the condemnation of courts, particularly where the purpose is to justify a proposed dividend distribution. In the Philippines, there was an early tendency to strike down any kind of dividend, whether in the form of cash or property or share, derived from unrealized appreciation.¹²² But it would seem that this has been relaxed. In one case,¹²³ the question squarely presented to the court was whether a share dividend paid out of unrealized reappraisal surplus could be considered income for tax purposes. The decision impliedly adopted the reconciliatory attitude of many American courts to permit, in the absence of contrary legislation provision, stock dividends to be issued, instead of absolutely disallowing the distribution of any form of dividend distribution, on the basis of unrealized appreciation.¹²⁴ It might be correct to state that when stock dividends are declared, the assets in the possession of the corporation remain the same as before; hence, existing creditors are not hurt. Theoretically, there is no distribution of corporate assets so that even if it should turn out later that the appreciation was fictitious, it could be argued that no portion of the original capital had been impaired. This analysis is inadequate, if not entirely fallacious, since the interests of subsequent creditors are utterly disregarded. They have the right to rely upon the statement of capitalization and its intrinsic soundness. Moreover, the danger of stock watering is ever present, particularly where dividends in one class of shares are distributed to holders of another class of shares. The payment, for instance, of common shares as dividends to holders of preferred stock could dilute the rights of the original holders of the common shares in relation to the surplus since, without increasing the actual capital of the corporation, earnings now have to be paid to a greater number of stockholders.¹²⁵ The argu-

of the balance sheet generally. For the most part, accountants have opposed them, and should continue to do so." *Id.* at 63.

¹²² *Enriquez v. Barrios*, 5 Phil. 232 (1905). In this case, the corporation declared a stock dividend mainly from unrealized appreciation in the value of its ships. The Supreme Court, per Arrelano, C. J., ruled this was not income, but a return of capital. The case, however, is not authoritative, because: (1) it was primarily a case of apportionment among heirs; (2) it did not clearly involve the kind of 'stock dividend' which is the subject of present day discussion. Hence, our use of the word 'tendency'.

¹²³ *Fisher v. Trinidad*, 43 Phil. 973 (1922).

¹²⁴ By the examples used in the above case at pp. 979, 980, and by the use of such phrases as 'unrealized increment,' increase 'as a result of business changes' there seems to be ample warrant for the statement above.

¹²⁵ Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends under Modern Corporate Laws*, 23 *Cal. L. Rev.* 229, 257 (1935).

ment against stock dividends derived from reappraisal surplus due to unrealized appreciation is aptly stated by one writer: "It is as objectionable to increase a corporation's capitalization upon the basis of uncertain asset value as it is to pay dividends out of such illusory funds."¹²⁶

In the United States, California has taken the lead of expressly prohibiting dividend distribution out of unrealized appreciation of the corporate assets.¹²⁷ In continental Europe, courts,¹²⁸ realizing the uncertainty inherent in price level valuations, refuse to allow unrealized gain to serve as basis for dividend distribution. In France, most respected critics would allow unrealized gain to appear on the balance sheet but argue against its availability for dividends in any form unless it has been realized or validated by sale.¹²⁹ There is ample reason to believe that Philippine courts will not object to the practice, advocated by some accounting authorities, of letting the appreciation appear on the balance sheet, provided it is shown adequately through a debit to a separate account as reappraisal appreciation, and to credit as a reappraisal surplus. That disclosure does not mean, however, that the surplus so created may be made available for dividends; on the contrary, the thesis is here made that carrying unrealized appreciation on the books may at times be desirable for purposes of marketing new securities or for rate-making purposes in case of public utilities,¹³⁰ but that in the interest of div-

¹²⁶ KEHL, D., *op. cit.*, 102.

¹²⁷ California Civil Code 1937. Section 346. * * * No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividend be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits are currently realizable in cash." Cf. Mich, 15 Sta. Ann. Sec. 21. 22 Penn. Sec. 2852-701.

