36, 1955

No. 12 of 1955.

In the Privy Council.

ON APPEAL

FROM THE SUPREME COURT OF CANADA.

BETWEEN

THE MINISTER OF NATIONAL REVENUE - - - *Appellant*

AND

ANACONDA AMERICAN BRASS LIMITED - - - *Respondents.*

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In the Supreme Court of Canada

IN THE MATTER OF THE EXCESS PROFITS TAX ACT, 1940

BETWEEN:

THE MINISTER OF NATIONAL REVENUE

(Respondent) APPELLANT;

AND

ANACONDA AMERICAN BRASS LIMITED

(Appellant) RESPONDENT.

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PART IV—JUDGMENTS

DONALD B. CRAWLEY, Sworn:

Examined by Mr. De Roche:

Cross-Examined by Mr. Pickup:

Q. Mr. Crawley, what is your position with Anaconda American Brass?—A. Assistant Controller.

Q. And you are in direct contact with the books?—A. Yes, I am.

Q. How long have you held that position, Mr. Crawley?—A. Since the latter part of 1943.

Q. When did you first join the company?—A. In February 1940.

Q. What was your position between 1940 and 1943?—A. As an accountant, I presume—there was no title.

Q. You were still working with the books?—A. That is right.

Q. Now you are familiar with the Income Tax Returns filed by the company?—A. I am, sir.

Q. And you are familiar with the assessments which were made for the years 1946 and 1947?—A. Yes, I am.

Q. Can you tell us, Mr. Crawley, of a conversation which you had with someone from the Department—I think I am on sound ground here, my lord—I do not think there will be any conflict about this—with regard to the preparation of your Income Tax Returns, after you had filed them, with regard to the Income Tax Returns for 1946 and 1947—or was there just the one conversation?

His LORDSHIP: Well what bearing can anything which the Departmental Officer said, have in the matter?

Mr. DE ROCHE: The question—if I might outline to your lordship what we are aiming at you may see whether the evidence affects this matter or not.

The actual figure which was assessed, was prepared by Mr. Crawley at the request of the Department—the actual figure which was assessed was prepared by Mr. Crawley and it is in connection with the preparation of that statement—

His LORDSHIP: What does the court care about that either, as to who prepared the assessment?

Mr. DE ROCHE: Perhaps I should say, what we are concerned with is the basis upon which it was prepared. What we would like to show to your lordship is that the assessment was prepared on the f.i.f.o. basis.

His LORDSHIP: The assessment was prepared on the f.i.f.o. basis?

Mr. DE ROCHE: Yes, my lord.

His LORDSHIP: Well why do I even care about that—on what basis it was prepared?

Mr. DE ROCHE: I would have thought as between the two methods of calculating income, this evidence might be admissible.

His LORDSHIP: I am not concerned with that. You make the contention that your method or system correctly reflects your profits on which you should pay the taxes.

Mr. DE ROCHE: Yes, my lord.

His LORDSHIP: Well am I concerned with what basis the Department may have used in making this assessment—if that method is shown not to reflect properly the profit, according to the manner in which you have done your business?

Mr. DE ROCHE: Your lordship is putting it in a negative way and that is exactly what we would like to show because we are saying that our method correctly reflects it, and we would also like to prove that the Department's method does not reflect it—that is in the negative way.

His LORDSHIP: That might have some bearing in determining whether the assessment was correct or not, which of course is the only issue before the court.

Mr. DE ROCHE: Yes, my lord.

His LORDSHIP: Well I will allow him to answer the question—I will allow you to ask the question.

Mr. DE ROCHE: Q. Were you requested, Mr. Crawley, by the Department to prepare certain figures?—A. I was.

Q. And what figures were you requested to prepare?—A. I was requested to prepare, in respect to the year 1946, a valuation for copper and zinc on the f.i.f.o. basis and for the year 1947 copper and zinc, tin and lead, on the f.i.f.o. basis.

Q. And did you prepare those figures, Mr. Crawley?—A. I did, sir.

Q. And are the figures which you prepared the figures which appear in the assessment for those years?—A. Those figures do not appear, as such, in the assessment. The assessment would indicate the increase in assessed income. In preparing those inventories on the f.i.f.o. basis I would also indicate the increase in values as compared with our books, to the inventories on the l.i.f.o. basis.

Q. You would prepare—if I understand you correctly, you would prepare a differential statement, showing the difference between the two systems, is that correct?—A. Eventually that is right—yes—my first determination is to arrive at the inventory of those metals on the f.i.f.o. basis and then I would deduct the inventories as shown in our books from that figure, to arrive at the increased value —the value and difference.

Q. And which was the figure you gave to the Department—the differential figure or the f.i.f.o. figure?—A. If you mean by the "f.i.f.o. figure"—if you mean the difference—

Q. Well I do not—I will separate it—was it the figure of the difference between the two systems which you gave to the Department?—A. I cannot be exactly certain. So far as my recollection goes I gave him the difference.

Q. And was the difference between the two systems that which appeared in each assessment?—A. That is so.

His LORDSHIP: Q. That is you had put in your returns on the l.i.f.o. basis? —A. That is right, my lord.

Q. And that was not acceptable to the Department apparently?—A. Apparently not.

Q. And did they ask you to prepare the returns on the f.i.f.o. basis—or ask you to prepare figures which would show the difference between the application of the l.i.f.o. principle and the application of the f.i.f.o. principle?—A. They just asked me to prepare or to supply them with—as I recollect—the difference between the two methods.

Q. Well then are you then able to say whether the assessment was made on the application of the f.i.f.o. principle?—A. I can, sir.

His LORDSHIP: Does the difference show on the notice of assessment?

Mr. DE ROCHE: Yes, my lord. If your lordship will refer to the assessment which you have before you—the assessment for 1947.

His LORDSHIP: You are now speaking of 1947?

Mr. DE ROCHE: Yes, my lord.

His LORDSHIP: Dated November 10th, 1948, is it?

Mr. DE ROCHE: December 6th, 1948, my copy is marked, my lord. That is the date mailed. My copy reads:

"Date mailed December 6th, 1948."

His LORDSHIP: That is December 6th, 1948, but it is the assessment for the year 1947?

Mr. DE ROCHE: Yes, that is what we are looking at.

Mr. PICKUP: Are you looking at the 1947 assessment?

His LORDSHIP: The assessment for the year 1947—date mailed—the note indicates that the notice was mailed on December 6th, 1948.

Mr. PICKUP: But I thought he had been referring to a conversation relating to the 1946 assessment—or the 1946 year.

The WITNESS: Both years.

Mr. DE ROCHE: Both years?—A. Both years.

Q. I show you, Mr. Crawley, a copy of the assessment—or the notice of assessment of the company for the year 1947 and I call your attention to an item under the heading "Adjustments of income declared" and the item reading "Inventory adjustment $1,611,756.43"—and I take it from your evidence, Mr. Crawley, that that is the figure which you furnished to the Department?—A. I do not remember the exact figure but if that is the same figure on the notice of assessment which arrived at our office, that is so.

Q. This is the copy of the assessment which arrived at your office—this is the same which arrived at your office—then that figure is correct?—A. That figure is correct.

Q. That is the figure which you gave them?—A. So far as I know.

His LORDSHIP: And that is the difference between the application—the difference which would result from the application of the f.i.f.o. principle instead of the l.i.f.o. principle?—A. That is so, my lord.

Mr. DE ROCHE: Then, Mr. Crawley, would you explain the process by which you arrived at this figure—perhaps it would be better if I asked you further back—the process by which you arrived at the income determined on the f.i.f.o. basis, the first-in, first-out basis?—A. You mean by that the total income of the company or do you mean—

Q. You are quite right, I should have confined myself to the opening and closing inventories.—A. To arrive—in order to arrive at the increased value, when valuing the inventories on the f.i.f.o. basis, I would go to our records and determine the purchases.

We will deal with copper in this—I would go to our records and determine the purchases of copper in the month of December—in the month of November—back until I equalled the quantity of inventory at the end of the year—in other words I would take the latest purchases to arrive at the inventory valuation on the f.i.f.o. basis; and that is true with zinc and tin and lead in that year.

Now a question has been directed—there is also another calculation which we make in respect to scrap. The purchases of scrap are made at a lower figure than the current price of the raw metal. Therefore we make some adjustment on the f.i.f.o. basis for that element or that difference between the purchase price of scrap and the purchase price of raw metal.

Q. I think Mr. McGinn described it to us, did he not, and I think he summarized his evidence by saying that there was some unrealized profit in the scrap transaction which the Department had been allowing and which calculation and allowance you included when calculating this figure?—A. I believe he did. I do not remember the exact words.

Q. Well is that a correct summary of it?—A. That is the correct summary, in my opinion.

Q. There was an element of unrealized profit in some scrap transaction and that was deducted from your income for the purposes of determining the correct income—as I understood it?—A. No, I do not think I would entirely agree with you on that point. I would say that it cost us less than, for example—if copper is costing us 21½ cents, we would buy copper scrap for a less figure than the 21½ cents. It was a matter of valuation of costs on the f.i.f.o. basis.

