

(1954) 25 ITR 377

Calcutta High Court

Case No: None

PATRICK
(INSPECTOR OF
TAXES)

APPELLANT

Vs

BROADSTONE MILLS
LTD.

RESPONDENT

Date of Decision: Dec. 11, 1953

Acts Referred:

- Finance Act, 1925 - Section 29
- Income Tax Act, 1918 - Section 1

Citation: (1954) 25 ITR 377

Hon'ble Judges: Singleton, J; Hodson, J; Birkett, J

Bench: Full Bench

Judgement

SINGLETON L.J. - I will endeavour first to state the question for our consideration as simply as I can. The company has always adopted a system of accounting which is known as the base stock system. Under that system the fixed process stock, i.e., the cotton which is on the machines, does not appear in the trading account at all, and the spare process stock is taken at an arbitrary figure. The contention of the company is that the system is well recognised and is in accordance with the principles of sound commercial accountancy and that it ought to be adopted in order to arrive at the companys liability to tax.

On behalf of the Crown it is said that, even if the system is satisfactory for ordinary commercial requirements over a period of years, it is not a proper way in which to arrive at the companys profits for taxation purposes in any year of assessment, and further that it does not show the full amount of profit for the year in question. Moreover, it is claimed that no system will give the true profits of the year unless there is a valuation of stock made (either on market price or cost price) at the beginning and at the end of the

accounting period; in other words, if there is a variation between the beginning and the end of the year in the amount of stock, or in its value, those are matters for consideration which are omitted to an extent if the company's method of valuation is applied.

The Commissioners found (in paragraph 15 of the case) that the method adopted by the company concerning its base stock in its accounts is one of the methods recognized in this particular trade of cotton spinning and is in accord with sound commercial practice. They also found that the method the company had adopted for computing its profits was in accordance with sound commercial practice; and they allowed the appeal against the assessment.

They did not consider the third contention put forward by the representative of the Crown, that the company's method "did not show the full amount of the profits of the relevant year, but showed a distorted view of those profits and understated them, and the company had been undercharged in the first assessment made upon it." Their failure to consider this has led to the expenditure of much time in this court. Mr. King, on behalf of the company, submitted that on the findings of the Special Commissioners the company was entitled to succeed. Sir Andrew Clark, on behalf of the Crown, submitted that, notwithstanding the findings, the method adopted could not be a proper way to ascertain the profits of the company in the year of assessment if it did not show the full amount of the profits, or if it showed a distorted view of them, and he set out to show that this was so; to which Mr. King replied that we ought to be guided by the findings of the Commissioners on fact. All this could have been avoided if the Commissioners had made a finding on the third contention. They ought to have done so. For some time I thought that this court ought to remit the case to them for a finding, but it was put to us that there could only be one answer, and that, in such circumstances, there was no point in sending the case back.

There is a further matter to which I direct attention. Four witnesses gave evidence before the Special Commissioners, who set out a summary of their evidence in the case. In each case the Commissioners say of the evidence, "which we accepted." I do not know what that means, particularly in regard to the evidence of the accountants. If it means that they accepted the views given as those of the witnesses who gave them it carries one nowhere. If it means more than that, it does not appear to me that they could accept both of two conflicting views. The essential requirement of a case stated is that it shall contain the findings of fact of the tribunal which states it. This case is lacking in that respect. It is said by Mr. King that we ought to assume that the Commissioners, by reason of their conclusion, accepted the evidence of Mr. Robson in preference to that of Mr. Gower. That may be a fair assumption to make; but the Commissioners, have already said that they accept the evidence of both, and nowhere do they say that Mr. Gower is wrong in the view he expressed that the method adopted by the company led to a distorted view of the profits in the relevant year.

I mention these matters with the object of saving time in future cases. It is not that which someone says which is of importance. The court ought to have before it the findings of fact of the tribunal; if those are clearly stated there is usually no need to set out the evidence which is given.