¹²⁸ See e.g., *Ministere Public v. Desliniers*, Cass. Crim. July 21, 1898, Sirey, 1901, 1, 537 (France, 1901). Cf. criticism of Houpin, *De la constatation des plus-values de l'actif dans les bilans des sociétés par actions* (44 *Journal des Sociétés*, France, 1923). German law is rigorous in its protection of the capital of a corporation from unwarranted disbursements to shareholders out of funds other than net profits. The provisions seem to rule out the possibility of declaring stock dividend out of unrealized appreciation of fixed assets, while adopting a very tolerant attitude towards write-downs. See German Comm. Code, secs. 260-264. But see Sec. 126 of the German Company Law of 1937; cf. TEICHMANN AND KOEHLER, *AKTIENGESETZ* (1939) 280.

¹²⁹ Houpin, *De la constatation des plus-values de l'actif dans les bilans des sociétés par actions*, *op. cit.*, at 481, 489; Houpin, *De l'établissement des inventaires et bilans en périodes de crise économique*, 53 *Journal des Sociétés* (France, 1932) 65, 59; Bosvieux, note in 47 *Journal des Sociétés* (France, 1926) 96.

¹³⁰ "Occasions arise when a company wishes to make some statement about the present value of its plant, particularly when that appears to be larger than the book value. Such occasions are the issue of new securities and the valuation of public utilities for rate-making purposes. Whenever it does seem desirable to make any statement

idend regulation, reappraisal surplus should have no effect of increasing the fund theretofore available for dividends in any form. The underlying emphasis is on the element of caution as against improvident speculation.

(2) *Realized Appreciation.*

It seems to be generally agreed among courts and accounting authorities that where fixed assets are sold at a price exceeding original cost, no valid objection may be presented to the practice of showing the excess as surplus account in the balance sheet, available for dividends.

In continental civil-law countries, there are at least two divergent views on the subject. The French rule is that realized appreciation in order to be available for dividend distribution should be liquid or promptly convertible into cash. This flows from the judicial restriction, native to France, which has been discussed earlier, namely, that net assets should be promptly realizable if any dividend contribution is to be considered valid. This has been vigorously criticized by eminent jurists in France,¹³¹ who favor the other view, existing in other civil-law countries, that such excess is distributable as dividend, regardless of its liquidity.

(3) *Depreciation.*

As buildings, machinery, equipment and similar capital assets become less valuable as they wear out, it becomes necessary for a concern to make sufficient and reasonable provision for their replacement. Hence, the necessity of a periodic depreciation charge with a view to preserving the integrity of the capital invested by the owners in the enterprise. This charge prevents the possibility of overstating the net earnings of the enterprise and the distribution of its capital funds in the guise of dividends resulting from such overstatement.

about present value, it seems eminently preferable to do so as a separate or parenthetical statement, without disturbing accounting figures for the original investment." SANDERS, HATFIELD, AND MOORE, STATEMENT OF ACCOUNTING PRINCIPLES (1938) 63.

In *Ynchausti Steamship Co. v. Public Utility Commissioner*, 42 Phil. 621 (1922), the Philippine Supreme Court ruled that for rate-making purposes, the 'present or market value of the particular utility is the basis of valuation. It said the original cost may be considered only for the purpose of determining the present market value. See also Sec. 17 (h) of the Public Service Act, Com. Act No. 146 as amended.

¹³¹ Wahl, note in *Sirey*, 1901, 1537: "Nous tenons, au contraire, qu'un dividende n'est pas fictif s'il ne dépasse pas l'excédent de l'actif sur le passif, sans que la liquidité de l'actif importe le moins du monde." See also Legal, note in *Sirey*, 1938, 1297: "Si la balance est en faveur du premier (l'actif), le différence, quelle qu'en soit l'origine, sera qualifiée de bénéfice et pourra être valablement mise en distribution." In the same sense, Lyon-Caen, Renault and Amioud, *op. cit.* 473. Cited by Badr, *op. cit.* 8.

