Privy Council Appeal No. 49 of 1994

Masport Limited *Appellant*

v.

Morrison Industries Limited *Respondent*

and Cross-appeal

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 14TH NOVEMBER 1994

Present at the hearing:-

LORD KEITH OF KINKEL
LORD OLIVER OF AYLMERTON
LORD MUSTILL
LORD LLOYD OF BERWICK
LORD NICHOLLS OF BIRKENHEAD

*[Delivered by **Lord Nicholls of Birkenhead**]*

This appeal and cross-appeal from a decision of the Court of Appeal of New Zealand raise questions on the proper interpretation of a written agreement between the parties and questions of fact. No point of law of general importance is involved. The judgments in the courts below set out the basic facts very fully; the judgment of Williams J. in the High Court covered 125 pages of the record of the proceedings, and the judgment of the Court of Appeal 35 pages. It would be of no assistance to the parties, or anybody else, for their Lordships to recapitulate the background facts yet again.

Their Lordships will therefore turn straight to the issues raised by the respondent Morrison Industries Limited ("Morrison") in its cross-appeal, after referring to the principal terms of the parties' agreement. The agreement was dated 29th September 1986. By this agreement the appellant Masport Limited ("Masport") agreed to buy from Morrison all its stock, including raw materials, work in progress, spares and finished goods located in New Zealand or Australia. The purchase price was to be "the aggregate book value of the assets as at

31 December 1986 using as the basis therefor the book values as per Morrison's accounts", subject to a reduction for obsolete or unusable stock (paragraph 6). Provision was made for arbitration on the amount of this reduction if the parties could not agree. The first $2 million of the price was to be paid on the date of settlement, which was fixed for three months ahead, on 31st December 1986. The balance was payable in two instalments over the next 18 months. One-third of the balance was to be paid on 30th September 1987, and the remainder on 30th June 1988. Immediately upon the value of the stock being determined, Masport was to issue to Morrison bills of exchange payable on 30th September 1987 and 30th June 1988 for the amounts then payable less, in the case of the earlier bill, the amount of $0.5 million. Stock was to be taken on the date of settlement by Morrison under the direction and control of Arthur Young and Co., who were Morrison's auditors, "as though for audit purposes". Masport was entitled to have observers present at the stocktaking, and to confer with Arthur Young "as to the financial determination resulting". For the purpose of fixing the time when Masport should issue the bills of exchange, the value of stock so determined, without any deduction for obsolete or unusable stock, was "deemed to be the determination of the value of stock" (paragraph 8).

Several documents were attached to the agreement when it was signed. Each page of these documents was initialled by the persons who signed the agreement. Among these documents, although not referred to in the text of the agreement, was one which had formed part of Morrison's accounts for the financial year ending 31st March 1986. It was headed "Statement of accounting policies". Under the heading "Accounting convention" appeared this statement:-

> "The general principles of historical cost accounting have been applied in the preparation of these financial statements except for ..."

Under a further heading, "Valuation of Assets - Inventories", the document stated:-

> "Trading stock, raw materials and work in progress are valued at the lower of cost or net realisable value. The standard cost method has been used to determine cost ..."

The book values as per Morrison's accounts.

Morrison's financial year ended on 31st March, so in the ordinary course the usual statutory accounts would not be prepared as at 31st December 1986. For this reason there could be no question of Arthur Young determining the value of the stock for the purposes of the agreement by simply going to the books and extracting the values of the stock as recorded therein for the purpose of the year-end accounts. Hence the agreement envisaged that, as at the settlement day of 31st December 1986, the "books" of Morrison would have to be specially written up with the values of the stock,

and that for this purpose there would be a stocktaking by Morrison under the direction of Arthur Young as though they were conducting a year-end audit.

In dispute is the value the books could properly ascribe to the raw materials, including the raw material element in the work in progress and finished goods. Clearly, and the contrary has not been suggested, Morrison was not at liberty at settlement to adopt whatever inflated value it might choose, however absurd. But there are several different ways in which the value of raw materials can be assessed. For instance, they may be valued at actual cost, or at replacement cost, or at net realisable value. Paragraphs 6 and 8 of the agreement did not set out which basis was to be used in the books of Morrison when the stock in hand in three months' time came to be valued. On this the agreement was silent.