Q. Well let us go back to 1946?—A. Possibly, to follow it a little further—scrap purchases were made in December or were made in November, the month which I used—and when I used those months I took the pounds and calculated them at 21½ cents but I still had to make an allowance for that difference between the cost of scrap and the 21½ cents. It is necessarily very slight and I do not think in that year, if my memory serves me, and as I recollect it, it amounted to about $50,000—but I am not certain on that point.

Q. I think for the present purposes all we need at the moment—a correction for the scrap adjustment was made in arriving at the figure of $1,611,756.43, to which you referred?—A. That is so.

Q. May I take your mind back now to the 1946 assessment, Mr. Crawley? Are you familiar with the 1946 situation?—A. I am.

Q. I believe Mr. McGinn told us that the only adjustment in the 1946 assessment related to this scrap account—is that your understanding?—A. That is my understanding, sir.

Q. May I have Exhibit 7. Mr. Crawley, I show you Exhibit 7—and that we were told is a photograph of one of the company's working sheets, is that correct?—A. That is correct, sir.

Q. Are you personally familiar with that work sheet?—A. I am, sir.

His LORDSHIP: Did you prepare it?—A. No sir, but it was under my direction.

Mr. De ROCHE: When was the work sheet prepared, Mr. Crawley?—A. That would be prepared early in January 1948.

Q. And for what purpose was it prepared?—A. It was prepared for the purpose of—there were really two purposes—one is to determine the cost of sales—the other purpose is to have an inventory valuation of copper as of December 31st, 1947.

Q. Now Mr. Crawley, Mr. McGinn told us that the figures on this sheet came from the books or the records of the company?—A. Yes they did, sir.

Q. Now can you show us the records from which they came—figure by figure—let us confine ourselves, if my friend is willing, to copper.

The first figure is 6,500,000 pounds—at a total value of what—$487,500. Now can you show us in the books where that figure came from?—A. I would not be able to sir, in detail. I can only show it to you in total.

Q. It is shown in total there?—A. These figures are carried forward from year to year. Our general ledger would not show that in detail. It would just show the total pounds carried forward at a total dollar value.

His LORDSHIP: Q. Starting from what?—A. So far as this year is concerned, starting from January 1st, 1947, my lord.

Q. But this figure, you have carried forward in years past apparently—where did it start?—A. I am not familiar with the general ledger earlier than the year 1940 —but since I have been there we have always carried forward inventories in the inventory account from year to year.

Q. Each year you started with 6½ million pounds?—A. No, the figure reflected in the ledger.

Q. I mean, plus the increment since?—A. That is right.

Mr. DE ROCHE: Q. The 6,500,000 pounds has appeared in every inventory with which you have had anything to do.

His LORDSHIP: Not necessarily.

The WITNESS: As part of the inventory.

Mr. DE ROCHE: That is what I meant.

His LORDSHIP: It would not appear as a figure because it would be added to each year.

Mr. DE ROCHE: I think, my lord, it does appear as the starting figure.

His LORDSHIP: It always appears as the starting figure?

Mr. DE ROCHE: Does it not, Mr. Crawley?

His LORDSHIP: Q. Is it described in any special way, to identify it?—A. No sir, not to my knowledge—not so far as the inventory records are concerned.

Mr. DE ROCHE: I am not talking, Mr. Crawley of the inventory record particularly. Let us confine ourselves not to one record but in any records of the company? —A. We have working papers in our possession.

His LORDSHIP: Q. Well this is a working paper—Exhibit 7 is a working paper? —A. Yes, and that would carry forward these inventories in detail from year to year.

Q. Mr. McGinn spoke of two accounts, I mean two records.

Mr. DE ROCHE: And would you have those both here, Mr. Crawley—the two which were mentioned yesterday?—A. I believe I have.

Q. Will you get them and explain how they worked?

His LORDSHIP: One was called the "perpetual inventory record", showing the copper in and the copper out.

Mr. De Roche: Q. Will you start with that—which one is that?—A. That is this one (indicating).

Q. Then take that.

His Lordship: And that is the record which Mr. Pickup was asking about.

The Witness: I do not think the point was actually clear yesterday as to which record.

His Lordship: Q. What is that?—A. I do not think the point was actually clear yesterday as to which record he wished to look at.

His Lordship: I specifically suggested to counsel that they might get together with the witness and make it clear which records were wanted.

Mr. Pickup: We did that last night, my lord—both Mr. Pattillo and I—and referred it to this witness and the Crown accountant—and they got together and I was told by this witness this morning that he understood just what was required. I do not know what the present difficulty is.

The Witness: I have brought the records anyway.

His Lordship: The first record that Mr. McGinn spoke of was the perpetual inventory, I think he called it.

Mr. De Roche: Which dealt with pounds only.

His Lordship: That dealt with pounds only and it simply showed the copper coming in and the copper going out.

Mr. De Roche: Q. Let us look at that one now.

Will you show us, Mr. Crawley, what are these entries made in the account both in and out?—A. To start with, the cathodes—and I might explain first, that this book is the inventory record of types of metal.

His Lordship: The various types?—A. The various types of metal.

Q. Which came in?—A. That is right, sir.

Now the first sheet in 1946 is headed "cathode".

Q. And that is one type of metal which comes in, in the form of cathode?—A. Yes, my lord.

The first line shows inventory 1,869,132 pounds. That represents the weight of cathode on hand on the first day of January 1946. From day to day from that date we record the receipt of cathode and the disposition of cathode, into the casting shop.

Mr. De Roche: Q. The first page, Mr. Crawley?—A. The first page—on this first page it shows we did not receive any cathode—but we did in January.

Q. In January?—A. But we did transfer into the casting shop 1,254,655 pounds.

Q. And the entries on the page, Mr. Crawley, I take it are the daily items of the number of pounds under the heading "used"—which means transferred to the casting shop, is that right?—A. That is right, sir.

Mr. PICKUP: And with my friend's concurrence, we were going to work along here a little together, if your lordship pleases.

The result was that you used up, during the month of January a good deal of this copper cathode—this copper cathode?—A. Yes.

Q. And you got none in?—A. No.

Q. And the result is you reduced the poundage from the 1,869,132, to 614,477 at the end of the month?—A. That is right.

Q. And I suppose you carry that forward to the next month?—A. That is right.

Mr. DE ROCHE: Now if we may continue to work together, Mr. Crawley, when Mr. Pickup says that you reduced the quantity—that did not, as I understand it, move those quantities out of inventory—it moved them from raw materials to "in process"?—A. You are quite right.

Mr. PICKUP: It is under that heading "used".

His LORDSHIP: Q. Which went into process?—A. Which went into process—that is right.

Mr. DE ROCHE: Now I see on the second page that there are entries under the heading "received".

His LORDSHIP: Now are you still on cathode?

Mr. DE ROCHE: Yes, my lord.

His LORDSHIP: You are moving into 1947?

Mr. DE ROCHE: 1946 I think it is, my lord—1946.

The WITNESS: Yes.

Mr. DE ROCHE: Q. And on the second page we see entries under the heading "received".

His LORDSHIP: You are moving into February?

Mr. DE ROCHE: February of 1946.

His LORDSHIP: Q. You carry forward the balance from the end of January as your first entry in February?—A. Yes, my lord.

Mr. DE ROCHE: Q. And will you just explain the first "received" item there, so that we know what that means?—A. That would represent the receipt of copper—or the receipt of cathode—from the Consolidated Mining and Smelting Company. We also indicate the car number of it, which arrived—and we assigned a lot number.

Q. And you indicate in the respective columns, the number of pounds received?—A. Yes, and we would add that to the book inventory.

His Lordship: Q. And in February you lift your amount of cathode used—that is the number of pounds that went into process?—A. Yes.

Mr. Pickup: Q. May I interrupt there—I see that shipment bears a lot number of 3015—just what does that mean? Is it a number which is physically indicated on the shipment or what do you do with that number?—A. So far as cathode is concerned, I am not certain as to whether that is marked on that particular metal.

Q. But is it generally so with regard to copper?—A. Copper shapes.

Q. You are not sure, I take it, about cathode but my question was as to copper generally—it is so that you carried it with a number that is shown in this book?—A. I believe that came out in evidence from Mr. Evans, as I recall.

His Lordship: I do not recall that it did.

Mr. De Roche: I do not think so.

Mr. Pickup: Q. Do you not know?—A. Oh yes—it does—there is a mark on the metal.

His Lordship: Q. The mark is put on the metal?—A. Yes, on the shapes of copper—I am not too positive about cathode.

Mr. Pickup: Q. You may not be positive about any particular one, although positive about others—but taking the general situation—the most of the copper—is it so marked?—A. Most of the copper is so marked.

His Lordship: Q. In what form do you get your copper—do you get it in the form of cathode?—A. We get it in the form of cathode and in the form of billets and in the form of cakes and in the form of—there are two billets.

Mr. Pickup: Is it marked on the billets?—A. I think so. I am not positive on the point but I think the number is punched.

Q. On the billets?—A. Yes, my lord. I should really refer this—I have never been out actually to see that that metal has that particular number on it, I am really speaking of hearsay in this respect, my lord.

His Lordship: He does not know.

Mr. De Roche: Mr. Evans knows, my lord. Mr. Evans, the plant manager, is the man who knows what mark is put on this.

His Lordship: And did he say?

Mr. De Roche: He was not asked, my lord. He was asked the broad question could he identify the raw material and he said "Yes, he could," and that is all he was asked.