The assumption underlying this discussion is that recorded peso cost, rather than cost of replacement, should be the basis for depreciation. This assumption has been criticized by judges and accountants.¹³² The burden of the criticism is that in a period of prosperity the retention of funds in the amount of original cost will not provide for replacement and that in a period of depression the funds so accumulated will exceed the amount required to ensure renewal of the original facilities. The implication is that the proper basis for depreciation is cost of replacement. Thus, one judge, writing for the majority in an American case,¹³³ expressed the rationale of the criticism. He said that depreciation was intended to protect the physical investment and not the dollar value; hence, replacement cost should be the proper basis. But one must not ignore, as Mr. Justice Brandeis pointed out in the same case, that annual depreciation is not the measure of the actual consumption of the plant, since no such measure has been discovered. It is merely a device by which an amount equal to the total net expense of retirement shall be produced. Any plan must be judged according as to whether or not it tends to achieve that objective. If based on value, the plant would be entirely speculative, since it is well-nigh impossible to know the value of the plant upon retirement. In so far as a public utility is concerned, a replacement cost valuation will have the result of making present consumers pay for the future plant in use after retirement. An analytical study of the consequences of a replacement cost basis has made it clear that the result would be an inequitable distribution of charges.¹³⁴ It must also be stated that from the legal

¹³² See e.g. *United Railways v. West*, 280 U.S. 234 (1930). Cf. Brandeis' dissenting opinion in the same case. But see *PCP v. Hope Natural Gas Co.* 320 U.S. 591, 606 (1944). MACNEAL, TRUTH IN ACCOUNTING (1938) 247-259; Dannenburg, Depreciation and Capital Replacement, 73 *Journal of Accountancy* (1942) 348.

¹³³ Sutherland, J. in *United Railways v. West*, note 158.

¹³⁴ If we suppose that the total replacement cost of the plant facilities of the X corporation increases regularly by 10% of the original cost each year, as measured by the market prices of component elements, and stands at ₱200,000 at the end of the expected service life, a policy of charging operations each year with 10% of replacement cost as of the beginning of each year would result as follows:

Year	Replacement Cost (at beginning of year)	Depreciation Charge	Total Accrued
1	₱100,000	₱10,000	₱10,000
2	110,000	11,000	21,000
3	120,000	12,000	33,000
4	130,000	13,000	46,000
5	140,000	14,000	60,000
6	150,000	15,000	75,000

point of view the maintenance of capital in terms of pesos, rather than physical capital, makes imperative a cost basis for depreciation.

The advantages of depreciation accounting have not been seriously challenged. It enables the burden of wear and tear to be spread over the life of the plant, as of the date it goes into service. It produces level cost of operations, and effectively segregate depreciation and maintenance expense.

An alternative to depreciation accounting is the so-called 'retirement accounting.' Under this method, the expense of wearing out equipment is recognized only on retirement. No uniform charge is

7	160,000	16,000	91,000
8	170,000	17,000	108,000
9	180,000	18,000	126,000
10	190,000	19,000	145,000

Here, an accumulation of funds equivalent to the total of the depreciation charges would fall short of the amount of replacement cost by ₱55,000. To finance the replacement of plant out of revenues, it would be necessary to retain funds representing net profits of ₱55,000 in addition to funds matching the depreciation cost recognized. To provide depreciation charges equivalent to replacement cost at date of retirement (as cost at that date cannot be ascertained in advance) it would be necessary to treat each increment as subject to depreciation during the remaining life of the property. That is, by writing off the first increment in 9 years, the second in 8 years, and so on, and absorbing the last increment at the end of the 10th year, it would be possible to charge the entire replacement cost to operations during the service life. e.g.