However, as already noted, the parties did attach and initial an extract from the March 1986 accounts, setting out the basis on which those accounts had been completed. The general principles of historical cost accounting had been adopted. In agreement with the Court of Appeal, their Lordships consider that from this the conclusion which inexorably follows is that it was implicit in the agreement that the valuation method used for the stock at settlement date would be the same as, or not less favourable to the buyer than, the method currently being used by Morrison in its books as stated in the attached statement of accounting policies, namely, historical cost. By attaching and initialling this statement the parties must be taken to have intended that the statement should have some legal effect for the purposes of their agreement. One obvious respect in which the statement must have been intended to have legal effect was that the buyer could rely on this as a statement of the way Morrison kept its books on which the price would be calculated.

Before the Board, as before the trial judge and the Court of Appeal, submissions were directed at the sentence in this statement which reads "The standard cost method has been used to determine cost". Their Lordships consider that, in this context, this sentence is empty of content and that it does not detract from the unambiguous statement concerning the use of historical cost accounting principles. Reference to "the standard cost method" tells the reader nothing about which of the several possible alternatives is the basis used in calculating the standard cost. A standard costing system may produce figures approximating to any of the various methods of calculating cost, such as "first-in, first-out", weighted average, "last-in, first-out", and latest purchase price. Of these methods, some approximate to historical cost, others do not: "first-in, first-out" does so approximate, latest purchase price does not.

The basis of valuation in Morrison's books.

Their Lordships turn next to consider what happened when settlement day arrived. The books were then written up in the sense that a stock valuation was prepared. Whether that valuation, as at 31st December 1986, was prepared on the same basis as the valuation in the March accounts is open to question. However, it is not necessary to pursue that issue. Even if the value of the stock at the later date was calculated in all respects on the same basis as the earlier date, it is clear that the basis adopted in the March 1986 accounts was not that of historical cost. The basis adopted was that of latest invoiced cost, with some modifications. This is established by the evidence. Further, that this was the basis used in the stock valuation of 31st December 1986 is expressly stated in Arthur Young's letter of determination dated 9th April 1987. In an inflationary economy this method aims at a different target from actual cost. Where raw materials in hand, or incorporated into work in progress or finished goods, derive from several batches of materials bought over a period of months, the latest invoiced cost may be a useful guide to replacement cost, but it is not a sound guide to actual historical cost. The latest invoice price tells one the price most recently paid for the lawnmower engines, or the bicycle parts, or the nuts or bolts, or whatever. It does not tell one the price actually paid, over a period of months, for all the raw materials in question.

The extent of overvaluation.

The next step is to identify the extent to which the amount as determined by Arthur Young ($7,944,339) exceeded the proper figure, that is, the value of the stock which would have been recorded in Morrison's books if they had been compiled on the basis of historical cost. This is a question of fact, on which the burden of proof rested on Morrison. It was for Morrison to establish the amount properly due to it from Masport under the terms of the agreement.

On this question the Court of Appeal took a different view from the trial judge. Williams J. much preferred the evidence of Morrison's witnesses, Mr. France, Mr. Gair and Mr. Tonkin, to the evidence of Mr. Leaning who was called by Masport. Mr. Tonkin's conclusion was that the review exercise carried out by him in conjunction with Mr. Fox showed an overstatement of book value in comparison with historical cost of raw materials on a FIFO basis of only 1.3 per cent. If this figure is sound, Masport's case must fail. Valuation of stock in a manufacturing business of any size can only be an approximation. However diligently records are kept, in practice it will be impossible to identify the precise purchase order from which emanated each item of raw material being valued, either in stock or as a component of work in progress or finished goods. An overstatement of 1.3 per cent would be well within the bounds of acceptable variation from one calculation to the next.

Mr. Tonkin's conclusion was not challenged by cross-examination. Despite this, and despite the trial judge's acceptance of Mr. Tonkin's evidence, their Lordships consider it was open to the Court of Appeal to reject Mr. Tonkin's conclusions. The review exercise, as described by Mr. Fox and Mr. Tonkin, was open to the criticisms set out by Robertson J. in his judgment. In particular, the 1.3 per cent figure was not extrapolated and carried into the calculation of the value of the raw material elements in work in progress and finished goods. That emerged from Arthur Young's letter dated 4th December 1987. Even with the unused raw materials, the adequacy of the sample tested was questionable. Stocks of items whose aggregate value was less than $3,000 were not tested at all. These comprised 39 per cent in value of raw materials in stock. And the items tested included, as a major element, one item (engines) whose price history may well have been exceptional and hence unrepresentative and distorting to the overall result when included in the sample.

