

A HIGH COURT OF JUSTICE (CHANCERY DIVISION)—18TH AND 19TH DECEMBER 1968
AND 12TH FEBRUARY 1969

COURT OF APPEAL—4TH, 5TH, 6TH AND 7TH NOVEMBER 1969 AND
23RD JANUARY 1970

B HOUSE OF LORDS—15TH, 16TH, 17TH AND 18TH FEBRUARY AND 5TH MAY 1971

**B.S.C. Footwear Ltd. (formerly Freeman, Hardy & Willis Ltd.) v. Ridgway
(H.M. Inspector of Taxes)⁽¹⁾**

C *Income tax, Schedule D—Stock valuation—Market value—Retailer—
Whether market value can be taken as value in wholesale market.*

The Appellant Company carried on business as shoe retailers, buying most of its stock wholesale. In order to maintain sales, it kept very high levels of stock in relation to turnover. It had at the end of each accounting year considerable stocks which could only be sold off at a reduction from the original selling price, owing to changes in fashion and other causes. The Company's practice for at least 30 years had been to value stock in hand at the end of the year at the lower of cost and estimated replacement value, viz., the notional purchase price which would yield the requisite gross profit or "mark-up" at the expected selling price. That practice had been accepted by the Company's auditors, a well-known firm of chartered accountants, and, until the 1959 accounts were reviewed, by the Inland Revenue for income tax purposes.

E *On appeal against an assessment to income tax under Case I of Schedule D for the year 1960–61 the Company contended that the stock valuations in its accounts were correct in principle and produced a fair result in the circumstances. For the Crown it was contended that, in arriving at the full amount of the profits or gains of any year of assessment, losses on stock in hand at the end of the basis period for that year could only reasonably be anticipated in relation to the net realisable value of the stock, as estimated after taking into account expenses specifically referable to the sale of the stock in question (viz. salesman's commission) but not the general expenses of the business for later periods of account. The Special Commissioners held that the basis of valuation put forward by the Crown must be substituted for the Company's method.*

G *Held, (1) that there was no substantive rule of law requiring stock-in-trade at the beginning and end of a trader's accounting period to be entered at cost or market value, whichever was the lower, but the formula was accepted as a convenient business method of ascertaining profits for tax purposes, notwithstanding that, contrary to principle, it allowed a measure of loss to be anticipated; (2) (Lord Reid and Viscount Dilhorne dissenting) that in the case of a retail trade market value for this purpose meant the value realisable in the retail market, and accordingly the Company's method of stock valuation was not calculated to show the full profits assessable to tax year by year and the Crown's method should be substituted.*

Brigg Neumann & Co. v. Commissioners of Inland Revenue (1928) 12 T.C. 1191 distinguished.

I ⁽¹⁾ Reported (Ch. D.) (*sub. nom.* Freeman, Hardy & Willis Ltd. v. Ridgway) [1969] 1 W.L.R. 1488; 113 S.J. 818; [1969] 3 All E.R. 165; (C.A.) [1971] Ch. 427; [1970] 2 W.L.R. 888; 114 S.J. 285; [1970] 1 All E.R. 932; (H.L.) [1972] A.C. 544; [1971] 2 W.L.R. 1313; 115 S.J. 408; [1971] 2 All E.R. 534.

CASE

A

Stated under the Income Tax Act 1952, s. 64, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the High Court of Justice.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 23rd, 24th and 25th May 1967, Freeman, Hardy & Willis Ltd. (hereinafter called "the Company") appealed against an assessment to income tax made upon it for 1960-61 under Case I of Schedule D in the sum of £2,800,000 less £200,000 capital allowances.

B

2. Shortly stated, the question for our determination was the value of the stocks held by the Company at the beginning and at the end of the accounting period forming the basis of the assessment, i.e. at 1st January and 31st December 1959.

C

3. (1) The following witnesses gave evidence before us: Mr. D.L.Roberts, the director of the Company responsible for purchases of certain types of footwear; Mr. A. T. E. Duncan, chartered accountant, a director of the Company and formerly its chief accountant; one of his responsibilities is to advise the directors on the balance sheet valuation of stocks; Mr. M. A. Coates, a partner in Price Waterhouse & Co., chartered accountants, who are the Company's auditors; Mr. E. Lawson, chartered accountant, principal advisory accountant to the Board of Inland Revenue.

D

(2) The following documents were admitted or proved:

An analysis of stocks at 31st December 1958 and 31st December 1959 (exhibit A).

A further analysis (in a different form from that in exhibit A) of stocks in the Freeman, Hardy & Willis division of the Company at 31st December 1959 (exhibit B).

E

A statement headed "Effect on profit for 1959 of replacing Company's basis of stock valuation by Revenue's" (exhibit C).

A statement headed "Examples of comparative effects on individual years' profits of applying Company's and Revenue's methods of stock valuation" (exhibit D).

F

(3) From the evidence, oral and documentary, we found the facts set out in paras. 4 to 13 below.

4. The Company carries on business as shoe retailers; it also repairs shoes for its customers and manufactures shoes, but most of the articles it sells are bought wholesale. Its business is carried on in two divisions, the Freeman, Hardy & Willis division, with (in 1959) 520 retail shops, and the True-Form division with (in 1959) about 270 retail shops. True-Form, originally a separate company, was acquired prior to 1959, and the Company retained the name and identity of its retail shops.