Year	Replacement Cost	Depreciation Charge	Total Accrued
1	₱100,000	₱10,000.00	₱10,000.00
2	110,000	11,111.11	21,111.11
3	120,000	12,361.11	33,472.22
4	130,000	13,789.68	47,261.90
5	140,000	15,456.35	62,718.25
6	150,000	17,456.35	80,174.60
7	160,000	19,956.35	100,130.95
8	170,000	23,289.68	123,420.63
9	180,000	28,289.68	151,710.31
10	190,000	48,258.69	200,000.00

It is clear that, on the theory that each year of entire service life should bear only its proportionate part of the total cost of replacement, this procedure results in a very inequitable distribution of charges. Of the total increase in cost of ₱100,000, over 38 per cent is written off in the last year and nearly 70 per cent in the last three years, and there is no reason for supposing that the revenues in these years will be at a level permitting the recovery of such charges. The converse is also true where the price level falls, the result being a highly unreasonable periodic distribution (PATON, *ADVANCED ACCOUNTING* 326-328).

Besides the above technical difficulties, there is the added complication that the price level does not rise or fall consistently, much less at a consistent rate.

made annually, but all replacements are charged directly to operations. This method has been advocated by public utilities principally because it invests them with a fair degree of discretion in determining income as against depreciation accounting which makes the expense automatic, not discretionary. Precisely because there is present the great temptation to manipulate income by delaying or anticipating replacements, utility regulatory bodies have insisted on depreciation accounting. There are, of course, other considerations. Depreciation accounting induces critical analysis for rate making purposes, since current rate payers pay for plant currently being consumed, which should be the case. Under retirement accounting, future rate payers pay for plant currently being used up. Likewise, depreciation is normally deducted from investment on which rate is based, thereby assisting in tying rates to original cost.

A middle-of-the-road method, which in effect underscores the need for some type of depreciation accounting, is the retirement reserve scheme. This consists of a fund accumulated before retirement to meet the expense of retirement of a large unit. Small items are directly charged to expenses, no reserve being put up during the early years. After a reasonable period of use, the remaining useful life of the asset is estimated, and a reserve is then created periodically so that upon retirement of the asset, the total of the reserve will be sufficient to replace it. The plan is therefore based on accumulation to take care of replacement, rather than spreading out the cost of the asset over its useful life. This method has been subjected to a great deal of criticism and comment.¹³⁵

Depreciation accounting is judicially recognized in the Philippines,¹³⁶ though we are left in the dark as to what particular method is considered acceptable. In the *El Hogar Filipino* case, supra, the attorney general questioned the exercise of discretion confided in the by-laws to the board of directors to determine the amount to be written down upon the expense of installation and the property of the corporation, and insisted that the depreciation policy, at the rate of 10% per annum on the real properties held by the corporation, tended to "increase unduly the reserves of the association, thereby frustrating the right of the shareholders to participate annually and equally in the earnings of the association." The court brushed aside the argument of the attorney-general, and said:

¹³⁵ See Chapters 13, 14, and 15 of PATON'S ADVANCED ACCOUNTING, *op. cit.*; See also the ICC depreciation hearings, 177, I.C.C. (1931).

¹³⁶ *Government of the Philippines v. El Hogar Filipino*, 50 Phil. 399 (1927).

"This count of the complaint proceeds, in our opinion, upon an erroneous notion as to what a court may do in determining the internal policy of a corporation . . . Certainly this court cannot undertake to control the discretion of the board of directors of the association about an administrative matter as to which they have legitimate power of action."

That was, of course, the easiest thing to do for the court. We do not know, aside from the court's rationalization, why this particular course was taken, but we do know that the effect of the decision upon the attitude of corporate management has been far-reaching. Since the decision in the above proceeding, no case has been appealed to the Supreme Court assailing the depreciation policy of a corporation either organized or licensed to do business in the Philippines.

