STOCK-IN-TRADE VALUATION FOR UK TAXATION PURPOSES 1925–71: HAS IT ALL BEEN THE ACCOUNTANTS’ WAY?

DAVID M SMITH

David M Smith is a Senior Fellow at the Taxation Law and Policy Research Institute, Monash University. He was formerly a Lecturer in the School of Law, Deakin University, Geelong.

I INTRODUCTION

The valuation of stock-in-trade stock might not, in itself, appear to be a very important question. However, the valuation method chosen could have a significant impact on both the profit and loss and thus the tax payable as well as the balance sheet of the enterprise. This paper considers in detail the court decisions dealing with the valuation of stock-in-trade for income tax purposes and then analyses these decisions in the context of contemporary accounting practices of the time and poses the question: have these decisions all gone the accountants’ way?

II BACKGROUND

In the United Kingdom the profits (income) derived from carrying on a business have been taxed since the introduction of income tax in 1799. The Income Tax Act 1799 (ITA1799) required a general return to be made. A major change was instituted with the introduction of the Income Tax Act 1803 (ITA1803), which required that returns be made for various classes of income derived by a taxpayer. From that time on income tax, being a tax charged on ‘any profession, trade or vocation’ carried on by the


2 The Bill for this Act was introduced as the Income Tax Bill by William Pitt (the younger) on 3 December 1798.
taxpayer, has been levied under Case I of Schedule D of the Act. The top rate set by the ITA1799 was 10 per cent for incomes £200 and upwards, with a graduated scale for incomes between £60 and £200. The ITA1803 was amended, but not so as to affect the question under discussion in 1805 and 1806, and became the Income Tax Act 1806 (ITA1806). After the end of the Napoleonic War, the income tax legislation was repealed. Income tax was not reintroduced in the United Kingdom until the Income Tax Act 1842 (ITA1842). The ITA1842 was for all intents and purposes a reprint of the ITA1806. The ITA1842 and subsequent amending Acts were later consolidated into the Income Tax Act 1918 (ITA1918).

As pointed out above, Case I of Schedule D specifically deals with taxpayers carrying on any trade. None of the pre-1900 Acts expressly referred to the necessity to take into account the value of stock-in-trade in-hand at the beginning and end of the year of income when ascertaining the ‘balance of profits and gains’ of a taxpayer.

While income tax was an annual tax, the liability was not calculated with reference to the current year’s income alone. A trader’s liability under Case I of Schedule D of the ITA was calculated on the basis of the average of the preceding three years’ income. From the point of view of the Board of Inland Revenue the valuation of stock was not a serious issue ‘because it was felt in the long run it would rectify itself’. This follows from the fact that one would expect that in the normal course of events the stock-in-trade would be realised in the following year. The effect of the three years’ average was to minimise the effect of any undervaluation of stock-in-trade in any one year. This is because the undervaluations in years one and two would normally be brought in to account as higher profits in years two and three respectively.

The Board of Inland Revenue believed that the abandonment of the three years’ average and the use of the lower of cost or market rule ‘would enable ... [the taxpayer] to work his profits advantageously’. A different interpretation on the effect of the use of the three years’ average was expressed by W L Gough:

There can be no doubt that it would be much more simple to make the assessment on the profits of the preceding year, but the average of three years is

3 Case IV charged annual profit or gains not charged under any other Schedule.

4 Other classes of income were charged on different bases: collieries on a five years’ average; manorial estates on a seven years’ average; with railways and gas companies charged on the year preceding the assessment. The change from three years’ average to assessment on a single year was recommended in the Report of the Royal Commission on the Income Tax, HMSO (1920) section VII: Basis of Assessment under Schedule D.

5 Evidence to The Royal Commission on Taxation on the Income Tax, HMSO, Minutes of Evidence (1920) para 12 488, 422 (E Stanford, Board of Inland Revenue).

6 Ibid para 12 425, 620.

clearly in the interest of the taxpayer. It may so happen that a heavy loss is sustained in a given year and moderate profits made in the following years.

III DOES THE VALUATION OF STOCK-IN-TRADE HAVE TO BE BASED UPON AN ACTUAL PHYSICAL STOCK-TAKE?

It may seem trite but the question as to whether an actual stock-take is necessary can have a significant impact. For instance, would it be permissible to simply rely upon a perpetual inventory system, which has been tested and shown to have a high degree of accuracy? Is it permissible to undertake the stock-take some days or weeks prior to closing of the book and make adjustments for later transactions—a procedure which is common in practice? Two of the earliest decisions affecting the valuation of stock-in-trade for income tax purposes are relevant to these questions: The James Cycle Co Ltd v The Commissioners of Inland Revenue and John Marston Ltd v the Commissioners of Inland Revenue. The facts of both cases are almost identical.

Both companies had taken a physical stock-take each year on 31 August and not on the dates required for preparation of Excess Profits Duty returns. The books of both companies were balanced at the appropriate dates and adjustments made from the audited stock-takes to bring into account sales and purchases during the period to estimate the volume and value of stock on hand for Excess Profits Duty purposes. In both cases the Commissioners for Income Tax found that as an actual stock-take had not taken place, the accounts did not disclose the profit for the quarter, but merely spread the profit for the year over the quarters of the year. In the James Cycle Co Case the Commissioners for Income Tax stated that:

the profit for each quarter shown in the said quarterly accounts was not the profit for that quarter, but merely the profit for the year distributed over the quarter of the year, and that, it was impossible from books kept as those of the Appellant Company were, and from such quarterly accounts, to ascertain readily or indeed to ascertain at all with any approach to accuracy the profits of such quarters without either actually taking stock or without the keeping of elaborate and accurate stock accounts.

8 Comment: this is an advantage because it smooths the income figure upon which tax is levied, and smooths tax burden as a result. If progressive rates of tax are used or a surcharge is payable above a certain amount, this would increase the benefit of being able to average income.

9 The James Cycle Co Ltd v The Commissioners of Inland Revenue (1919) 12 TC 98.

10 John Marston Ltd v the Commissioners of Inland Revenue (1919) 12 TC 106.

Rowlatt J, the judge at first instance, and the Court of Appeal, dismissed the taxpayer’s appeal as the issue raised by the appeal was clearly a question of fact for the Commissioners to determine.\(^{12}\) In the *Marston Case* L J Rowlatt LJJ commented that:\(^{13}\)

> No doubt the books if looked at by persons with the necessary knowledge contained the materials for finding out the profits for those months, but the books had not been made up within the meaning of this Section. ... Adding up a book is not making it up for this purpose because you make it up in order that the profits may be readily ascertained from the making up, *which means something more than adding up and something more than entering.*

And later referring to the accounts which had been prepared by the taxpayer that:

> I have no doubt they did it with very substantial accuracy, but they *did not do it really properly*, because, of course, they did not have and could not have, now that the time had gone by, a stocktaking on the 31st July to which they had transferred the end of the year, but *they got at it by reasoning from the state of affairs which existed on the 31st August*.

The taxpayer decided not to pursue their appeal given the decision in *James Cycle Co*.

These two cases indicate that an actual stock-take is necessary to comply with the requirements to properly value stock-in-trade. However it is less than clear if it would be permissible to take stock on the weekend before balance date, so as to avoid disruption to business, and adjusting the physical quantities through careful record keeping and then applying the stock values of the balance day to the figures so calculated.

There is clear evidence in the accounting literature that an actual stock-take was not always undertaken for the preparation of accounts.\(^{14}\) That taking a physical stock-take was not always the case is demonstrated by J Rhodes who notes that taking stock *‘is not generally looked upon as a sine qua non’*.\(^{15}\) He goes on to point out that some taxpayers need only take stock every three years because of the three years’ average. Unfortunately, he does not further explain this intriguing comment.\(^{16}\)

Adam Murray and Roger N Carter make an obtuse comment on the valuation of stock-in-trade, suggesting that ‘stock has been analysed, and the amount of it appertaining to

\(^{12}\) Ibid, Rowlatt J, TC 98, 103; M R Sterndale, MR105; Atkin, LJ 105; and L J Younger LJ agreeing, at 105.

\(^{13}\) *John Marston Ltd v the Commissioners of Inland Revenue* (1919) 12 TC 106, 112. Emphasis added.

\(^{14}\) There are numerous comments in *The Accountant* to the effect that is was very common not to get a value for stock-in-trade until all the other information had been tabulated.

\(^{15}\) The ‘indispensable condition or qualification’.

each item at the beginning and end of each year has been taken into account17 and that this has the same effect as doing a stock-take and using the figures ascertained as the opening and closing figures for stock-in-trade.17 They also point out that one of the common errors made by taxpayers who keep accounts for cash transactions only, is to forget that any increases and decreases in the value of stock-in-trade have to be taken into account to determine income for the period.18 This clearly shows that a physical stock-take was not contemplated.

Another example showing that doing a physical stock-take was not the normal practice follows from a question raised by an ‘Enquirer’.19 The problem involved a retail ironmonger whose stock-in-trade consisted of ‘thousands of articles’. The taxpayer had only taken stock ‘every two or ... three years’ due to the tremendous amount of work involved.

Similarly an editorial note in The Accountant discusses the case of a timber merchant who had not taken stock for over ten years. Income (profits) had to be calculated by deducting purchases from gross sales. Due to the actions of the Timber Controller, it was impossible to purchase any timber during the current year, therefore, all sales were out of the prior years’ purchases. As a result the current year’s assessment was ‘unduly inflated’. It was asked by ‘FCB’, if this could be avoided. The tax editor responded as follows:20

Rule 1 to Case I of Schedule D only charges the “balance of the profits or gains”, and it was laid down in inter alia Usher’s case that profits for income-tax must be computed on ordinary commercial principles, provided that where there is a specific provision in the Income Tax Acts disallowing a particular expense, that provision must be followed. ... The income-tax is only an annual tax ... an income-tax assessment for one year has no effect whatever on that of a subsequent year ... The position is, therefore, that ... profits for [each year] ... have to be ascertained on commercial principles quite separately and independently of what has been adopted [previously]. Now, as there are no stock figures, the profits must be estimated by estimating the difference in stocks. ... [T]he 1917 accounts do not give the “profits” without taking stock into account ... These accounts are incorrect by their incompleteness in not containing debits and


19 ‘Enquirer’ (anon), ‘Stocktaking for Retail Accounts’, letter to the editor (30 October 1909) The Accountant 547.

It is clear from the above discussion that there was some disagreement in the accounting profession as to the need for an actual stock-take to be undertaken or whether estimates could be used.

IV CONSISTENCY AND THE VALUATION OF STOCK-IN-TRADE FOR INCOME TAX PURPOSES

Consistency is a very important factor to be taken into account where there are competing accepted accounting methods (see full discussion below, particularly in relation to Duple Motor Bodies Ltd v Commissioners of Inland Revenue). In the United Kingdom consistency involves a consistent use of a particular method by a taxpayer, and may give rise to a form of estoppel against the Revenue. This approach can be traced to the case of Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd, where it was stated that where an incorrect method of accounting had been used it could not be corrected for the closing balance only: the opening balance must also be adjusted. Later cases have however cast doubts over the scope and application of this rule. In Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd, for example, the United Kingdom courts have made the taxpayer change its method of valuing stock-in-trade when that method was found not to produce the true profit for taxation purposes, despite the fact that it had been used constantly between 1920 and 1949. The expert evidence clearly showed that the method in question, the base stock method, was accepted as appropriate throughout the industry as the method for valuing stock-in-trade. Another case in point is BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) where only Lord Reid, in his dissenting judgment, would have allowed the appeal in the present case, mainly based on the acceptance of the Revenue of the company’s use of the method for such a long period. However he was of the opinion that the Revenue could prevent the adoption of this method by companies who had not been using it for a substantial number of years as the method adopted by the company was ‘stretching unduly the concession to taxpayers involved in ‘cost or market value, whichever is the lower’. However, the crux of his Lordship’s decision was that the Revenue had only sought to change the values of stock-in-trade for the current year, and not earlier periods.


22 Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd (1953) 35 TC 44.

23 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) (1972) AC 544.

24 [1971] 2 WLR 1313, at 1317.

25 His Lordship was relying on Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd (1929) 46 TLR 68.
Steel Barrel Co Ltd v Osborne (No 2)\textsuperscript{26} is another case where the consistency doctrine has been greatly limited. Somervell LJ observed that:

Sir Roland argued the case on the merits. With his main submission agree [sic]. He said normally, in dealing with a particular year of assessment, the opening figure which you take in respect of stock must be arrived at on the same basis as the closing figure. With that, as a general principle, nobody would quarrel; but, for the reasons I have sought to give, in the facts of this case, you have to analyse the position, and analysing it, as I have attempted to do, it seems to me plain that the Inspector of Taxes was right in saying that as a result of what had happened when the agreement was come to, this adjustment must be made in this year, and the adjustment is made by deducting the figure of £4,848 at the beginning of the year as if this old stock was still there, deducting nothing on the assumption that it was all sold.

For these reasons, as it seems to me, the learned Judge was right, though I think I have analysed it perhaps rather more fully than he did. I agree with the conclusion which he reached and also with the conclusions of the Commissioners.

Consistency in valuation methods has always been important in the valuing of stock-in-trade for accounting purposes. The introductory paragraph of Recommendation X of the Institute of Chartered Accountants in England and Wales states that:\textsuperscript{27}

No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, \textit{it should be applied consistently} ...

And later that:

\textbf{(C)} \textit{Inconsistency in method} may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

And

\textbf{(6)} Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and \textit{should be applied consistently} regardless of the amount of profits available or losses sustained.

Similarly, Recommendation N22 states that:\textsuperscript{28}

\textit{Circumstances vary so widely that no one basis of arriving at the amount is suitable for all types of business nor even for all undertakings within a particular

\textsuperscript{26} Steel Barrel Co Ltd v Osborne (No 2) (1948) 30 TC 73, 78. The facts are discussed below.

\textsuperscript{27} Published in \textit{The Accountant} (16 June 1945) 302–03. The emphasis is added

trade or, industry. Unless the basis adopted is appropriate to the circumstances of the particular undertaking and used consistently from period to period ...

The following comments by F R M de Paula give a reasonable reflection of the accounting approach. Throughout his discussion he emphasised the ‘great importance’ of applying a consistent basis of valuation to stock-in-trade from year to year. If the basis of valuation is changed: 29

the trend of the operating results for the year will be distorted. In my view, it is of the utmost importance that the proprietors of a business should be given a clear view as to the trend of the normal earnings of the concern. If, therefore, the basis of inventory valuation has been altered and the amounts involved are material in amount, then, in my opinion, this fact and the amount involved should be made clear to the proprietors of the business.

Thus it can be seen that the courts have been concerned with finding the actual value of the stock-in-trade in question, whereas the accounting profession seems more concerned with consistency in use of valuation methods. The virtue in being consistently wrong has alway escaped the current author.

V OPENING VALUE IS SAME AS CLOSING VALUE OF PRIOR YEAR

It is a basic premise of double entry bookkeeping that the closing value for one year will be the opening value for the next succeeding year. This may seem a trite observation but the following comment by Mr E Stanford of the Board of Inland Revenue before the 1920 UK Royal Commission on Taxation when questioned by one of the member of the Royal Commission gave evidence that: 30

even before the Excess Profits Duty it is not uncommon to find that stocks were being unduly written down; in fact, I was very much mused, on one occasion, to find that the taxpayer invariably wrote 10 per cent off his stock at the end of each year, and quite reasonably so, but he carried it forward into the next year at the unreduced figure 12,489. That is not really a stock evasion; that is imply changing the figures? As a matter of fact, he was perfectly innocent. He did not know what he was doing, although he had accumulated a reserve by that means of several thousand pounds, and he did not know where his money had come from, so he said, and I believe he was right.

There is little direct judicial authority on this point, although the doctrine of consistency discussed above gives some insight as to why this should be the case. In the Osborne Case 31 problems arose from an agreement between the revenue authorities and the

29 F R M de Paula, ‘The Valuation of Stock-in-Trade or Inventories’ (a paper delivered before the Chartered Accountant Students’ Society of London on 10 February 1937) in Developments in Accounting (1948), 43–50, 50.

30 Above n 5, 622. Emphasis added.

31 Steel Barrel Co Ltd v Osborne (No 2) (1948) 30 TC 73, 78.
taxpayer for the 1933 to 1939 years inclusive, arising out of an previous income tax dispute. By that agreement the opening and closing stock figures were reduced for 1933 to 1939. However due to oversight the Inland Revenue opening stock figure for the 1938 year was not reduced so as to correspond with the closing figure of stock as at 31 December 1937. The taxpayer objected to the amended assessment which reduced the opening stock figure for the 1938 year as per the agreement. Judge Macnaghten, the judge at first instance, held that:

It is plain that the figure taken for the opening figure on 1st January must be the same as the figure for the valuation of the stock on the previous day.

On appeal all the judges agreed on this point. Vaisy J saying that once a figure having been fixed ... as the closing [stock] figure at the end of 1937, it would, in my judgment, of necessity also be the opening [stock] figure for the year 1938.

Tucker J agreed noting that:

the closing figure for stock for 1937 should be treated, as it would normally be, as the opening figure of the stock for 1938.

Somervell LJ agreed that the primary judge had come to the correct conclusion.

VI VALUATION AND SUBSEQUENT KNOWLEDGE

Generally if during the preparation of accounts it is discovered that after the balance date, but before the accounts are finalised, there is a deficiency which was present at the balance date then that deficiency would be reflected in the accounts. The question arises: can the deterioration in the value of stock-in-trade which is present on the balance date, but which is not discovered until after the balance date, be taken into account at the balance date for taxation purposes. This issue was considered in *Brigg Neumann & Co v Commissioners of Inland Revenue*. The taxpayer company had 268 pieces of cloth from Messrs Harper which were still ‘in the grey’ or were still at the dyers, and had not yet been found to be defective. The Commissioners for the Special

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32 *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293. Discussed below.

33 *Steel Barrel Co Ltd v Osborne (No 2)* (1948) 30 TC 73, 78. The case follows from agreement reached in *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293 which is discussed below.