Mr. Pickup: No, he said he could identify the raw material coming into stock up to the time that it went into process—and that is what this indicates.

Mr. De Roche: That is the inventory of that particular metal—the material which has not gone into process yet.

Mr. Pickup: Now do not let me interrupt you.

Mr. De Roche: No—this is for you more than for us, Mr. Pickup.

Q. Then the book goes on, during the year, dealing with cathode in the manner in which you have described?—A. That is right.

Q. Just take it generally—unfortunately we are talking of these—can we find the different copper shapes?—A. Here.

Q. We are referring now to 6 x 6 x 16 electro copper rod billets—and that page has the opening figure inventory, with something opposite—does that mean the same thing here, relative to this billet as the other meant in relation to cathode?—A. Yes, that has the same relationship.

Q. I see in this column you have something filled in—you have prices as well as pounds, have you?—A. No, that is pieces. There are no dollars in these records.

Q. There are no dollars in these particular records?—A. No, my lord.

Mr. Pickup: Q. I think something might be gained by just following the cathode—not page by page—but just by looking at the end of the year—and we find there that the poundage at the end of the year is 1,747,451—and you start with 1,869,532—that is right?—A. That is right.

Mr. Pattillo: My lord, I cannot hear a word which is being said there.

Mr. Pickup: I should be speaking louder—but that is a habit which one gets into when one gets close to a witness. That is why I try to keep away from the witness.

Q. But in the month of January we have again the figures—and February—it is running along about between five and seven hundred pounds or thereabouts—right?—A. That is the way it indicates, sir.

Q. I am just going by the book?—A. That is right.

Q. And in March the poundage runs from a low of 73,000 pounds to a high of 574,654.

His Lordship: You mean there was a time in March when the total poundage in cathode was only 73,000 pounds?

Mr. Pickup: That is the fact, my lord.

His Lordship: All of it, which has come in, in January and February has been used, except 73,000 pounds?

Mr. Pickup: That is what this indicates. In fact that is what it says.

Mr. Pickup: Q. Then in March the figures—Oh, that was March—the low of 73,000—and in April there were considerable purchases and the low is 91,621 but the month ends with 975,246—right?—A. That is right, sir.

Q. Then if we jump over to say December, you open the month with 1,568,637 and close the year with even a larger quantity of 1,747,451.

Now that seems to indicate the history of the cathode according to this record, in the year 1946, is that right?—A. That is right, sir.

Q. So that you start off with a large quantity—go down to a very small quantity compared with what you started with and then at the end of the year you finished off with a large quantity again?—A. Yes.

Q. And is that fairly representative of the way in which the copper was handled —or is that a fair question to put to you?

His Lordship: What happened in January 1947?

Mr. Pickup: Q. Yes, I will follow through.

Is cathode a large percentage of your copper or is it small?—A. No, no, I would not say it is a large percentage of the copper.

Q. Will you find me 1947—we want the cathode in 1947. Now in 1947—A. Can I add a remark with respect to that?

Q. Certainly.—A. The amount of scrap which we purchased.

His Lordship: Q. Which?—A. The amount of scrap which we purchased from month to month.

Q. But we are speaking only of cathode.—A. It was just a matter of understanding the ups and downs.

Q. Are there entries of scrap that go into your inventory records relating to the receipt and—not going to the question of cathode?—A. I wanted to explain the reason—the possible reason—why we would have a low inventory of cathode copper at any time. It was due to the fact that we may have had a fairly large inventory of scrap. You see scrap is used in the casting shop, as well as the cathode.

Q. And that might be the reason why you might have a low inventory of cathode—but have a large stock of scrap?—A. That is right, my lord.

Mr. Pickup: Q. Well then carrying on in 1947 with the cathode, you start with 1,747,451.

His Lordship: In January?

Mr. Pickup: Q. On January 1 and you have shipments coming in and poundage going into the casting shop—reducing the quantity at the end of the month on the difference by about 500,000 pounds.

Then in February you still have incoming cathode and outgoing, reducing it still further but not very much—but another 190,000 pounds.

March goes down to a low of 668,275—I think, is that right?—A. That is right.

His LORDSHIP: How much?

Mr. PICKUP: A low of 668,275.

His LORDSHIP: Q. So the fairly large amount which you had on hand at the end of December was used by the end of March?—A. That is right, my lord.

Mr. PICKUP: Q. But at the end of March, with more purchases of copper, you end with a total of 1,103,642 pounds?—A. That is right, sir.

Mr. DE ROCHE: That is cathode—you said "copper".

Mr. PICKUP: Q. I am sorry, all this is cathode.

Then again in April, we find the inventory dropped—let us see if we can get the low figure—the lowest figure that the balance seems to be is 805,702—but the month ends again with a high figure of 1,364,546.

Then in May the inventory dropped down to 612,776 and ends the month with a figure of 924,718.

Then I am just jumping to the end of the year without going through the remaining months, my lord—jumping to the end of the year; and we see December begins with an opening of 1,673,708—and after adding what comes in and subtracting what goes into process, you end the year with 1,694,614—as compared with the opening of the year of 1,747,461?—A. That is right.

Q. And that I think fairly gives us the picture of the cathode, my lord.

His LORDSHIP: Yes.

Q. Then do you keep a similar account of the various shapes?—A. Yes, my lord.

Q. The various forms of copper which come from the suppliers?—A. Yes, my lord.

Q. And do you similarly keep track of the scrap which comes in?—A. Yes, we keep a record of scrap on the basis of—it is rather technical—whether it is brass, nickel, silver, copper or turnings.

Q. Yes, but you keep track of the scrap in the same way—in this same inventory record?—A. It is in another book, my lord.

Q. You have another book for scrap?—A. Yes, my lord.

Mr. PICKUP: Q. This is highly irregular, my lord, but it may be the shorter way. May I ask the witness here:

Q. What is your largest classification of copper—we have been dealing with cathode—is there one which is your largest one? And if so, what would that be?—A. I am not just certain which is the largest but I would say that cathode is, by itself, is one of the largest.

Mr. PICKUP: Then we have one of the largest?

His LORDSHIP: You have a representative piece of copper in the form of "cathode".

The WITNESS: Yes, my lord.

Mr. PICKUP: Q. Then I suggest to my friend that we might next look at the records which he has in respect of scrap.

Q. That is not in this book, I understand?—A. No.

Mr. PICKUP: May I dispense with this—so far as I am concerned is there something else you wish from this book?

Mr. DE ROCHE: No, we just wanted to bring them in because they were asked for.

(*Witness produces another book*)

Mr. PICKUP: Q. Is there any way of identifying "scrap" with what you call "cathode", for comparison purposes at all—or is scrap just generally scrap and nothing else?—A. Pardon me we have four divisions of scrap and I do not know how—we do not identify it with cathode. Cathode is copper by itself. Scrap is an alloy, my lord, as a rule unless it is copper scrap.

Q. What I am trying to get at—you said to his lordship a little while ago that the explanation for the inventory which we looked at regarding cathode, going down, might be caused by having a large stock of scrap on hand at that time which could be used for the same purpose or for a similar purpose?—A. Yes.

Q. Now it is the kind of scrap which you are using in the place of your cathode that I want to get at.

His LORDSHIP: That would be copper scrap?—A. Not necessarily.

Q. Your cathodes are copper cathodes?—A. Yes, my lord. However there is copper—

Q. It is a mixture—you might have enough of the other metal in some other form of scrap, to add it to your cathodes in the casting shop?—A. That is right, my lord.

Q. It is a matter of weighing it up and determining the quantity of the various metals in the alloy?—A. Yes.

Mr. PICKUP: Does that mean you might use any kind of scrap in the place of your cathode—or one particular division of your scrap in place of cathode?—A. I am not prepared to answer that because that is of a technical nature.

Mr. De ROCHE: It is a little unfair to ask this witness that.

His LORDSHIP: There would be so much copper in a special kind of scrap and there would be some other metal in that scrap and if you want to have an alloy, you measure them up.

Mr. PICKUP: Then what is the reason for divisions of scrap—or rather are there divisions of scrap—I thought there were?—A. It is in the nature of—or for purposes of—identifying the price of scrap.

His LORDSHIP: Well you said that you had four kinds of scrap?—A. Yes, my lord.

Q. What are they?—A. They are brass scrap, copper scrap, brass turnings and nickel silver scrap.

Mr. PICKUP: Then let us have the copper scrap—that would be the one I think.

Mr. De ROCHE: Which is your largest one—brass I would think, is it not?

Mr. PICKUP: But the brass is an alloy.

His LORDSHIP: You use an alloy scrap to go into the casting shop?—A. Yes.

Q. Along with the copper cathode?—A. I would say offhand that copper scrap is the largest item for the reason that we have considerable scrap coming back from the copper mills.

Q. But that is your own scrap?—A. Yes, my lord

Q From the trimmings and so on?—A Yes, my lord.

Mr. De ROCHE: You mean the company generates scrap?—A. Yes, that is a part of our scrap inventory.

His LORDSHIP: And you keep that in your scrap inventory too?—A. Yes.

Q. And that would be the 30 per cent?—A. Yes.

Q. Of your total?—A. Yes.

Mr. PICKUP: Now you opened this book—what do you call this book?—A. Scrap inventory record.