It is very possible that the court was here grappling with two concepts: (1) whatever is expressed in the by-laws is expressive of the will of the shareholders; (2) that the board of directors is the 'agent' of the shareholders. In the context of present corporate structures, these two concepts have broken down, and what we have now may be expressed thus: (1) that the by-laws more often than not express the will of the very few who are in effective control of the corporation at the very start of its existence; (2) that the board of directors usually perpetuates itself, thanks to the manipulative devices at its control. The thesis is here made that the court in the above case should have made an intelligent, conscious approach to the depreciation policy of the defendant and consider the 'corporation' not as an artificial person, but an economic institution that has a definite responsibility to the community that it purports to serve.

There are at least three types of depreciation accounting worth considering. The most common type is called 'straight-line.' The nomenclature suggests the procedure taken. The periodical depreciation charge is computed by deducting the estimated salvage value from original cost and dividing the difference by the useful life of the asset, estimated in advance. The second method, called the sinking fund method theoretically sets aside a fund which, at compound interest, would produce a sufficient amount to equal cost of retirement. The third, the segregated fund method sets aside the reserve, at any rate in theory, and gives the corporation the interest earned thereon as a windfall. Because of the uncertainties of interest rate—which lies at the foundation of the two last methods—straight line depreciation accounting is relatively favored.

In the United States, depreciation accounting was not recognized until the early part of this century.¹⁸⁷ The hostility to depreciation

¹⁸⁷ See, e.g., *Eyester v. Centennial Finance Board*, 94 U.S. 500 (1876); *U.S. v. Kansas Pacific Railway Co.*, 99 U.S. 459 (1878).

accounting is explained by many to have been due to the optimistic belief, occasioned by the tremendous prosperity of the earlier period, that prices and values would continue rising, offsetting the physical wearing out process. But the continued heavy dependence on industrial machinery required larger investment in depreciable equipment. The panic of 1873 helped change the attitude. Subsequently the requirements of income tax authorities and regulatory administrative bodies compelled the unwilling to adopt depreciation accounting. Courts have likewise recognized the necessity of making allowances for depreciation. In the important case of *Cannon v. Wiscasset Mills Company*,¹³⁸ a mandamus proceeding was brought by certain stockholders and directors of the corporation to compel it and the other directors to declare in dividends all the accumulated profits in excess of paid-in capital and the working capital fixed by the stockholders. The North Carolina statute required such excess to be distributed, the dividends being limited to 'surplus or profits arising from the business.' The balance sheet revealed assets with a book value of about \$7,500,000; the net worth was \$5,400,00 which was the sum of capital stock paid in, plus working capital. The reserve for depreciation on the liability side made up the balance. The availability of dividends devolved on what valuations were to be given to the assets. The issue was whether the reserve should be considered a liability. In reversing the lower court for not trying the validity of the reserve, the court said that "in determining value of assets, reserve for depreciation as well as all other liabilities should be considered," as otherwise "serious injury to the corporation, its stockholders and creditors may result from the payment of a dividend in such amount as to leave the capital stock and working capital impaired." The court did not indicate what system of depreciation should be used for dividend purposes, although there is dictum in the case which seems to favor the setting aside of a depreciation reserve after an appraisal. This would imply an annual appraisal at current value, with the loss written off as depreciation. The validity of this method has already been discussed earlier.

Obsolescence.

Somewhat related to depreciation, obsolescence represents the effect of technical developments, new inventions, sudden cessation of demand, or any similar functional cause upon plants assets in use.¹³⁹ Depreciation is traced to physical or internal causes, while the causes of obsolescence are functional or external in nature. Hence, it is

¹³⁸ 195 N.C. 119, 141 S.E. 344 (1928).

¹³⁹ PATON, *op. cit.* 256.

sometimes referred to as 'functional depreciation.' In a highly industrialized society, where there is a progressive change in technical and business conditions, obsolescence may wield a greater influence upon the early retirement of a plant or a unit of equipment.