G

The Company is a subsidiary of British Shoe Corporation Ltd., which also owns a number of other shoe retailers, including Dolcis, Saxone, Lilley & Skinner, Manfield and Benefit Footwear.

H

5. The Company's accounts are made up to 31st December in each year. The accounts were not produced to us, it being agreed between the parties that it was not necessary for us to see them to determine the question in issue. It also makes up half-yearly accounts to 30th June.

6. In order to maintain its sales the Company keeps very high levels of stock in relation to turnover; the shoes in stock at the beginning of each year

I

- A equal about one-third of the amount sold during the year. It also holds a very large number of items, but a comparatively small number of lines. The sale of footwear is very much affected by changes in style and fashion, and (to a lesser extent) by unforeseeable circumstances such as a very mild winter. For these (and other) reasons the Company has at the end of each accounting period considerable stocks which it can only sell off by making a reduction from the original retail selling price. It hopes to dispose of these stocks at sales held regularly in January and in the summer and (occasionally) at other times. At 31st December 1959 the stocks so reduced in price for the January sale (or expected to be reduced later for later sales) amounted to about one-third of the total stock then held.

7. The Company's directors fix periodically a mark-up, being a margin between buying price and selling price: this is the Company's expected gross profit if the goods should be sold at the selling price originally fixed, and is designed to cover all the Company's expenses and its net profit. The mark-up so fixed is an average overall margin which the Company intends to achieve; the buyer can thus easily calculate the retail selling price which will achieve the mark-up, and can estimate the selling price at which the goods must be offered in the first place. The buying department have a discretion to vary mark-up between different lines of footwear; within fairly narrow limits they may fix a greater margin on some lines and a smaller one on others, the mark-up fixed by the directors being an overall average. At the end of each year the results are analysed and the mark-up actually achieved is calculated; the exact figures achieved in 1958 and 1959 were:

E	31st December 1958	31st December 1959
Freeman, Hardy & Willis Division	35·80 per cent.	37·19 per cent.
True-Form Division	35·87 per cent.	36·99 per cent.

8. (1) Exhibit A contains an analysis of the Company's stock at the beginning and end of 1959.
- F (2) The stock in the Freeman, Hardy & Willis division at 31st December 1959 is on sheet 1 and at 31st December 1958 on sheet 3. The stock in the True-Form division at 31st December 1959 is on sheet 2 and at 31st December 1958 on sheet 4. Sheets 3 and 4 thus analyse the opening stock for the year 1959, and sheets 1 and 2 the closing stock. At the hearing of the appeal both parties confined their detailed examination of the schedule to sheet 1, and, so far as detail is concerned, we do the same here.

- (3) Column A shows the totals of the retail selling price as originally fixed for each line.

Column B shows the original cost, as agreed between the parties. This is in fact calculated by deducting the mark-up achieved (37·19 per cent.) from the figures in column A.

- H Column C shows the totals of retail selling price marked on the stock at 31st December 1959; for certain lines the figures are less than those in column A, as some lines have been marked down for the January sale (or may indeed have been marked down for earlier sales and left unsold).

- I Column D shows the price at which the Company expects eventually to sell the goods. For some lines the figures are even less than those in column C, because the Company does not expect to sell all the reduced price articles in the January sales; a proportion will be unsold and further reduced at later sales.

EXHIBIT A TO CASE

FREEMAN, HARDY

F. H. W.

Analysis of Branch Stock

	A	B
	<i>Original retail selling price</i>	<i>Original cost, being original R.S.P. less mark-up of 37.19%</i>
	£	£
1. Window samples	300,000	188,430
2. Reduced stocks		
(a) January 1960 sale stock		
(i) Expected to be sold at marked retail	373,100	234,344
(ii) Not expected to be sold unless further reduced ..	159,900	100,433
(b) Previous sale stock		
(i) Expected to be sold at marked retail	12,944	8,130
(ii) Not expected to be sold unless further reduced ..	5,548	3,485
(c) Clearing		
(i) Expected to be sold at marked retail	28,531	17,920
(ii) Not expected to be sold unless further reduced ..	12,227	7,680
3. Dated unreduced stocks		
(a) Previous summer stocks		
(i) Expected to be sold at original retail	39,000	24,496
(ii) Not expected to be sold unless reduced	17,000	10,678
(b) Current autumn stocks		
(i) Expected to be sold at original retail	1,053,000	661,389
(ii) Not expected to be sold unless reduced	229,000	143,835
4. Exceptional stocks		
(a) Bootees		
Not expected to be sold unless reduced	220,000	138,182
(b) Coloured suedes		
Not expected to be sold unless reduced	53,982	33,906
5. Clean stocks		
Expected to be sold at original retail other than odd- ments and damaged	1,163,855	731,017
6. Total	3,668,087	2,303,925
Deduct Factory profit on own make stocks		43,814
		<u>2,260,111</u>

STATED—SHEET I

& WILLIS LIMITED

DIVISION

at 31st December 1959

C	D	E	F	G	H
<i>Marked retail price 31.12.59</i>	<i>Expected retail selling price</i>	<i>Balance sheet valuation, being expected R.S.P. less mark-up of 37·19%</i>	<i>Amounts by which original cost (or expected R.S.P. if lower) exceeds balance sheet value</i>	<i>Deductions agreed by Inland Revenue</i>	<i>Undervaluation claimed by Inland Revenue</i>
£	£	£	£	£	£
300,000	285,000	178,997	9,433		9,433
255,500	255,500	160,468	73,876		73,876
109,500	54,750	34,386	20,364	3,422	16,942
8,575	8,575	5,386	2,744		2,744
3,675	1,837	1,154	683	115	568
18,900	18,900	11,871	6,049		6,049
8,100	4,050	2,544	1,506	253	1,253
39,000	39,000	24,496			
17,000	10,200	6,407	3,793	637	3,156
1,053,000	1,053,000	661,389			
229,000	152,667	95,883	47,952		47,952
220,000	176,000	110,537	27,645		27,645
53,982	35,938	22,571	11,335		11,335
1,163,855	1,150,855	722,754	8,263	8,263	
3,480,087	3,246,272	2,038,843	213,643	12,690	200,953
		43,814			
		1,995,029			