Q. And is it in pounds?—A. It is in pounds only, sir.

Q. And you opened it at a page which is February 1946—does it go right through to the end of 1947?—A. So far as I know, sir.

Q. Well supposing—A. Would you like to have January?

Q. Where do we get January?

(Witness indicates same)

Mr. Pickup: Where do we get the total figures, without going into the details, as to the poundage of sheets—the poundage of rods and the poundage of tubes—can I get anything which is a total figure?—A. The total column of the debits in the month of January is 8,800,000—I beg your pardon, 883,658 pounds—and it represents the scrap received from customers and scrap generated in our mills in the month of January.

Q. And where do we find what goes out?—A. On the credit side, we show the transfer of scrap into process in the casting shop.

Q. So that if I look—take these two figures—first the figure you gave us of 883,658—that is the total that came in in January?—A. That came into the scrap room.

Q. Yes, the total which found its way into this book?—A. That is right, sir.

Q. And the total going out in January is 870,474?—A. That is right, sir.

Q. So that is pretty much going out what came in—what came in pretty much goes out?—A. That is right.

Q. Then where do we find February?

Mr. De Roche: I think that assumption is perhaps not just correct.

Mr. Pickup: When I say "going out" I mean goes to process.

Mr. De Roche: I appreciate that but the day to day—to simply say "the same quantities came in that went out" the day to day flow could affect it very seriously. They might have had 800,000 pounds there all the time. I have not looked at the book. It is only the inference in your remark. You said "800,000 came in and 800,000 went out,"—well yes, that is what the book shows.

Mr. Pickup: Well the balance is shown at the end of the month and that is the difference between the two figures which I read, is it not?

The Witness: Not the difference—it is the difference added to the opening inventory.

Mr. Pickup: That is right.

Mr. De Roche: Q. And that balance figure will correspond with the figures we were dealing with in cathode?—A. That is right.

Mr. Pickup: Q. You start January 1946 with a balance of scrap carried forward of 880,398?—A. That is copper scrap.

Q. And you had at the end of the month a total of 146,582 pounds. Where do we come to February, on copper scrap here—you carry over the figure which you began with and it is much reduced during the month, so that at the end of the month you have only 20,025 pounds left of the copper scrap which you started with and which came in during the two months?—A. That is right.

Q. All the rest has gone into process?—A. Yes.

Q. Where do we come to March—(Witness indicates same)

Mr. PICKUP: Q. March seems to be small—you start with 20,000 odd pounds and you end with 28,000 pounds?—A. That is right, sir.

His LORDSHIP: Q. Are you able to say whether the likelihood is that your scrap is used up continuously—that is you have not any old scrap lying around?—A. Off-hand I would say so, my lord, that they do use the copper scrap just about as it comes in.

Q. As it comes in it goes into the casting shop?—A. That is right, my lord.

Mr. DE ROCHE: Q. In fairness, my lord, I might say that it goes into the casting shop,—does it go into the furnace or into the bins, Mr. Crawley?—A. I am not certain on that point, sir. Somebody else in the production could say that. I have never watched it, that I know of.

Mr. DE ROCHE: The only point that I wanted to make is that I do not think Mr. Crawley knows whether there is any old scrap in the bins or not.

His LORDSHIP: There would be scrap in those bins?

Mr. DE ROCHE: It goes in on top of the bin and goes from the top of the bin to the furnace. I do not know whether anybody knows whether the bottom of the bin is old or new.

Mr. PICKUP: Then I will carry this on to April.

In the month of April I note that all the scrap is gone?—A. You must understand, sir, this is a book figure. It is subject to error by the mill clerks.

Q. But the book figure shows that in April all scrap which you had started the year with—of copper scrap and all that you had got in during the first four months —is all gone?—A. That is right, sir.

Q. Now will you turn to January 1st, 1947—

His LORDSHIP: There was not any old scrap lying around at that time then.

Mr. DE ROCHE: Unless it was in the bin. This book just gives it into the casting shop.

The WITNESS: I am sorry—

Mr. DE ROCHE: Mr. Crawley suggests it is the furnace.

Mr. DE ROCHE: Q. Does this follow it to the furnace or to the casting shop?

His LORDSHIP: Q. To the casting shop—it is started on its way to the process? —A. That is so, my lord.

Q. It would be part of the metal that was gone in to "process", is that correct? —A. Yes, my lord. As a matter of fact the copper has been put in the furnace in the process of melting.

Mr. DE ROCHE: And that eliminates my suggestion, my lord.

His LORDSHIP: I understood—maybe I am wrong—I understand that when it goes into the casting shop it has started on its way towards processing?

Mr. DE ROCHE: That is true, my lord, but perhaps I should not give evidence. It may hang around in the casting shop.

His LORDSHIP: But it is copper in process.

Mr. DE ROCHE: Yes, my lord, but this witness says this book is the copper into the furnace and not into the bin—so it very definitely is in process when it leaves this book.

His LORDSHIP: When it leaves this book it is in process. If it is a few days in the bin, what difference does it make, it is in process now—it is part of the metal in process.

Mr. PICKUP: Then in 1947 I see you begin the year with a carry-over of copper scrap of 68,338 pounds?—A. That is right, sir.

Q. And it dropped, during the month, to 26,088 pounds—right?—A. Yes.

Q. Then at the end of the month you carry over 29,800 pounds?—A. That is right, sir.

Q. Let us see February, please.

(Witness indicates same)

Mr. PICKUP: Q. And in February all the scrap—metal copper scrap—which you had at the end of the year and had got in in January and down to the 20th—no, down to the end of February—had gone out?—A. Looking at the figures there—

Q. The red—does not the red figure mean there is no scrap there?—A. No, sir. It might. But the receipts of scrap in our records go into this account only when they are paid—not actually when they are received. However, we pay for scrap in the same month in which it is received. This purchase here of 107,000 pounds, added to—if you deduct this red book figure from that figure—we have the closing figure of 55,172 pounds. The purchase of 107,922 pounds probably was received prior to the end of the month.

Donald B. Crawley (Appellant)—Examination-in-Chief by Mr. De Roche (Cont.)
Cross-Examination by Mr. Pickup (Cont.)

Q. Look at the date—the last entry in the account—and it follows the date of February 28 and it is "28(a)" for some reason—and on February 28 your account shows that you have no copper in it—does it not—before this last entry?—A. That is right.

Q. There is the account on the 28th of February showing no copper in it. Then an entry is made under date February 28 (a) showing the purchase of 107,922 pounds of copper. Now what do you say that that entry means?—A. My explanation is this—that that entry is made after the end of the month, based on the fact that it is paid for or the liability is set out in the month of February because the metal was received in February—but in order to be certain that we have the right pounds, we do not enter the pounds until we have the voucher all prepared—the voucher payment.

His LORDSHIP: Q. That item will go into your inventory probably in March?—A. No sir, no, my lord. Those pounds are actually received in February.

Q. Yes?—A. And we pay for it—at least we set up our liability in February. The fact that it is not entered on the day it is received is the question in point, my lord.

Mr. DE ROCHE: May I try to clear that up?

Mr. PICKUP: Certainly.

Mr. DE ROCHE: Q. Mr. Crawley, if I understand you, the red entry in the book does not necessarily mean that previously you have "minus" 77,000 pounds in the plant?—A. That is right.

Q. And that zero entry in the book does not mean that there was no scrap in the plant at that time?—A. That is right.

Mr. PICKUP: Q. But the red entry in the book, in the account we are looking at, does mean that the copper scrap that you had shown as coming in according to this book, had gone to the processing room, does it not?—A. So far as the credits are concerned, yes.

Q. Well as far as the facts are concerned as well as you can tell us?

Mr. DE ROCHE: I think Mr. Pickup, if I might ask Mr. Crawley.

Q. There may be a variation, as I understand your evidence, of a few days either way between the physical facts and the book facts—is that right?—A. That is right, sir.

Q. But in broad outline—and for the average period—the book facts would pretty well correspond with the physical facts?—A. That is right, sir.

Mr. DE ROCHE: And that is it.

Mr. PICKUP: Q. It is only the difference of a few days here or there?—A. I would not say that. Just what do you mean by "a few days"?

His LORDSHIP: Will you be long with this witness?

Mr. PICKUP: I just want to go through the rest of this year, 1947. It will not take me very long but I could not do it in just a short time.

His LORDSHIP: It is one o'clock and we will adjourn until 2.30.

(At 1.00 p.m., the court adjourned, to be resumed at 2.30)

AFTERNOON SESSION

His LORDSHIP: All right, Mr. De Roche.

DONALD B. CRAWLEY, Recalled:

Mr. DE ROCHE: Q. Mr. Crawley, before we go back into the books again, there was something I failed to get on the record this morning. You described to us the process by which you revalued the closing inventory on the f.i.f.o. basis and I neglected to ask you, did you also revalue the opening inventory?—A. Yes, I used the same ending—f.i.f.o. inventory figures—which we had used for tax purposes in the previous year. I did not recalculate it at that time.

Q. You had available to you the particulars for the opening figure?—A. That is right.

Mr. DE ROCHE: The only point I wanted to make, you had not corrected both the opening and closing entry?

The WITNESS: That is right.

His LORDSHIP: We have it in evidence, have we not somewhere, that prior to 1946 the company always filed its returns on the—its income tax returns—on the f.i.f.o. basis?