Accounting authorities favor a write-down of the plant or unit of equipment in proportion to its estimated service life.¹⁴⁰ The admitted difficulty here is that the effect of obsolescence is often unpredictable, and that any book entry based on estimates of effective service life would at best be a guess.¹⁴¹ But the experience of many corporations bear out the accounting viewpoint that reasonable estimates can be made.¹⁴² In estimating the service life of a unit or group of similar units, the effect of ordinary wear and tear is first considered. The second step in the adjustment of the preliminary estimate is to allow for the effect of supercession, cessation of demand, and other external causes. Because of the uncertainty of these factors, past experience and current developments are all taken into account in arriving at what may be called a reasonable estimate.

In this aspect of dividend regulation, there is no Philippine case that may be cited squarely deciding the necessity of write-down. In the American case of *United Light and Power Co. v. Grand Rapids*¹⁴³ the question was posed whether in computing surplus available for dividends, the factor of obsolescence should be considered. The facts showed that the entire physical property of the corporation, though

¹⁴⁰ PATON, ACCOUNTANTS HANDBOOK (1948) Sec. 13. HATFIELD, ACCOUNTING (1928) 285.

¹⁴¹ Thus, the Interstate Commission, after having made an extensive study of the subject, reported:

"It has been urged that most property is not used until worn out but is retired because of obsolescence, inadequacy, or governmental requirements, that it is utterly impossible to predict when inventions will be made, when business will outgrow existing plants, or when public authorities will impose restrictions and that depreciation accounting based on estimated service lives is accordingly founded on mere guesses. There is substance in this contention, but the future is not altogether inscrutable. It is known with certainty that most units of plant will in time be retired for one reason or another, and past experience—where proper records have been kept—affords some basis for judgment. With respect to inventions it should be pointed out that a considerable amount of time ordinarily elapses before they are perfected and the resulting devices become generally available for commercial use, which means that the management often has some advance notice of probable retirement on this account. Nor it is beyond reason for a management to anticipate the time when business growth will render existing facilities inadequate. Granting that future service lives are uncertain we are nevertheless satisfied that they can be estimated with sufficient accuracy to warrant the use of depreciation accounting." (Cited by PATON, ADVANCED ACCOUNTING, [1941] 259).

¹⁴² PATON, ADVANCED ACCOUNTING (1941) 259-261.

¹⁴³ 85 F. (2d) 331, (1936).

not worn out, became worthless because of the construction of high-days between the points served by the railway, and the almost universal use of the automobile for short journeys, thus eliminating the demand which had been the source of its patronage. The court found that the board of directors knew, or should have known, the reason for the sharp decline in net earnings. Said the court:

"The obsolescence due to decreased patronage was no longer theoretical; it had become an accomplished and evident fact. It necessarily affected the net earnings and therefore the true value of the capital assets of the company. The extent to which this value was thereby affected is, of course, largely conjectural. Regardless of theories of depreciation in accounting systems, it was in any event a fact of outstanding importance for consideration of the board of directors in declaring dividends."

The court held that the dividends paid to the defendant as owner of all the shares of the insolvent corporation constituted "a lack of good faith to creditors, and especially to bondholders who had contributed all of the original investment," and was in practical effect a gift of the entire property of the corporation. The dividends paid were considered entirely unwarranted and illegal, and may therefore be recovered by the plaintiff receiver of the railway company.

"That the books of the corporation then disclosed a surplus is not of controlling importance. If theoretical accounting fails to record obvious facts, the duty of the board of directors in considering declaration of dividends is not performed unless such facts are given due weight and consideration * * * (The) fact of depreciation through obsolescence was too apparent to be overlooked * * * Any amounts paid thereafter in dividends clearly resulted in impairment of assets."