Column E is the Company's valuation of the stock as at 31st December 1959. This is explained in detail in para. 9 below, but it is sufficient to say here that in the case of each line it represents either original cost or the Company's estimate of replacement value, whichever is the lower. A

Column H shows the amount by which, according to the Crown's contention, certain lines are undervalued in column E. This is arrived at by deducting the amounts in column G from those in column F, which are explained in detail in para. 10 below. It is sufficient to say here that the Crown's figures are based on valuing each line at original cost or expected retail selling price (column D) less salesman's commission (column G). B

(4) Line 1 shows the figures for stock which has been used for window display. This suffers a certain amount of damage, and the expected retail selling price is slightly below the price originally marked. C

Line 2 (a) shows stock which is going into the January sale, to be offered for the first time at reduced prices. On experience three-tenths of this will not be sold at this price, and will have to have its price further reduced by half for selling off in the summer sale or later. For this reason seven-tenths of this stock is in line 2 (a) (i) and three-tenths in line 2 (a) (ii).

Line 2 (b) shows stock which has been offered at reduced prices in previous sales, and was unsold. It will be offered again in the January sale at the (reduced) marked retail price. Here again seven-tenths is expected to be sold in January (2 (b) (i)) and three-tenths will be left over for selling off later with a further price reduction of one-half (2 (b) (ii)). D

Line 2 (c) includes odd items and damaged or faulty footwear. It is also divided into 2 (c) (i) and 2 (c) (ii) on the same basis as in the cases of 2 (a) and 2 (b). E

Lines 3 (a) and (b) cover "dated" stocks, i.e. lines for which no new orders are being placed. They are offered for sale without any price reduction, but again approximately 18 per cent. are expected to have to be reduced in price in the future, and are shown separately in (a) (ii) and (b) (ii).

Lines 4 (a) and (b) cover stocks held in excess of normal requirements due to unforeseen happenings. They are still offered for sale without any price reduction, but it is expected that they will have to be reduced in price at some later date. There were no such stocks at 31st December 1958 (*vide* sheets 3 and 4). The excess stocks of bootees were the result of a very mild winter, and the coloured suedes had gone out of fashion faster than had been anticipated. It was intended to hold a special sale for these items in April 1960. F

Line 5 covers all other stocks; no price reductions were in contemplation, but there is a small difference between columns C and D to take care of odd or damaged items. Owing to the different approaches adopted by the Company and the Crown to the question of valuation this results in certain figures in columns F and G, but as the Crown's valuation was the same as the Company's nothing turned on these figures, and we do not refer to them again. G

9. (1) It will be seen from sheet 1 that in the case of lines 3 (a) (i), 3 (b) (i), and 5 the Company's valuation coincides with original cost. (In line 5 there is the small reduction for odd or damaged articles, which it was agreed was immaterial.) This accounts for about two-thirds in value of the total stocks, of which the valuation was not in dispute. In the case of all the other lines the Company's valuation was below original cost, and the question in dispute concerned them all; it will be seen that they are all lines where the expected retail selling price in column D is lower than the original retail selling price in I

A column A. In four cases (lines 2 (a) (ii), 2 (b) (ii), 2 (c) (ii) and 3 (a) (ii)) the expected retail selling price is below the original cost, but in all the other cases it is above the original cost.

(2) In all cases where the Company's valuation was below original cost, the valuation figure was what the Company estimated to be replacement value, i.e. the value at which the buyer would be prepared to go into the market to replace such stocks, if he had any occasion to do so and if he could do so at that price. Although the Company normally orders footwear from manufacturers in advance, it does occasionally make "spot" purchases; often a manufacturer makes footwear for stock without orders, and will offer them to the Company. The goods so offered will generally be in excess of the Company's buying requirements, and if purchased must be cleared quickly; the buyer estimates a retail selling price for quick clearance (i.e. considerably less than the normal price), and by deducting from that his mark-up he calculates the price he can offer to the manufacturer. The stock valuation is done in the same manner; the mark-up (37.19 per cent.) is deducted from the expected retail selling price, and the figure so arrived at is taken to be the replacement value. The Company's valuation is therefore the price at which the Company would go out and try to buy the stocks if it had any occasion to do so; if it had any occasion to sell off the stocks in bulk to other retailers that is the sort of price it would expect to get, as the purchaser would calculate the price he could offer in a similar way. Mr. Duncan and Mr. Roberts agreed that the Company would never be likely to try to sell off the stock at its valuation figure; taking the stock in line 1 as an example, it would never sell the window samples at its valuation of £178,997 when it expected to obtain £285,000 for them over its own counters.