Mr. DE ROCHE: Yes, we have, my lord.

Mr. PICKUP: No, that is not quite right if I may say so, my lord. There was a difference in there. They had filed on the f.i.f.o. basis down until 1936 and then from 1936 on down to 1945—am I right?

Mr. DE ROCHE: In 1945 and my lord, I would like to clear this up.

Mr. PICKUP: There was a period prior to 1946 when you filed on the basis of your book and then adjusted those figures to f.i.f.o.

His LORDSHIP: Yes, I presume you could put it that way.

Mr. PICKUP: Your lordship probably put it more correctly—you took the closing—they took the book figure and then adjusted it to the f.i.f.o. figure.

His LORDSHIP: They made the necessary adjustment. Well they kept their books from 1936 on, on the l.i.f.o. basis, though when it came to filing their income tax returns they had to make certain adjustments which had the result—may I put it that way—of making the returns, returns on the f.i.f.o. basis.

Mr. PICKUP: That is right.

Mr. DE ROCHE: If I might add one thing to that, my lord. The company's annual report—that is the thing which Mr. Gordon put in—I forget the number.

His LORDSHIP: Exhibit 9.

Mr. DE ROCHE: Q. Those reports showed the company's income attached to the income tax return, on the l.i.f.o. basis?—A. That is right.

Q. And in the returns themselves you made the correct adjustment to bring the result to f.i.f.o. basis?

His LORDSHIP: Q. Yes, that is right.—A. That is so, my lord.

Mr. PICKUP: Q. Then may I go on with the book, and I do not think I will be very long, my lord.

His LORDSHIP: What were you on?

Mr. PICKUP: The copper scrap of February 1947 and I think we had finished February—and perhaps you will now turn to March, please.

Q. Then in the month of March the books show the opening figure of 55,572 pounds of scrap and then very early in the month it drops right down to 6,782—almost out—right?—A. That is right.

Q. And then about the 13th of the month it is all gone?—A. That is the way it shows, sir.

Q. Yes, and by the end of the month you have a similar increase to what we had in February under date of 31 (*a*) an entry of a purchase of 125,413 pounds, which has the effect of changing the red ink figure to a carry-over figure of pounds, is that right?—A. That is right, sir.

Q. Then let us see April—no, before I go to that—we have dealt now with March but you will recall that in your earlier evidence, when we were dealing with cathode, his lordship called to your attention, that in the month of March the inventory was practically all gone—do you remember that?—A. Yes, I remember—that is in March 1946.

Q. Oh, it was not 1947?—A. No.

Q. I see. Then I wonder if we might look back to March 1946?—A. We would have to take all the scrap—take the other three scrap accounts.

His LORDSHIP: There were other alloys that could go into the furnace at the same time as the copper cathode.

Mr. PICKUP: Q. Maybe we had better look at this in March?—A. That is here (indicating).

Q. Now then—A. That is brass scrap.

Q. And we have already looked at copper scrap?—A. Yes.

His LORDSHIP: Q. You have them all together?—A. Yes, the brass scrap, the copper scrap and the nickel-silver scrap.

Mr. PICKUP: Q. The three sheets?—A. The four sheets.

Q. Then may we have the figures to see what they show.

The scrap brass, on the 1st of March 1946, opens with?—A. 1,229,845.

Q. 1,229,845 pounds?—A. That is right, sir.

Q. And it drops down to 399,208 pounds, is that right?—A. That is right, sir.

Q. That is about the 22nd or the 21st of the month—I may not be correctly carrying along the line but that is within a day of it—and then it goes back to 1,024,537 at the end of the month?—A. That is right.

Q. The brass turnings account opens with 270,293 pounds—and it is shown in red figures at the middle of the month—so that is gone?—A. The reason of that is the transfer from the brass scrap account into turnings—I beg your pardon—not that month—that is a transfer—there is a purchase of turnings of 415,000 pounds, which actually we received prior to the date shown on the record.

Q. Well but when you say, "prior to the date shown on the record"—how long prior—would that not be just a matter of two or three days?—A. I have not that knowledge. It might be ten days or it might be one day.

Q. Anyway that entry is on the 25th of March, is that right?—A. That is right, sir.

Q. And the account would go into debit when?—A. The 15th of March on that book.

Q. In the debit on the 15th of March to the extent of 112,279 pounds—that is a debit on the 15th of the month?—A. You mean you want to know the first day of it—the correct balance so far as the inventory?

Q. Yes.—A. It would be along about the 10th or the 11th of the month, yes.

Q. Then at the end of March in the brass turnings account you carry forward 224,174 pounds?—A. That is correct.

Q. What is the turnings account at that time?—A. We have already dealt with that. The nickel-silver scrap is the next one.

Q. Is that something which is used for copper?—A. There is the copper content in the nickel-silver scrap.

Q. And where do we find that?—A. There it is there (indicating).

Q. 131,856 to open that—and it drops down on the 22nd of the month to 6,819, am I right?—A. That is what the record shows, sir.

Q. And at the end of the month 112,553?—A. That is right, sir.

Q. That is all complete?—A. Yes.

Q. Then let us go back—

Mr. De Roche: May I ask some questions, Mr. Pickup?

Mr. Pickup: Do, please.

Mr. De Roche: Q. Mr. Crawley, these various scraps which you have described, have copper content?—A. Yes.

Q. And do you know what the various copper contents are?—A. I would not know, no sir.

Mr. Pickup: Q. Then we have dealt, I think, with March. Then if you will look at April—this is 1947—we find the copper scrap containing copper shows 70,522 pounds on hand and the middle of the month, about the 17th I think it is?—A. Yes.

Q. The 17th or 18th, it is down to 6,000 pounds, 6,403 pounds?—A. That is what it shows, the scrap.

Q. And it is in the red then until a purchase comes in on the 29th of the month which has the result of showing, according to this book, on hand at the end of this month, 37,975 pounds?—A. That is right, sir.

Q. Then May—well I see in May that the account runs into the red again on the 16th of the month and continues in the red until the closing entry under date of 31 (*a*) where there is a large purchase recorded of 93 thousand odd pounds, with the result that the closing inventory recorded is 113,748 pounds—that is right?—A. That is right, sir.

Q. June shows that 113,748 pounds goes down to a low of 42,775 and ends with 327,654 pounds?—A. The reason for that—

Q. Yes.—A. At that point we took a physical inventory and we have made a further additional adjustment to the inventory account because this is the book record prior to that time. The additional adjustment is approximately 70,000 pounds.

Q. Added to the inventory?—A. Added to the inventory—added to the book record.

Q. To make the book agree with the physical inventory at that time?—A. That is right.

Q. Then July?—A. There it is (indicating).

Q. You carry forward then the correct figure of 327,654, do you?—A. That is right.

Q. And the book shows that down from that 327,654 figure to 13,710 on the 18th of July—and in the red on the 25th?—A. That is right, sir—that is what the record shows, sir.

Q. And the purchases—a similar entry under 31 (*a*) puts it back with a balance of copper scrap in the account, 51,483 pounds?—A. That is right, sir.

Q. August—I see in August it goes down to 12,062 pounds on the 21st of the month and out altogether on the 22nd of the month—and a purchase on or about the 28th brings it back to showing 10,729 on hand—and a similar entry under date of 31 (*a*) to what we have seen before, shows a purchase bringing the account again back to 110,542 pounds?—A. That is right.

Q. September—copper scrap—well the situation is practically the same in September—it goes back into the red and shows a balance at the end of the month of what—145,014 pounds?—A. Yes.

Q. The low in the month before it went into the red was 28,473 pounds, right? —A. That is right.

Q. October—and October does not seem to go into any red figures—but opens with 145,014 pounds and drops to a low point of 42,984 and closes with a figure of 60,034?—A. That is right, sir.

Q. November—and here again it drops into the red—it starts with the figure of 60,034 which is carried over—drops down to 22,027 on the 7th of the month and we find a red figure shown on the 21st of the month—and on the 29th of the month a purchase brings it to a figure of 18,539 pounds and the closing entry increases it to 77,794?—A. That is right, sir.

Q. Now we have just one more month—that is December—where we start with copper scrap amounting to 77,794—the account goes into the red on the 5th of the month—continues there until the 24th of the month when a purchase shows in the account a balance of 22,056 and the figures at the end of the year are 95,262 pounds—right?—A. That is right, sir.

Mr. PICKUP: I think that is all I want from this book.

Mr. De Roche: Q. Mr. Crawley, the two books we have discussed to date represent your book records of that part of the inventory which I believe one of the other witnesses described as possibly one-third—that is the part before it gets into process?—A. That is right.

Q. I do not know whether it is one-third or not but one witness described that class as one-third, two-thirds?—A. Actually I do not remember.

Q. You do not remember that evidence?—A. I do not remember that evidence. However could I describe what it consists of?

Q. The two books, as I understood it, are the part of the inventory before it has gone into process?—A. That is right, sir.

Q. Then Mr. Crawley—

His Lordship: Then there was another book—

Mr. De Roche: There were two books—both of these books deal with that.

His Lordship: But then there was another account—where the inventory was represented in dollar value?

Mr. De Roche: Yes, my lord, I have that here but, if I may, to keep the story logical, put this thing in first.

His Lordship: What is that?