The validity of the accountant's treatment of obsolescence has not been seriously questioned by the courts. It is a practice, dictated by sound business policy and common sense considerations. There is ample reason to believe that Philippine courts in future will, even in the absence of clear statutory requirement, demand of corporations a write-down of an asset affected by the impact of external factors, in the interest of faithful and adequate disclosure of corporate income.¹⁴⁴

¹⁴⁴ The interesting case of *People ex Rel. Brooklyn Heights v. State Board of Tax Commissioners*, 131, N.Y.S. 49 (1911) may raise some important questions. The court in that case placed squarely upon the board of directors the duty to anticipate obsolescence where there is "reasonable ground to apprehend its approach." Said the court: "In the electric field, it is just as sure that certain machinery now in use will be superseded by better machines and that the public service will require better ones * * * Earnings should provide for wear and obsolescence." Quere, whether in this day of

(4) *Depletion.*

Where depreciation involves the gradual wearing out of an asset which may be restored or replaced, depletion involves a wasting asset the fundamental characteristic of which is the impossibility or impracticability of restoration or replacement. A wasting asset corporation is organized for the very purpose of consumption and sale of its major assets. Depletion, in short, involves a process of permanent, irreparable exhaustion. Each sale is a *pro tanto* diminution of the initial investment of the stockholders. The most usual examples are corporations organized for mining operations. Corporations engaged in land improvement are subsumed under the same category. Though not strictly wasting asset corporations, concerns holding patents or copyrights are likewise included, it must be pointed out, however, that here the disappearance of value is a function of time rather than operation, and may therefore be amortized without creation of a reserve for depletion.

The significant question in connection with wasting asset corporations is whether depletion should be deducted in determining income. There is a common law rule, first laid down in the English case of *Lee v. Neuchatel Asphalt Co.*,¹⁴⁵ which allows a mining corporation to pay dividends without making allowance for depletion. Admittedly, this rule, usually referred to as the 'wasting asset doctrine,' would authorize by implication the payment of dividends out of capital. Supporters of this practice argue that the adoption of a contrary rule would in effect force the corporation to hold funds idle or place them in investments—a situation not contemplated by stockholders of a mining corporation. Again, the contrary rule would compel a corporation either to purchase new mines or resort to stock retirement, in order to prevent the hoarding of cash.

These arguments were dismissed in one American case, *Wittenberg v. Federal Mining and Smelting Co.*,¹⁴⁶ where the court required depletion in computing 'surplus or net profits arising from the business' at least to the extent of enabling the corporation to retain sufficient net assets to cover the asset preference on liquidation of the preferred stock. The bill in the case was brought by the preferred shareholders of a mining company whose stock had cumulative rights and liquidation preference to restrain a proposed dividend to common stock, the claim being that no dividend could be paid unless the

tremendous technological development, especially in the realm of atomic energy, corporations whose equipment may be affected by such advances should be required to make immediate allowance for obsolescence.

¹⁴⁵ 41 Ch. Div. 1 (1889).

¹⁴⁶ 15 Del. Ch. 147, 133 Ad. 48 (1926).

ore body depletion of the mine be made up, or alternatively, until it had been made up to the extent of the capital interest of the preferred stock. In holding that the dividend could be enjoined, the court said:

"It is not necessary to decide whether the general rule as to dividends laid down by the statute is applicable to wasting asset corporations. If it is not, then it is solely because they constitute an exceptional class. The statute does not except such corporations from its general rule. If, therefore, they are to be excepted it is only because the courts have discovered such peculiarities in their nature as to warrant the conclusion, that as a matter of reason, common business practices and sound policy, it was never intended that the ordinary rule of the statute should apply to them. But where a great injury would be done to one class of stockholders and a correlative benefit conferred upon another class by allowing the exception, it would seem clear that to the extent at least of preventing the inequity of such a result courts which in the furtherance of justice have erected the exception ought in a like furtherance of justice refuse recognition to it."