(3) The principle underlying the Company's basis of valuation was that of passing one year's stock into the next year at a value which would enable the Company to show its normal mark-up (i.e. gross profit) in the next year. The goods which are not expected to realise the original retail selling price at the end of 1959 have all been stocks necessary for the purposes of the trade in 1959; by standing on the shelves or on display in branches in 1959 (or in warehouse ready to go to branches) they have, it is said, facilitated sales in 1959 and have helped to earn profits in 1959. When at the end of 1959 the question of their retail price has to be reviewed, any drop in replacement value, it is said, should be regarded as a loss referable to 1959 trading. This method of valuation is intended to accept in 1959 a loss of stock value, or diminution in the normal average gross profit, expected to mature when the stock held in 1959 is sold in 1960 or later. It aims at taking account of such loss in 1959, leaving the Company in a position to make its normal gross profit on all sales in 1960. All the companies in the British Shoe Corporation Ltd. group adopt a similar method of stock valuation, and Mr. Duncan had personal experience of two multiple stores which did so.

(4) Inasmuch as the mark-up includes the Company's expected net profit as a component, the Company's witnesses agreed that a small reduction in retail selling price (as in line 1) could result only in a diminution of net profit, and would not necessarily result in a net loss after taking overheads into consideration. Where there was a big reduction below the original retail selling price the expected selling price would produce a net loss (e.g. line 2 (a) (ii)); Mr. Duncan agreed that if the whole of such loss and no more were reflected in 1959 the accounts would show neither profit nor loss on the line in 1960, and that if the accounts did show a profit on the line in 1960 the loss shown in its 1959 accounts would be greater than the net loss. In agreeing with these two propositions, however, Mr. Duncan was looking at the matter (as he had been asked to do) as a question of apportioning the overall profit or loss on buying, handling and

selling the goods; he did not agree that the valuation adopted by the Company distorted the profits of different accounting periods; in the case of line 2 (a) (ii), for example, he regarded the loss reflected in the 1959 account as a loss actually suffered in 1959 trading, inasmuch as the replacement value of unsold stock had fallen below cost, while the profit which would be reflected in the 1960 account he regarded as a profit actually earned in 1960 trading, the stock having been brought forward (in his view correctly) at replacement value.

10. (1) Columns F, G and H of exhibit A show the adjustments which the Crown contended should be made to the Company's valuation, in order to adjust the valuation to a figure based on the lower of cost or net realisable value. There was no dispute concerning the arithmetic; the dispute concerned the principle.

(2) Column F shows the amount by which the cost, or the expected retail selling price (if lower than cost), exceeded the Company's valuation. In those cases where cost was the lower (e.g. line 1) the same figure appears in column H, headed "undervaluation"; thus in line 1, for example, the addition of £9,433 to the Company's valuation figure would lift the valuation of the window samples to the figure of cost. In those cases where the expected retail selling price is lower than cost (e.g. line 2 (a) (ii)) the Crown make an adjustment to the figure in column F, intended to reduce the "expected retail selling price" to a figure representing "net realisable value"; this adjustment is in column G, and it is simply the amount of the salesman's commission which the Company would incur when the goods should eventually be sold. Thus, in line 2 (a) (ii), for example, the addition of £16,942 to the Company's valuation figure would lift the valuation to the expected retail selling price minus the salesman's commission: this the Crown describes as net realisable value, and being lower than cost is substituted for the Company's valuation figure.

11. The Company has consistently adopted the "replacement value" method of valuing its stocks since (at the latest) 1940; in the case of True-Form the method dates back to (at the latest) 1933. This method has also been adopted by the other members of the British Shoe Corporation Ltd. group, and has always been accepted by the eminent firms of chartered accountants who audited their accounts. The Inland Revenue also accepted accounts drawn on this basis until the 1959 accounts were being reviewed.

12. Mr. Coates, who has had in the course of his practice a great experience of companies engaged in retail trade, had found in his connection with the Company's audit that the Company's staff used an exceptionally high degree of care in ascertaining stock qualities and values. His opinion was that the Company's valuation reflected a fair replacement price. Stocks are normally valued at the lower of cost or market value, but, as he saw it, there is more than one method employed by accountants and traders in determining market value; one well-accepted method is to take the lower of replacement price and net realisable value. Mr. Coates's opinion was that the replacement price, as calculated by the Company, produced a fair allocation of profits and losses to different periods, because it fairly measured the adverse circumstances regarding stocks held at the accounting date, the chief adverse circumstance being that they are expected to realise less than the original selling price. Even if the reduced selling price is still such as will show a profit, the diminution of profit originally expected was, to his mind, an adverse circumstance, bearing in mind that stocks expected to be sold in the January sales at reduced profit were the tail-end of lines of which the major part had been sold at the full profit margin—the profits had been creamed off. The Company adopted a policy of carrying very large

A stocks; this policy enabled it to produce more sales than if it had carried smaller stocks, but the penalty of carrying larger stocks was greater stock losses, and in Mr. Coates's opinion these losses should be reflected in the same accounting period as that in which the profits were made.

B He was also of opinion that to adopt net realisable value on the basis put forward by the Inland Revenue would overstate the value of the stocks; he attached importance to the fact that the stocks represented nearly one-third of the following year's sales, so that a considerable part of the expenses of the following year would be incurred in disposing of those stocks.

C He agreed that annual accounts should reflect profit or loss rather than the extent to which expectations are realised, and that the Company's method could produce a gross profit on (for example) window samples in year 2 larger than the profit actually involved in buying, holding and selling the stocks, but he considered that the Crown's method overstated the profit in year 1; the window samples, for example, dropped in value as soon as they were put in the window, and in his opinion the accounts should reflect that.