It is not easy to state the facts in this case, which involves some technical matters, without reading a considerable part of the case itself. Paragraph 3 : "At all stages in the production of yarn, quantities of cotton in various stages of manufacture are either on the machines or are waiting by each machine ready to take the place of the cotton on that machine. The cotton which is actually on the machines and undergoing process is termed fixed process stock and that which is waiting to replace the cotton on the machines is termed spare process stock..." Paragraph 4 : "We were concerned in the appeal with the method of dealing, in computing the companys profit for income tax purposes, with the fixed process stock and an agreed weight (hereinafter called the base weight) of spare process stock (being the minimum required to ensure continuity of production); these are together referred to as base stock. The company in fact held spare process stock in excess of the base weight of spare process stock but there was no dispute as to how this should be dealt with. It was agreed that for income tax purposes the excess should be valued at cost price (being lower than the market value)." Paragraph 5 : "(1) The company, and its predecessor, Broadstone Spinning Company Ltd., has always adopted a system of accounting known as the base stock system. In this system the base stock and any further spare process stock held are not carried in the accounts at cost or market value, but are carried, either at a fixed price or at an arbitrary price. (2) There was produced to us, for the purpose of illustration, a hypothetical account in illustration of the companys trading account for the accounting period (which follows closely the actual trading figures for the period) and a copy of the companys balance sheet as at April 3, 1948. (3) In the trading account, the base stock assumed to be 123,000 pounds in weight does not figure at all, either in opening or in closing stocks, and the further spare process stock in excess of the base weight is carried at a figure of 28 pence per pound. This is an arbitrary figure designed to represent the cost of raw cotton plus a weighting for the cost of processing. The figure was originally 12 1/2 pence, and was increased in 1945 to 17 pence, then to 28 pence at March 29, 1947, and later to 30 pence, at April 3, 1948. (3) In the trading account, the base stock assumed to be 123,000 pounds in weight does not figure at all, either in opening or in closing stocks, and the further spare process stock in excess of the base weight is carried at a figure of 28 pence per pound. This is an arbitrary figure designed to represent the cost of raw cotton plus a weighting for the cost of processing. The figure was originally 12 1/2 pence, and was increased in 1946 to 17 pence, then to 28 pence at March 29, 1947, and later to 30 pence, at April 3, 1948. (4) In the balance sheet the fixed process stock is included in the item Land, buildings, boilers... and fixed stock - \$ 333,236. It is so included at an unascertained figure representing the cost of the fixed process stock on the purchase of the mills by the company in 1920, and has not been changed since."

That paragraph makes clear two or three matters of great importance in this case. The first is that the fixed process stock, that is, the cotton which is on the machines which has been processed, is not taken into account so far as regards the trading account. It is omitted entirely, because on the company's system it is not treated as part of the stock in the ordinary sense but is said to be included in the item of "Land, buildings, boilers, and fixed stock" in the balance sheet. It is not in the profit and loss account, or in the trading account. Another matter to notice is that the spare process stock which is included in the trading account is taken, not at its value, but at an arbitrary figure. The third matter of importance is the very large variation in the price of cotton which has taken place over the years. Paragraph 5(3), which I read, shows values from 12 1/2d. a pound rising to 30d., and I think that I am right in saying that the later figures show that by the end of the accounting year the value had risen to 42d. per pound.

Paragraph 6 states the practice which had been followed by the company : "(1) In all previous years of assessment the profits of the company and of its predecessor, Broadstone Spinning Company Ltd., were computed for income tax purposes according to the base stock system, i.e., the fixed process stock did not figure in the account (although, as stated in paragraph 5 above, a value was in fact attached to it in the company's balance sheet), the base weight of spare process stock was valued at the arbitrary figure referred to in paragraph 5(3) above, and any further spare process stock in excess of the base weight was valued at cost. (2) The assessments under appeal were made on the basis of bringing in all stocks of cotton at cost (which was agreed to be lower than market value); i.e., the base stock and the whole of the further spare process stock in excess of the base weight were brought in at the opening and the close of the account at a price representing the cost(at such opening or close) of raw cotton plus the cost of processing. (3) The question for our determination was whether the company was entitled to have its profits" (for the accounting period) "computed for income tax purposes according to the base stock system."

Paragraph 7(b) again sets out the variation in prices. Paragraph 8 mentions two documents to which I shall have to refer later, D1 and D2, which become important when the court is asked to consider whether there could be more than one answer to the Crown's third contention : "The weight of fixed process stock on machines in No. 1 mill rose during the accounting period from 31,191 pounds to 44,204 pounds (vide statement D1 and D2). No. 1 mill was put out of production in 1942 as a result of arrangements for the concentration of industry, and the cotton on the machines was run off. The company then created a reserve of \$ 7,132 (which figures in the balance sheet), to cover the estimated cost, at prices then current, of re-clothing the mill. No. 1 mill is now gradually being brought back into production, and the machines are partially re-clothed; the cost of the fixed process of cotton on the machines in this mill has not yet been debited to the reserve account, but has temporarily been charged against revenue, although the company intends to capitalize it. When fully clothed, the machines in No. 1 mill will carry a weight of 88,000 pounds of cotton." Let me add that No. 2 mill carries 92,000 pounds of

cotton on the machines, so that the two mills together would carry upon the machines 180,000 pounds of cotton. It is not shown in the company's trading account, though it is said that it is in the balance sheet figure of land, buildings, etc.

The next four paragraphs in the case concern the witnesses who appeared before the Special Commissioners and paragraph 9 begins in this way : "... the secretary of the company attended and gave evidence before us (which we accepted) to the following effect." He said that it was essential for the economical running of a mill that the machines should always remain clothed, and he described the system of buying and selling the cotton. He said that the fixed process stock was taken into the company's balance sheet as a fixed asset and did not figure in the trading account, and that the directors of the company had always taken the view that that was the way they wished the accounts to be presented to the shareholders, it being their view that a true trading result was arrived at in that way. I think it might well be said that if one had every year the same amount of base stock and fixed process stock, and if the value of it was the same, it would not affect the position of the trading account. But if the amount changes and the value changes, the position is not the same.