Mr. De Roche: This is the two-thirds—this is the poundage record of the inventory which is in process.

His Lordship: I see.

Mr. Pickup: I understood we could not trace this after it once got into process—and I did not see the purpose of going beyond the point where it could be identified—unless my learned friend wants something.

Mr. De Roche: No, I merely wanted to complete the story. There was an implication that we did not keep a record—I just want to produce the book to show that we have a record.

Mr. Pickup: I understood the record does not help us at all, to identify scrap at all, from the moment it goes into process.

His Lordship: The evidence was that the copper—the metal—could be identified up to the time it went into process and that thereafter it could not be identified.

Mr. De Roche: That is quite right.

Q. And Mr. Crawley, this is the book?—A. There is no inventory book—there is no inventory.

Q. Then I believe we have what you call your "general ledger".

His Lordship: Then there was another book called something.

Mr. De Roche: I think it was referred to there as the "metal control account", my lord, which is in the general ledger.

His Lordship: It was spoken of differently by the other witnesses.

Mr. Pickup: Yes, my lord.

Mr. De Roche: I think, Mr. Pickup, this is the account that you asked for in your notice to produce.

Mr. Pickup: I want that later but that is not the account that his lordship is referring to—and I do not know that it will really help us but there certainly was another account.

His Lordship: It was referred to as the "Perpetual inventory record." That was put in in pounds and then the receipts were entered in dollar values in what were called "Purchase records".

Mr. De Roche: Q. And that I think, my lord, is in the general ledger—is that right?

His Lordship: Oh, that might be so.

Mr. De Roche: May I ask the witness?—Q. I understand there is a sheet in the general ledger called "Copper control account" or "Metal control account"?—A. Copper control account.

Q. And does it enter the purchases and the prices—both pounds and price?—A. Pounds and amount.

Q. That is what I mean—the total amount of the purchase?—A. That is right, sir.

Mr. De Roche: I think that is it.

His Lordship: Q. And is that what Mr. McGinn referred to as an entry in the purchase record?—A. I would assume that is the record he was referring to.

Mr. Pickup: I think, my lord, it is the record which will give me what I want and the witness has control of it and has gone over it and I think he can very quickly check the figures that I want to check.

His Lordship: Q. And they would be found in the general ledger, you say?—A. Yes, they would, my lord.

Mr. Pickup: Q. Now then probably you can verify this from the memorandum which I showed to you and I will just go over it with you.

First I want to get from you the copper purchases during the last three months of 1946 and the laid-down cost of them. Now then they are—and you might confirm this:

October 913,560 pounds—cost $109,029.86.

Q. Now you want to say something?—A. Now, so far as the general ledger is concerned, I would need to add several figures together in order to arrive at these figures. They are not entered separately in that manner.

Q. I do not think we need to do that. The figures are correct, are they not—when you do add some figures which you have in your general ledger, you get that result of copper—so many pounds purchased at such and such a cost?—A. Yes.

Q. And the November figure is 5,726,548 pounds and the cost $678,494.03—right?—A. Right.

Q. And the December figure is 5,969,811 pounds and the cost $705,378.21. And then when we total those figures we find that the company purchased, during the three months, a total of 12,609,919 pounds at a total cost of $1,492,902.10. Right?—A. There is a slight variation there. Included in those cost figures which you are showing are several—what we call "extraneous items" which are not the actual price of copper in those months.

His Lordship: In the price which you paid to the refinery or the supplier?—A. It is not—the price of copper in 1946 was 11½c a pound and if you multiply those pounds by that figure you will not arrive at this cost figure which Mr. Pickup is quoting, my lord.

Mr. Pickup: Q. But they are the cost figures appearing in the book?—A. They are the cost figures appearing in the book.

Q. And you might explain to the court the difference—you explained it to me a little while ago and it should be on the record?—A. The difference is this, that, during 1946, we were exporting metals. The refinery required us to bill our export customers at a higher figure than the domestic selling price in Canada and we merely collected this amount from our customers and we paid it back to the refinery,—in the same month in which this difference was made.

Q. And does that mean this, that we would eliminate this—what do you call it—A. Export premium.

Q. You would eliminate this export premium—if you take the poundage which you have just given us and multiply it by 11½c?—A. No sir, there is another qualification in addition to those costs. There are the shapes—premiums charged by the mine for different types of copper.

Q. Over and above the 11½c?—A. Over and above the 11½c a pound, my lord.

Mr. Pickup: Q. And would that additional amount be included in the figures which are given here of cost?—A. Yes.

Q. I see. Well the record then in the book as to cost—with the qualifications you have given us—would be the figure on the cost of $1,492,902.10?—A. That is right, sir.

Q. And you showed your closing inventory on the same date, for income tax purposes, as being $1,439,867.78?—A. On the l.i.f.o. basis, yes.

Q. Then on zinc and does this question of foreign export premium and the other premium, enter with zinc too?—A. Just the export premium arises in this connection.

Q. Then the figures on zinc for the same three months are:

October, 69,660 pounds—with a laid down cost of $4,015.62;

November, 1,449,529 pounds—laid down cost of $84,047.40;

December, 1,937,181 pounds—with a laid down cost of $112,653.96;

The total figure for the three months being 3,456,370 pounds—with a laid down cost of $200,716.98.

Now am I right in this case, in saying that we would eliminate the export premium if we multiplied the pounds by the controlled price of zinc at that time? —A. That is right.

Q. Then your closing inventory at the end of the year 1946 for zinc showed 4,331,320 pounds with a value of $212,901.82—is that right?—A. I am sorry, I did not catch the figure. It is in the schedule—I would like to see the exhibit—Exhibit 7—that is right, sir.

Q. And in that case you increased—well the amount of the inventory at the close of the year is of course more than the purchases during the three months?—A. The value we assigned to the inventory is greater than the figure you show for purchases in those three months, yes.

Q. And the poundage also?—A. The poundage also.

Q. And again the figures which I show you are the figures taken from your books?—A. That is right, sir.

Q. Then turning to 1947—do we still have the export premium to consider? —A. Yes, we did, sir.

Q. Then I want those figures.

The copper purchases for the last three months are:

October, 5,006,815 pounds—at a laid down cost of $1,102,948.13;

November, 5,136,768 pounds—with a laid down cost of $1,136,874.02;

December, 4,602,396 pounds—with a laid down cost of $1,008,176.28;

And the totals for the three months are 14,745,979 pounds and $3,247,998.43 as the laid down cost.

Then the closing inventory is very close, I see, to the total purchases during the last three months of 1947—the actual figure being 14,291,007—right?—A. That is right, sir.

Q. Yet in making your return on the l.i.f.o. basis you showed the value of that inventory as being $1,355,836.93—am I right?—A. That is right, sir.

Q. Although the purchase of approximately the same quantity of copper during the last three months of 1947 was $3,247,998.43?—A. That is right, sir.

Q. Then zinc in 1947—to complete the record:

October purchases were 294,442 pounds—at a laid down cost of $32,566.78;

November, 820,871 pounds—at a laid down cost of $90,295.78;

December, 949,552 pounds—at a laid down cost of $102,970.38.

The total for the three months being 2,064,865 pounds purchased during the three months—at a laid down total cost of $225,832.94;

And your closing inventory for tax purposes, on the l.i.f.o. basis at the 31st of December showed 3,720,321 pounds on hand—and that is approximately 1,700,000 pounds more than you purchased during the last three months?—That is right, sir.

Q. And you show a value of that larger quantity at a much less amount than was paid for the similar quantity in the last three months of the year?—A. That is right.

Q. The figure being $177,768.37?—A. Right.

His Lordship: If you have some of those figures perhaps you could give them to the reporter.

Mr. Pickup: I will do that. They are all right here—all the figures which I have read out.

Mr. De Roche: Q. Just to avoid confusion—you answered one of Mr. Pickup's questions with regard to the zinc situation in 1946, when he said "This was what was in the book" as if the inventory figures shown were not the correct figures.

The inventory figures shown in the inventory are the correct figures from the book, are they?—A. That is right, sir.

Q. And the figures for the purchases of the last three months, as given by Mr. Pickup, are the correct figures?—A. Are the correct figures.

Mr. Pickup: That is what I meant.

Mr. De Roche: I understood it, but it did not sound that way.

And that is all, Mr. Crawley, unless Mr. Pickup has some further questions.

Mr. Pickup: There were a couple of questions of another nature that I wished to ask this witness.

His Lordship: Are these the returns (indicating)?

Mr. Pickup: Yes, it was the assessment. I do not think it was put in but the witness referred to it.

Mr. Pattillo: It is part of the record.

His Lordship: It is filed by the Appellant pursuant to one of the sections of the Act.

Mr. PICKUP: Q. But maybe the witness can answer what I want without referring to it. You will recall, witness, that you spoke of some interview with some officer of the Tax Department?—A. Yes.

Q. And I think you said that at one stage he asked you to give him an inventory figure on the f.i.f.o. basis—and later I understood you to say that he simply asked you to give him the difference between l.i.f.o. and f.i.f.o.?—A. I think I was not—I do not quite recall what he did say.

Q. Quite, but then you took the figure or were shown the figure on the assessment notice—which was $1,611,756.43 and you spoke of that as being the figure of difference which you gave to the officer of the Department.