34 Ibid, the *Osborne Case* (1948) 30 TC 73, 81.

35 Ibid 82.

36 Ibid 81.

37 *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

38 Ibid 1205–06. However, ‘40 other pieces of the same weaving had come back from the dyers and had been examined and were all found to have one similar defect running through them’.
Purposes of Income Tax held that these pieces should be at the ‘value the said goods at 31st March, 1921, at the current market value of perfect goods of the same description (market value being lower than cost price)’. Rowlatt J held that:

I think the Commissioners were right in saying “We must treat these 268 pieces of goods merely on the same footing as perfect goods which they appeared to be at the time.” Therefore I think both the appeals fail, with costs.

Thus it is clear that only knowledge at the balance date can be taken into account in valuing stock-in-trade for income tax purposes.

VII THE UNDERLYING ASSUMPTION OF THE COMMON LAW: THE ‘LOWER OF COST OR MARKET RULE’

The fundamental basis for the valuation of stock-in-trade adopted by the United Kingdom courts under the Income Tax Acts, is the use of the ‘cost or market price, whichever is the lower’ rule. It is common for writers in this area to refer to the often-quoted words of Lord President Clyde who described the situation as follows in Whimster & Co v Commissioners of Inland Revenue:

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 ... and the expenditure laid out to earn those receipts the account ... 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 .... 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 statute.

Lord Sands observed in the same case that:

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 realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks

39 Ibid 1199. Emphasis is added.

40 See also discussion of Hinchcliffe (HM Inspector of Taxes) v Crabtree (1970) 47 TC 419. Discussed below.

41 Whimster & Co v Commissioners of Inland Revenue (1925) 12 TC 81, 823. It is interesting to note, though no doubt totally irrelevant, that in this case there was, by the time it reached the courts, no longer any question of stock-in-trade involved, as the taxpayer had withdrawn any such claim, being a shipping company. Note the other members of the court made similar observations.

42 Ibid 827.
which have fallen in value. No loss has been realised. 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.

The overriding consideration, in Lord President Clyde’s view, is conformity with the provisions contained in the relevant legislation. In *Commissioners of Inland Revenue v Marshall* his Lordship expressed the following view of the function of the court when considering the appropriateness of stock-in-trade valuation methods:

> It is not for this Court to fix principles of valuation, for a principle of valuation is not a part of the law universal at all, but of course it is necessary sometimes to ask this Court whether a particular principle of valuation, if adopted, would or would not accord with the prescription of the Income Tax Acts which requires the balance of profits and gains to be duly ascertained.

Lord Guest made the point most forcefully in *Duple Motor Bodies Ltd v Commissioners of Inland Revenue* that:

> It can never rest with the taxpayer [or anyone else for that matter] to decide upon what principle his income is assessed for tax purposes. The directors’ [or anyone else’s] decision can never be decisive of the matter for income tax purposes .... The Assessment, in addition to being consistent with normal accounting practice, must be made according to the provisions of the Income Tax Acts.

Later in the same case Lord Reid commented as follows:

> Normally a court attaches great weight to the view of the accountancy profession, though the Court must always have the last word.

Similarly, Lord Carmont in *Commissioners of Inland Revenue v Broomhouse Brick Co Ltd*, commented that:

> it must not be left out of account that the approach to the question is not whether any given expenditure would be treated by a chartered accountant in a perfect system of book-keeping as an appropriate deduction in the ascertainment of a taxpayer’s true profits, but whether the scheme of the Income Tax Acts permits of the given expenditure being treated as a deduction.

Singleton J, in *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* described the attributes of an acceptable valuation method as follows:

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43 *Commissioners of Inland Revenue v Marshall* (1927) 14 TC 319, 322.

44 *Duple Motor Bodies Ltd v Commissioners of Inland Revenue* (1959–61) 39 TC 537, 573–74.


46 *Commissioners of Inland Revenue v Broomhouse Brick Co Ltd* (1952) 34 TC 1, 10.
The [method] ... 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 ... 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.

The author endorses the above approach as being the only rational one that can be adopted in the valuation of stock-in-trade. Singleton J enunciated the following general rule:48

(1) You cannot arrive at the profits of the year without taking into account the value of the stock ... (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.

One hopes Salmon LJ, in B S C Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes), was not being completely serious when making the following comment with respect to the valuation of stock-in-trade:49

Much turns upon accountancy practice. Although this may appear elaborate and artificial to a lawyer [or for that matter the man in the street] ... it is aimed, almost always successfully, at arriving at an aspect of the truth.

Tables 1 and 2 summarise the views expressed in books, articles and letters to the editor of The Accountant during the period 1921 to 1925. From this it is clear that while the use of the lower of cost or market rule was popular with the accounting profession it certainly could not said to be the established practice for valuing stock-in-trade. Many of the authors who referred to it did not use it for all purposes. This is reinforced by the discussion below.

47 Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd (1953) 35 TC 44, 64. The emphasis is added.

48 Ibid 68.

49 B S C Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) (1971) Ch 427, 436.
### TABLE 1 Valuation of stock-in-trade 1921–25: Net of Multiple Authors

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F R M de Paula opens his extensive discussion of the valuation of stock-in-trade by saying that he has for ‘many years ... been disturbed’ by the ‘so many different’ methods that are used to value stock-in-trade. A matter of particular concern was ‘that there is not an accepted basic principle’ for valuing stock-in-trade.\(^{50}\)

\(^{50}\) Above n 29, 50.
J H Burton identified the following methods used for valuing stock-in-trade that were in current use about this time. They included the following:\(^{51}\)

1. Actual cost.
2. Market value.
3. Average purchase price during a period.
4. Market or selling price, less a percentage to bring the value down to cost.
5. Standard cost based on the values in a normal period.
7. Scrap or forced sale value in the case of obsolete or excess stock.

All these methods are based on theories which in particular circumstances are commercially sound. [Emphasis added.]

More significantly it is noted that:\(^{52}\)

Many methods are adopted ... in valuing stock and stores, which contravene the popular maxim of “cost or market value, whichever is the lower.”\(^{\dagger}\)

For instance, there is the use of the ‘base stock’ method under which stock-in-trade ‘may be priced at a minimum figure, as these materials represent the smallest quantity of stock absolutely essential to the conduct of the concern’.\(^{53}\) The consequences of over and under valuation of stock-in-trade are that there will be:\(^{54}\)

an understatement of the total net expenditure for the period, or a big disparity between the cost accounts and the financial books.

Under-valuing causes an over-statement of total expenditure and a similar discrepancy.

Many other authors in the accounting literature referred to inconsistent or different methods.\(^{55}\)

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\(^{51}\) J H Burton, *Stores Accounts and Store Management* (first published 1929, second ed, 1930) 61–62; third edition, (3\(^{rd}\) ed, 1937) at 60. The emphasis is added. See also J H Burton, ‘Practical Problems In Stocktaking And Stores Accounts’ (30 August 1924) *The Accountant* 309–17, 316, where the same comment is made. It should be noted that the fourth edition published in 1947 contains the same list at pages 59–60. Thus, these practices survived after the issuing of Recommendation X.

\(^{52}\) Ibid, Burton 1929, 62. The emphasis is added.

\(^{53}\) Ibid 62.

\(^{54}\) Ibid 62.

It is clear from the discussion above that there were many methods of valuing stock-in-trade in use other than the lower of cost or market value rule.

A report in *The Accountant* shows that the use of the lower of cost or market rule was not the only way to reduce income tax liability. Nor was it the most effective one. The report was as follows:56

A question has been asked in The House of Commons if relief can be given from demands of Surveyors of Taxes that, for Income-tax and Excess Profits Duty, stocks should be taken at cost or market value, whichever was the lower. It was urged that this acted unfairly, as many traders had been in the habit of taking their stocks below cost or market value, and that traders should be allowed to charge against present profits sums necessary to reinstate stocks to pre-war level.

The opinion of *The Accountant* was that:

> It is impossible to lay down a general rule for treatment of stocks, but, on stock depreciating in a particular year, the above method [the lower of cost or market rule] gives a full allowance in that year by the credit for stock being reduced.

In 1920 E W Newman noted that often the valuation of stock is not based upon any method but rather the ‘sole consideration’ is the amount wished to be declared as profit to the Inland Revenue.57 He notes, not in the context of tax, that:58

> one finds that many different methods are adopted in valuing stock-in-trade. Some of these methods contravene the popular maxim of “cost or market value.” All of them are based upon theories which in particular circumstances

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are commercially sound. ... [T]he fundamental principle of all may be broadly stated in this way – that no profits should be anticipated and that all known losses, whether actual or contingent, should be provided against.

And furthermore, significantly, ‘[w]e may grant that cost price is the proper basis for stock valuations in ordinary cases’.59

Before the 1920 Royal Commission Mr E Stanford London, of the Board of Inland Revenue, was questioned extensively on the proper way to value stock-in-trade for income tax purposes. He gave evidence that the practice of the Inland Revenue was to accept accounts drawn up on the basis of the rule, and that the Inland Revenue usually requested signed statements from taxpayers stating the value of stock-in-trade and how it was valued.60 The lower of cost or market rule was only accepted by the Board of Inland Revenue because of its (assumed/claimed) long use in business, despite the inconsistencies in its application and its lack of logic. He described the use of lower of cost or market rule as ‘an unsatisfactory practice’.61 He indicated that accounts which were based upon current values62 of closing stock-in-trade would be acceptable for income tax purposes, as would be accounts based upon historical cost values alone. Neither of these methods would lead to the types of manipulations and inconsistencies which were associated with the use of lower of cost or market rule. He gave evidence that prior to the war and the introduction of the Excess Profits Duty, the Inland Revenue did not worry about stock certificates and the value of stock-in-trade because ‘it was felt that in the long run it would rectify itself’.63

Mr London, when questioned by commission member Mr William McLintock, gave evidence that undervaluation of stock-in-trade was quite common, either by creating a fixed ‘reserve’ which did not vary from year to year, or by reducing the closing figure by a percentage of say 10 per cent, and using the original cost of the stock for the opening figure the following year.64 Further evidence of such practices brought out by Dr Josiah Charles Stamp’s questioning of Mr London, where he reported that large reserves (arbitrary write-downs in stock values) had been made in the cotton boom of 1910 by a number of taxpayers.65 Mr London believed it would be a far more

59 Ibid.

60 These statements were called stock certificates and are discussed below. For examples of two different types of certificates see APPENDIX 5-6. It is to be noted that one type of certificate referred to did not require that any particular method of valuing stock-in-trade be used see APPENDIX 5-4.

61 Minutes of Evidence, The Royal Commission on The Income Tax, HMSO, 1920, at 622. At 628 he agrees with the statement that ‘the matter has only become acute by reason of the rise in rates during the war and the very rapid rise in prices’.

62 The words ‘current market values’ could mean either replacement market or selling market. The meaning is not apparent from the text.

63 Above n 5, para 12 488, 622.

64 Ibid paras 12 484–489, 622.

65 Above n 5, para 12 631, 628. See also paras 12, 410–12, 412 under questioning by Lord Colwyn and paragraphs 12, 566-12569 questions by Mr Walker Clark at 625.
satisfactory state of affairs if the method of valuation of stock-in-trade were specifically
dealt with in the Income Tax Legislation.

The lower of cost or market rule’s place in tax accounting practice can also be
questioned by the following comments in the 1950s. Evidence to the Tucker
Committee66 indicated that there was the belief that stock-in-trade should be valued
according to the custom in the trade. Mr Frank Bower67 in answer to a question from
the chairman is reported as saying that:68

each industry had its own method of valuation and it should be left to them to
establish a suitable basis. Some fences had to be put up and it was suggested
that they could and should be reduced to three. Firstly, the method adopted
should be in accordance with the custom of the trade. Secondly, it should be
applied consistently from year to year. Thirdly, it must be such as to result in a
fair view of the profits or losses of the period, even if this involved some degree
of departure from the second proviso.

Mr B M Berry advocated the use of the base stock method69 while Mr K A Lacey
recommended the use of a replacement reserve technique which would ‘iron out booms
and slumps’.70 Mr T B Robson noted that ‘on the whole a lack of rules had worked
reasonably well in relation to stock valuations’71 and Mr E G Turner felt that ‘the main
difficulties had been in arriving at facts rather than principles’.72

The Report of the Royal Commission on Taxation in 1955 also recommended giving
substantial choice to the taxpayer for valuing their stock-in-trade.73

A How is the ‘Lower of Cost or Market Rule’ to be Applied?

Given that Lord Clyde, and the other judges quoted above, specifically approved the
use of the lower of cost or market rule, it is important to point out in the strongest terms
that the ‘lower of cost or market’ rule is not of itself a valuation method. It is merely a
decision matrix which is used to decide which of two valuation methods is the one to be
used for a particular item in a particular case.

66 Committee on Taxation of Trading Profits, The ‘Tucker Committee’.

67 Frank Bower was representing Federation of British Industry and the Association of British Chambers
of Commerce.

68 ‘Taxation of Profits - Foreign Profits; Stock Valuations; Group Accounts - Tucker Committee’s Fourth
Public Hearing’ (1 April 1950) reported in The Accountant 355–58, 355.

69 Ibid, for the International Chemical Co Ltd, 358.

70 Ibid, Lacey 358.


72 Ibid.

The case of *Commissioners of Inland Revenue v Cock Russell & Co Ltd*\(^{74}\) established an important principle with respect to the application of the lower of cost or market rule. The company was incorporated to acquire a partnership which carried on the business of wholesale wine and spirit merchants, operating under the same name. The firm had purchased, just prior to the outbreak of war, a quantity of port for the price of £3486. In late October 1945 a large quantity of port became available on the market at substantially lower prices. The two remaining pipes of port for which the firm had paid £1620 could then be purchased for a price between £1280 and £1360, and by January the following year for a price of between £1200 and £1340.

For the year ending 31 December 1945, the company valued this port, after allowing for shortages due to evaporation at £1182/15/-, that is, at its present market price. The rest of the company’s stock was valued at cost, which was lower than the current market price. The company, and the firm before it, had always valued each item of stock separately, after having tasted them, using the lower of cost or market price for each. The Commissioners of Inland Revenue objected to the application of the lower of cost or market rule in such a way, with only two items being valued at current market value, the remainder of which had values in excess of cost however being shown at cost.

The evidence given by Mr Cock, the company’s Managing Director, to the Commissioners for the General Purposes of Income Tax for the City of London, showed the firm had written down wines in the past when their value fell below cost. The last time this had occurred was after the 1914–1918 war, and since then the prices had been continually rising. Additional evidence was given by Mr R G Barrett, the Managing Director of another firm of wine and spirit merchants, James L Denman & Co Ltd. This firm used the same practice when valuing their stock.

Two chartered accountants also gave evidence, Mr Francis Feather of Harper, Feather and Paterson, and Mr G G P Goldney of A C Palmer & Co, both of whom said the company’s application of the lower of cost or market rule was the appropriate method of valuing their stock to allow for both deterioration of the stock and also for falls in the market price of the stock. Mr Goldney also produced Recommendation X of the Institute of Chartered Accountants in England and Wales,\(^{75}\) and the Commissioner quoted this part of the recommendation:\(^{76}\)

> on the other hand, a more prudent and equally proper course is to take each item of stock or each category group, and value it on the basis of the lower of its own cost or market value.

\(^{74}\) *Commissioners of Inland Revenue v Cock Russell & Co Ltd* (1949) 29 TC 387 [1949] 2 All ER 889.

\(^{75}\) Published in *The Accountant* (16 June 1945) 302–03. The extract is from para 4 of the Recommendation, 303.

\(^{76}\) *Commissioners of Inland Revenue v Cock Russell & Co Ltd* (1949) 29 TC 387, 389.
The Commissioners for the General Purposes of Income Tax of the City of London held the method used by the company was the practice of the trade and they were justified in using it. The Commissioners of Inland Revenue were dissatisfied with their findings and appealed.

The case was argued before Croom-Johnson J, who pointed out the evidence in this case all pointed the one way, supporting the method adopted by the company. His Honour was not impressed with the method of applying the lower of cost or market rule contended for by the Revenue which would, if adopted by the company, ‘not entitle [them] to go through that “stock-in-trade” item by item and look to see what in truth was the position’. After reviewing the applicable case law his Honour found there had been no misapplication of these general principles and the Special Commissioners had directed themselves accurately and properly, and their decision was supported by all the evidence put before them. Croom-Johnson J, indicated that during the argument of the case he had given several illustrations of the ‘unjust results which might follow’ by applying the lower of cost or market rule in the manner argued by the Crown. Consequently the appeal was dismissed.

As such, it is argued that to properly apply the lower of cost or market rule, it should, at a minimum, be done class by class, if not item by item, as the lower of the total cost or total market value may well exceed the value ascertained using the approach approved of by Croom-Johnson J. Such an approach is also common sense. Clearly in most instances it will not be possible to value each item of stock item by item, due to the cost involved. Thus it will be up to the professional judgment of the accountant to determine how the stock is divided into appropriate classes for valuation purposes.

The case of Worthington (HM Inspector of Taxes) v Oceana Development Company Ltd is another instance where the Revenue tried to apply the lower of cost or market rule globally. By consent of the Inland Revenue, judgment was entered for the taxpayer by Croom-Johnston J, on the basis that the law had been clearly determined in the Cock Russell Case (above).

77 Ibid 390.
78 Ibid 392.
79 Ibid 391.
80 Ibid 392–94. See also Whimster & Co v Commissioners of Inland Revenue (1925) 12 TC 81; Edward Collins & Sons Ltd v Commissioners of Inland Revenue (1925) SC 15 1; 12 TC 773; JJ H Young & Co v Commissioners of Inland Revenue (1925) SC 30; 12 TC 827; Absalom v Talbot (1944) 26 TC 166, 197.
81 Commissioners of Inland Revenue v Cock Russell & Co Ltd (1949) 29 TC 387, 394.
82 Worthington (HM Inspector of Taxes) v Oceana Development Company Ltd (1949) 65 Times LR 726. A number of books and articles by accountants cite this case rather than Commissioners of Inland Revenue v Cock Russell & Co Ltd, this intriguing anomaly has not yet been explained by the author’s research.
VIII ‘MARKET VALUE’ WHICH MARKET: BUYING OR SELLING?