D The Company's method of valuation, he said, was a modern and sophisticated form of accounting; the Crown's method failed to recognise that a diminution of expected profit should be regarded as an expense, and that was an old-fashioned approach.

13. Mr. Lawson, whose experience included employment as Chief Accountant and later Finance Director of a Division in the Ministry of Food from 1944 to 1954, in the Enquiry Branch of the Inland Revenue from 1954 to 1960, and thereafter in the office of the Solicitor of Inland Revenue, stated that in his opinion it was a cardinal principle of commercial accounting that one must avoid anticipating profits but must take account of and provide for expected losses. Where stock has fallen in value but the trader has reason to believe he will still make a profit (though smaller than he originally hoped) the stock should be valued at cost; prudence requires that the expected profit should not be anticipated, but a valuation below cost would (in his view) be wrong, as it would amount to a provision for a loss where a profit was expected. Where stock has fallen in value below cost, so that a loss is expected, prudence requires a valuation below cost in order to provide for the expected loss; for this purpose market value was taken, and by "market value" Mr. Lawson insisted that selling price must be the criterion (although replacement price would sometimes be acceptable where that afforded the best guide to market price). He did not accept the view that it was the function of a profit and loss account to make a provision for a diminution of expected profit, although he agreed that this might be a very important function of a company's internal management accounts.

H Mr. Lawson was of the opinion that the Company's method of valuation distorted the Company's profits in that, by anticipating a diminution of expected profit (e.g. line 2 (a) (i) of exhibit A) where no loss was expected, it threw up a loss in year 1 and an exaggerated profit in year 2; similarly, where a loss was expected (e.g. line 2 (a) (ii)) it exaggerated the loss in year 1 and threw up a profit in year 2. He produced a schedule (exhibit D⁽¹⁾) showing the extent of what he described as distortions as between 1959 and 1960 on two selected items of stock (the notes on this schedule being his comments upon the figures shown). He demonstrated by exhibit B⁽¹⁾ that the Company's valuation on sheet 1 of exhibit A was £200,953 lower than the Crown's, and by exhibit C⁽¹⁾ that if the Crown's valuation were correct the Company's valuation understated the 1959 profits by £138,676.

(¹) Not included in the present print.

He questioned whether the arithmetical method employed by the Company to arrive at its valuation produced a fair replacement value. In arriving at net realisable value, he considered that only direct expenses connected with sale should be deducted from the expected selling price, and that nothing else should be deducted, because fixed expenses (such as rent, rates, salaries and other overheads) are incurred in any event; there was a large body of opinion in accountancy circles that fixed expenses should not be anticipated or deferred in any way.

14. The following cases were referred to in the course of the hearing: *Whimster & Co. v. Commissioners of Inland Revenue* 12 T.C. 813; 1926 S.C.20; *Duple Motor Bodies Ltd. v. Ostime* 39 T.C. 537; [1961] 1 W.L.R. 739; *Brigg Neumann & Co. v. Commissioners of Inland Revenue* (1928) 12 T.C. 1191; *Commissioners of Inland Revenue v. Cock Russell & Co. Ltd.* (1949) 29 T.C. 387; *Patrick v. Broadstone Mills Ltd.* 35 T.C. 44; [1954] 1 W.L.R. 158; *Minister of National Revenue v. Anaconda American Brass Ltd.* [1956] A.C. 85; *Wetton, Page & Co. v. Attwooll* 40 T.C. 619; [1963] 1 W.L.R. 114.

15. It was contended on behalf of the Company that the stock valuations in the Company's accounts were correct in principle and produced a fair result in all the circumstances, and that the Company's profits should be computed accordingly.

16. It was contended for the Inspector of Taxes:

(i) that the computation of profits for the purpose of Case I of Schedule D had to reflect as nearly as possible "the full amount of the profits or gains of the year", as prescribed by s. 127(1) of the Income Tax Act 1952, in accordance with the ordinary principles of commercial accounting and the provisions of the Income Tax Acts;

(ii) that it was established law that accounts drawn up for this purpose should not anticipate profits or losses, except in the case of expected losses on stock-in-trade;

(iii) that such losses could only reasonably be anticipated in relation to the net realisable value of stock-in-trade, and "replacement price" was only relevant in so far as it might in some circumstances be the best guide to net realisable value;

(iv) that the selling expenses to be taken into account in estimating net realisable value were the expenses specifically referable to the stock in question and not the general expenses of the business for later periods of accounting;

(v) that the basis of valuation adopted by the Company was not a true "replacement price" basis and distorted the financial achievement of the year;

(vi) that the Company's profits should be computed on the Crown's basis of valuation.

17. We, the Commissioners who heard the appeal, gave our decision in writing as under:

It is established law that, in computing the profits of a trader for the purpose of assessment to income tax under Case I of Schedule D, stock-in-trade may be entered at cost or market value, whichever is the lower. The principle was explained by Lord Reid in *Duple Motor Bodies Ltd. v. Ostime* 39 T.C. 537, at pages 569-70, as being that a trader may enter stock at cost to avoid taxing a profit before it is realised; on the other hand, if the market value at the accounting date is below cost that lower value may be taken, to enable the trader to anticipate the loss which he expects to incur when he sells the stock.