I am wondering if you are really right on that. I would like you to reconsider it a bit—whether you gave the Department or the officer of the Department that figure or some figure like it?—A. I am not positive whether I gave him the opening or the closing inventory on the f.i.f.o. basis—and let him determine the difference —or whether I just gave him the difference only.

Q. I was taking your evidence as suggesting that the Department had taken from you the figure of the difference and simply added that—and I am suggesting to you that that is not what the Department did—I take it from your evidence that you are not pretending to say what they did—is that right?—A. That is right, sir.

Q. And if what the Department did was to take the actual quantities of copper on hand and value it and reach this difference—you would not question that at all as being such a price?—A. I did not follow you on that question, sir. I think I stated in my evidence that I calculated the inventory on the f.i.f.o. basis and whether he got that—

His LORDSHIP: Q. Whether you gave him that calculation or whether you gave him only the difference between the two, you are not sure?—A. I am not sure, my lord.

Mr. PICKUP: Q. And whether—no matter which you gave him—whether he took the figure you gave him or reached the figure shown which was something like that, you are not sure?—A. No, I am not sure. The books were available to him.

Mr. DE ROCHE: Yes, and that is all, thank you.

His LORDSHIP: Any re-examination?

Mr. DE ROCHE: No, my lord.

GEORGE RICHARDSON, Sworn:
Examined by Mr. De Roche:

Q. Mr. Richardson, I believe you are a member and a partner of the firm of Clarkson, Gordon and Company?—A. Yes.

Q. How long have you been a practising accountant?—A. I entered the practice as a student in 1921 and I have been in practice ever since.

Q. And when did you join Clarkson and Company?—A. In 1927.

Q. And became a partner when?—A. In 1939.

Q. I understand, Mr. Richardson, that you have had a wide range of accounting and audit investigations since, with that firm?—A. Yes.

Q. And you have served—or you have served I believe on various committees regarding accounting practices?—A. That is right.

Q. And have you made several particular studies of inventory matters and the approach to inventory problems?—A. Yes.

Mr. DE ROCHE: My lord, as Mr. Pattillo mentioned in opening, we are calling Mr. Richardson primarily in the hope that he can be of assistance to your lordship in giving you a general accounting background of the various inventory methods—how they operate and such things—rather than as to what one might call the ordinary experts to back up our case.

We ask Mr. Richardson to address himself to that aspect of the matter and I am sure your lordship will appreciate it has not been so easy to condense the whole of accounting practices into a reasonably small compass and without going into too great detail, we have felt it would be best if we would let Mr. Richardson proceed, without question, with the hope that at any point—and whenever your lordship has the slightest doubt as to a complete understanding of what he is saying, that your lordship will interrupt and ask him to explain in full.

I say that to your lordship now because it is departing a little from the ordinary method.

Mr. PICKUP: And might I just add to that—in view of what my learned friend has said—might the witness not go too fast?

His LORDSHIP: Yes.

Mr. DE ROCHE: Q. Well Mr. Richardson, will you explain to us the accounting method and with particular reference to inventory valuation?—A. These remarks, your lordship, are directed to an outline of the determination of business income, with particular reference to inventory and cost of sales.

I would like to start by making a few remarks regarding the determination of what we refer to as "periodic income". The reason for that is that a great many of the accounting problems which have to be faced in present day practice arise from the fact that it is not sufficient that income be determined only once over the life—the whole life of the enterprise.

If that were the case, income determination would be relatively simple, since most problems arise in the determination of income for the fiscal year—or for some shorter period. But the determination of "periodic income" is however necessary for many business purposes.

This involves: First—a determination of gross income for the period; and secondly—an allocation of all costs and expenses as between those applicable to such income and those applicable to future periods.

It is these determinations—and particularly the allocation of costs, which give rise to most accounting difficulties. The result of these determinations are reflected in a statement which is known in accounting terminology as "a statement of profit or loss" or more briefly "an income statement."

In modern double entry accounting, this statement is prepared by bringing together all of the items in the account which represent gross income on the one hand—that is sales or other revenues—and all applicable costs and expenses on the other hand.

The statement thus arrives at a balance of net profit or loss for the period by a process of analysis of all transactions in the account.

Now proceeding from there I would like to make a few remarks about "the allocation of production and related costs between current and future periods in the preparation of an income statement."

I am instructed that there is no need, in this case, to discuss the determination of "gross income" since there is no dispute on this point; that the figures used by the company for "gross income" represent the sales of the period following the usual accounting practice of recognizing income when sales are made.

A consideration of the allocation of costs and expenses can also be restricted to those costs and expenses which relate to the production or acquisition of products for sale to customers.

The question is as to what portion of the expenditure for the purchases of raw material, for labour and for manufacturing supplies, and expenses, is properly chargeable against the gross revenues from sales during the year; and what portion is properly to be carried forward as a charge against future periods.

The first mentioned item—that is the portion of the expenses which is properly chargeable against the income for the period, is usually referred to in accounting terminology as the "cost of sales for the year."

The latter, that is the cost applicable to future periods, is referred to as the "closing inventory."

These allocations, of course, must not be made arbitrarily but by reference to the actual quantity of goods sold during the year and the quantity on hand at the end of the year.

When I referred to the "amount of cost applicable to future periods being the closing inventory" I mean, of course, that that is the dollar valuation of the quantity actually on hand.

In the statement of "Profit and Loss" of a manufacturing business there is, first, gathered together all production costs for raw materials, labour and manufacturing expenses which have not previously been charged against the income of prior periods. Now these will consist of two general classifications:

First—the amount of such costs incurred in prior periods and brought forward into the current period, as the valuation of the opening inventory; and secondly—the expenditures in the current periods for raw materials purchased—or for purchases of finished products—or labour expended in the plant—and for various manufacturing expenses. That is—those expenses such as power, fuel, factory supplies, workmen's compensation—and other items which are directly related to the production of the plant.

Now it is the total of those two groups of items—the opening inventory and expenditures during the period connected with the manufacture or acquisition of products—which must be allocated as between costs chargeable against the year's income—and costs chargeable to future periods.

Consequently it will be evident that, if the portion allocated as being "cost of sales" is increased—and the dollar valuation of the closing inventory is correspondingly reduced, then the income of the current period will be reduced—and the income of some future periods increased—and the reverse is true.

This allocation, therefore, directly affects the determination of income for the current year. The determination of income for the year is, of course, also affected by a similar allocation which was made at the end of the preceding year, when all of the accumulated costs up to that point were allocated as between what is chargeable to the income of the preceding year—and what should be carried forward—but obviously the determination which was made the previous year has an opposite effect on the income of this year.

Having arrived at an allocation of those accumulated costs, the amount to be carried forward as a charge against future periods—that is, the dollar valuation of the closing inventory—is eliminated from the costs—being treated as an asset in the balance sheet—while the cost of sales becomes one of—if not the major element in the costs and expenses in the year's income statement.

The question of the methods to be followed in allocating costs between the current and future periods can obviously be approached in one of two ways:

Either, how much of the cost should be charged against the gross income of the current year; or, conversely, how much should be carried forward to succeeding periods as the dollar valuation of the closing inventory.

It will be obvious that the two amounts are interdependent—and what we are talking about is merely the allocation into two parts of a certain total.

While I will refer frequently in my later remarks to the second of these approaches—that is how much should be carried forward to succeeding periods as the dollar valuation of the closing inventory—I wish to emphasize two points.

First, the determination does not involve a determination of inventory in the sense of arriving at "value"; that is, I would put "value" in quotation marks there, to emphasize my meaning;

Secondly, the significance of the inventory value when determined is primarily of importance as a complement to determining the cost of sales.

That is another way of saying that the emphasis is on the income account.

I would like to proceed to describe "inventory methods" in general. There is no uniformity—

His Lordship: Q. Inventory valuation?—A. Inventory valuation methods, my lord.

There is no uniformity of inventory valuation method in general use. Some methods are suitable for some industries or for some particular segment of an industry.

His Lordship: Q. What do you mean by that?—A. Some methods are suitable for a particular industry or a segment of a particular industry—that is, you may, in a given industry or in a given business, employ several inventory methods—one for one segment and another for another segment of the industry—nor is there complete uniformity in practice between different industries.

Most inventory methods are founded on cost. That is, they represent either cost, determined by one of a number of methods—or the lower of cost or market. We need not be concerned here with other methods which are only occasionally found—such as the "valuation at market".

There is considerable diversity in the method of determining cost, however. I do not refer now to the problem of what elements should be included in "cost"—for example—as to whether the raw materials inventory should include, in addition to the invoice price, freight, customs duties, etc., which apply—about which there is no dispute here.

George Richardson (Appellant)—
Examination-in-Chief by Mr. De Roche (Cont.)

I refer to the question as to the assumptions to be made in what we call the "flow of cost factors". There are at least four inventory methods based on cost, which are in general use. The first of these is the method under which the cost of specific items is established by physical identification of the goods on hand. In other words, the items are identified as being part of a particular lot or shipment—or as being a particular item which is covered by a specific invoice—and the specific cost of those items is established by reference to the invoices—and to other charges which are applicable.

Mr. De Roche: Q. And that is what method?—A. I would call that the "method of specific identification". This method is useful in a limited number of cases—and in some cases might even be necessary.