A Introduction

The question of the meaning of market price has been considered in several cases, the first being the Brigg Neumann Case.\textsuperscript{83} Rowlatt J enunciated the general principle for determining the market value of stock-in-trade as follows:\textsuperscript{84}

\textit{Prima facie} I take it when there is cloth to be valued at a cloth merchant’s the question to be answered simply is: “What is this cloth worth here to-day that is on these shelves?” That involves the contemplation of some market, because it is not to be supposed that you would value and it would not be right, of course, to, do so—the cloth at a figure which you could get by having a break-up sale, or a forced sale, or anything of that sort.

Thus, he interprets market value as meaning realisable value. This point becomes clearer when Rowlatt J considers the market value of the actual stock-in-trade held by the taxpayer.

The taxpayer company was a trader in textiles, purchasing woollen goods ‘in grey’ from weavers and sending them out to be dyed by dyers. If any defects were to be found in the cloth, they would only become apparent after the dyeing process had been carried out. There were three types of agreements that the company had with its weavers which governed the question of defective cloth. Under the first, the defective goods were returned to the weavers for a credit of the original cost. Under the second, the goods were either returned for credit or sold and the difference in the price received—from that which perfect cloth would have brought—debited to the supplier’s account. The third type of agreement had no specific provisions, however the goods were, in practice, sold for the best price obtainable, and the weaver was debited for the difference between the contracted price plus the cost of dyeing and the price which had been realised on the sale.

There were two different agreements with the dyers. Under the first type of agreement, where there was a fault in the dyeing, the piece was sold for what it would fetch in the market, and the dyer debited with the difference between the cost price of the piece plus the cost of dyeing and the price realised. In the second situation, the pieces were charged to the dyers at the cost of the piece plus the cost of the dyeing, and one presumed that they then became the owners of the cloth.

The company valued the imperfect cloth still on hand at the actual sale price of the imperfect cloth and did not include the amounts which they were to receive from the spinners or dyers. The Commissioners of Special Purposes valued these spoiled goods that were subject to these special arrangements at the market-selling prices for perfect goods, as this was the amount the company would actually receive, and not the amount

\textsuperscript{83} \textit{Brigg Neumann and Co v Commissioners of Inland Revenue} (1928) 12 TC 1191.

\textsuperscript{84} Ibid 1202.
which would be received by way of sale alone. Rowlatt J upheld the Commissioners’ method, justifying it as follows:85

What they have got to get back in some way or another is the price they have paid for the goods and for the dyeing of them. If the goods sell for more they will not have to ask the weavers for so much; if the goods sell for less they will have to ask the weavers for more, but the amount that they will recoup themselves from one or the other, the manufacturer or the weaver, is the amount of the cost price plus the cost of dyeing by which they have been out of pocket. I do not think that affects it. I think the Commissioners are right.

Rowlatt J decided that the effect of these provisions in the contracts was that the condition of the cloth did not matter. The taxpayer would either sell it as perfect cloth in the market and gain the market price, or it would be returned to the manufacturer and perfect cloth substituted, or the imperfect cloth would be sold and the loss on the sale debited to the manufacturer’s account. As such, it did not matter to them if the cloth was perfect or not, because the imperfect goods would be exchanged, or the difference in sales price would be made up by the manufacturers. Furthermore:86

in either case they get back their purchase price ... If the goods are defective and there also has been a great fall in the market, it follows that Messrs Brigg Neumann will themselves get back from their weavers not only the shortage in value which is attributable per se to the defects in the goods, but they will also get back that which is attributable to the general fall in the market; so that it was better [if the cloth] ... should turn out defective ...

The same considerations applied to cloth which had been defectively dyed. A substantial amount of stock on hand at the balance date had subsequently been found to be imperfect, and this had been valued by the company at its imperfect value. Rowlatt J held that it should be valued in the condition it was known to be in, at that date, that is, as perfect goods, and the Commissioners were correct on this point:87

We must treat these ... on the same footing as perfect goods which they appeared to be at the time. Therefore I think both the appeals fail, with costs.

Two points are clear as a result of this case. First, the relevant market price under the lower of cost or market rule, is the market in which the company usually sells. Secondly, where goods are subject to a special arrangement, that is, there is an indemnity or signed contract for sale, then it is the actual price to be received under the arrangement and not the general market price, which is relevant: for this is the amount which will actually be received.

C J Allan Macleod reports that he read with ‘growing amazement’ about the use of net realisable value for market value in Recommendation X. He says he was relieved ‘to

85 Ibid 1206.
86 Ibid 1204–05.
87 Ibid 1207.
find that up to the King’s Bench Division the Inland Revenue are still bound by Brigg Neumann & Co. (1191, TC, Vol. 12) of which your Council may be unaware’. 88 He then claims to quote from the case that ‘[m]arket value is the price at which the appellants could purchase the goods in the market’. 89

It is claimed that ‘[o]ur predecessors in this profession maintained’ that stock-in-trade was valued using the lower of cost and market rule and that by ‘market value they meant the lowest buying price in the best market open to the buyer’. 90 He would be pleased to see ‘these unfortunate recommendations withdrawn’. 91

This is a clear misrepresentation of the case. The only place where the two terms are used together is when Rowlatt J is describing how the taxpayer referred to replacement cost as market value, that is, where Rowlatt J says:92

they say: “If in fact there is no spot market”; but at any rate the case proceeded upon the footing that there was no market. You could not simply value those goods as things you could take out and sell there and then, or anything of that sort, and so they had recourse to cost price, but they distinguished, in not very happy language, between two forms of cost price. One form is: What have you actually given for these goods? That is the cost price in the normal sense. But the other cost price they have described in a phrase which they have used again for this purpose, namely, the phrase “market value” in paragraph 28 of the Case, meaning by that the price at which Messrs. Brigg Neumann & Company could purchase in the market.

The editor of The Accountant notes immediately under the letter of C J Allan Macleod that fiscal rules have nothing to do with accounting or auditing practice. The formulation of the Recommendations ‘aim simply at formulating a guide to the “best practice” in publishing accounts’. The editor points out that the Brigg Neumann Case decision was based on ‘on special facts relating to the treatment of damaged goods’. 93


89 This is not the case at all. Replacement cost was only used as a surrogate for cost, which was inapplicable in the circumstances to some stock of the total stock in question. Rowlatt J held that market value meant realisable value. A computer text scan and word search of the judgment was unable to find this supposed quote. This a clear misrepresentation of the findings and reasoning of Rowlatt J’s judgment. A report (Brigg, Neumann & Co v Commissioners of Inland Revenue) in The Accountant Tax Supplement (14 July 1928) 361–62, at 362, gives a misleading impression by referring to the findings of the General Commissioners for Income Tax stating that market value meant replacement cost without pointing out that this approach was rejected by Rowlatt J.

90 Above n 91, 107.

91 Ibid 108.

92 Brigg Neumann and Co v Commissioners of Inland Revenue (1928) 12 TC 1191, 1202–03.

93 The editor, ‘The Institute and the Valuation of Stock-in-Trade’ (1 September 1945) The Accountant 107–08, at 107. This is a note to C J Allan Macleod’s letter. It to be noted that in Brigg Neumann it was perfect cloth which had replacement cost attached to it and the imperfect cloth realisable values. The correct citation is Brigg Neumann & Co v Commissioners of Inland Revenue (1928) 12 TC 1191.
This a misrepresentation of the facts, as it was used as a surrogate for the cost of the undamaged goods as is shown above. Damaged goods were valued at realisable values under the supply contracts.

The view expressed by C J Allan Macleod is not isolated. J H Burton discusses several income tax cases in relation to the valuation of stock-in-trade.\(^{94}\) However, for some reason he omits vital facts in his discussion of *Brigg Neumann*. Whilst correctly stating that it was held that replacement cost means the cost one would have to pay in order to have the stock on hand at the end of the tax year he fails to point out that it was being used as a surrogate for cost because there was no ‘spot’ selling market at the time and thus the realisable value could not be ascertained. He also misrepresents how goods known to be imperfect should be valued. He does not point out that the discussion was based upon how much they would in fact receive for the particular goods in the normal course of their business.

The Report of the case in *The Accountant* concluded as follows:\(^{95}\)

> The Special Commissioners held that the market value ought to be *the price at which the appellants could buy cloth in the open market*, and if, in fact, there was no spot market enabling the market value at 31st March to be readily ascertained, then the value ought to be the price which ruled at the time when contracts for delivery at 31st March were entered into.

The appellants appealed. There was also a cross appeal by the Crown as to the valuation to be put on the 268 pieces of cloth, which were, in fact, defective but had not been discovered to be so at 31st March 1921 as was found by the Commissioners.

*Held*, dismissing both appeals with costs, (1) *that the Commissioners had ascertained the correct basis for arriving at the market value of the cloth brought into stock*; (2) that as regards all defective cloth other than defective cloth purchased from P. & Co., and the 268 pieces purchased from H., Ltd., the Commissioners were right in holding that such cloth should have been valued at its cost price as the appellants had a claim for reimbursement from the weavers; (3) that the decision of the Commissioners as regards the value to be placed on the 268 pieces purchased from H., Ltd., was correct.

This is a clear misrepresentation of the findings of Rowlatt J. Similarly, in an article which appeared in 1941, it is asserted that:\(^{96}\)

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\(^{94}\) J H Burton, *Costing for Control* (1948) 46–47. The cases are *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191; *Ahmedabad New Cotton Mills v Bombay Commissioners* (1930) 8 ATC 575; *Craig (Kilmarnock) Ltd v Cowperthwaite* (1914) 13 TC 627; *Hunly & Palmers Ltd v Commissioners of Inland Revenue* (1928) 12 TC1209; *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293; *Greene v Inland Revenue Commissioners* (1926) 6 ATTC 461 and *Smith & Son v Commissioners of Inland Revenue* (1928) 7 ATC 135.

\(^{95}\) *The Accountant Tax Supplement* (14 July 1928) 361–62, 362. The emphasis is added.

\(^{96}\) ‘Valuation of Stock for Income Tax’, (22 November 1941) *The Accountant Tax Supplement* 293–95, 293–94. The emphasis is added.
The Special Commissioners held, however, and their decision was affirmed in the High Court, that the correct method of valuation was to compute the price which would have been paid had the goods been actually delivered on 31st March, 1921, that is to say, had they been ordered on 31st December, 1920. As regards that part of the stock which was defective, the Court decided that where defects had not been discovered before 31st March, the goods could be valued at the current market value (being below cost price) at that date, i.e. the price at which they could be purchased in the market.

Max Englard says that:

"With regard to market price the position is not quite clear. Generally, it is taken as the estimated realizable value of the stock in its existing condition after taking into account expenditure incurred before disposal. In Brigg Neumann & Co v CIR (7 ATC 269; 12 TC 1191), however, it was defined as the price at which the goods could be purchased by the trader in the market. Where there is no spot market a notional cost price to the trader of the goods on the day of valuation is to be taken."

There are many similar comments to be found in the literature. These comments are hard to understand given Rowlatt J’s explicit comments that market value meant realisable value. Having reread the case many times, the current author could find no such comment. Even scanning the judgment and doing a word search produced no guide as to how the mistake could have happened. It is as if these authors had not in fact read Rowlatt J’s judgment. In para 28 of the findings of the General Commissioners for Income Tax they conclude that:

"We hold that the correct method of stock valuation at 31st March, 1921, is cost price or market value whichever is the lower. By market value we mean the price at which Brigg Neumann & Co could purchase the goods in the market. If in fact there is no spot market for goods of the same description as the goods dealt with by Brigg Neumann & Co. enabling market value at 31st March, 1921, to be readily ascertained, then market value at 31st March, 1921, will be the price which ruled at the time when contracts for delivery at 31st March, 1921, were entered into."

97 Max Englard, ‘Stock Valuation’ (28 January 1956) The Accountant 80–82, 80. The emphasis is added.


99 Brigg Neumann and Co v Commissioners of Inland Revenue (1928) 12 TC 1191, 1200.
This finding is also included in the head-note to the case.\textsuperscript{100} When read in conjunction with the head-note—‘Held, that the decision of the Special Commissioners was right in all respects’— the situation becomes abundantly clear. In other words, these authors have read the head-note only, and have not read Rowlett J’s judgment.

The case of \textit{Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (H M Inspector of Taxes)} also considered the issue of the meaning of market value in the lower of cost or market rule.\textsuperscript{101} Cross J, the judge at first instance, rejected such an interpretation, as follows:\textsuperscript{102}

\begin{quote}
I cannot treat it as authority for the proposition for which the taxpayers are contending, namely that a retailer can value his unsold stock by reference to the wholesale or replacement value, if less than cost, even though the price which he could obtain for it on a retail sale would be above cost.
\end{quote}

His Honour rejected their contention that because the Court had accepted the accountant’s rule of the lower of cost or market and that therefore ‘Its meaning must be determined by reference to the practice of accountants’\textsuperscript{103} those views might well have had weight in determining what ‘cost’ means. However, the question of determining the meaning of the term ‘market value’ was quite a different matter. His Honour concluded:\textsuperscript{104}

\begin{quote}
... the words ‘market value’ prima facie connote the price which can be obtained for the article in question in the market which offers the best price.
\end{quote}

Russell LJ in the Court of Appeal made the following comment with respect to the meaning of the word ‘market’ in the lower of cost or market rule:\textsuperscript{105}

\begin{quote}
I must say ... that I have always thought that in this context market value meant the price at which the stock could be expected in due course to be sold in the market in which the trade of selling by the taxpayer was conducted. And after extensive argument I am not persuaded that my original assumption was wrong. For a retailer this value was the retail sales price expected to be realised in the due course of that business and ‘[t]he trader’s market is the retail market, and while that market exists for the goods I see no justification for turning to any other market’.
\end{quote}

\textsuperscript{100} Ibid 1192.

\textsuperscript{101} \textit{Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (H M Inspector of Taxes)} (1969) 1 WLR 1488; [1971] Ch 427 (CA) and [1971] 2 WLR. 1313 (HL); (1971) 47 TC 495.

\textsuperscript{102} Ibid [1969] 1495.

\textsuperscript{103} Ibid 1196.

\textsuperscript{104} Ibid.

\textsuperscript{105} \textit{BSC Footwear Ltd v Ridgway (Inspector of Taxes)} [1971] Ch 427, 434.

\textsuperscript{106} Ibid.
Megaw LJ also agreed that it was the market in which the company would actually sell the shoes which was relevant in this case. The company was involved in the retail trade and as such ‘the wholesale market is not relevant’.

In the House of Lords, Lord Pearson was of the opinion that where a company is a retailer his stock should normally be valued in the retail market, which is the one in which he expects to sell and the wholesale market in such a case will probably be irrelevant as:

He is not vitally concerned with the wholesale price at which he might buy more of the goods, because he does not need to buy more of them and probably does not wish to do so.

Lord Morris of Borth-y-Gest, concluded that the decision of Rowlatt J, in Brigg Neumann, merely indicated that:

there may be some cases in which the wholesale market value may be taken as the appropriate market value the case does not establish that a retailer who on a retail sale will sell at a price above what it cost him to buy may value his unsold stock-in-hand by reference to the wholesale or replacement value if that is less than what it cost him.

Lord Guest agreed it was the market in which the company actually sold its stock which was relevant under the lower of cost or market rule, and it was not permissible to use replacement cost.

In Hinchcliffe (HM Inspector of Taxes) v Crabtree the question arose whether the actual market price of quoted shares truly reflected their value. In this case confidential preliminary negotiations had commenced for the takeover of a company. However, a firm intention to enter into negotiations did not take place until some months after the relevant date. It was held unanimously by the Court of Appeal and the House of Lords that it was the quoted market price on the relevant date which was the value of the shares. No special circumstances existed which would permit a higher value under s 44 of The Finance Act 1965 which would have increased the cost base of the shares for capital gains purposes. The same considerations would appear to apply with respect to the valuation of shares that are stock-in-trade.

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107 Ibid 440.
108 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1971] 2 WLR 1313, 1333.
109 Ibid 1323.
110 Ibid 1325.
111 Hinchcliffe (HM Inspector of Taxes) v Crabtree (1970) 47 TC 419.
Tables 3 and 4\textsuperscript{112} are drawn from the accounting books, journal article and letters to the editor of \textit{The Accountant}. Looking at Tables 3 and 4 it is clear that the majority of the accounting profession at the time of \textit{Brigg Neumann} would have considered ‘market value’ to mean ‘replacement cost’ and not ‘realisable value’.

\begin{table}
\centering
\begin{tabular}{|l|c|c|}
\hline
\textbf{Meaning of ‘Market Value’} & \textbf{Number} & \textbf{\%} \\
\hline
Realisable value & 7 & \textbf{29.2} \\
Net realisable value & 0 & 0.0 \\
Replacement cost or price & 9 & \textbf{37.5} \\
Market value or price & 18 & \textbf{75.0} \\
Lower of replacement price and realisable value & 1 & 4.2 \\
Lower of replacement price and net realisable value & 1 & 4.2 \\
\hline
Number of authors using the Lower of Cost and Market & \textbf{24} & \\
\hline
\end{tabular}
\caption{The Lower of Cost or Market Rule: The Meaning of ‘Market Value’}
\end{table}

\textbf{X REPLACEMENT COST}

The case of \textit{Brigg Neumann \& Co. v Commissioners of Inland Revenue}\textsuperscript{113} also raises the question of the use of replacement cost to value stock-in-trade. As seen above, the company was a trader in textiles, purchasing woollen goods ‘in grey’ from weavers and sending them out to be dyed by dyers. It was admitted in the facts, and accepted by the Commissioners for Special Purposes, and Rowlatt J, that at the relevant time there was no selling price for the appellant’s stock-in-trade, as there was no spot market. The company, however, wished to value their stock at market price, as there had been a considerable fall in the prices in the market since they had purchased their stock and, therefore, actual ‘cost’ was not a measure of the value of the stock at the balance date.