- A As we understand the authorities, when profits are being computed for tax purposes the law does not permit stock to be entered at a value (being below cost) which is lower than what is sufficient simply to anticipate the loss expected to be realised when the goods are sold. The value must be taken at the accounting date, and the loss being anticipated is the loss expected at that time; it must be recognised that if things turn out better than expected the valuation may produce a profit in the following year's account, but if the expectation is precisely fulfilled the sale of the stock will produce neither profit nor loss in the next year's account.
- B

In the present case such part of the stock as is not entered at cost has been entered by the Company at a figure designed to enable the Company to show (in the following year's account) its normal margin of profit when the stock is sold.

- C The practice, in our opinion, produces a valuation of such stock below that which the law allows for computing profits for tax purposes.

The basis of valuation for which the Crown contended was described as "net realisable value", and was calculated by taking the expected retail selling price less known or anticipated direct selling cost (which the Crown took to be salesman's commission). In our opinion, in the circumstances of the present case this is a fair basis for valuation and produces a result which accords with the law as we understand it. It was suggested on behalf of the Company that there might be other items of direct selling cost, besides the salesman's commission, which should be taken into account, but no attempt was made to specify them or attach a figure to them.

- D
- E The Company's method of valuation has been consistently used by it and accepted by the Inland Revenue authorities for income tax purposes for many years. In these circumstances we have considered very carefully whether the authorities, as we understand them, require us to adopt in its place the basis of valuation put forward by the Crown. We think they do, and we accordingly hold that the appeal fails in principle and we leave the figures to be agreed.

- F Agreement of the figures on the basis of our decision having been reported to us, on 4th August 1967 we increased the assessment to £3,266,763 less £254,903 capital allowances.

- G 18. The Company, immediately after our determination of the appeal, having declared to us its dissatisfaction therewith as being erroneous in point of law, in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act 1952, s. 64, which Case we have stated and do sign accordingly.

The question of law for the opinion of the Court is whether we erred in law in our conclusions in para. 17 hereof.

19. Subsequent to the hearing of the appeal the Company changed its name to B.S.C. Footwear Ltd.

- H
- | | | |
|---------------|---|--|
| R. A. Furtado | } | Commissioners for the
Special Purposes of the
Income Tax Acts. |
| W. E. Bradley | | |

Turnstile House,
94-99 High Holborn,
London W.C.1.
1st May 1968

- I The case came before Cross J. in the Chancery Division on 18th and 19th December 1968, when judgment was reserved. On 12th February 1969 judgment was given in favour of the Crown, with costs.

C. N. Beattie Q.C., Michael Nolan Q.C. and Denis Carey for the Company. A
H. H. Monroe Q.C. and Patrick Medd for the Crown.

The following cases were cited in argument in addition to those referred to in the judgment:—*Whimster & Co. v. Commissioners of Inland Revenue* 12 T.C. 813; 1926 S.C. 20; *Minister of National Revenue v. Anaconda American Brass Ltd.* [1956] A.C. 85; *Sharkey v. Wernher* 36 T.C. 275; [1956] A.C. 58.

Cross J.—The Appellant, Freeman, Hardy & Willis Ltd. (which I will call “the Company”), is a subsidiary of British Shoe Corporation Ltd. and carries on business as shoe retailers in two divisions, one the Freeman, Hardy & Willis division, which in 1959 had about 520 retail shops, and the other the True Form division, which in 1959 had about 270 retail shops. The Company manufactures some of the shoes which it sells but most of them are bought wholesale. Shoe retailers, if they are to effect large sales, must keep large stocks, and the number of shoes which the Company has in stock when its trading year closes at the end of December is generally equal to about a third of the number of shoes sold during the year. When the Company’s buyers purchase shoes from wholesalers they calculate the price which they are prepared to pay by reference to a so-called “mark-up”, which is fixed periodically by the directors, being the percentage margin between wholesale buying price and retail selling price which will cover the Company’s expenses and produce the rate of net profit which is considered appropriate. But a substantial part of the stock still in hand at the end of the year will never be sold at the retail price which the buyer had in mind when he bought the shoes in question. Some of it will be sold at reduced prices in the January sales; some may be sold at still lower prices in subsequent sales. The gross prices realised on these sales may sometimes be less than the cost of purchase of the articles, even if one makes no deduction for expenses. In other cases, although the gross prices exceed the cost, the net price realised may fall below it. A third possibility is that the net prices exceed cost but show a smaller profit margin than was envisaged by the “mark-up”. B C D E

The practice which the Company has followed for at least 30 years past in making up its accounts has been to value the stock in hand at the end of the year at its then replacement value, that is to say, the price which the Company would pay in the wholesale market for stock of that type. The effect of doing this is to pass the unsold stock into the next year’s accounts at a price which should enable the Company to achieve its normal rate of gross profit on the sale of that stock and to throw the anticipated shortfall in profit or the anticipated loss, as the case may be, on the year in which the stock was purchased. This method of valuation has been adopted by the other members of the British Shoe Corporation group, and has always been accepted by the well-known firm of chartered accountants who audit their accounts. Further, until 1959 it was accepted by the Inland Revenue for income tax purposes. But in reviewing the accounts of the Company for that year the Revenue claimed that to enter the unsold stock at replacement value, though it might be appropriate for the Company’s own purposes, did not show the true profit for income tax purposes made in the preceding year, and that the unsold stock must appear in the accounts either at cost or at the market value at the end of the year, whichever was the less, the market value being the price which could be obtained for the stock on a sale by retail less any expenses, such as seller’s commission, directly referable to its sale. F G H I

The Special Commissioners, though they were reluctant to allow the Inland Revenue to disturb a basis of accounting which they had accepted for so long, came to the conclusion that the Company’s method was wrong in law

(Cross J.)