The secretary is further recorded as saying : "... that the cotton on the machines (i.e., the fixed process stock) is always changing and is always on the move, and that the cotton on the machines at the end of the accounting period had in fact cost the company 42.85 pence per pound as shown in exhibit D2. The cotton on the machines at the end of the accounting period must have been bought during the period, and its price would be included in the purchases charged in the company's accounts. The price would, however, have been debited to the particular sale occasioning the purchase of the cotton. The 136,000 pounds of cotton on the machines at the end of the accounting period had cost the company 31.88 pence per pound; that was the bale price, plus the cost the company 31.88 pence per pound; that was the bale price, plus the cost of processing work done on that stock. That cost turned into sterling was \$ 7,892 plus \$ 16,425. The company had in fact allowed cotton bought at the advanced price to replace cheaper cotton on the machines. It had, however, advanced the price of yarn immediately the raw cotton price increased : the increase in the price of raw cotton was immediately (and, in his opinion, rightly) priced on yarn and not left on the base stock on the machines."

Mr. Robson, a member of a firm of chartered accountants, gave evidence on behalf of the company, which again the Commissioners say that they "accepted." He said that the company had followed "a recognized commercial accountancy basis. The base stock method is a good method of accounting, though some other people might say there is a better method. He did not agree that it was undoubtedly a better method to bring in base stock at the beginning and end of the year at cost or market value; business people who consider the base stock method suitable in their businesses consider it the best." He added that "an accountant would give an unqualified certificate to accounts as giving a true and fair view of the profits of a company whether it employed the one method or the other so long as the company had adhered to one method consistently" from year to year.

Later, in the record of his evidence : "He agreed that in times of rising prices accounts prepared on the base stock method would show profits lower in amount than accounts prepared on the cost or market value basis; in times of falling prices, the opposite result would be produced."

As far as I can gather from the figures shown in the case, there have been for some years consistently rising prices for cotton. That means that if the fixed basis is followed year after year their accounts would show profits lower in amount than accounts prepared on the cost or market value basis. The record of the witness evidence continues : "But, on the basis of the principle which those people who use the base stock method hold, there is no distortion of profits in times of rising prices." The meaning of that is that those who use this principle prefer to look on the base stock in precisely the same way as they look on the machines. In other words, they regard the cotton, the raw material, at one stage as part of their fixed capital merely because it is on the machines. It passes through the machine in the course of a few weeks and is treated just as is any other cotton.

That is the meaning of Mr. Robsons words. "on the basis of the principles which those people who use the base stock method hold." He added : "Business people who use the base stock method do so because they consider it an appropriate method for their particular businesses; they regard the cotton clothing the machines as part of the machines, without which the machines cannot function, just as a sewing machine cannot function without a certain minimum weight of thread upon it. They say, in effect, that the weight of base stock is just as much a part of the machine as the lever which engages it." On this view, which the witness considered a tenable view, "the base stock is part of the fixed assets, and replacements are replacement for maintenance purposes to be charged against trading as a maintenance cost." It must follow from that principle, if it is adopted, that as prices rise the cotton which is on the machine costs more. It is paid for out of revenue, but the cotton which is on the machines is not shown in the revenue account.

The case then deals with the evidence of Mr. Gower, chartered accountant, who is the principal advisory accountant to the Board of Inland Revenue. Some criticism was directed to the evidence of this gentleman. Mr Gower has for some years been contending for that which he regards as the true principle of real prices and real values, and he has sought to show that the base stock method of accounting is not right, at least for tax purposes. I can well understand that those who follow that system of accounting equally hold the view that they ought to be allowed to have their own method of accounting.

Mr. Gowers evidence begins in this way : "He thought it was common knowledge that the general basis for the valuation of stock in trade in all forms whether raw material, processed material, or finished goods, was cost price or market value, whichever was the lower." There is no finding on that. Is it common knowledge that the general basis of the valuation of stock in trade in all forms is cost price or market value ? That has been stated in one or two of the cases to which our attention was drawn, but I am concerned here

