Republic of the Philippines
Securities and Exchange Commission
SEC Bldg., EDSA, Greenhills, Mandaluyong City

09 March 2011

SEC Opinion No. 11-14
Definition of 'Gross Income' under
Sec. 126 of the Corporation Code

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Sir/Madam:

This refers to your letter dated 14 January 2011 requesting us to confirm that:

1. In the case of a foreign merchandising corporation engaged in the sale of goods, the additional securities required under Section 126 of the Corporation Code[1] should be computed based on gross income/gross profit/gross margin and not on sales/gross revenues/sales revenues; and

2. Rolex's obligation to deposit additional securities must be computed based on its gross income and not on its sales revenues.

In your letter, you stated that Rolex Centre Phil. Limited – Philippine Branch ("Rolex") is the Philippine branch of Rolex Centre Phil. Limited that was granted the license to do business in the Philippines by the Commission. You likewise stated that Rolex is engaged in the import and distribution of "Rolex" and "Tudor" brand watches and parts thereof, as well as the repair and supply of spare parts of said brands of watches.

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[1] Batas Pambansa Blg. 68 (1980).

You further stated that in 2009, Rolex earned a gross income of ₱211,454,313.00[2]. On the basis of this amount, you secured in favor of the Commission the earmarking of additional securities worth ₱4,229,086.26, in accordance with the manner of computation provided by Section 126 of the Corporation Code. Subsequently, however, you were required by the Company Registration and Monitoring Department (CRMD) of the Commission to deposit additional securities with an actual market value of ₱20,321,184.14, computed using Rolex's gross revenues for the same year amounting to ₱1,016,059,207.00. Said computation by CRMD was based on the Memorandum dated 19 May 2009 issued by the Office of the General Accountant (OGA) of the Commission finding that "gross income" is synonymous with "gross revenue" for the purpose of determining the additional securities required to be deposited by a corporation pursuant to Section 126 of the Corporation Code.

In questioning the computation by the CRMD of the amount of additional securities required to be deposited by Rolex, you made the following assertions:

1. The memorandum issued by OGA to a service enterprise should not be applied to a merchandising enterprise such as Rolex because "revenue" is defined differently from "income" when used in financial reporting of a merchandising business. In merchandising, "gross income" is defined as the total sales less cost of goods sold, while "revenues" or "sales revenues" or "sales" are defined as the amount a merchandiser earns in selling its inventory.

2. Examples of income statements of a service enterprise *vis-à-vis* a merchandising enterprise show that "revenue" and "income" are treated differently in merchandising because factors such as inventory and cost of goods sold have to be taken into account.

3. With respect to merchandising enterprises, the intent of the law in requiring the deposit of additional securities, which is to ensure that the corporation may be able to settle its obligations to Philippine residents and the government, is sufficiently met by pegging the amount of securities on gross income and not on gross revenue. It is unnecessary to include the cost of goods sold in the computation since Rolex's liability therefor does not pertain to the Philippine government or any Philippine resident but directly to its foreign supplier/mother company.

4. As Section 126 of the Corporation Code expressly provides for the computation of additional securities based on "gross income", then gross income must be used and not gross revenues.

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[2] 2009 Income Statement of Rolex, attached to request-letter as Annex "A".

We do not agree with the above contentions.

After obtaining the comments of OGA[3] on this matter, it is our opinion that the Commission's treatment of "gross income" in the OGA memorandum dated 19 May 2009 as being synonymous with "gross revenues" is applicable to merchandising enterprises such as Rolex.

Paragraph 7 of PAS 18 defines "Revenue" as follows:

> "Revenue is the **gross inflow** of economic benefits during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants." (Emphasis and underscoring ours)

Based on the foregoing definition, the starting point for the computation of revenue is the "gross inflow", without any deduction.

Moreover, the company's illustration of income statements of a service enterprise *vis-à-vis* a merchandising enterprise is correct but only for the purpose of financial presentation in computing their respective net income. The same should not be used for the purpose of computing the security deposit required by the Corporation Code because the intention of the law would not be met if the deductions allowable under the Tax Code[4] or financial reporting are considered. This is due to the fact that the components of said deductions such as cost of sales or cost of services are precisely the source of obligations that must be covered by a security deposit.

As you correctly stated, the intention behind Section 126 of the Corporation Code is to provide reasonable assurance that the branch shall be able to settle its obligations to the Philippine government and residents. Thus, to allow the deduction of the cost of sales from the company's revenues would significantly reduce the base and render inadequate the security deposit to cover said obligations which, in the first place, may include accrued expenses and payables arising from cost of sales.

At this juncture, please be informed that on 19 August 2010, the Commission *en banc*, after considering the facts presented, confirmed OGA's position that "gross income" as contemplated under Section 126 of the Corporation Code is **without any deduction** for the purpose of determining the 2% security deposit prescribed by law for branch offices of foreign corporations.

During the said meeting, the Commission *en banc* resolved to provide a modified formula in the case of Etihad Airways in view of the special circumstances

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[3] Memorandum dated 21 February 2011.
[4] Presidential Decree No. 1158, as amended (1998).

of its business and upon showing of reliable documents to prove the same. The said formula was arrived at after Etihad Airways' presentation of its **Audited Special Purpose Income Statement (ASPIS)** showing Direct Operating Costs and Expenses actually incurred in the Philippines.

The alternative computation is based on our conclusion that for Philippine branches of foreign airlines, there is a need to scrutinize the composition of the "gross income" being presented as basis of the 2% security deposit. This is due to the fact that the operation of said branches extends across borders and as such, certain revenues and expenses from within and without the Philippines are being recognized in the Philippine books.

In this situation, the computation of the security deposit should account only for the proportionate share of Direct Operating Costs and Expenses actually incurred in the Philippines as against the Total Direct Operating Cost – Philippine Branch Operations incurred both within and without the Philippines to arrive at the proportionate share in Gross Revenue – Philippine operations (without deductions) based on the company's ASPIS, which is within the meaning of "gross income" as defined by Section 126 of the Corporation Code.

Applying the foregoing to Rolex, the claim that its liability for the cost of its inventory does not pertain to the Philippine government or residents but directly to its foreign suppliers or mother company must be supported by the branch's Direct Operating Costs and Expenses actually incurred in the Philippines.

Based on the foregoing ruling of the Commission *en banc*, we are of the opinion that Rolex must first present sufficient and reliable supporting documents before a modified formula for the computation of its security deposit may be recommended for the Commission's approval.

The foregoing opinion rendered is based solely on the facts disclosed in the query and relevant solely to the particular issues raised therein and shall not be used in the nature of a standing rule binding upon the Commission.[5]

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[5] SEC Memorandum Circular No. 15, series of 2003.