Rowlatt J considered there were two possible surrogates for the market (selling) value, those being the actual cost of the stock and the notional cost for which the stock could have been bought, whichever of the two were lower. His Honour was forced to rule out actual cost as a surrogate because the facts clearly showed there had been a substantial drop in the value of the cloth since it was purchased.\textsuperscript{114}

In the special circumstances of the case his Honour found the appropriate value to use as a surrogate was the notional cost of replacement. This cost was to be calculated by using the estimated contracted price for the goods which could have actually been delivered at the balance date, and not the cost of goods contracted to be bought on the

\textsuperscript{112} Table 4 is in Appendix 1.

\textsuperscript{113} \textit{Brigg Neumann and Co v Commissioners of Inland Revenue} (1928) 12 TC 1191.

\textsuperscript{114} Ibid 1203.
balance date as was the practice in the trade, where goods were to be delivered in three months time, as:115

When one is seeking to get what in building or engineering is called the constructional value ... based upon current prices three months ago of a building, it is the price that you have to pay which will give you the building here now, not the price that you have to pay now to give you a building at some future time.

It should be noted, however, that prima facie it is the actual cost which should be used under the ‘lower of cost or market’ rule. It is only in exceptional cases, such as the instant one, where replacement cost can be used as a surrogate for the market value of the stock under the lower of cost or market rule.

In Watson Bros v Hornby (HM Inspector of Taxes),116 Macnaghten J found that ‘market value’ for a taxpayer who sold the same items in two markets, the relevant market was the market in which those goods, as a matter of course, would be sold.

In the case of Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd, Viscount Simon made the following comment in the House of Lords, where it was held that replacement cost could not be used as an alternative to actual cost at the time of acquisition:117

To put the matter in its simplest form, the profit or loss to a trader in dealing with his stock-in-trade is arrived at for Income Tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market [purchasing] values for what it in fact cost him.

This extract and the discussion in the next section of this paper, reinforces the inappropriateness of using replacement prices for the valuation of stock-in-trade for income tax purposes despite the clear evidence shown in Tables 3 and 4 that the majority of accountants would have interpreted ‘market value’ as meaning replacement cost.

115 Ibid 1204.

116 Watson Bros v Hornby (HM Inspector of Taxes) (1942) 24 TC 506. The facts of this case are discussed further in this paper when considering the meaning of the word ‘cost’.

XI REPLACEMENT COST ESTIMATED BY THE ‘RETAIL INVENTORY METHOD’\textsuperscript{118}

The ‘retail inventory method’ is used to estimate the price at which the company would be willing to pay for stock, given the company’s current selling price. This is achieved by taking stock at their selling price and reducing the selling price by the standard mark up used for the particular line of goods. This reduces the selling price to the amount which the item would have cost. This method is also referred to as the ‘adjusted selling price’ method. The are no decided cases on the use of this method, however a variant was discussed in the case of \textit{Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes)}.\textsuperscript{119}

This case dealt with the question of the acceptability of the use of what would appear to be the ‘retail inventory method’ of determining cost. However the method was not being used to calculate actual cost but, rather, the cost price at which the company would be willing to purchase such stock, given the current ticketed selling prices, where a substantial amount of the company’s stock had been marked down. The case also considered, with respect to the stock on hand, the question of the use of a variant of the ‘net realisable value’ method for valuing stock-in-trade under the lower of cost or market rule, which was also argued as an alternative method of valuation. The case has usually been discussed in the context of the latter issue, although both issues were of equal importance.

The stock-in-trade in this case consisted of shoes, the selling price of which had been reduced at the end of the season in order to sell them off. The company’s pricing policy was to fix the selling price of the shoes by the use of a standard mark up on the actual cost price of the shoes. To value the stock on hand a reverse calculation was used, that is, the standard mark up was deducted from the marked prices of the shoes, including those whose prices had been marked down. This amount represented the price at which the company’s buyers would have been prepared to pay for the shoes, given the company’s current selling price for them. The underlying reason for the company’s use of this method was to enable it to show a normal mark up (that is, gross profit) on the shoes in the next year, or whenever they were sold.

The company had consistently adopted this method\textsuperscript{120} for valuing its stock for many years, and had done so since at least 1940. The Inland Revenue had accepted their accounts drawn up on this basis until 1959. The company justified the use of this method, relying on the comments of Rowlatt J in \textit{Brigg Neumann} whereby he suggested that in certain circumstances it was possible to use replacement cost as a surrogate for actual cost. That is, the company should be permitted to value its stock at

\textsuperscript{118} This method is also referred to as the ‘adjusted selling price’ method.

\textsuperscript{119} \textit{Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes)} [1969] 1 WLR 1488; [1971] Ch 427 (CA) and [1971] 2 WLR 1313 (HL); (1971) 47 TC 495.

\textsuperscript{120} Referred to in the judgment as ‘replacement value’.
the wholesale market value (at which it would be willing to buy), which was less than actual cost, but higher than the retail market value of the stock.

Cross J, the judge at first instance, rejected such an interpretation, as follows:121

I cannot treat it as authority for the proposition for which the taxpayers are contending, namely that a retailer can value his unsold stock by reference to the wholesale or replacement value, if less than cost, even though the price which he could obtain for it on a retail sale would be above cost.

His Honour rejected their contention that as the Court had accepted the accountant’s rule of the lower of cost or market therefore ‘Its meaning must be determined by reference to the practice of accountants’122, and that, furthermore, those views might well have had weight in determining what ‘cost’ meant. However, the question of determining the meaning of the term ‘market value’ was quite a different matter. His Honour concluded:123

the words ‘market value’ prima facie connote the price which can be obtained for the article in question in the market which offers the best price.

The case came before the Court of Appeal in the BSC Footwear Case,124 which upheld the judgment of Cross J.

Russell LJ made the following comment with respect to the meaning of the word ‘market’ in the lower of cost or market rule:125

I must say ... that I have always thought that in this context market value meant the price at which the stock could be expected in due course to be sold in the market in which the trade of selling by the taxpayer was conducted. And after extensive argument I am not persuaded that my original assumption was wrong.

For a retailer this value was the retail sales price expected to be realised in the due course of that business and ‘[t]he trader’s market is the retail market, and while that market exists for the goods I see no justification for turning to any other market’.126 This value, according to Russell LJ was the retail market ‘price’ for the shoes in question.

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121 Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes) [1969] 1 WLR 1488 1495.
122 Ibid 1196.
123 Ibid.
125 Ibid 434.
126 Ibid.
Salmon LJ was not at all impressed with the action of the Revenue in seeking to force a change of method from the one which the company had been allowed to use for such a long period of time. While feeling it might well be acceptable for accounting and commercial purposes, to use a method which over a period of years showed the real profit of a business, though with distortions in some individual years, the Court had to look to the requirements of the relevant legislation. Therefore the question was whether or not the taxpayer’s system, taking the 1959 year alone, showed the actual profit for the particular year for income tax purposes.

Salmon LJ felt there were good reasons to change the method of accounting, which more than outweighed the problems of the transitional years.127

because the method ... does not for the year ... accurately reproduce the profits or gains ... [It] must, for tax purposes, be not only consistent ... but must produce the full profits or gains for each year.

Secondly, for the purposes of the income tax legislation, was the method employed by the taxpayer which had the effect of pushing income (profit) from one year to later years, an acceptable method of accounting? Salmon LJJ answered this question as follows:128

It has never yet been held that the taxpayer may anticipate in year A a diminution of the profits which he may have hoped to make in year B on the closing stock for year A by writing down his closing stock for that year below its cost price ...

Later Salmon LJ makes the following observation about the company’s argument that they should be permitted to value stock-in-trade in order to obtain a fixed margin of profit in following years on the stock-in-trade in question. He suggests that their129

contention that they may ... enter their closing stock in their accounts below cost price at a market price which would show them a gross profit of 37.19 per cent is beset with difficulties ... there was certainly no market in which they could have acquired the goods at such a price.... [they] could not have been bought from manufacturers or wholesalers at such a price.

Similarly, neither the company, nor any other retail shoe seller, would have been prepared to sell their stock at such a price when they could sell it in their own shops at a higher price.

Megaw LJ also agreed that it was the market in which the company would actually sell the shoes which was relevant in this case. The company was involved in the retail trade

127 Ibid 437.

128 Ibid 438.

129 Ibid 439.
and as such ‘the wholesale market is not relevant’.\footnote{Ibid 440.} They were trying to sell the shoes and were not interested in buying them.

The case was heard on appeal in the House of Lords by Viscount Dilhorne and Lords Morris of Borth-y-Gest, Reid, Guest, and Pearson.\footnote{BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1972] AC 544.} Lord Reid, though he would have allowed the appeal in the present case, mainly based on the acceptance of the Revenue of the company’s use of the method for such a long period, was of the opinion that the Revenue could prevent the adoption of this method by companies who had not been using it for a substantial number of years.\footnote{BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1971] 2 WLR 1313, 1317.} His Lordship felt the method adopted by the company was ‘stretching unduly the concession to taxpayers involved in “cost or market value, whichever is the lower”’. However the crux of his Lordship’s decision was that the Revenue had only sought to change the values of stock-in-trade for the current year, and not earlier periods.\footnote{His Lordship was relying on Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd (1929) 46 TLR 68. Later cases have cast doubts over the scope and application of the case.}

Lord Pearson felt, given the special facts of this case, that Revenue could only force the company to change its method of valuing stock-in-trade if the company’s method produced values which were ‘seriously and substantially incorrect’ leading to a distortion of the profits and gains of the company during the tax year.\footnote{BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1971] 2 WLR 1331, 1331.} In this context, his Lordship applied the taxpayer’s system to the profits and gains for the year in question, by the use of several examples. One of the examples will be more than sufficient to indicate the results that followed from the use of such a method:\footnote{Ibid 1332.}

The total of the original retail selling prices was £3,668,087. The total of cost ... was £2,303,925. The reduced total of expected retail selling prices was £3,246,272. Thus the valuation at cost was nearly £1 million below the total of expected retail selling prices. And yet according to the appellants’ system the valuation at cost was reduced to £2,038,843, being approximately £1.2 million below the total of expected retail selling prices. …

[Even] when all due allowance is made for the expectations involved in “expected retail selling prices” being some times frustrated, these figures still demonstrate that the appellants’ system produces valuations of stock which are seriously and substantially incorrect.
His Lordship was of the opinion that where a company is a retailer his stock should normally be valued in the retail market, which is the one in which he expects to sell. The wholesale market in such a case will probably be irrelevant because:136

He is not vitally concerned with the wholesale price at which he might buy more of the goods, because he does not need to buy more of them and probably does not wish to do so.

Lord Morris of Borth-y-Gest, being unable to find any authority which could throw weight behind the company’s contention, concluded Cross J was correct in his evaluation of the decision of Rowlatt J in *Brigg Neumann* as merely indicating:137

there may be some cases in which the wholesale market value may be taken as the appropriate market value the case does not establish that a retailer who on a retail sale will sell at a price above what it cost him to buy may value his unsold stock-in-hand by reference to the wholesale or replacement value if that is less than what it cost him.

Lord Guest, in a short judgment, felt the company’s ‘replacement value’ was open to serious objection, as it did not ‘claim to represent the price at which the appellants would replace the shoes’ and it was totally artificial. The use of such a method ‘would make it possible for a taxpayer to control his profits for tax purposes by a calculation at his own hand’.138 His Lordship agreed it was the market in which the company actually sold its stock that was relevant under the lower of cost or market rule, and it was not permissible to use replacement cost.

After a brief discussion of the Court’s recognition of the lower of cost or market rule Lord Guest concluded:139

Market value in this context appears to me to signify real value, the value that the goods have on the accounting day.... Cross J said ... the words 'market value' prima facie connote the price which can be obtained in the market which offers the best price. That usually will be the price at which the goods are sold to the public, but surely it cannot be right to value goods in the possession of a manufacturer or wholesaler at a higher price than they can obtain in the course of their trade, to attribute to their stock the price it would fetch if sold in the best market, the retail market. ... I therefore think that in making the valuation some regard must be paid to the nature of the trade carried on.

With all respect Cross J made no general observation, he was at all times referring to a company carrying on a retail trade, which is what the taxpayer was doing in this case.

136 Ibid 1333.
137 Ibid 1323.
138 Ibid 1325.
139 Ibid 1328–329.
His Lordship’s last comment is correct, however the judgment is very confusing in all its aspects. His Lordship clearly rejected the use of replacement cost as a method of determining market value, and concluded that the term ‘market value’ denotes an exit value.

Reference should also be made in this context to the case of Watson Bros v Hornby (HM Inspector of Taxes), where Macnaghten J found that where a taxpayer sold in two markets, the relevant market was the market in which those goods, as a matter of course, would be sold. However, in that case, his Honour was more interested in determining their cost for another business carried on by the taxpayer.

**XII NET REALISABLE VALUE**

Having established that it is the selling market in which the company actually sells its goods which is relevant under the lower of cost or market rule, the question arises whether it is possible to use the net realisable value method of valuing stock-in-trade. It was not until BSC Footwear, which first came before the courts in 1969, that it was suggested that anything approaching the use of net realisable value might be used by a trader to value his stock-in-trade. It is to be remembered that the taxpayer in that case had estimated the ‘replacement cost’ of its stock-in-trade by the use of the ‘retail inventory’ method. This method was rejected by the courts and as a consequence the courts were placed in the situation of having to accept the Revenue’s method of valuing the stock-in-trade, which was to take the gross sales values expected (that is, the marked prices) less an allowance for the salesmen’s commissions. This method was throughout referred to as the ‘net realisable value’ method of valuing the stock. The Revenue were not prepared to allow any other deductions to be made. As Viscount Dilhorne in the House of Lords pointed out:

>I think that perhaps some of the difficulties in this case have arisen from the appellants labelling the figure arrived at after making the deduction of the mark-up as the replacement value when it might equally have been called the net realisable value.

The same comment, though in reverse, could be made with respect to the Revenue’s use of the term ‘net realisable value’ in a non-conventional manner.

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140 See Brigg Neumann & Co v Commissioners of Inland Revenue (1928) 12 TC 1191.

141 Watson Bros v Hornby (HM Inspector of Taxes) (1942) 24 TC 506. The facts of this case are discussed in this paper when considering the meaning of the word ‘cost’.

142 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1969] 1 WLR 1488; [1971] Ch 427 (CA) and [1972] AC 544; (1971) 47 TC 495.

143 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) (1971) 2 WLR 1313, 1330.
Nowhere during the progression of the case was it argued why it was permissible to make any such deduction from the realisable value. Nor was it argued what, if any, other deductions might legitimately be made to ascertain the net realisable value of stock-in-trade. The reader should therefore take great care when reading the case, as the judges, when referring to this method, meant, unless the contrary intention is indicated, realisable value, with the only deduction being that of the salesman’s commission. As such, this does not conform with any of the normal meanings associated with the words ‘net realisable value’ as used by accountants.

Cross J, the judge at first instance, having rejected the company’s method had no option other than to accept the method suggested by the Revenue, and made this important comment upon which there had been no argument:144

I am expressing no view on the question what, if any, anticipated expenses can be deducted from the anticipated retail selling price in arriving at market value.

In the Court of Appeal Russell LJ also rejected the company’s method and thus had no alternative to accepting the Revenue’s method, which included the deduction of a salesman’s commission. This follows from the fact that there had been no argument as to whether or not it is permissible to make a deduction. His Lordship tries to justify this method using the following spurious analogy:145

... it seems to me logical and reasonable to look for the money expected to reach the till as a result of sales: in effect the salesman’s commission does not reach the till, though in practice he does not abstract it from money handed over the counter.

However his Lordship clearly indicates it is not possible, under the lower of cost or market rule, to use a method which deducts an amount sufficient to enable a normal profit to be made when the stock is actually sold. He states:146

But if it is estimated that on sale it will not contribute to the gross profit of the second period ... the shortfall is to be regarded in the course of stock valuation as irrecoverable and may properly be treated as a loss incurred in the first period. This I believe to be the basis of the principle ... market value ... may be taken as the value of stock-in-hand. The principle relates to loss of all gross profit and more, and not to diminution.

Salmon LJ, as noted above, approached the question as follows, that it is permissible to enter stock-in-trade at less than cost price:147

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144 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1969] 2 WLR 1488, 1498.

145 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1971] Ch 427, 435.

146 Ibid 435.

147 Ibid 439.
... only if its net realisable resale price is less than its cost price. The question as to what items (if any) of indirect selling costs can properly be deducted ... to arrive at the net realisable resale price of the closing stock was not fully explored before the Commissioners, nor was it argued before the judge or in this court. Therefore, like the judge, I express no view upon this point ...

Later Salmon LJ makes the following observation on the company’s argument that they should be permitted to value stock-in-trade in order to obtain a fixed margin of profit in following years on the stock-in-trade in question, suggesting that their:148

contention that they may ... enter their closing stock in their accounts below cost price at a market price which would show them a gross profit of 37.19 per cent is beset with difficulties.... there was certainly no market in which they could have acquired the goods at such a price.... [they] could not have been bought from manufacturers or wholesalers at such a price.

It is to be noted once again that Salmon LJ merely accepts that it is permissible to deduct the salesman’s commission, for the reasons outlined by the author above.

Megaw LJ was not impressed with the Revenue’s method, though preferring it to the method suggested by the company, and made the following point with respect to this matter:149

I do not see any really acceptable or logical basis for a differentiation being drawn between the salesman’s commission and the other overhead expenses. The latter, I think, were rightly disregarded. But the Crown has made this concession.

It appears his Lordship, if given the opportunity to do so, would have concluded that no costs should be deducted from the amount actually realised.

In the House of Lords, Lord Reid, contrary to the evidence, felt that there was no market in the normal sense of the word for the goods, and therefore:150

If there is not then we must look for the next best way of estimating their value. It is here that we should have regard to commercial accounting practice. The last word must always be with the court. ... If there is a uniform accounting practice it should not be rejected without good reason. If there is not the court must choose which version appears to give the fairest and most reasonable result in the particular case.