rather with the evidence of the witness. Mr. Gower produced a book to which I do not propose to refer. "He said that the base stock method had been employed by a limited number of concerns-limited both as regards the trades in which it was used, and the number of concerns in any particular trade using it. He considered that it was unobjectionable and made little difference to results over a number of concerns in any particular trade using it. He considered that it was unobjectionable and made little difference to results over a number of years, provided that the quantity of base stock did not vary, and provided that there were no violent fluctuations in the cost of the raw material; but in a time of violent fluctuations, and in particular in a time of constantly rising prices, in his view, the use of the base stock method could and did give rise to very misleading results." He said that when prices were rising continually, the accounts did not show a fair view of the position. In the present case he said that the quantity of base stock had risen and that in the period under review "the price of raw cotton had risen seriously, The cost of the fixed process stock had increased during the year by something like 10 1/2d. per pound from about 32d. per pound to about 42d. per pound. Valued in accordance with the Revenues contention at cost, the process stock was worth pound 22,502 at the beginning of the year and pound 37,947 at the end - an increase of pound 15,445. As shown by the companys books, the increase during the year in the value of the process stock was pound 4,289. There was thus a difference of pound 11,156 which had been charged against the profits in this year." He went into further figures, and said that they pointed to the conclusion that the base stock method resulted, in the prevailing circumstance, "in an understatement of profits and the creation of a hidden reserve. This was due to the fact that the base stock method was being used for times for which it could not be considered at all suitable." The paragraph which summarizes the evidence of Mr. Gower said that the Commissioners "accepted" it. Again, there is no finding of the Commissioners on the last part of that evidence, the statement of Mr. Gowers evidence continues : "He agreed that the base stock method is a reasonable and recognized method of accounting, and one which business men could reasonably and properly adopt, and is good commercial accounting, but he made the qualification that in times of rising prices it is a conservative method, and does no produce such correct results as the cost or market value method. By conservative he meant keeping something well in hand. No auditor would cavil at conservative accounts; he rather welcomed them for shareholders purposes. It was open to the company to use the base stock method. Asked whether the companys accounts were erroneous, he expressed the view that they were conservative and understated the profits by reason of a hidden reserve of the true cost of cotton. In his opinion the base stock method did not show the true quantum of profits earned in the relevant year. In times of falling prices it worked in the reverse way; where costs were falling you were losing some of the conservative element and were absorbing some of the hidden reserve. Once you got back to a stage where the prevailing cost of cotton was the same as that adopted for base stock, you were back to zero. On present day prices he described the base stock method as distorting the real trend of results. In a stable period, when prices hardly rose or fell, there was nothing in it."

Mr. Gower emphasized that the Special Commissioners were asked to consider the tax position for one accounting period. The evidence which he gave was to the effect that he did not like the base stock accounting system for tax purposes. It did not matter if one kept the base stock at the same figure and if prices remained the same. If one or other of the elements changed one did not get, by using it, the true profits of the relevant year. He went on to say that the process stock was not a fixed asset. It was just the same as any other cotton bought that passed through the mill and through the machines in the mill, and it ought to be treated as any other cotton was.

Another witness, the principal inspector of taxes, said that efforts had been made to get everyone to adopt the system of cost or market price in regard to stock; he had gone into the position and investigated it and he had found that in the cotton trade 88 1/2 per cent. of the spinners were now valuing process stock at cost in their books, and 11 1/2 per cent. were adopting the base stock method, although he added, "the latter concurred in the adjustment to the cost basis for taxation purposes." There is no importance in that from the point of view of the law, but I think that it does show that on the whole it is recognized by accountants who advise trading concerns that when there are violently fluctuating prices the cost or the market value of the stock gives the more accurate result in any accounting period.

The first matter for consideration is : what is fixed process stock and what is spare process stock ? The answer surely is clear. They are both stock. They are so called. They are bought as stock. All the cotton, the raw material, is bought for the purpose of being turned into yarn by being passed through the mill in the ordinary way. Both the fixed process stock and the spare process and the spare process stock are paid for out of revenue. The evidence of the companys secretary shows "that the cotton on the machines at the end of the accounting period" must have been bought during the period and its price would be included in the purchases charged in the companys accounts. The cost of that cotton has passed through the companys accounts.

How can one arrive at the profits of the year without considering what one has on the other side ? The position is illustrated by the two documents I mentioned earlier, D1 and D2. D1 shows the companys cotton stock as at the commencement of the accounting period, March 29, 1947. D2 shows the position at the end of the accounting period, April 3, 1948. The first thing which I notice on looking at them is the figure in regard to cotton on the machines, the fixed process stock. In the case of No. 2 mill the amount on the machines remains the same. It is working to capacity, and the amount on the machines was then 92,000 pounds. No. 1 mill had been used for something else during the war and had been stripped of its cotton. During this accounting year it was being gradually brought back to full production. At the beginning of the accounting year the amount of cotton on the machines was 31,191 pounds. At the end of the year it was 44,204 pounds, an increase, as the case shows, of 13,000 pounds in the accounting year, so that there was in No. 1 mill somewhat over \$ 2,000 worth of cotton more in quantity at the end of the accounting period than there was at the beginning of that period; and that cotton had

been paid for out of revenue.