The trial judge, while preferring the evidence of Morrison's witnesses, stated that he did not doubt Mr. Leaning's integrity. But if the results of the exercise carried out by Mr. Fox and Mr. Tonkin are to be discounted, Mr. Leaning's evidence was the only credible evidence on this point. Mr. Leaning's conclusion was that the extent of the overvaluation was in the range between $332,000 and $562,000. Their Lordships consider that, overall, Mr. Leaning's reasoning in support of the lower of these two figures is cogent.

Mr. Leaning described his lower figure as conservative. The Court of Appeal preferred the top end of Mr. Leaning's range and accepted his higher figure. On this their Lordships have to part company with the Court of Appeal. In his second calculation Mr. Leaning made assumptions concerning the percentage of stock which had been subject to two revaluations. Their Lordships consider these assumptions lack a persuasive factual base. Accordingly their Lordships consider that Morrison established an entitlement to the amounts claimed less $332,000.

Before turning to Morrison's cross-appeal, their Lordships add a general observation on this part of the case. They recognise that the directors of Morrison were concerned to obtain a price equal to the value at which, obsolescent stock apart, the stock appeared in Morrison's books. The only discount they were prepared to agree was that the price could be paid, free of interest, over a period of 18 months. On the face of it, paragraph 6 of the agreement achieved that objective. However, the attached statement of accounting policies was unequivocal in what was said concerning the manner of compilation of Morrison's accounts. The directors of Morrison may well not have appreciated the consequences of this. Presumably they did not. Had they done so, the

accounting policies statement, strictly incorrect so far as the raw materials were concerned, would not have been included in that form in the March 1986 accounts. In the result Morrison will be paid, so far as can now be ascertained, an amount equal to the price it paid for the raw materials; it will not be paid anything in respect of the unrealised profit element built into the stock valuation in its books.

Interest.

Paragraph 5 of the agreement set out the dates on which payment was due, as already noted. Paragraph 5 continued:-

> "No interest shall be payable on any unpaid portion of the purchase price except that if Masport shall default in making any of the above payments on due date Masport shall pay interest at the rate of 20% on the amount in default from the date of default until payment is made but without prejudice to any other rights or remedies of Morrison in relation to such default."

Masport contended that, since the stock value as determined by Arthur Young was prepared on an incorrect basis, it was not in "default" when it failed to make any payment either in September 1987 or June 1988, beyond issuing two bills of exchange for a further $2 million altogether.

The Court of Appeal declined to accept this submission. Their Lordships agree. In the context of this paragraph, "default" meant no more than failure to pay the amount due under the agreement at the relevant date. Their Lordships do not accept that a determination of value, correct in every respect, was a condition precedent to Masport being under an obligation to make any payment on the prescribed dates. There needed to be a determination. That triggered an obligation to issue the bills, in accordance with paragraph 8. But Masport's obligation was to pay a price calculated in accordance with paragraphs 5 and 6. Arthur Young's determination was no more than machinery in that regard. Under the agreement the price would be book value, with the books compiled on the basis of historical cost. The figures were to be audited by Arthur Young, who were to report the result. If their auditing exercise was erroneous, and the figures were incorrect, this did not displace Masport's obligation to pay, on the due dates, the correct sums calculated in accordance with the terms of the agreement. If Masport successfully challenged Arthur Young's determination, its obligation was to pay only the reduced amount. In that event Masport was not in default in respect of the excess. In respect of the excess, Masport was never under a contractual obligation to pay. But, as to the sum found to be due, that should have been paid on the prescribed date. If Masport chose to pay a lesser amount, it was at risk as to interest so far as the balance was concerned. This approach did not work hardly on Masport for it was in possession of the assets and ran the business from settlement date onwards.

Conclusion.

Their Lordships will humbly advise Her Majesty that Morrison's cross-appeal should be allowed to the extent of varying the order of the Court of Appeal by substituting $332,000 for $560,000, with a consequential adjustment in the amount of interest payable. The cross-appeal is otherwise dismissed, as is Masport's appeal. There will be no order as to costs before their Lordships' Board and the orders as to costs in the courts below will not be disturbed.