148 Ibid 39.
149 Ibid 442.
150 BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes) [1971] 2 WLR 1313, 1316.
For some reason Lord Reid thought the expert price setters employed by the company would not mark down the shoes to a price at which they would be sold, and therefore there would be expenses incurred in keeping large quantities of this marked down stock on hand. His Lordship seems to confuse shoes that are out of fashion or last year’s fashions with shoes that are obsolete, or unsaleable. As a result, his Lordship felt some deduction must be made from the market selling price, by taking off a ‘fair estimate’ of the total cost involved in selling the shoes, in order to estimate their value. His Lordship felt the allowance made by the Revenue was unrealistic, but he could ‘see objections to the appellants’ method of taking what they call replacement value’ and he thought their method was ‘stretching unduly the concession to taxpayers involved in “cost or market value, whichever is the lower”’. The crux of the matter was that the Revenue had only sought to change the method for the year in question and not to adjust prior years.

Viscount Dilhorne’s dissenting judgment is difficult to follow in many respects, however, he was also concerned about the lack of argument as to what, if anything, should be deducted from the amount expected to be realised on sale. He expressed his concern as follows:

> Little argument was directed to the question whether ... it is right only to deduct expenses directly referable to the sale. ... I am unable to see any valid ground for deducting one kind of expense and not another from the retail price when one is endeavouring to ascertain the value of stock. ... To arrive at the net realisable value ... it appears to me that one should deduct not only the profit element, not only the salesmen’s commission but also the other expenses referable to the sale from the retail price, in other words, the mark up. If this is done, the net realisable value and the appellants’ replacement value are the same.

His Lordship’s discussion was based on the assumption that the Revenue were proposing the use of the ‘net realisable value’ method as commonly used by accountants. This was not, however, what they were advocating, which was a ‘net value after salesman’s commission’. It does not necessarily follow that his Lordship would conclude the ‘net realisable value’ method was preferable to ‘gross realisable values’, particularly as these points were not argued at any stage of the proceedings.
Lord Pearson rejected the use of ‘net values’ strongly, in the following terms:  

the correct principle is that goods should not be written down below cost price unless there really is a loss actual or prospective. So long as the fall in prevailing prices is only such as to reduce the prospective profit the initial valuation at cost should be retained.

As Lord Morris of Borth-y-Gest points out ‘our concern must be to consider whether the method required by the Crown is better’ than the taxpayer’s method, as such, not necessarily the best of all methods. His Lordship also pointed out that the expert evidence presented in the case was completely contradictory, and later that:

the Crown accept ... the figure of expected retail selling price (if lower than cost) may be taken ... there may in certain cases be deducted the known or anticipated direct selling cost (salesman’s commission) ...

Lord Guest in a short judgment evaluated the Revenue’s method as follows:

The Revenue have [made this concession] … I cannot think that it is necessary or appropriate to make a further deduction on a pro rata basis of overhead expense ... in another type of case some such deduction [may] have to be made. But the failure to make such an allowance does not, in my view, invalidate the basis of valuation suggested by the Crown.

His Lordship concluded that the Crown’s method ‘more fairly and reasonably’ represented the profits of the company’s business.

It is clear from the above discussion that this case cannot be used to support the use of the ‘net realisable value’ method for the valuation of stock-in-trade. The most that can be said is that the Revenue were content to concede the deduction of salesmen’s commission for this particular taxpayer for the income tax years in question, without any argument on the acceptability of such a deduction. Thus, the judges had no option but to accept such a deduction.

**XIII HOW IS COST TO BE CALCULATED?**

There are two central issues in determining the cost of an item of stock-in-trade. The first is what costs are to be included. The second issue is to determine what stock remains on-hand and its cost.

156 Ibid 1332.

157 Ibid 1319.

158 Ibid 1320.

159 Ibid 1324–325.

160 Ibid 1325.
A How Wide is the Word ’Cost’?

There are a number of court decisions which have specifically dealt with the question of what is to be included in the cost of the stock-in-trade and these will be considered in chronological order.

In *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)*\(^{161}\) the taxpayer company had taken over several of the businesses previously carried on by J and M Craig Ltd. The consideration for the purchase of the assets was at ‘the reduced upset price of £25,000’.\(^{162}\) In addition to these assets the new company also took over some contingent liabilities.\(^{163}\) No stocktake took place at the time of the sale nor immediately prior to the sale. The £25 000 was not apportioned at the time of sale. The initial entry in books of the taxpayer was as follows:\(^ {164}\)

\[
\begin{array}{|c|c|c|}
\hline
\text{4 Hillhead Brickworks—Buildings A/c} & \text{£2,500} & 0 \\
\text{8 Hillhead Colliery Buildings and Land} & \text{7,600} & 0 \\
\text{12 Hillhead Brickworks—Plant A/c} & 2,380 & 0 \\
\text{16 Hillhead Colliery—Plant A/c} & 1,750 & 0 \\
\text{28 Hillhead Brickworks—Office Furniture A/c} & 45 & 0 \\
\text{40 Longpark Pottery—Buildings A/c} & 2,700 & 0 \\
\text{44 Longpark Pottery—Plant A/c} & 2,390 & 0 \\
\text{52 Longpark Pottery—Office Furniture A/c} & 10 & 0 \\
\hline
\text{Total Purchase Price} & \text{£25,000} & 0 \\
\hline
\end{array}
\]

\(^{161}\) *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627.

\(^{162}\) Ibid 628.

\(^{163}\) Ibid 629.

\(^{164}\) Ibid 629.
At the same time a valuation of stock-in-trade was made of £12 789 1s 4d. The difference between these two amounts was entered into a ‘stock suspense account’. This amount in effect could be said to be an allowance for the value of the contingent liabilities taken over. The contemporary discussion of this case is quite misleading. The facts are not fully described, in particular no reference is made to the contingent liabilities.\textsuperscript{165}

In computing their income tax liability the latter amount was used for the value of opening stock, not the former amount. The Survey of Taxes assessed them on the basis that the opening stock was £5625 as per the original book entry. The Special Commissioners also rejected taxpayer’s argument. On appeal by the taxpayer The Lord President (Strathclyde) noted that:\textsuperscript{166}

Of all the assets purchased by the Company from the liquidator the market value of one alone was susceptible of definite ascertainment. It is agreed that for the stock-in-trade there was always a considerable demand and that its true market value at any given time was susceptible of ascertainment. The Appellants straightway proceeded to ascertain the value of their stock-in-trade and valuing it \textit{on the basis of ordinary stock-taking} the figure of £12,798.

And furthermore that:\textsuperscript{167}

Now, it is apparent that the £5,625 thus reached [after valuing all items except stock-in-trade and the contingent liabilities] does not represent the true value of the stock-in-trade, nor indeed does it represent the price which they paid for the stock-in-trade to the selling Company. If this be so, then plainly the trading period to which I have referred cannot commence with a stock-in-trade of £5,625, and, if not, there is one and one only alternative offered – £12,798. If we take the £12,798, therefore, as the appropriate value of the stock-in-trade at the commencement of the trading period, \textit{ascertained as I have described on an ordinary stock-taking basis}, it follows inevitably that the profits of the Appellants for that period were £2,911.

Lord Johnston noted that assets taken over were at a ‘price very much below their book value’\textsuperscript{168} and that:\textsuperscript{169}

\textsuperscript{165} The case of \textit{Craig (Kilmarnock) Ltd v Cowperthwaite} (1914) 13 TC 627 was discussed in ‘Income Tax’ (21 February 1914) \textit{The Accountant} 248; and a similar situation discussed in ‘Value of Stock’ (29 May 1915) \textit{The Accountant} 715–16, 716.

\textsuperscript{166} \textit{J and M Craig (Kilmarnock) Ltd v Cowperthwaite} (Surveyor of Taxes (1913) 13 TC 627, TC665. The emphasis is added.

\textsuperscript{167} Ibid 666. The emphasis is added.

\textsuperscript{168} Ibid 668.

\textsuperscript{169} Ibid 669.
The Inland Revenue are not entitled as matter of course to hold the Company to entries made in their books for purely book-keeping purposes, and these entries may in many cases be wholly disregarded, and that for two reasons: the first, a general reason, viz., that the Revenue cannot have it both ways; they cannot accept entries in a company's books when they find them to be to the advantage of the fisc and discard them when they are to its disadvantage. They invariably set aside, and rightly so, entries which would favour a company, but which do not give the real results of their business. And I do not think that they can be allowed to hold a company to entries which favour the Revenue but equally do not show the real results of their business. The second, a special reason, that the Revenue authorities cannot be allowed to pick and choose their figures, taking those that suit them and rejecting others.

And later that:

If the Appellant Company were not to show fictitious results and delude their shareholders, it was necessary that they should begin their business operations on a true and not a fictitious valuation of these assets. They could never reach correct figures for these assets if they simply took, as the Inland Revenue maintain that they did take, and irrevocably take, the gross price paid, and, having attributed empirical values to the fixed or capital assets, simply attributed the balance whatever it might be, less or more, to the working stock in their trading and profit and loss accounts. I think that the Appellants took the proper course and revalued the working stock on a basis of stock-taking, with the result that whereas on the empirical division of the £25,000, the sum left for the working stock was £5,625, the revaluation made on stocktaking basis was £12,798. And with this latter sum distributed over its different departments the Company commenced its trading accounts.

Lord Salvesen agreed that the only proper corse was to make an allowance for the contingent liabilities taken over and noted that:

After their acquisition of these assets the Appellants allocated the price for bookkeeping purposes. They apportioned £19,375 to all the assets other than the stock-in-trade, leaving £5,625 as the assumed value of the latter. At the same time they had the stock-in-trade separately valued on the basis of ordinary stock-taking and this valuation brought out a sum of £12,798 1s. 4d.

And later that:

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170 Ibid 670. The emphasis is added.

171 Ibid 673.

172 Ibid 672. The emphasis is added.

173 Ibid 673.
The mere fact that the Appellants had estimated the total value of the assets which they acquired at a higher figure than the cash purchase price would have been no ground for treating the difference as part of the profits earned; and that even if the appreciation had not merely been assumed, but was capable of accurate ascertainment by the end of the year and there had been no indefinite liabilities to set against it. An appreciation of capital value is not the subject of taxation under the Income Tax Acts; although if it is actual it may be reflected in the profits of succeeding years.

The other judges were of the same opinion. From this case it is clear that it is not only the cash consideration that is taken into account in determining the cost of stock-in-trade, it is all the consideration expended and that consideration includes taking over liabilities even if they are contingent. The contemporary accounting literature and later published works rarely refer to the taking over of the contingent liabilities and thus misrepresent the facts underlying the decision.

In *John Smith & Son v Moore (HM Inspector of Taxes)*, which was heard in Second Division Court of Session by the Lord Justice Clerk (Scott Dickson), Lords Dundas, Salvesen, and Guthrie, Lord Salvesen made some interesting comments with respect to the sum of £30 000 paid to the executors of the estate of the deceased, for the assignment of contracts for the delivery of coal upon very favourable terms. His Lordship could not see why the firm should have to pay tax on this £30 000, which would be the effect of the exclusion of this amount from the cost of the coal delivered to them under the contracts. His Lordship summed up his finding as follows:

> In my opinion the case would be exactly the same if the coals had all been delivered and lay in the vendor’s yard but he had refused to sell them unless he got £30,000 more than he had himself paid for the coals.

The majority, the Lord Justice Clerk (Scott Dickson), and Lords Dundas and Guthrie, however, were of the opinion that the £30 000 was outlaid for the purchase which was of a capital nature, made at the commencement of business by the firm, and it was not

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174 Lord Dundas, *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627, at 667; Lord Mackenzie at 674; Lord Guthrie at 674; and Lord Skerrington at 675.

175 Above n 169, ‘Income Tax’ and ‘Value of Stock’. See also J H Burton, *Costing for Control* (1948) 98, where he contrasts the decision to that in *Commissioners of Inland Revenue v Huntly & Palmers Ltd* (1928) 12 TC 1209. The latter case is also discussed in this paper.


176 *John Smith & Son v Moore (HM Inspector of Taxes)* (1921) 12 TC 266.

177 Ibid 278.

178 Ibid.
made in respect of the purchase of their stock-in-trade. Rather, it was paid in order to secure future supplies of coal at a favourable price, and not for the coal itself.

The firm appealed from this decision to the House of Lords.\textsuperscript{179} Viscount Haldane was of the opinion that though the contracts were of a short duration ‘they were none the less part of his fixed capital’.\textsuperscript{180} It was irrelevant that the £30 000 had been paid for the contracts.

Viscount Cave considered the problem as follows:\textsuperscript{181}

> those contracts belonged to the firm from the time when they were entered into. The £30,000 was not paid by the firm for coal, nor was it paid by the trading firm as such for coal contracts; it was paid by John Rose Smith out of his private pocket as part of an overhead transaction under which the business with its assets and future profits passed into his hands, and it left the trading profits of the firm unaltered.

This is a line of argument that the present author finds tenuous to say the least. Lord Sumner justified his decision as follows. The firm, being merely middlemen, never actually saw the coal, it was delivered directly from the mine to the final purchaser and the firm ‘need never have any stock-in-trade’.\textsuperscript{182} The firm bought no coal from the estate, it had none to sell and, furthermore:\textsuperscript{183}

> He did not pay this sum as the consideration for an assignment of the benefit of these contracts to himself; he took no assignment. The contracts were presumably in the firm’s name and were part of its assets. ... £30,000 was the value of an important part of the subject matter of the business, to use a neutral term. It is an accident that the last of the contracts expired during the accounting period.

Viscount Finlay in his dissenting judgment felt a deduction had to be made from the gross profit of all the expenses incurred by the ‘owner for the time being’ for the purposes of earning the profits as:\textsuperscript{184}

> The profits are not fruits yielded by a tree spontaneously. They are the result of operations carried on by the owner of the business for the time being and of the ability which he brings to bear upon it.

\textsuperscript{179} Ibid, before Lord Sumner, Viscounts Haldane, Finlay and Cave, 280.

\textsuperscript{180} Ibid 293.

\textsuperscript{181} Ibid 293–94.

\textsuperscript{182} Ibid 295.

\textsuperscript{183} Ibid 295–96.

\textsuperscript{184} Ibid 286.
The change in ownership had altered the situation. The appellant was bound by the settlement made by his father which required him to pay the values shown in the balance sheet for these contracts, that is £30 000. It was the only way in which the benefit of the contracts, for the supply of the coal in question, could be transferred to the taxpayer’s business. It was with this coal that the appellants carried on their business.\footnote{185 Ibid 297.}

The profits must be computed in the usual way by comparing the amount got by the sale of the coal with the amount which it cost the owner for the time being to acquire it. Lord Salvesen ... points out with great force to what absurdities the argument for the Crown would lead.

This statement was made by his Lordship at the conclusion of his judgment. His Lordship reinforced the point that all the contracts had expired during the period and covered only stock acquired by the taxpayer for the year in question. His Lordship continued:\footnote{186 Ibid 288–89.}

If the amount of coal which they [the contracts] represented had been in stock in yards belonging to the coal dealer it could not have been disputed that the price paid for it would have been a proper deduction as against the price realised by the re-sale. It can make no difference for this purpose that the coal dealer followed the more convenient practice of having contracts with the collieries and despatching it from the pit’s mouth straight to his customers. ... [T]he distinction between ‘goods’ and ‘chooses in action’, such as contracts for coal ... seems ... untenable.

The contracts had given the taxpayer the means of obtaining the coal in question at an advantageous price, and logically there can be no difference between ‘having coal stored in your yard and having a contract which enables you to get’\footnote{187 Ibid 289.} the coal as and when it is required. His Lordship pointed out that this had been conceded by the Lord Advocate when Lord Haldane had specifically asked him the question. His Lordship concluded:\footnote{188 Ibid.}

If the Crown is entitled to disallow what the appellant had to pay for these contracts, it would be equally entitled to disallow as a deduction the price paid for coal actually in stock.

The author finds his Lordship’s argument a strong one indeed when, even though not a direct cost of stock-in-trade, it was made in relation to the purchase of the stock-in-trade of the taxpayer, and was not of a capital nature. Thus, the majority were of the
opinion that the expenditure of the £30 000 was not deductible as it was of a capital nature.

There are many other cases which consider the issue of whether payment for the right to gain stock-in-trade should be included as part of their cost by the courts. In nearly all these cases the amount has been found to be capital in nature (as in the *John Smith case*), usually because they were for the acquisition of a *profit à prendre*, that is, the right to take or mine something from another’s land.\(^{189}\)

The facts surrounding the case of *Commissioners of Inland Revenue v Huntly & Palmers Ltd*, are quite unusual.\(^{190}\) The company was a biscuit manufacturer who purchased their supplies of tin boxes in which they packaged their biscuits from an associated company, Huntly, Borne & Stevens Ltd, which had been a wholly owned subsidiary since 1918. This associated company was in financial difficulties and in order to ‘save’ it from liquidation, and thereby ensure the supply of tins essential to their business, the company ‘bought’ from Huntly, Borne & Stevens Ltd all the stock which they held of the tins used by the company at twice their market value,\(^{191}\) as well as the stock of partially completed tins and (printed) tin plate.