The figures in D1 and D2 show also the spare process cotton, and it appears from D1 as though the company had on March 29, 1947, 45,000 odd pounds of spare process cotton, that is, cotton waiting nearby to be used on the machines as occasion arose. That 45,000 pounds odd was taken in the accounts at an arbitrary figure of 28d. a pound. How it is possible to get accuracy in any account by taking an arbitrary figure I do not know. The broad middle column in D1 shows the division up of that 45,000 pounds odd into 23,278 pounds and 21,774 pounds. I take it that that was because it had been pointed out by someone, no doubt on behalf of the Revenue, that the company could not well claim, even on their valuation basis, to have so much spare process cotton as 45,000 pounds at any one time. It was too much; so they reduced that figure to 23,278 pounds, and thereafter in the accounts the figure of 28d. appears against 23,278 pounds, and the balance of 21,774 pounds is taken at what is said to be the cost price of 32.1d. a pound. I find it difficult to see any reason for putting on the spare process cotton a lower figure than cost or market price. Prices were rising all the time. When I look at D2, which shows the figures for the end of the year, I find in the left hand column the figure of spare process cotton is there put as 76,371 pounds. I do not appreciate the reason for that great increase. True, it is said that the mill was coming into further use, as is shown by the increased cotton on the machines in No. 1 mill, but I should not have thought that there would have been anything like that increase in spare process cotton, and indeed that seems to have been recognized, because in the broad column in the middle, in the same way as in D1, the figures are split up later and the same weight is taken, 23,278 pounds, for the spare process cotton, on which an arbitrary figure of 30d. is put, whereas the balance of 53,093 pounds has against it the value of 42,85d., to which the price had risen. I do not follow the reason for any arbitrary price at all in a matter of this kind, but again it may not matter if conditions do not change through the year. As I have said, the justification for the practice, so far as there is justification, was said by Mr. Robson to be that those who adopted the practice in this trade - and it may be in some other trades - regarded the cotton on their machines as part of the machines.

In arriving at the correct position, those who have to make valuations are guided by section 29 of the Finance Act, 1925 : "any income tax in respect of profits or gains or income chargeable under Case I, Case II, Case IV, or Case V of Schedule D which would but for the foregoing provisions of this section have been computed as aforesaid shall be computed, subject to the provisions of this Part of this Act and subject as hereinafter provided, on the full amount of the profits or gains or income of the year preceding the year of assessment." The same is shown by section 1 of the Income Tax Act, 1918, and by Schedule D, 1(a)(2) The object is to find the profits or gains from the trade for the year of assessment.

In considering the question of stock, I think that the principle stated by the Lord President Lord Clyde. In *Whimster & Co., v. Inland Revenue Commissioners*, has been accepted generally. The Lord President is reported as saying *Ibid* 823, : "In computing the balance

of profits and gains for the purposes of income tax, or for the purposes of excess profits duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating excess profits duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes." As I say, that has been adopted in general and it is sound in practice, the Lord President, in saying that "the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower," was in one sense going into accountancy matters. But I venture to think that that view of his is based on general experience and common sense - one cannot get at the true position unless one takes actual figures as distinct from arbitrary figures.

In the same case Lord Sands said : Ibid 826. "Where a trader sits down to ascertain from his books his profits or losses for the year, it is not enough that he should set on one side the money he has paid out, other than capital outlay, and on the other the money he has received in respect of the year's business plus the price he paid for commodities now in his possession. There are at least three other things that he must take into account - the present value of these commodities, the debts he has incurred, and the debts due to him, in respect of the year's operations." The cotton in this case, whether it be in bale in the mill or ready to be used alongside the machine or in the machine, is a commodity which the trader has bought in order to turn into yarn. Later Lord Sands said : Ibid 827. "The consideration of how it would be prudent for a trader to act does not solve the question here presented to us as one of Revenue law. Under this law the profits are the profits realized in the course of the year. What seems an exception is recognized where a trader purchased and still holds goods or stocks which have fallen in value. No loss has been realized. Loss may not occur. Nevertheless at the close of the year he is permitted to treat these goods or stocks as of their market value. This exception to the general rule has never, however, been extended to the case of probable or indeed apparently inevitable loss to be incurred in the execution of future contracts entered into during the year in question, and the authorities are against it."

Mr. King referred us to *Inland Revenue Commissioners v. Cock Russell & Co., Ltd.*, in which Croom-Johnson J., cited the words which I have just read from the *Whimster* case, and said himself : "There is nothing in the relevant legislation which indicates that in computing the profits and gains of a commercial concern the stock-in-trade at the start of the accounting period should be taken in and that the amount of the stock-in-trade at the end of the period should also be taken in. It would be fantastic not to do it; it would be utterly impossible accurately to assess profits and gains merely on a statement of receipts and payments or on the basis of turnover. It has long been recognized that the right method of assessing profits and gains is to take into account the value of the stock-in-trade at the beginning and the value of the stock-in-trade at the end as two of the items in the computation."