A and that the Revenue was entitled to refuse any longer to accept it. The Company was dissatisfied with this decision, and asked the Commissioners to state a Case for the opinion of the Court.

The Income Tax Act 1952 says nothing about valuation of stock unsold at the end of a trading year. It simply says that tax must be paid on the full amount of the profits or gains of the year preceding the year of assessment: see s. 127(1). As Lord Simonds said in *Duple Motor Bodies Ltd. v. Ostime*⁽¹⁾ 39 T.C. 537, at page 567, a layman might be pardoned for not realising that it was proper to treat unsold stock as a receipt and to put a figure on it. After all, the regular replenishment of stock is a normal outgoing of a retailer's business, and one might have thought that the expense might be left to lie in the year when it was incurred even though some of the stock bought, as would normally be the case, was unsold at the close of the year. But of course, if an unusually large quantity of stock was bought in year A and a correspondingly smaller quantity in year B, to put no figure on the unsold stock at the end of the year of purchase would unduly depress the profit shown for year A and unduly swell the profit for year B; so for many years it has been the accepted practice of accountants to bring in the unsold stock as a closing item on the receipt side of the account of year A and an opening item on the expense side of the account for year B. But at what figure is the unsold stock to be brought in? If one regards the object of the exercise as being simply to exclude from the expense side of the account in year A the cost of the unsold stock, then obviously the figure which you bring in will be that cost. But if the value of the stock, whether in the wholesale or retail market, has changed since its purchase, to bring it in at cost may distort the picture if one is trying to achieve a fair balance in estimating the profits as between year A and year B, for if the value has fallen it may be said to be unfair to year B to allow all the cost to be excluded from the expenses of year A, whereas if the value has risen it may be said to be unfair to year A to give it no share in the rise. In fact, the practice of accountants for many years has been to bring unsold stock in at cost unless the market value, whatever that may mean, is less than cost.

In the *Duple* case Lord Reid said, 39 T.C., at page 570, that this was an illogical compromise, since it permitted the bringing in of an anticipated loss while forbidding the bringing in of an anticipated profit. Counsel on both sides in this case joined in submitting that Lord Reid was wrong in thinking that there was any illogicality. Of course what he said was only a *dictum*, but after giving the point such consideration as I can, without paying, I hope, any undue deference to his opinion, I cannot see that he was wrong. But, illogical or not, the formula "cost or market value whichever is the lower" has become sacrosanct, and in this case there is no question of introducing any higher figure than cost. The contest is simply whether, if the wholesale market value is less than cost, you can take that figure although the retail market value is above cost. As I have said, there is no statutory provision which throws any light on the problem, nor apparently any decided case. Counsel for the Company suggested indeed that *Brigg Neumann & Co. v. Commissioners of Inland Revenue* (1928) 12 T.C. 1191 lent support to the contention that the wholesale market value should be, or at all events could be, taken. The goods which were in question there were partly undyed cloth "in the grey", for which there would presumably have been no retail market, and partly dyed cloth, which could presumably have been sold to tailors or others wishing to purchase finished cloth. The Court, it is true, took the wholesale price as being the appropriate value for all the cloth, but it may be that the proportion of finished cloth was

(1) [1961] 1 W.L.R. 739.

(Cross J.)

quite small. Again, it may be that having regard to the trade recession at the time there was no retail market. At all events the question whether the wholesale price was appropriate to the finished cloth appears not to have been argued. The case undoubtedly illustrates the point, which the Crown does not contest, that there may be cases in which the appropriate market value to take is the wholesale market value; but I cannot treat it as authority for the proposition for which the Company is 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. The Company's argument, as I see it, must really be that the formula "cost or market value whichever is the lower" is an accountant's formula which has been accepted by the Courts and that its meaning must be determined by reference to the practice of accountants.

In the *Duple* case⁽¹⁾ the Court had to consider the meaning of the cost limb of the formula with reference to the valuation of work in progress. The evidence showed that some accountants thought that cost of work in progress ought only to include direct manufacturing costs, while others thought that it should include a proportion of the overheads—the "on-cost" method. The Court there held that, as either view was tenable and the former view, for which the taxpayer was contending, had in fact been accepted by the Revenue for some time in connection with the accounts of that company, it should continue to govern its accounts, though it did not follow that the direct cost method ought to be adopted as a rule in the case of all manufacturers irrespective of the circumstances of the particular case.

In this case Mr. Coates, who is a partner in Messrs. Price, Waterhouse & Co., the Company's auditors, and who has great experience of the accounts of companies engaged in the retail trade gave evidence to the following effect:

"Stocks are normally valued at the lower of cost or market value, but, as he saw it, there is more than one method employed by accountants and traders in determining market value; one well-accepted method is to take the lower of replacement price and net realisable value. Mr. Coates's opinion was that the replacement price, as calculated by the Company, produced a fair allocation of profits and losses to different periods, because it fairly measured the adverse circumstances regarding stocks held at the accounting date, the chief adverse circumstance being that they are expected to realise less than the original selling price. Even if the reduced selling price is still such as will show a profit, the diminution of profit originally expected was, to his mind, an adverse circumstance, bearing in mind that stocks expected to be sold in the January sales at reduced profit were the tail-end of lines of which the major part had been sold at the full profit margin—the profits had been creamed off. The Company adopted a policy of carrying very large stocks; this policy enabled it to produce more sales than if it had carried smaller stocks, but the penalty of carrying larger stocks was greater stock losses, and in Mr. Coates's opinion these losses should be reflected in the same accounting period as that in which the profits were made." Then, further on: "The Company's method of valuation, he said, was a modern and sophisticated form of accounting; the Crown's method failed to recognise that a diminution of expected profit should be regarded as an expense, and that was an old-fashioned approach."