It is important to note that Huntly, Borne & Stevens Ltd had made similar agreements with its other customers, and as such this was not an isolated transaction. However, this extraordinary fact was ignored in the judgments.\(^{192}\)

The questions to be settled in this case were: for what reason had the expenditure been incurred, and consequent upon that, what was the nature of the expenditure? The Commissioners for the General Purposes of Income Tax were of the opinion that the amounts paid were not expended in respect to the acquisition of stock-in-trade, but rather:\(^{193}\)

\[^{189}\text{These cases include: Old Silkstone Collieries v Marsh (HM Inspector of Taxes) (1941) 24 TC 25, at 34; Golden Horse Shoe (New) Ltd v Thurgood (HM Inspector of Taxes) (1934) 18 TC 280; Stow Bardolph Gravel Co, Ltd v Poole (HM Inspector of Taxes) (1954) 35 TC 459; The Commissioners of Inland Revenue v Broomhouse Brick Company, Ltd (1952) 34 TC 1; Stratford (HM Inspector of Taxes) v Mole & Lea (1941) 24 TC 25, 10–25, 31–33; Kauri Timber Co Ltd v Commissioner of Taxes [1913] AC 771 (a decision of the Privy Council on appeal from the New Zealand Court of Appeal); Hood Barrs v The Commissioners of Inland Revenue (No 2) (1954–57) 37 TC 188; Coates v Holker Estates (1961) 40 TC 75; Mohanial Hargovind of Jubbiupore v Commissioner of Income Tax, Central Provinces and Berar, Nagpur, (Privy Council) [1949] AC 521, [1949] 2 All ER 652; H J Rorke Ltd v Inland Revenue Commissioners (1960) 39 TC 194, [1960] 3 All ER 359; Hopwood (HM Inspectors of Taxes) v C N Spence Ltd (1964) 42 TC 169; Murray v Commissioners of Inland Revenue (1951) 32 TC 238; Craigenlow Quarries v Commissioners of Inland Revenue (1951) 32 TC 326; Hughes (HM Inspectors of Taxes) v The British Barmah Petroleum Co Ltd (1932) 17 TC 288. Many of these cases relied on, or considered, the criminal trespass case of Marshall v Green (1875) 1 CPD 35. The discussion of these cases has been removed from this version of the paper for the sake of brevity.}\]

\[^{190}\text{Commissioners of Inland Revenue v Huntly & Palmers Ltd (1928) 12 TC 1209.}\]

\[^{191}\text{They were invoiced to the taxpayer at their cost to Huntly, Borne & Stevens Ltd plus 10 per cent.}\]

\[^{192}\text{Commissioners of Inland Revenue v Huntly & Palmers Ltd (1928) 12 TC 1209, TC1213.}\]

\[^{193}\text{Ibid 1219.}\]
to ensure the supply of tins essential to their trade, and we upheld the inclusion of the whole of the claim as a necessary expense of their business ...

From this comment it is certainly clear that the Commissioners for the General Purposes of Income Tax thought the expenditure was of a revenue nature, but there is nothing in their discussion of the case or in their findings to indicate why they considered the expenditure to have been incurred for the acquisition of stock-in-trade.

Rowlatt J agreed with the Special Commissioners’ conclusions with respect to the purpose of these inflated payments ‘which was to ‘make good’ the deficiency which was arising in Huntly, Borne & Stevens Ltd and thus ‘get them out of their difficulties’. On this basis:194

for one company to make a purchase of goods from another at double the value in order that the other company may not come to grief, so stated that does not describe an item which may be brought in to diminish the profits. ... this is money put into another business or thrown into another business without any security, or with some possible security by way of goods, or something of that sort, but it is thrown into another business in order to keep that business alive, and that is a capital risk ...

Thus, the expenditure being of a capital nature it was not deductible, even if it were made in relation to the acquisition of the stock-in-trade. It is clear, therefore, that at common law the courts will look to the real purpose of the payments being made, and the consequent nature of the expenditure, that is, whether it is of a capital or revenue nature.

Another unusual case dealt with the ascertainment of the cost of a particular piece of land which had been purchased for the purpose of re-sale at a profit. The land in question was acquired by a partnership from the father of one of the partners, with the purchase price being stated to be £15 000. At the time of signing the contract for the purchase of the land, the partners, other than the son, agreed in writing to pay a further amount of £25 000 ‘as and when they resold the property’ to the son, Mr Worskett (Jnr).

The question which arose was at what opening figure the land should be shown: the £15 000 specified in the contract for the sale of the land, or the total consideration of £40 000 agreed upon by the parties in the two agreements? The question was resolved by Lawrence J in *Bennett, Oswald & Worskett v Bennet (HM Inspector of Taxes)*,195 where his Honour concluded that while the matter was one involving some difficulty the £15 000 was not ‘the true cost of the property’ as the arrangement had to be looked at as a whole and the arrangement included.196

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194 Ibid 1221–222.
195 *Bennett, Oswald & Worskett v Bennet (HM Inspector of Taxes)* (1937) 21 TC 209.
196 Ibid 219.
an obligation which was owed by Mr Bennett and Mr Oswald to Mr Worskett, Senior, that they should undertake to pay to Mr Worskett, Junior, a minimum price of £25,000 when they re-sold the property. That obligation was a valuable obligation, and constituted ... a part of the cost of the property. They did not get the property for £15,000, but ... for £15,000 plus that obligation. I think, therefore, that that figure being a minimum figure, it ought to be taken at its face value as a part of the cost price of this property, and that the true figure ... ought to be £40,000.

Thus Lawrence J found one must look to the entire arrangement to determine what consideration was agreed upon to be paid for the stock-in-trade and of what it consisted.

In Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes) one Mr Hood Barrs had entered into a contract to purchase a business being carried on by an insolvent company, for £10 500. Having done so Mr Hood Barrs incorporated a new company, The Steel Barrel Co (of Uxbridge) Ltd. This newly incorporated company in turn purchased the business from Mr Hood Barrs for a consideration, which consisted of the £10 500 he had outlaid to buy the business along with an additional consideration of 29 997 fully paid shares of £1 each in the company. Various evidence was given as to the value of the stock-in-trade at the time of the transfer; for example, independent valuation and the stamp duty paid on the transfer. The question to be determined was, what was the appropriate cost of the stock-in-trade acquired by the company?

Macnaghten J, who heard the case at first instance, concluded that the issue of the shares had cost the company nothing and as such could not form part of the price of the stock-in-trade. The judgment upon the company’s appeal was delivered by Lord Greene MR (with him du Parcq LJ and Singleton J) which reversed this strange finding by Macnaghten J.

There were two questions to be answered by the court: first, did the issue of the shares by the company form part of the consideration for the purchase of the business; and consequent upon that, what was the value attributable to the purchase of the stock-in-trade. His Lordship was of the opinion that when shares are ‘properly issued’ for consideration consisting of other than cash, such consideration must be ‘at least equal in value to the par value of the shares’ and be based upon an ‘honest estimate’ made by the company’s directors of the value of the assets acquired. He continued by saying the description ‘nominal value of shares issued’ was a ‘slovenly and inaccurate expression’ used to describe the value of the assets acquired by the company in return for the issue of the shares. A more accurate description was the ‘value of [the] rights acquired by the company under the contract’.199

197 Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes) (1941–42) 24 TC 293.

198 It would appear that the company had at some time prior to the commencement of the action changed its name to its present title.

It was not to the point that the company later wrote down these assets on re-evaluation, as they were perfectly entitled to do, and such an action had no affect on the value arrived at the time of acquisition; that is the £29 997 for shares issued to Mr Hood Barrs plus the £10 500 in cash.\footnote{Ibid.}

Lord Greene MR summed up the Court’s findings as follows:\footnote{Ibid.}

\begin{quote}
it cannot, we think, be open to doubt that as a general rule stock acquired by a trader must be brought in at the price which he paid for it in order to calculate the profit which he makes by its sale. … In our opinion, what had to be found in the present case was the price paid for the stock. Now as this price was cash plus shares, it is necessary in the first instance to ascertain what payment in cash was represented by the issue of the fully paid shares. In our opinion, on the facts of the present case it must be taken as a sum of cash equal to the par value of the shares.
\end{quote}

Thus, it is all the consideration given by the company, as in Craig’s Case (above),\footnote{J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes) (1913) 13 TC 627. Discussed above.} which must be taken into account in determining the cost of stock acquired by a company. Thus, where part of the consideration is shares in the company itself, the par value of the shares is to be included in the total acquisition cost. Clearly, if the shares were issued at a premium, the amount of the premium would also form part of the consideration.

In Watson Bros v Hornby (HM Inspector of Taxes)\footnote{Watson Bros v Hornby (HM Inspector of Taxes) (1942) 24 TC 505.} the taxpayers carried on the business of poultry dealers and breeders. This involved them in carrying on both the production of eggs and the operation of a hatchery, which produced chickens primarily for sale as ‘day-old chicks’. The two businesses carried on by Watson Bros were liable for tax under different Schedules of the income tax legislation. As a result the question arose, at what value should the chicks be transferred from the hatchery to the farm. Was it the cost of production of 7d, or the price at which the chicks could have been bought or sold, on the open market, which was 4d? The answer to this question would have a significant affect on the value of the taxpayer’s stock-in-trade.

The taxpayer sold its chicks to the public at their catalogue prices, and those which could not be sold at the catalogue price to the public were either auctioned off or transferred to the –‘brooder house’. The average price the taxpayer received at auction was 4d each and this is the figure at which they wished to transfer the ‘chicks’ to the ‘brooding house’. The Revenue contended, however, they should use the actual cost of production which was 7d each. The Commissioners for the General Purposes of Income Tax had decided the cost of production should be taken as the value of the chicks.

\begin{thebibliography}{9}
\footnote{Ibid.}
\footnote{Ibid.}
\footnote{J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes) (1913) 13 TC 627. Discussed above.}
\footnote{Watson Bros v Hornby (HM Inspector of Taxes) (1942) 24 TC 505.}
\end{thebibliography}
The case came before Macnaghten J in the Kings Bench Division, and his Honour came to his decision as follows:204

I have no doubt that in this notional sale between the hatchery and the farm the rule laid down in s 8 of the Sale of Goods Act 1893, ought to be followed and that the Commissioners ought to have ascertained what was a reasonable price for the day old chicks in view of the circumstances of the case … But it appears that the Commissioners never considered what, in view of the circumstances, was a reasonable price. … that is, reasonable as between the hatchery on the one hand and the farm on the other ...

His Honour therefore concluded the decision of the Commissioners was ‘erroneous in law’ and that:205

The cost of the production of an article … might no doubt happen to be its reasonable price, but there is no ground for saying that in the absence of any agreement it should be taken as the reasonable price. On the contrary, the market price would as a general rule be the reasonable price.

Thus, the cost price to the ‘brooder house’ was the price which they could reasonably expect to pay for the chicks, and the relevant price was to be determined by the ruling market price in the market in which they would have been bought, that is, the spot auction market. Consequently, the appropriate cost was 4d for each chick. Presumably, this would also be the value of any stock on hand, at the balance date of the hatchery. In the instant case, however, there were no chicks in the hatchery at the balance date.

In the unusual case of Julius Bendit Ltd v Commissioners of Inland Revenue,206 the company was incorporated in England in 1936 by a German Jew, who was carrying on the business of a textile exporter in Germany where he lived. He owned all the shares in the company. To move his wealth from Germany to England he entered into contracts with the company to sell textiles at substantially less than normal market prices. The company contended that the figure which should be transferred to the profit and loss account was not the actual purchase price (that is, their actual cost) but rather the market value of the textiles at the time of the transactions. This would have had the effect of reducing the profits of the company significantly.

The Commissioners for the General Purposes of Income Tax concluded the ‘real bargain’ between the company and Mr Bendit was, as follows. He would sell the textiles at the price stated on the invoices ‘which were deliberately fixed at less than the market value’ and which would have the effect of enabling the company to realise a larger profit than would normally be the case. This bargain was in fact carried out by

204 Ibid 509–10.
205 Ibid 510.
206 Julius Bendit Ltd v Commissioners of Inland Revenue (1945) 27 TC 44.
the parties and therefore ‘these prices represented the true cost to the Company’ of the textiles.\textsuperscript{207}

The company appealed against this decision of the Commissioners for the General Purposes of Income Tax, and the case was heard by Macnaghten J, who dismissed the appeal as follows:\textsuperscript{208}

\begin{quote}
I have listened with interest and pleasure to Mr King grappling with the difficulties of [the company’s] ... contention, but it seems to me that not only was there ample evidence on which the Commissioners could find the facts as they have found them. ... The result, therefore, is that the appeal must be dismissed ...
\end{quote}

As a result of this case, it is clear one must look to the actual bargain made, and not what the instigators of the bargain seek to achieve, if the two do not coincide, and this is the vital difference between this case and the \textit{Huntly & Palmers Case}.\textsuperscript{209} It should be noted that there was no substantive argument put forward by the company as to why the market value at the time of purchase should be substituted for the actual cost of the textiles, other than the possibility of considering the whole arrangement as a sham, entered into to achieve the transfer of Mr Bendit’s wealth from Germany to England.

A case with similar issue to that considered in the \textit{Osborne Case}\textsuperscript{210} came before the court in \textit{Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd}.\textsuperscript{211} In this case the company had been formed from the reorganisation of an existing company. Under this reorganisation the company ‘acquired’ all the speculative investments of the original company at their book value. The shares in question were valued in the books of Zevo Syndicate Ltd at their original acquisition cost, however, since the time of their purchase there had been a significant drop in their market value. The consideration which the company gave for these shares to Zevo Syndicate Ltd consisted of the issue of fully paid shares in the company, and in addition to these shares Zevo Finance Co Ltd assumed the responsibility for debenture liabilities of Zevo Syndicate Ltd.

The Revenue contended that in such a case the correct method for calculating the cost of the company’s stock-in-trade (that is, the shares), was to treat the shares issued by the company to Zevo Syndicate Ltd as not having been fully paid shares, but instead they should be treated as being issued at an amount equal to the market price (value) of the shares at the time of the transfer. These shares had been issued fully paid. The

\begin{flushright}
\textsuperscript{207} Ibid 49.
\textsuperscript{208} Ibid 51.
\textsuperscript{209} \textit{Commissioners of Inland Revenue v Huntly & Palmers Ltd} (1928) 12 TC 1209. See above.
\textsuperscript{210} \textit{Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)} (1941–42) 24 TC 293, 307. See above.
\textsuperscript{211} \textit{Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd} (1946) 27 TC 267.
\end{flushright}
Commissioners for the General Purposes of Income Tax found that the cost included the full value of the shares issued to acquire the stock-in-trade.\textsuperscript{212}

Macnaghten J, the judge at first instance, countered the Revenue’s argument as follows:\textsuperscript{213}

> the contention of the Crown amounts to an allegation that the Respondent issued shares at a discount and I do not see how, in the absence of fraud, such an allegation could be sustained in a case where a company took over property at the value which was properly placed upon it by the vendor.

Macnaghten J misses the point that in this case the companies were not acting at arm’s length in relation to the transaction in question.

In the Court of Appeal, Lord Greene MR said that prima facie where a company makes an issue of fully paid shares in return for property acquired, the value of the property is the nominal value of those shares. The onus was in this case on the Revenue to displace this presumption, which they had failed to do.

MacKinnon LJ agreed with the judgment of the Master of the Rolls, while Luxmoore LJ dissented on the basis that there was no ‘sale’, there being merely a transfer of ownership on the reconstruction of the former company, and thus, the value of the shares at the time of the transaction should be used as the cost of the shares.

The Revenue, being dissatisfied, appealed to the House of Lords.\textsuperscript{214} Viscount Simon agreed with the reasons given by Lord Greene MR in the Court of Appeal and summarised the situation as follows:\textsuperscript{215}

> To put the matter in its simplest form, the profit or loss to a trader in dealing with his stock-in-trade is arrived at for income tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market [purchasing] values for what it in fact cost him.

Lord Thankerton found that the arguments of the appellant had been fully addressed by Lord Greene MR and therefore dismissed the appeal. Lord Wright pointed out that the matter was beyond doubt in this case. The construction of the contract was unambiguous and entered into in the ‘ordinary course of a reconstruction’ of the original company, the consideration for the assets acquired being clearly specified. This agreement was ‘unimpeachable’, and that:\textsuperscript{216}

\textsuperscript{212} Ibid 272.

\textsuperscript{213} Ibid 274.

\textsuperscript{214} Ibid 284. Before Viscount Simon, Lords Thankerton, Wright, Parker and Simonds.

\textsuperscript{215} Ibid 287.

\textsuperscript{216} Ibid 289.
It is well established that the issue of shares at a discount is illegal. It has also been held that, if the consideration for the issue of shares is a sum of money which is less than the nominal value of the shares, the shares will be treated as issued at a discount. If, on the other hand, the shares are issued for something other than a money consideration, the position is different because the Court does not enquire into the adequacy of the consideration so long as the transaction is a genuine and honest agreement deliberately entered into between ... [the parties]. These rules are clearly established by many cases ... [the Revenue] seem to disregard the obligation which was assumed by the Respondent to discharge the debentures and interest, and simply compare £620,030 with £360,000. The bargain, however, in any case, would have to be looked at as a whole.

His Lordship fully approved the judgment of Lord Greene MR in the Court of Appeal.217

Lord Porter dismissed the appeal as the Revenue had not proved the contracts to be ‘colourable’.218 Lord Simonds also agreed with the reasoning of Lord Greene MR and dismissed the appeal as the transaction had not been impeached. There were no grounds to find the shares had been issued at a discount and he concluded:219

> I cannot distinguish between consideration and purchase price, and (using again the language of the Master of the Rolls) I find that, acquiring the investments “under a bona fide and unchangeable contract”, they paid the price which that contract required, a price which, whether too high or low according to the views of third parties, was the price upon which these parties agreed.

As in Osborne,220 the Court took the view that the cost of the stock-in-trade included the cost of the shares issued to acquire it, as the revenue had failed to impeach the ‘purchase agreement’.

In Ryan (HM Inspector of Taxes) v Asia Mills Ltd,221 the courts were once again faced with the question of what should be included in the cost of the company’s stock-in-trade. The company were cotton spinners, and the question at issue was how the sum of £55 087, paid by the company to the Cotton Controller in respect of its stock of cotton, should be treated for taxation purposes. This represented the amount they were required to pay to the Cotton Controller to reflect the upward movement in the price for cotton which they held and which was in excess of their contracted needs. Should the £55 087 be included in the current year’s profit and loss account as a period cost or should it be included as part of the cost of the cotton purchased by the company?

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217 Ibid 290.

218 Ibid 293.

219 Ibid 294–95, and 295.

220 Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes) (1941–42) 24 TC 29. Discussed above.