There is one other authority to which I should like to refer. Mr. King directed our attention to the *Sun Insurance Office v. Clark (Surveyor of Taxes)* of which the headnote reads. "A company carrying on the business of fire insurance had made a practice of carrying forward annually, in its published accounts, as a reserve, 40 per cent. of the yearly premium receipts representing estimated losses on unexpired risks, and had claimed to be assessed on this basis, it was found as a fact by the Commissioners that 40 per cent. was a reasonable and proper allowance, and the company's claim was admitted. The Crown contended that the company was not legally entitled to the allowance. Held," (by the House of Lords) "that *The General Accident, Fire, and Life Assurance Corporation v. McGowan* notwithstanding there is no rule of law as to the admissibility of an allowance for unexpired risks in estimating profits, but the question is one to be decided by reference to the facts in each case; and that on the facts found in this case the allowance claimed was a proper allowance to be made." The General Commissioners for the City of London in that case had found that the allowance was a proper one to make. There was an appeal to the Revenue Court, and Bray J. dismissed the appeal. The Court of Appeal allowed the appeal from Bray J., and the House of Lords restored the order of Bray J. and of the Commissioners, allowing the appeal from the order of the Court of Appeal.

The difficulty which arose in that case was owing to a misunderstanding which was said to be a failure to appreciate the reasons for the decision of the House of Lords in the *McGowan* case. Mr. King relied on this case and on *Inland Revenue Commissioners v. Cock Russell & Co. Ltd.*, in support of his submission that the court ought not to interfere with what he claimed was a finding of fact by the Commissioners. If the report of the case is examined, I think it hardly supports the proposition for which Mr. King contends. Lord Loreburn : "An estimate being necessary and the arriving at it by in some way using averages being a natural and probably inevitable expedient, the law, as it seems to me, cannot lay down any one way of doing this. It is a question of fact and of figures whether what is proposed in each case is fair both to the Crown and to the subject." The Lord Chancellor considered the decision in *McGowan's* case : "In *McGowan's* case, to which reference is made, three methods of estimating these gains or profits were before the House. I place first, merely for convenience sake and not for its importance or value, a

faint suggestion which was made in the case of McGowan, which, as I understand it, was as follows :- It was suggested that each contract of insurance made during a particular year should be considered separately. If it had expired then the actual result should be taken, whether profit or loss. If it had not expired then an estimate should be made, having regard to the period unexpired and the degree of risk, which might be different (in summer and winter for example) during that period. I do not imagine that either the Crown or the company would seriously desire such an inquiry. I do not know how many fire insurances are effected by a great company within a twelve month, probably scores of thousands or even hundreds of thousands. Such a process, as to the unexpired contracts, would be minute and almost interminable. It was rejected because there was no evidence that it would be a reasonable way of ascertaining what was desired.

"The second method suggested in that case was that of merely taking for each year the sum total of the premiums received and the sum total of the losses paid and subtracting the one from the other, without regard to the fact that the premiums cover risks running on into subsequent years and the losses include losses arising out of contracts made in previous years. This method is of course not precise or scientific. It proceeds upon the view that when this is done for the three consecutive years indicated by the statute and the figures thus reached are averaged, a fair and reasonable conclusion is attained. This method was adopted long ago and has more than once been the subject of consideration in courts of law. I can conceive it being unfair either in the case of a rapidly increasing or of a rapidly diminishing fire insurance business. It may prove unfair in both cases. But in McGowan's case it was not proved to be unfair. On the contrary it closely corresponded with the dividends actually distributed and was upon the facts of that case clearly the most accurate and reasonable of the methods which alone were propounded for our consideration. Accordingly it was adopted. I think it is in general a good working rule, but no one in this House has said that it ought to supersede the truth if the truth is in conflict with it in any case.

"A third method, similar in principle to that advanced by the now appellants, was also considered by your Lordships in the case of McGowan. 308. This method is to carry forward annually at the close of the year a percentage of the premium income in order to allow for unexpired risks. It has no pretensions to being precise. I can easily imagine cases in which an actuary could show it was misleading. But if it comes nearer to the truth than any other method in a particular case, I do not understand why it should not be adopted. This third method, however, in its application to that case, the McGowan case would have meant that the insurance company was to pay income tax upon the footing of about \$ 15,000 profits and gains in the three statutory years, whereas they had divided dividends of about \$ 60,000 in those three years. And there was no evidence and no finding, nor could there honestly have been, that the third method worked fairly between the Crown and the subject. In those circumstances this House rejected the third method. The house adopted the second, but so far from laying it down as a rule of law, it was expressly pointed out that the second method was of itself imperfect and, though a good

working rule generally, would not be applicable if in any case it appeared upon the facts to involve hardship. The headnote in the Law Reports is quite wrong and the view of Bray J. of what the House decided in McGowan's case is accurate." Towards the end of his speech the Lord Chancellor added : "I am equally anxious that your Lordships should not be supposed to have laid down that the method applied by the Commissioners in the present case has any universal application. If the Crown wishes in any future instance to dispute it they can do so by evidence, and it is not to be presumed that it is either right or wrong. A rule of thumb may be very desirable, but cannot be substituted for the only rule of laws that I know of, viz. : that the true gains are to be ascertained as nearly as it can be done."