(1) 39 T.C. 537.

(Cross J.)

- A Mr. Lawson, the principal advisory accountant to the Board of Inland Revenue, disagreed with Mr. Coates's views as to the meaning of "market value". But as the Revenue had for many years accepted a valuation on Mr. Coates's basis, and as that basis was one which, though not universally accepted, was according to the evidence accepted by many modern accountants, the Crown, so the argument ran, had not discharged the onus which was on them to show that
- B the Company's accounts had for years been prepared on a wrong basis for income tax purposes.

These arguments are plausible, but they do not convince me; for to my mind there is a considerable difference between looking to the views of accountants to discover the meaning of the word "cost" in the formula and looking to them to discover the meaning of the words "market value".

C The word "cost" does not itself suggest any answer to the question what items of a manufacturer's expenditure may properly find a place in an estimate of his costs of manufacturing or partially manufacturing some object. The Court must necessarily look to the views of accountants to discover the answer to that question, and if different accountants take different views and neither view appears to be inherently unreasonable, the Court may well conclude that

D neither view is necessarily wrong and that how the estimate should be made in any particular case must depend on such considerations as how the costs of manufacturing those goods have in fact been estimated for tax purposes in the past. But 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. Of course, the formula is one which the law has accepted from the practice of

E accountants, and if the evidence showed that accountants had always interpreted the phrase in connection with the valuation of a retailer's stock as covering at the option of the trader the price in the wholesale market, i.e., the replacement value, even though that was less than the retail selling price, then no doubt the Court might bow to the views of the accountants. But all that the evidence

F of Mr. Coates shows is that a certain number of accountants, whom Mr. Coates regards as "up to date" and whose approach to the problem he shares, have come to think that in calculating the profit of a year's trading one should regard a diminution of expected profit as an expense, and that accordingly it is desirable to value unsold stock at its replacement value, which necessarily involves treating the words "market value" in the formula as referring to the prices in the wholesale market. Mr. Coates and those who share his views

G may, of course, be right in thinking that their approach gets nearer to that elusive conception, the true profit of the year's trading, which is the object of all this inquiry; though in connection with the unsold stock of this Company the words "expected profit" are perhaps hardly justified, since the buyers who bought the unsold stock, together with the similar stock which was sold during the year, must have known perfectly well that about the proportion of the

H stock bought which was left unsold would be left unsold and would be later sold at reduced prices which would show a smaller, if any, margin of profit. But the fact—if it be a fact—that Mr. Coates is right, though it would be an argument in favour of embodying his views in some statutory direction as to the appropriate method of computing profits, is not really an argument in favour of construing the words "market value" in the accepted formula in

I what I can only regard as a quite unnatural sense. For these reasons, which are I think substantially the same as those given by the Commissioners, I shall dismiss the appeal.

Before parting with the case I would say that 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. The Crown was

(Cross J.)

only prepared to allow the deduction of expenses directly connected with the sale, such as sellers' commission. Mr. Lawson's evidence on this point was as follows: A

"In arriving at net realisable value, he considered that only direct expenses connected with sale should be deducted from the expected selling price, and that nothing else should be deducted, because fixed expenses (such as rent, rates, salaries and other overheads) are incurred in any event; there was a large body of opinion in accountancy circles that fixed expenses should not be anticipated or deferred in any way." B

Mr. Coates, on the other hand, considered that, even if "market value" must be determined by reference to the retail selling price, a proportion of overheads should be deducted. His evidence on this point was as follows:

"He was also of the opinion that to adopt net realisable value on the basis put forward by the Inland Revenue would overstate the value of the stocks; he attached importance to the fact that the stocks represented nearly one-third of the following year's sales, so that a considerable part of the expenses of the following year would be incurred in disposing of those stocks." C

The Commissioners dealt with this aspect of the case as follows: D

"The basis of valuation for which the Crown contended was described as 'net realisable value', and was calculated by taking the expected retail selling price less known or anticipated direct selling cost (which the Crown took to be salesman's commission). In our opinion, in the circumstances of the present case this is a fair basis for valuation and produces a result which accords with the law as we understand it. It was suggested on behalf of the Company that there might be other items of direct selling cost, besides the salesman's commission, which should be taken into account, but no attempt was made to specify them or attach a figure to them." E

Counsel for the Company told me that, so far as he recollected, he had never suggested that there might be other items of direct selling cost beyond salesman's commission, and it may be that the word "direct" is a mistake for "indirect" and that the Commissioners were referring to the question whether a fraction of the overheads should be included. However that may be, it is common ground that this question was not fully explored before the Commissioners because the Company was relying on its contention with regard to replacement value. Similarly, the argument before me was confined to this point. So, as I have said, I express no view as to whether in ascertaining market value of unsold stock one should deduct a proportion of the overhead expenses as well as expenses directly referable to the sales. F

That again is another victory at first instance for you, Mr. Medd. G

Medd—My Lord, may I ask for the appeal to be dismissed with costs?

Cross J.—That is right, is it, Mr. Beattie? H

Beattie Q.C.—Yes, my Lord, I cannot resist that.