221 Ryan (HM Inspector of Taxes) v Asia Mills Ltd (1951) 32 TC 275.
The cotton in question had been purchased by the company under fixed price contracts. The Commissioners for the General Purposes of Income Tax in their decision agreed with the taxpayer, finding that the cost of the cotton was the invoice price for the cotton purchased under those fixed price contracts and the £55 087 was not part of the cost of the cotton. Consequently the payments made to the Cotton Controller had been properly treated by the company as period costs.\(^{222}\)

Croom-Johnson J, the judge at first instance, and the members of the Court of Appeal (Tucker, Singleton and Jenkins LJ) decided the £55 087 formed part of the cost of the taxpayer’s stock-in-trade. The following extracts, from the judgment of Jenkins J in the Court of Appeal is indicative of the reasoning applied by the other members of the Court and Croom-Johnson J, with respect to the company’s arguments as being:\(^{223}\)

> too narrow a meaning on the term “cost” for the present purposes ... the cost with which we are here concerned is not merely the contract price and incidental expenses paid for the stock in order to get it, but must also take into account any payments the appellants became liable to make or entitled to receive which had the effect of adding to or reducing the total outlay attributable to their stock as a whole ...

This was so, whether it was attributable to the company’s stock as a whole, or merely to the amount of stock in excess of the amount required to meet their existing orders, and consequently:\(^{224}\)

> the “difference” payment of £55,087 7s 4d made by the Appellants was in the relevant sense an addition to the cost of the stock, since it had to be paid under the agreement with the Controller ...

The payments were directly attributable to the stock which the company held, although not calculated with respect to the total of the company’s stock. It was calculated on their ‘excess stock’ at the relevant dates. If the price of the cotton had fallen rather than risen and the company had received payments from the Cotton Controller then:\(^{225}\)

Conversely, I think a ‘difference’ payment received by a spinner who was ‘long’ at the date of a reduction in price would properly be treated as a reduction in the cost of his stock.

The company, not unexpectedly, was dissatisfied with this decision and the appeal was heard by Lords Porter, Reid, Radcliffe, Normand and Oaksey in the House of Lords. Their Lordships differed from the opinions expressed in the Court of Appeal and

\(^{222}\) Ibid 278.

\(^{223}\) Ibid 291.

\(^{224}\) Ibid 291.

\(^{225}\) Ibid 292.
Croom-Johnson J at first instance, deciding the amounts paid by the company to the Cotton Controller were ‘ordinary’ business expenses and did not form a part of the cost of the company’s stock-in-trade.

Lord Porter expresses his opinion on the matter succinctly:226

My Lords, to my mind the payment is not an increase in the cost of the cotton. It is a global payment in respect of a holding of cotton in excess of that required to fulfil the appellants’ contracts.

His Lordship concluded that to include these payments as part of the cost of the company’s stock-in-trade was ‘to extend unduly the meaning of the word “cost”’ and although the payments were undoubtedly part of ‘the expenses incurred ... in carrying on their business’ they did not, however, form part of the cost of the company’s stock-in-trade.227

Lord Reid was of the opinion that if these payments could have been classified as an ‘adjustment of price’ then they would have to be included in the cost of the stock-in-trade, but this clearly was not the situation in the present case. With respect to the Solicitor-General’s argument, relying on the judgment of Jenkins J in the Court of Appeal which was discussed above, that while these payments did not form part of the price they ‘had the effect of adding to or reducing the total outlay attributable to their stock as a whole.’228 His Lordship concluded:229

I cannot agree that every payment or receipt which has that effect must come in to the cost of the stock. If a trader keeps perishable stock for a considerable time he may have to incur large expense in keeping it in proper condition—expense which he would not have incurred if he had not been carrying the stock. ... But I do not think that it was seriously argued that such expense incurred after the stock has been acquired and delivered to the trader must go to swell the cost of the stock for income tax purposes.

Whilst Lord Radcliffe put the matter succinctly that:230

after everything has been said it remains the fact that monies paid under it were not paid as part of the consideration for acquiring stock, but as a contribution to the Controller’s pool.

His Lordship felt that this did not ‘necessarily prevent such a payment being treated as an element of cost’ but one had to look to the agreement under which the payments

226 Ibid 296.
227 Ibid 297.
228 Ibid 298.
230 Ibid 300.
were made, and it was the legal effect of the agreement which the Commissioners for the General Purposes of Income Tax had to take into account. Consequently his Lordship could find nothing to detract from their finding that the payments did not form part of the cost of the company’s stock. Similarly, there was no evidence presented to the Commissioners to show the appropriate method of accounting was to include the payments as a part of the cost of the company’s stock-in-trade, and that:

If there were such evidence, uncontradicted, it might well have been the Commissioners’ duty to act on it, for if the law guides itself by the principle of accountancy as to cost or market price, whichever be the lower, it must I think guide itself also by any of its principles which determine how cost is made up.

Yet, in this case there was no such evidence available which showed the accounting practice was to include such payments as being part of the cost of a company’s stock-in-trade.

As a result of this case, it is suggested that holding costs of stock-in-trade should not be included in determining its cost, but should be treated as an expense in the profit and loss account. It should be noted, however, that the stock-in-trade in question consisted of raw materials of a manufacturing concern. The question was never raised as to whether any part of the £55 087 paid to the Cotton Controller should or should not be included in the cost of the manufactured goods which were made from those raw materials, and which formed part of the company’s stock-in-trade at the close of the year.

1 Direct v Absorption Cost

The use of direct, versus absorption costing, was dealt with in the case of Duplex Motor Bodies Ltd v Ostime; Duplex Motor Bodies Ltd v Inland Revenue Commissioners. The appellant was a coach builder, building bodies on various kinds of vehicles. It built only on an order basis, often building bodies on the chassis supplied to it. The most accurate description of its business was that of a contract jobber, with almost all of the bodies being built to the specifications of the purchaser. It was not, therefore, involved in ‘mass production’ or production line activities. During the relevant period most of the company’s work was concerned with the building of bus bodies to order.

The appellant, and its predecessor in title, had always used for income tax purposes what was described as the ‘direct cost’ method to ascertain the cost of stock-in-trade at the end of each relevant period. It did not in fact use a full direct costing method, as it only included direct labour costs and the material actually used, and did not include

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231 Ibid 300.

232 Ibid 301.

233 Duplex Motor Bodies Ltd v Ostime; Duplex Motor Bodies Ltd v Inland Revenue Commissioners (1961) 39 TC 537.

234 Ibid 544.
other direct costs. For example, unused labour and electric power were charged directly
to the profit and loss account, as well as other direct expenses.

At the end of the year in question nearly all the stock on hand consisted of work in
progress, and there was no selling market for the unfinished buses; and consequently
the only relevant valuation method for stock on hand was cost. A complicating factor
was that the appellant had for some years been experiencing a downturn in its activities,
and it was not therefore operating at full capacity.

By the time the case was heard the appellant had admitted many of the overheads that
had been charged directly to the profit and loss account to be in fact direct costs, and
this issue was settled by the Commissioners for Special Purposes. The appellant,
however, was dissatisfied with the Commissioners’ conclusion which ‘confirmed in our
view that “on-cost” [full absorption costing] is really, in this kind of case, the better
method to follow by the recommendations of the Institute of Chartered Accountants’.235

The case was heard by Vaisey J, at first instance, who allowed the appeal on the basis
that it was the directors who had the right to choose between the two alternative
methods of valuation:236

I can come to no conclusion other than that the directors have elected to use the
direct cost method of arriving at the value for income tax purposes of work in
progress ... I am not here to tell the directors what it would be good for them to
decide.

This remarkable statement seems unjustifiable, and it was squarely put to rest by the
Master of the Rolls, Lord Evershed, on appeal, who said that, when considering such
matters for the purposes of income tax law,237

[Y]ou cannot say: ‘Well, it is a matter for the directors. If the directors had
decided to adopt ... the direct cost method, that concludes it for income tax
purposes’. The duty of the directors is to make their decision on this matter in
the best interests of the company, looking at it as a business entity; and quite
plainly it could not be said that their conclusion ... was decisive of the matter for
income tax purposes.

Lord Evershed then considered the effect in the relevant years, where the business of
the company was contracting, of the adoption of the direct cost method. He observed in
regard to those years, ‘for these particular years and in relation to this particular
company’ the on-cost (absorption cost) method was shown to produce, on the face of it,
‘an unfair result’ but he pointed out that he was ‘in no way affirming the view as a
matter of principle’.238

235 Ibid 544.
236 Ibid 554.
237 Ibid 560.
238 Ibid 562.
Pearce LJ agreed that in this particular case, where the court was required to choose between these two competing methods, it would be wrong to lay down a general rule as if it were a rule of substantive law. It was a question of fact in each case to ascertain the true profit. His Lordship agreed with the Master of the Rolls, Lord Evershed, that in these circumstances, where the factory was idle and unprofitable:

[T]he costing of the work in progress is inflated by the fact that it has, under the on-cost method, to bear an abnormally high proportion of the overheads during an uneconomic period. As a result, the profits are notionally increased, whereas in fact there are no true profits to justify that increase. In such a case, an actual loss could be converted on paper into a theoretical and untrue profit. Both theories rest ultimately on the fact that cost is a guide to value.

Harman LJ agreed with the reasons given by the Master of the Rolls and Pearce LJ, and in the course of a very short judgment he made this comment:

This case has been a good illustration of the sometimes forgotten fact that an English law suit is not a moot or a debate, but an attempt to arrive at a result on the facts before the Court. Broad academic arguments are quite unsuited to the processes of the English law.

The Revenue was dissatisfied with the decision of the Court of Appeal and appealed to the House of Lords, the decision of which was given by Viscount Simonds, Lord Reid (with Lord Tucker and Lord Hodson agreeing) and Lord Guest.

Lord Guest agreed with the Master of the Rolls’ comments in the Court of Appeal on the reasoning of Vaisey J:

It can never rest with the taxpayer to decide upon what principle his income is assessed for tax purposes. The directors’ decision can never be decisive of the matter for income tax purposes (see Patrick v Broadstone Mills Ltd).

As the Court had found on the facts and figures before it that the on-cost method produced an unfair result in these particular circumstances and that the direct cost method was the correct one to apply, the burden was stated by Lord Guest to be therefore on the Crown to show that the direct cost method was not in accordance with the requirement of the Income Tax Acts. Lord Guest noted that the House of Lords had been informed that the Crown had for a period of 50 years accepted the direct cost method and that this was the first time they had attempted to oppose the use of the direct cost method. Consequently the burden on the Crown was a particularly heavy one.

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239 Ibid.
240 Ibid 563.
241 Ibid 573–74.
242 Patrick v Broadstone Mills Ltd (1953) 35 TC 44.
Lord Guest dismissed the Crown’s claim to apply the on-cost method.243

[W]hen trade is slack the trader’s profit on the goods sold will be low as his expenses are high, but his profit in respect of work in progress will be increased. I cannot think that a method which leads to these absurd results is in accordance with the principles of income tax law or, I may add, with common sense. … The direct cost method ascertains the amount which the production of work in progress has actually cost. In his Lordship’s view the Crown had failed to show that the on-cost method was of universal application. The accountancy profession was divided in its opinion on the matter, and the Crown had also failed to show that the direct cost method did not comply with the test enunciated by Lord Clyde in the Whimster & Co case.244

Viscount Simonds believed the company should not be exposed to the risk of being charged with a higher amount of profit than could be reasonably determined, and he said that he would, if he had to choose between two vaguely defined methods, ‘choose the direct cost method as the less likely to violate the taxing Statute’.245 He added that if under the direct cost method the cost were to be put too low the error would be made good in the ‘following year’—by this one must presume that he meant when the stock was sold. He found that any method was remote from common sense if, when used for taxing purposes (or any other), it resulted in inflated stock-in-trade or work in progress valuations because ‘a slump in trade has reduced the articles between which overhead costs can be apportioned’.246 He rejected the imposition of any such method upon the taxpayer, and added the following observation:247

But I will add, in order to show how impossible it is to lay down any universal or even general rule, that it may be equally open to the taxpayer in special circumstances to show that something less than the cost of material and wages should be taken as the value of work in progress or stock-in-trade.

Lord Reid, with whom Lords Tucker and Hodson agreed, approached the problem in a most appropriate way. His Lordship first referred to the finding of the Commissioners for Special Purposes that the accountancy profession was satisfied that either method would produce a true profit figure for income tax purposes. He then continued:248

\[\text{Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners (1961) 39 TC 537, 575–76.}\]
\[\text{Whimster & Co (1925) 12 TC 813.}\]
\[\text{Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners (1961) 39 TC 537, TC 568.}\]
\[\text{Ibid.}\]
\[\text{Ibid 569.}\]
\[\text{Ibid 570.}\]
This cannot mean that, taking a particular business in a single year, either method will produce a true figure: the methods will produce very different figures of profit and both cannot be true figures of profit for the same year.

Rather, it means that if either method is consistently used over a number of years it will produce the same aggregate profit. His Lordship went on to state as to the finding of the Commissioners that ‘it may mean that one or other method will produce a true figure depending on the nature of the business, and that seems to accord with the ‘Recommendations’ of the Institute’.\(^\text{249}\) It is submitted in this article that these views of Lord Reid are entirely correct.

Lord Reid then pointed out that while the courts usually attach a great weight to the views of the accountancy profession, the courts, of necessity, must always have the last word on the question. However, the problem for the Court in the present case was made far more difficult because this assistance was not available, as both methods were acceptable to the members of the accounting profession. As a result the courts were called upon to choose, as were the Commissioners, between these two competing methods of determining cost for the determination of the taxpayer’s liability for income tax in the years in question. He continued by saying, ‘I find that very difficult: if the accountancy profession cannot do that I do not see how I can’; and he added that the most that he could do was to try to bring common sense into the consideration of the problem, on the basis that ‘common sense is the same for lawyers as for accountants’.\(^\text{250}\)

Lord Reid then pointed out that it had long been accepted with respect to the Income Tax Acts that it was permissible to deduct expenses whether or not they were attributable to the production of goods during the relevant year. It did not matter if such expenditure might be ‘abortive’ or spent with the view of producing income in future years, and have no relationship to the production during the year. It is part of ‘the whole general expenditure during the period, and it can only be said to have been spent to earn the profits of that year in the sense that it was all spent during that year to keep the business going’\(^\text{251}\). The question to answer therefore is what expenditure can properly be excluded from the expense account by setting it off against a figure representing work in progress and stock-in-trade: ‘You must justify what you seek to exclude in this way as being properly attributable to, and properly represented by, those articles’.\(^\text{252}\)

His Lordship found that it was impossible as a matter of principle to say which overheads must be brought into account and which left out, in determining cost under the on-cost method, and he continued.\(^\text{253}\)

\(^{249}\) Ibid.

\(^{250}\) Ibid 571.

\(^{251}\) Ibid.

\(^{252}\) Ibid.

\(^{253}\) Ibid 572.
One thing clearly emerges as approved by the accountancy profession - whatever method is followed, it must be applied consistently. I accept that the real question is, what method best fits the circumstances of a particular business. And if a method has been applied consistently in the past ... it should not be changed unless there is good reason for the change ...

Lord Reid’s subsequent observation has more than passing significance. His Lordship specifically stated that:254

I would not go so far as to say that this consideration condemns the on-cost method in every case. No doubt all these methods have their weak points. But this does, to my mind, make it more than ever necessary to find good reason for adopting the on-cost method in any particular case.

Thus it can be seen that there were a number of crucial factors in this case. First, the Revenue had accepted the company’s income tax return for many years, in which it had valued its stock on hand using a limited version of the direct cost method, and therefore it was necessary for the Revenue to have very good reasons for compelling the company to change its method of accounting for income tax purposes. Secondly, there were the peculiar facts of the case, which were attributable to the fact that the company’s business was contracting due to the economic conditions of the time. Thirdly, the company was a contract jobber. And fourthly, the lower of cost or market price could not be properly applied in this case due to the nature of the stock-in-trade, which consisted of work in progress, that is, partially completed buses with no selling market.

It should also be noted that this case was argued in 1960 and the decision was handed down at the end of March 1961. On 16 November 1960, the Institute of Chartered Accountants in England and Wales issued its Recommendation on Accounting Principles 22, Treatment of Stock-in-trade and Work in Progress in Financial Accounts, which replaced Recommendation X. For the purposes of the Recommendation ‘cost’ means ‘all expenditure incurred directly in the purchase or manufacture of stock and ... of the overhead expenditure as appropriately carried forward in the circumstances instead of being charged against the revenue of the period in which it was incurred’.255 In May 1975 the Institute of Chartered Accountants in England and Wales issued SSAP 9, which advocates the use of the absorption method of costing only.256

It is submitted that the Duple Motor Bodies Case257 does not stand for the proposition that the direct cost method of valuing stock-in-trade, under the lower of cost or market rule is, per se, a better method of valuation than the full absorption cost method. Nor

254 Ibid 573.
255 See above.
256 See above.
257 Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners (1961) 39 TC 537.
does it stand for the proposition that the direct cost method is, per se, an acceptable method for valuing stock-in-trade for income tax purposes. The true situation can be summarised by once again referring to Lord Reid’s comment that the relevant finding of the Commissioners ‘may mean that one or other method will produce a true figure depending on the nature of the business, and that seems to accord with the ‘Recommendations’ of the Institute’. And later Lord Reid summarised the problem to be resolved by the courts: ‘the real question is, what method best fits the circumstances of a particular business’. These would seem to be the determinative factors underlying the decision of the House of Lords.

The accounting literature of the time shows that there was considerable support for both the direct cost method and the absorption cost (on cost) method for determining cost of stock-in-trade—this is supported by the evidence given in this case. It is interesting to note that in the United States and Australia the question of ‘direct cost’ versus ‘absorption cost’ has also been addressed and it was found that the absorption cost method should be used. Unlike Duple Motor Bodies the taxpayers in those cases were large scale manufactures using production line production.

B Methods of Determining Cost: Cost Flow Assumptions

In addition to these general principles, which have the underlying decision rule of the ‘lower of cost or market price’, the United Kingdom courts also considered the appropriateness of various cost flow assumption used for ascertaining the cost of stock-in-trade. These cases are considered below.

1 The Base Stock Method for Determining Cost

Under the base stock method it is assumed that a minimum quantity of trading stock (base stock) is necessary at all times in order to carry on business. The base stock is valued at cost current at the time when the base stock was established. Inventories in excess of the base stock are valued in accordance with some other method, for example, First in First Out (FIFO), or average cost. Ian M Bowie explains the use of the base stock method as:

also applied to work-in-progress as well as its raw materials, is founded on the principle that a business requires always to hold in stock a certain basic quantity of stock which is more in the nature of a fixed asset than a current asset. For example, an estimate may be made of the minimum pipe-line stocks plus a

258 Ibid 570.

259 Ibid 572.

260 Photo-Sorties Inc v Commissioner of Inland Revenue 66 FTC 85, 577; and Waukesha Motor Company v United States of America, 71 FTC 85, 954.