Thus I read Lord Loreburn as having said that there may be one or two or three methods of arriving at the profits for the relevant period. The one which shows most accurately the position between the revenue on the one hand and the taxpayer on the other hand is the one which ought to be adopted. In other words, it is not sufficient to say that a particular system of accounting is a well recognised system of accounting and all right during normal times, if the contention on the other side is that the system does not give a true result for the particular year, the accounting year.

That was the case which the Crown put forward before the Special Commissioners. It is shown by their contentions, particularly the one to which I have already referred, but the Special Commissioners, although they had this case before them for quite a long time, failed to consider that contention.

I would state these general propositions : (1) One cannot arrive at the profits of the year without taking into account the value of the stock one has at the beginning of, and at the end of, the accounting year. (2) The figures for stock are just as important as any other figures. Values may have to be estimated when market price is taken, but any departure from accuracy is reflected in the trading account. (3) Stock should be taken either at cost price or at market price, whichever is the lower. The company's method of accounting does not meet these requirements for the relevant year. They have more stock, purchased out of income, than their trading account shows, and other stock is not taken at the right figure. It seems to me that the submission of Sir Andrew Clark that there can be only one answer to the Crown's third contention is established.

Vaisey J. towards the end of his judgment said : "On the whole I have come to the conclusion that my decision in this case must be for the Crown. I am satisfied that the base stock method of accountancy as adopted by the company is recognized and accepted in the industry and is unobjectionable for some commercial purposes. But I hold that it is not appropriate for the purpose of assessments to income tax, because it does not afford a true picture of the profits in any one year of charge, and because for that purpose the process stock of the company at the beginning and end of a year of charge should be valued and brought into account at cost (being lower than market value). It seems to me that in computing the company's profits no part of such stock should be

either treated as a fixed asset or brought into account as a mere arbitrary figure."

The Special Commissioners, after making their findings, stated : "We held that the appeal succeeded and we left the figures to be agreed." I think that it is right to say that they held that the appeal succeeded on their findings already stated in paragraph 15 of the case. It appears to me that on the facts they misdirected themselves in law in so holding. The decision of Vaisey J. was right, and in my view this appeal ought to be dismissed.

BIRKETT L.J. - I am of the same opinion. In view of the comprehensive judgment which my Lord has just delivered I will state quite briefly the reasons why I have come to the same conclusion, though I should like it to be clearly understood that I accept his reasoning and conclusions on all those detailed matters with which he has dealt so fully.

The case has been one of very great interest, and because of the nature of the figures a case of some complexity, and I should like to acknowledge the help which I have received from the arguments of counsel on both sides.

When the matter came before the Special Commissioners it was by way of an appeal by the company from the assessment made on them by what I may call the Gower method of assessment. The company took the view, and submitted to the Special Commissioners, that they were not bound by that method at all, and were entitled to have the figures for income tax assessed on the system which they and their predecessors in trade had used for almost 50 years. that was the issue before the Special Commissioners.

I was very much impressed by the argument of Mr. King that the only question before this court was whether there was evidence to support the findings of the Special Commissioners. If the answer to that question was in the affirmative, he submitted, then this court had no course other than to support the decision of the Special Commissioners and reverse the judgment of Vaisey J.

During the argument I was at some pains to try to ascertain the real question which this court had to determine. The question formulated by the Special Commissioners on the face of it seems complete. The question for their determination was "whether the company was entitled to have its profits computed for income tax purposes according to the base stock system." Mr. king said that the Commissioners had the precise question and the detailed evidence before them. They formulated the questions for this court thus : "The questions of law for the opinion of the court are :- (1) Whether there was evidence on which we could arrive at our findings in paragraph 15 of this case, and (2) whether, in view of such findings, our decision was erroneous in law."

My Lord has said that the Commissioners had not really made the proper findings, but Mr. King most strenuously argued during the discussion that they had, and that when one looked at the form in which they had stated their question, they must have been taken to know that the point before them was the assessment for the income tax year. It is plainly

so stated : "Those are our findings which we set out in paragraph 15," and those findings are two. They are (1) : "We,....., found that the method adopted by the company dealing with its base stock in its accounts is one of the methods recognized in this particular trade of cotton spinning and is in accordance with sound commercial practice." I do not think that anybody is ready to dispute that finding, because Mr. Gower in his evidence lent support to it. Mr. Robson certainly said the same thing. (2) : "We also found that the method the company had adopted for computing its profits was in accordance with sound commercial practice." So far as the accountants were concerned, that too would seem to follow from their first finding, because both Mr. Gower and Mr. Robson said that there are reputable firms who prefer this method for their companies accounts. Finally they said : "We held that the appeal succeeded." By that they must have meant, I think, that "because we have found that this base stock method employed by this company was in accordance with sound commercial practice, and because we found that the method of computing the profits by that system was in accordance with sound commercial practice, therefore it was suitable for income tax purposes."