The court said the alleged dilemma confronting the corporation—that of being converted into an investment company by holding reserves to cover capital depletion of the ore body—may be solved by buying preferred stock or by resorting to capital reduction. The observation was also made that in *Lee v. Neuchatel*, while there were two classes of shares, neither enjoyed any asset preference upon liquidation. Again, the facts of the English case showed that the corporate capital was not depleted, but on the contrary increased through the acquisition of adjoining areas at nominal cost. The important point, though, is that the decision derives from, and is closely tied up with, the English doctrine that losses, however caused, in fixed capital assets need not be made good before dividends can be declared, if there are current operating profits to cover the dividend. That this doctrine has not been accepted by a majority of American jurisdictions cannot be gainsaid.¹⁴⁷ In spite of this, however, there seems to be more authority in the United States in favor of the wasting asset doctrine.¹⁴⁸ This poses the question whether in the Philippines, the wasting asset doctrine should be rejected or adopted, entirely or partially. A California case,¹⁴⁹ decided under a statute

¹⁴⁷ See note 3, DODD AND BAKER, *op. cit.* 1094-1095; WEINER, *THEORY OF ANGLo-AMERICAN DIVIDEND LAW*; The English cases, 28 *Col. L. Rev.* 1046 (1928).

¹⁴⁸ There are only 2 cases so far that hold unequivocally that depletion should be deducted in determining income, *Wittenburg v. Federal Mining and Smelting Co.*, note 90, and *Petroleum Rights Corp. v. Midland Royalty Corp.*, 167 *Atl.* 835 (Del. Ch. 1933). See KEHL, *op. cit.* 125-129; BALLANTINE, *CORPORATIONS*, (1946) 585-587.

¹⁴⁹ *Excelsior v. Pierce*, 90 *Cal.* 131, 27 *Pac.* 44 (1891).

practically identical to the Philippine dividend section, held that the then California statute—which forbade withdrawal of capital or capital stock and confined dividends to ‘surplus profits arising from the business’—did not forbid a mining corporation from distributing the net proceeds of its mining operations without provision for depletion, though the necessary result was the diminution in the value of its mine. The *Neuchatel* case was cited with approval. Because of the importance of the role played by mining corporations in the economic development of the Philippines, and because of the absence of any case squarely in point, it may be well to explore this aspect of the law in greater detail. It has been shown that the case of *Lee v. Neuchatel* cannot properly apply, first because there existed no impairment of capital and second, because the English doctrine permitting payment of dividends out of current profits, while capital impairment exists, had never been accepted in the Philippines. The California case is similarly distinguishable in that no impairment was shown, and the stockholders were all of one class.

The argument is here made that, in the interest of a sound financial policy, corporations engaged in the exploitation of wasting assets should be required to set aside a reserve for depletion. Sanctioning the practice of paying dividends without making any allowance for depletion may seriously and unfairly prejudice the interests of creditors and senior shareholders entitled to asset preference upon liquidation. In the case of creditors, their security is progressively dissipated as the major capital assets are transmuted periodically into money and paid out to shareholders in the form of dividends. Senior shareholders are hurt, since the assets to which they have a preference on liquidation are gradually being diverted to the common stockholders. The preferred shareholders have a permanent investment in the business akin to those of the bondholders.

Because depletion is clearly an actual cost of production that should be considered in the determination of income, accounting authorities¹⁵⁰ have vigorously insisted that the practice of entirely ignoring depletion, which has found legal basis in the so-called ‘wasting asset doctrine,’ is highly objectionable. From the point of view of both corporate managers and investors, depletion accounting will be desirable since it will give them a true and faithful picture of actual corporate earning power. The balance sheet surplus test should be held to require such disclosure.

Because of the absence of any explicit statutory rule on the point, it may be well to consider the advisability of requiring by legislation

¹⁵⁰ See, e.g. PATON, *ADVANCED ACCOUNTING* (1941) ch. 17,

corporations to set aside a reserve for depletion, at least where (1) there is more than one class of shares; (2) where, even in the case of one-class-of-shares corporations, the purpose is to engage in the exploitation of wasting assets as a continuing business, rather than the exhaustion of a particular property, since there is no reason for discriminating in their favor as against other kinds of continuing concerns; (3) in any case where long-term debts are involved. Thus stated, the wasting asset doctrine would be confined in application to a situation where the corporation has only one class of shares. That situation evidently justifies the application of the doctrine, since the shareholders may be said to contemplate a gradual return of the capital they invested after deducting expenses of operation.