261 Philip Morris Ltd v FCT (1979) 10 ATR 44; 79 ATC 4352.

reasonable reserve stock, the total of which would be considered to be the base stock which should always be held if economic production is not going to be interrupted. It is held that that portion of the stock which constitutes this base stock should be valued at the cost of the equivalent quantity of stock originally purchased at the commencement of the business, or at the cost of the equivalent quantity of stock on hand when the base stock method of valuation was first introduced. By so doing, in times of rising prices the increased cost of replacing the base stock is written off to profit and loss account and accordingly that portion of the capital of the business which was utilised in providing the base stock remains intact. [Emphasis added]

The base stock method of valuing stock-in-trade was considered by the United Kingdom Court of Appeal in the case of *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* on appeal from the decision of Vaisey J, at first instance.

Broadstone Mills Ltd were engaged in the business of cotton spinning, and at all stages of the manufacturing process quantities of cotton were either on the machines or waiting beside them, ready to take the place of cotton on the machines. These two amounts of cotton were referred to as the ‘fixed process stock’ and the ‘spare process stock’ respectively. These two classifications of stock together were classified by the company as their ‘base stock’ when calculating the value of their stock-in-trade for income tax purposes.

The ‘fixed process stock’ was valued at the 1920 balance sheet price, and just how this 1920s cost price was computed was unknown when the dispute arose, and was heard by the court in 1953. The remainder, that is, the ‘spare process stock’ was carried in the accounts at an arbitrary figure of 28d per pound weight.

Evidence given to the Commissioners, and accepted by the court, showed the base stock method was widely accepted in the industry, though according to an assessor who specialised in the industry, the method was rapidly becoming less popular, with now only 11.5 per cent using the base stock method. The Commissioners found the base stock method was ‘one of the methods recognised in this particular trade of cotton spinning and is in accordance with sound commercial practice’. Mr T B Robson, a chartered accountant, and a member of the Council of the Institute of Chartered Accountants, who was a partner in the firm of Price Waterhouse & Co, gave expert evidence on behalf of the taxpayer. Vaisey, noted that Mr Robson:

nowhere in his evidence ... shows any but a very grudging approval of what is surely a very strange notion, nor does he really commend it as an appropriate basis for an assessment to Income Tax.

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263 *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* (1953) 35 TC 44, Singleton, Birkett and Hodson LJ.

264 Ibid 51.

265 Ibid 56.
The expert evidence in this case, which was accepted by the judge at first instance, Vaisey J, and the members of the Court of Appeal, disclosed the base stock method, which was adopted by the company, was a recognised and accepted method of valuing stock-in-trade in the industry and might well be a recognised and accepted method of some commercial purposes. However, it did not reflect the true income of the year and consequently was not an appropriate valuation method for income tax purposes, particularly when arbitrary prices had been used. No part of the stock-in-trade could either be treated as a fixed asset, as the company had attempted to do, or brought into account at an arbitrary figure.

In the Court, Singleton LJ, was greatly concerned with the use of arbitrary figures, and made the following comments with respect to this point:266

> How it is possible to get accuracy in any account by taking an arbitrary figure I do not know ... I do not follow the reason for any arbitrary price at all in a matter of this kind ... you cannot get at the true position unless you take actual figures as distinct from arbitrary figures.

Singleton LJ could not find any justification for using a figure lower than either ‘cost’ or ‘market’ when the prices of the company’s stock-in-trade were actually continually rising.267 His Honour then expounded his criteria for evaluating accounting methods and stated his rule for valuation, (as quoted above), and concluded that:268

> 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.

Birkett LJ added the following comment with respect to the expert evidence given to the Court:269

> he nowhere says: 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 *Ryan v Asia Mill Ltd* (1951) 32 TC 275 at 296:

> Moreover what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for Income Tax.

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266 Ibid 64–65.
267 Ibid 64.
268 Ibid 68.
269 Ibid 71.
Hodson LJ agreed with the judgments of Singleton and Birkett LJ, and thus the base stock method of valuing stock-in-trade was found to be inappropriate under the circumstances.

This is because first, the values attributed to the stock-in-trade in question were in no way related to the actual value or cost of the cotton which made up the ‘spare process stock’ and the ‘fixed process stock’. Secondly, even if the original values of these stocks had been used, it was not the same cotton which was originally purchased by the company. That is, in this case, the underlying cost-flow assumption, that a fixed amount of stock always remained in these two classes of stock, was not supported by the facts.

The application of the base stock method of valuing stock-in-trade can be summarised as follows. Prima facie it would appear that the base stock method of valuing stock-in-trade is not an appropriate method, unless it describes the actual stock-flow situation, and the actual costs of the current stock are used. In such cases the amount of base stock is a part of circulating capital, that is, on revenue account, and is not a part of the fixed capital, and thus would have to be brought into account in determining the profit of the company for the period. The evidence before the court (11.5 per cent of the particular industry at time of the case) and from Table 5 below indicates some 8.5 per cent of authors referred to the use of the base stock method. Evidence to the Tucker Committee indicated that there was the belief that stock-in-trade should valued according to the custom in the trade. Mr B M Berry in his evidence advocated the use of the base stock method. The Base Stock method is mentioned immediately after para 5 of the discussion of cost in Recommendation X of the Institute of Chartered Accountants in England and Wales, as one of the ‘other methods’ of valuation. It is noted that there is ‘limited application’ of this method in the United Kingdom.

### Table 5 – Use of the ‘Base Stock’ and ‘Retail Inventory’ Methods

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<td>115</td>
<td>67</td>
<td>53</td>
<td>235</td>
</tr>
</tbody>
</table>

2 Last in First Out

270 Detailed above.

271 Berry for the International Chemical Co Ltd, reported in ‘Taxation of Profits - Foreign Profits; Stock Valuations; Group Accounts - Tucker Committee’s Fourth Public Hearing’ (1 April 1950) The Accountant, 355–58, 58.

272 Published in The Accountant (16 June 1945), 302–03.
The Last In First Out (LIFO) method of valuing stock-in-trade was considered by the Judicial Committee of the Privy Council in the Canadian case of *Minister of National Revenue v Anaconda American Brass Ltd.* The relevant provisions of the Canadian Income Tax Legislation provided that tax was to be levied on the net profits of a taxpayer, which was defined as being:

the annual net profit or gain ascertained and capable of computation as being the profits from a trade or commercial or financial or other business.

Their Lordships concluded after an examination of these provisions that both the Canadian and United Kingdom income tax legislation are in this respect founded upon the principles enunciated by Lord President Clyde in *Whimster & Co v Commissioners of Inland Revenue.*

The company did not in fact keep actual records of the metal they used in their operations, but they did keep records of the physical quantities of the metal used, and of its opening and closing stock, along with its purchases and the prices paid for the purchases from time to time. The company was, as such, not using the LIFO method as a consequence of the physical flows of their stock, but was, instead, using an arbitrary assumption as to the flows of their stock, which in no way reflected the actual stock flow of the company. Their Lordships summarised the company’s situation as follows:

it did not know and could not ascertain ... in respect of all the metals which it used during the year what price had been paid for them or in respect of all the metals which it had at the end of the year what price had been paid for them. Yet in order to determine its annual profit or gain for the year 1947 it is necessary to ascribe the proper cost to the metals .... In the absence of knowledge an assumption or estimate must be made and it is at this stage that the difference between the parties arises.

During the year in question, 1947, there was a rapid increase in the price of copper, and it was in this year the taxpayer first adopted the LIFO method for taxation purposes, although it had used this LIFO method for its own purposes for some time prior to this date. The effect of the company’s adoption of this method of valuing their stock of metal during a period of rising prices was described by their Lordships:

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273 *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85; (1956) 2 DLR (2d) 1; [1956] 1 All ER 20, Viscount Simon, Lords Oaksey, Reid, Keith of Avonholm and Sornervell of Harrow.

274 *Whimster & Co v Commissioners of Inland Revenue* [1956] AC 85, at 100.

275 Ibid 96.

276 Ibid 96–97.

277 Ibid 98.
The result is obvious. By attributing the higher cost to the metals processed and the lower cost to those retained in stock the company was able to show far lower profits. ... The question is whether the new method is permissible for income tax purpose.

Their Lordships concluded that in such circumstances the LIFO method was an unacceptable method of valuing the company’s stock-in-trade for income tax purposes, on the basis that:278

the present case shows that under the LIFO method, if the business continues and stock is carried forward, substantial purchases may never come into the profit account at all.

There is no room for theories as to flow of costs, nor is it legitimate to regard the closing inventory as an unabsorbed residue of cost, rather than as a concrete stock of metals awaiting the day of process. It is in their Lordships’ opinion the failure to observe, or, perhaps it should be said, the deliberate disregard of, facts ... which vitiates the application of the LIFO method to the present case. It is the same consideration which makes it clear that the evidence of expert witnesses, that the LIFO method is a generally acceptable, and in this case the most appropriate, method of accountancy, is not conclusive of the question that the court has to decide ...

Their Lordships concluded the LIFO method did not comply with the prescription of the 

Income Tax Act, despite the fact that the LIFO method, or some variant of it, may be appropriate for corporate or other purposes of a trading company. However, the figures which such a method produced represented ‘neither market value nor its actual cost’ but, rather, a far lower amount, which represented the cost of similar stock purchased by the taxpayer company many years earlier and which it no longer possessed.279 There is, as their Lordships pointed out, a significant and important distinction between ‘what is permitted for tax purposes and what prudent businessmen may think fit to do’.280

Given the similarity of the Canadian and United Kingdom legislation it is the author’s view that the use of the LIFO method should not be used for valuing stock-in-trade. This is on the basis of their Lordships’ discussion and their findings, the LIFO method is, prima facie, inappropriate for the valuing of stock-in-trade, unless it actually reflects the physical flow of stock. The figures do not reflect either the cost of the stock on hand or the value of the stock and, as such, do not comply with the basic rule that requires stock-in-trade to be valued at the ‘lower of cost or market price’. The method, therefore, should not be adopted for taxation purposes, unless the stock flows of the company are actually on a LIFO basis, adequate records are kept of actual purchase prices, and these are matched to flows of the stock. It should be noted that here we are

278 Ibid 102.
279 Ibid.
280 Ibid 103.
talking about the use of an arbitrary cost flow assumption. If the actual flow of materials was on a first in first out basis then there would be no objection to the use of the LIFO method as it would accurately represent the cost of the stock-in-trade.

There is little discussion of the use of LIFO in the accounting literature of this time, however there was a debate on the LIFO versus FIFO in the mid–1940s. The debate seems to have been initiated by K A Lacey. The LIFO is mentioned in a footnote immediately after para 5 of the discussion of cost in Recommendation X of the Institute of Chartered Accountants in England and Wales, as one of the ‘other methods’ of valuation. It is noted that there is ‘limited application’ of these methods in the United Kingdom.

3 Conclusions as to Determining Cost

From the above discussion it can be seen that the United Kingdom courts have always taken a wide view as to the costs which have to be included to determine the cost of stock-in-trade for income tax purposes. It is the total consideration to be given for the acquisition of the stock-in-trade which is relevant. However, in Duple Motors they refused to lay down as general principle whether or not the direct costing or absorption cost method should be used for income tax purposes. In addition the courts will not tolerate the use of arbitrary cost flow assumptions. The cost flow assumption used must reflect the actual flow of the stock-in-trade.


283 Published in The Accountant (16 June 1945) 302–03.
XIV CONCLUSIONS

The basic rule for determining the value of stock-in-trade for income tax purposes is the lower of cost or market rule. The lower of cost or market rule is to be applied to each item or group of items individually and not with respect to the total stock-in-trade. That ‘cost’ means the actual cost of acquiring the stock-in-trade, which includes all the consideration given for such acquisition. The cost flow assumptions on the base stock and LIFO method do not represent the cost of stock-in-trade, unless they describe the actual physical flow.

The words ‘market value’ or ‘market’ mean the realisable value of the stock-in-trade in the market in which it would normally be sold, without deductions. In exceptional circumstances, where there is no market selling value and the historical cost of the stock-in-trade bears no relation to its current value, then cost of having the stock-in-trade delivered on the balance date can be used as a surrogate.

Finally, the use of the retail inventory method is not an acceptable method of determining cost, except when used to determine the actual cost of the stock-in-trade. Proper adjustments must be made for mark ups and mark downs, and the gross margin used must be the real gross margin.

It is clear that while the accounting profession managed to convince the courts that the usual method of valuating stock-in-trade was the use of the lower of cost or market rule, the courts have regularly rejected accepted accounting practice with respect to how it is applied and what the term ‘market value’ means.
### APPENDIX 1

#### TABLE 4 – MEANING OF MARKET VALUE IN LOWER OF COST OR MARKET RULE – NET OF MULTIPLE AUTHORS BY DECADE

<table>
<thead>
<tr>
<th></th>
<th>1901 to 1910</th>
<th>1911 to 1920</th>
<th>1921 to 1930</th>
<th>1931 to 1940</th>
<th>1941 to 1950</th>
<th>1951 to 1959</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realisable value</td>
<td>4</td>
<td>14</td>
<td>13</td>
<td>22.8</td>
<td>26</td>
<td>13</td>
<td>27.7</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>80</td>
</tr>
<tr>
<td>Net realisable value</td>
<td>0</td>
<td>0.0</td>
<td>4</td>
<td>11.8</td>
<td>4</td>
<td>7.0</td>
<td>9.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>46</td>
</tr>
<tr>
<td><strong>Replacement cost or price</strong></td>
<td>3</td>
<td><strong>25.0</strong></td>
<td>13</td>
<td>38.2</td>
<td>16</td>
<td><strong>28.1</strong></td>
<td>35</td>
</tr>
<tr>
<td>Market value or price</td>
<td>11</td>
<td>91.7</td>
<td>22</td>
<td>64.7</td>
<td>47</td>
<td>82.5</td>
<td>59</td>
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<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>66.3</td>
</tr>
<tr>
<td>Lower of replacement price and realisable value</td>
<td>0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
<td>3</td>
<td>5.3</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4.5</td>
</tr>
<tr>
<td>Lower of replacement price and net realisable value</td>
<td>0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
<td>0</td>
</tr>
<tr>
<td>Number of authors using the lower of cost or market rule</td>
<td>12</td>
<td>34</td>
<td>57</td>
<td>89</td>
<td>47</td>
<td>41</td>
<td>280</td>
</tr>
</tbody>
</table>
APPENDIX 2

Stock Certificates letter to the Editor of The Accountant

The following is copy of a letter which appeared in the same issue of The Accountant requesting a form of balance sheet to be supplied to the Surveyor of Taxes\textsuperscript{120}:

The following is the correspondence referred to in our weekly note:-

To the Editor of the Standard.

SIR, - I received this morning the following remarkable communication, which I enclose for your perusal, from the Surveyor of Taxes for this district:-

“6, Head-street, Colchester, April 27, 1886.

INCOME TAX RETURNS.

Schedule D.

SIR, - As these Returns will shortly be under consideration, it would aid the Commissioners in making an equitable assessment upon you if you would kindly prepare and forward to me, within fourteen days from this date, a debtor and creditor account, according to the subjoined form, for each of the past three years.

Yours faithfully,

R.G. HEDGEMAN, Surveyor of Taxes.

Mr. F.W. Friend, Hosier, &c, Colchester.

Year ended.* * Enter date.
Stock at beginning of year. Sales during the year.
Purchases during the year. Stock at end of year.

Gross Profit.

Trade Expenses, viz.-:
- Wages, &c., giving amount under each head.

Net profit, £.

\textsuperscript{120} Friend, F.W. letter to the Editor of The Standard, reproduced in The Accountant, 8th May 1893, at page 279.
This was enclosed in an envelope bearing the usual superscription, “On Her Majesty’s Service.” Has the Surveyor any legal warrant for this most inquisitorial, not to say impertinent, inquiry, which I understand has been received by most of my fellow-tradesmen? Personally, I may say that I have paid my income tax for many years without appealing against the assessment, although considerably surcharged, rather than submit my business affairs to the criticism of a committee composed possibly of my neighbours.

I am, Sir, your obedient servant,

F.W. FRIEND.

Alma House, Colchester, April 28.
APPENDIX 3

STOCK CERTIFICATES FORMS

Stock Certificates type A: 121

Stock.

State on what basis this stock was valued.
Has any reduction been made from the values so obtained before arriving at this
amount?
Was the same basis adopted in previous years?
Have you certified that this figure includes the value of stock, the cost price of which
has been charged against Revenue but which has not been actually delivered?
In arriving at the above figure, has any consideration been given to any change in
prices or values since the above date?
Does this figure include any outlay incurred in connection with the stock, such as
carriage?
Please state what steps you have taken to verify the quantities, values and calculations,
leading up to the above figure.

Stock Certificates type B: 122

Accounts. One year ended ............ We hereby certify that the whole of our stock on
hand on the ............... is shown in our Stock Sheets produced to ............ and amount to
£ ......
We further certify that the Stock is valued at cost, or market price if under cost, on the
same basis as hitherto, and that no deductions have been made from the value of the
Stock in arriving at the above figures, which represent its total value to the best of our
knowledge and belief.

We further certify that to the best of our knowledge and belief all transactions
relating to the business of ................. are correctly entered in the books of account
during the period ...... to ........ which have been produced to Messrs ........ and that we
know of no other transactions which ought to be included and which would affect the
Balance Sheet and Trading Account of the Company, or which should be brought into
an account of the Company’s dealings.
We further certify that no reserves whatever have been created (whether by writing
down Stock, Book Debts, or otherwise) beyond those disclosed on the face of the
Balance Sheet sent to the Surveyor of Taxes.
Dated this ......day of ........ 191 .

To be signed by an Acting Partner in a firm or a Managing Director of a
Limited Company