I am bound to say that I think that third conclusion was wrong. If that be a proper construction of the findings of the Commissioners, it was erroneous in law, as it is not a pure question of fact so much as a mixed question of fact and law.

My Lord has read the relevant words of section 29(1) of the Finance Act, 1926 : "subject as hereinafter provided, on the full amount of the profits or gains or income of the year preceding the year of assessment." The Rules applicable to Cases I and II in the Income Tax Act, 1918, provide : "(1) The tax shall be charged without any other deduction than is by this Act allowed." "(3) In computing the amount of the profits or gains to be charged, no sum shall be deducted in respect of..... (e) any loss not connected with or arising out of the trade, profession, employment or vocation"; and "(f) any capital withdrawn from, or any sum employed or intended to be employed as capital in such trade, profession, employment or vocation."

I should have thought that the true question properly formulated and properly stated for the Special Commissioners was this : did the base stock method of accountancy, for which this company contends, correctly ascertain the full profits as enjoined by section 29 for income tax purposes for the year of assessment in question ? I do not think that they really answered that question. I have looked again at the evidence of Mr. Robson on which Mr. King placed so much reliance, and I had in mind his criticism of Vaisey J. who had said that Mr. Robson did not seem to commend that system. Mr. King said that it was not part of the duty of Mr. Robson to commend any system -he was merely giving evidenced about the matter. Mr. King also complained of Vaisey J. arrogating to himself that which was the task of the Special Commissioners, when he said : "but I hold that it is not appropriate for the purpose of assessments to income tax, because it does not afford a true picture of the profits in any one year of charge." Mr. King said, with great force, that the only reason that was said was because the company did not adopt what is called the Gower system but adopted its own base stock system. If the evidence of Mr. Robson is

analysed carefully, it is a little singular that he seems to skirt this central question in the case : is the base stock method of computing profits the proper method in accordance with the Income Tax Acts ? I will summarize what Mr. Robson was saying in this way : It is quite true that there is no one method that can be said to be the proper method to apply, speaking generally, among cotton spinning concerns : some use the base stock method and others the Gower method of cost or market value. But the company, when they did follow the base stock method, were following commercial practice. It is a good method, though other people may say that there is a better method. Mr. Robson then said that he did not think it was better to adopt the Gower method, and bring in the base stock at the beginning and end of the year at cost or market value. He said that people who use the base stock method do not agree with that; that if it were employed consistently this method gave a true view of the profits of the company. He said that he had given certificates certifying companies accounts framed on that basis. For example, he said that if there were a question of ascertaining the commission of a manager in a particular company he would adopt the method consistently used by the company and would not institute any other method. But all the way through, while he was discussing the question of rising and falling prices and the base stock system in relation thereto, he nowhere said : "In my view this system produces an accurate result in that it provides the full profits for the year of assessment." I think that Vaisey J. was to that extent justified in commenting on the evidence of Mr. Robson.

Perhaps I may refer to what Lord Porter said in *Asia Mill Ltd. v. Ryan* (H. M. Inspector of Taxes) : "Moreover what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for income tax."

I am bound to say that the view which I have taken of the findings of the Special Commissioners here is that they were concerned almost wholly with the first part of that sentence of Lord Porter. The base stock system is the appropriate method for this company which it has adopted consistently for its own purposes, for company purposes; but I do not think the Commissioners have really addressed themselves to the true question in this case : did this base stock method of accountancy correctly ascertain the full profits for income tax purposes for the year of assessment ?

Quite naturally, all sorts of subsidiary questions there upon arise, as, for example, did the base stock method have the effect of making deductions from profits which are expressly or by necessary implication forbidden by the Act of 1918 or any other relevant taxing statute ? But if we are asked to say : That if there be evidence to support the findings by the Special Commissioners, then the task of this court is ended, because it must support them, I am bound to answer that the findings of fact by the Special Commissioners do not conclude the matter. Even if one were to say that so far as these findings went there is nothing with which one can quarrel, nevertheless the true issue in this case is still left undermined, and I think that Vaisey J. was right, though his way of expressing it does not perhaps cover quite accurately the real issue in the case. I would prefer to formulate it in this way : the Special Commissioners who considered the facts of this case considered

them only up to one particular point and then stopped short. Bearing in mind the essential features of this base stock system which has been most accurately described by my Lord, taking into account that the fixed stock never comes into the trading account or appears in the balance sheet, and bearing in mind that the spare process stock had an arbitrary figure attached to it, the true view is that the Special Commissioners reached that stage and then stopped. They said : "There is not doubt at all that the base stock method has been the method in vogue among cotton spinners for very many years-in this particular case for nearly fifty years." For computing profits for the companys purposes there was no fault to be found with it. But as the real question was whether that system was a proper system for ascertaining accurately the full profits in accordance with section 29, I think that the Special Commissioners did not really address their minds to that topic.

For this reason I am of opinion that this appeal ought to be dismissed, and I concur quite fully in the judgment which my Lord has just delivered.

HODSON L.J. - I agree.