It breaks down, however, both in practice and in logic in the case of goods of similar characteristics and similar utility. In practice it breaks down because physical identification is, in many cases, impossible.

Many illustrations will occur but a few will suffice. Take, for example, various lots of scrap steel purchased from numerous sources and piled in the yard of a steel mill. That pile may be 50 feet high and a couple of hundred feet or more across the base—and may include thousands of tons of scrap steel.

Another illustration would be coal acquired from various sources at different costs, in a single pile in the yard of a plant—or a coal jobber for that matter.

Another illustration would be work in process, in which the raw materials, even if they have been kept separately identified originally, lose their identity completely in the process of melting, milling or fabrication generally.

Another illustration would be in those industries in which melting is part of the process, where scrap is produced and where it circulates constantly in the process. This scrap is produced, it goes back and is re-melted, and it continues through a cycle of that kind, over and over again.

In other cases it would only be possible to maintain records of physical identity with a great deal of effort—either additional accounting effort or in marking every item in an inventory. For example, it might in some cases be practical to put a tag on an item and identify it as being of a particular lot or shipment—and either mark the cost on the tag or give it such identity as would enable the cost to be determined later by reference to the invoices—as could, in some cases, be done.

Or the identity could be maintained with considerable additional handling by keeping every lot or shipment in a distinct or separate pile—although, in every case again, that would not be possible. This, of course, would frequently involve a great increase in storage space and additional accounting records. Even in those businesses where physical identification is possible at the time of physical inventory taking, information may not be available at a subsequent date when the financial statements are being prepared from book records. I refer to the practice which is quite common in industry of verifying stock at some convenient date during the year—possibly when the plant is shut down for the summer holidays—and having established at that time the correctness of the book record, then all further determinations at the end of the company's fiscal year are made from the book record, which have been thus proved.

This method of specific identification also breaks down in logic. It turns on the question as to whether physical identification serves any useful purpose. If a manufacturer has on hand a large quantity of a specific type of raw material acquired from ten different sources in a hundred different lots, is there any importance in establishing how much, from each source—and how much of each lot—is on hand, if all the goods have identical characteristics and equal utility.

The question is, whether the mere establishing of the identity of the particular lots sold and the particular lots remaining on hand—and assigning to each the exact costs of those particular lots, arrived at by identification—would arrive at the most accurate determination of income, where the characteristics and utility are identical or similar for all practical purposes.

Accountants generally do not think so, as applied to this class of inventory and by "this class of inventory" I mean the classes which I am discussing where the characteristics and utilities are identical or so similar as for all practical purposes to be identical.

His Lordship: Q. Or what one witness calls "being homogeneous"—A. That is right, sir.

The use of specific identification can lead to either of two evils. The deliberate manipulation of the account; or a variation in profit caused by the pure accident of which items happen to be selected for delivery.

This condition will be particularly true in an industry where costs—and especially material prices—are subject to fairly wide fluctuation. This can be illustrated from the case of an inventory in which physical deterioration cannot occur and which is not subject to style changes or obsolescence.

The metal ingot would be a case in point. The cost of one ingot, which is 10 cents a pound—and the cost of a second ingot which was 15 cents a pound—due to an increase in price which had occurred recently. One ingot is sold. Should the valuation of the inventory depend upon whether the ingot delivered was the ingot costing 10 cents or whether it was the ingot of identical weight, shape and physical characteristics, which cost 15 cents?

George Richardson (Appellant)—
Examination-in-Chief by Mr. De Roche (Cont.)

If an answer is given in the affirmative the resulting profit will depend upon which ingot the management actually selected for delivery, having regard to results which they wish to reflect in the accounts—or alternatively by the pure accident of which ingot happened to be selected—possibly which one happened to be on top of the pile—and was therefore the one most readily accessible.

To sum up, the position of "physical identification" is, in respect of this class of homogeneous inventory:

First, that it is either an absolute or practical impossibility, to apply to the entire inventory in most cases;

Secondly, even if it were readily possible, it is usually not the desirable method.

While physical identification has largely been abandoned, except in cases where it is obviously applicable by the nature of the stock with which you are dealing, it is frequently suggested that there is a presumption that physical movement will occur in the order that the items first received into stock will be those first issued. This presumption is colored by the popular conception that, since goods deteriorate, any prudent businessman will inevitably move his older stock first. This assumption is frequently quite solid in the case of inventories which are subject to physical deterioration—such as fresh fruit—goods subject to style changes—and various other classes which will readily come to mind,—such as, as I say, in those industries in which physical deterioration and style changes occur. It is not necessarily true of many classes of inventory. In fact, in those industries in which physical deterioration and style changes do not obtain, it is usual that the governing factor connected with physical movement of items of identical character is—which goods can be moved out with the least effort.

Maybe I should explain that a little further—what I am intending to convey is this, that in certain types of inventory if you look for the reason which will motivate the people who are handling the stock physically—and try to find out what governs them—it will very often be—not which item—not which item happened to be received first or which item they supposed may have happened to be received first—but which item can most readily be moved and, therefore, incur the least expense in the plant.

The reason for this I think is obvious. In modern plants employing a great deal of automatic machinery, the handling of material represents a substantial part of the total cost of the products. In a large pile of ingots, billets, bars or similar classes of inventory, the item first received into stock will not be moved out first if it is at the bottom of an orderly pile. Nor would a papermill turn over a woodpile in order to obtain the logs at the bottom. Your lordship will have, no doubt, frequently seen the immense piles of logs in paper mill yards—usually in a single pile—and the logs flow into the top of the pile—and logs are taken off from the top or sides or wherever it may be most convenient.

This does not mean that on the average, in all businesses, inventories actually move in last-in-first-out order. It is merely to indicate that a presumption of usage in first-in-first-out order is often far from reality.

If inventories are not physically identified and priced at the specific cost of those items, it is obvious that some assumption must be made as to which goods—or the cost of goods—accumulated in an inventory account, are to flow out as sales are made; and consequently, as to the dollar valuation to be assigned to the items remaining on hand in each inventory.

There are three methods in general use—

HIS LORDSHIP: Would this be a convenient place to take a recess?

The WITNESS: Very convenient, my lord.

HIS LORDSHIP: Then we will recess for ten minutes.

(A short recess was here taken)

HIS LORDSHIP: Q.—All right, Mr. Richardson. A.—Thank you, my lord.

I was about to say that there are three methods in general use which are based on assumptions as to the flow of cost; these three methods are:

First, first-in-first-out—frequently referred to as "f.i.f.o.", about which you have already heard something; second, average cost; and the third, last-in-first-out—frequently referred to as "l.i.f.o."

The first observation I would like to make is that none of these methods are based on any presumption as to the actual physical movement of goods. As I indicated in my opening remark in referring to these three methods, they are methods that are based on assumption as to the order in which costs should flow into cost of sales and for the establishing of the amount of cost to be assigned to the quantity on hand. I think that will become more evident as we go on to describe these various methods but it may suffice, if I just repeat myself. They are not based on presumption as to the physical movement—or what we sometimes call the "physical flow of goods through the inventory and out to customers," but rather are indicative of the flow of costs which are employed in the method.

I will describe each of these three principal methods which are based on assumptions as to the flow of costs and which, as I have indicated, are in addition to the fourth method which I mentioned first, the physical identification.

Dealing first with first-in-first-out—the name first-in-first out implies that the cost of items which have first been received into stock is the cost to be assigned to those items which are first removed from stock.

If you think of the inventory as a sort of reservoir with items coming in at one end and going out at the other, the first-in-first-out method visualizes that the cost of that item which is first in, will be the cost of the first item removed. As a consequence the cost of the goods on hand is deemed to be the cost of the corresponding quantity of items which have been most recently received into stock.

As I have already indicated—and again I wish to emphasize—this is an assumption as to the order in which costs should flow from the inventory account—not a presumption as to the order in which stock moves physically.

The origin of this term—first-in-first-out—is probably found in the common practice of keeping stock records covering the quantities and values of the inventory. In the case of a manufacturer, a stock register is usually kept for each division of the inventory. For example, one for raw materials—one for finished goods—possibly one for work in process—and/or possibly one covering the raw material content of the whole inventory.

Now each of these divisions of stock records, for example, the raw material records, will have a number of accounts—one for each class of raw material. That is such as we heard a little earlier in the examination of a previous witness where, in the case of this company, there is a record in quantity only covering cathodes—copper and various other classes of copper—while in practice you will find in the case of a manufacturing company, as a rule, raw material account, finished goods account, work in process account—and so on.

I think this will simplify the presentation if I refer to a stock record kept for a trading concern, which does no processing and where the stock record consequently consists only of goods purchased for resale—just a single classification of account. Each account then will show in detail the opening inventory of that item—that is the quantity of the opening inventory—the individual purchases received into stock and the items delivered to customers—that is the sales.

If the inventory is kept on the first-in-first-out basis the deduction to be made in dollars in what I would call the "valuation portion of the account"—we have quantities in the account of record I am speaking of, side by side with values—and in the valuation section of that account the deduction which is made for the items delivered out of stock to customers will be the cost of the earliest item received into stock which has not previously been deducted against a previous sale. What you have in the account is the opening quantity and the opening value. You have purchases in quantity. You have purchases in value. You have deductions for the cost of the sales moving out—and the quantity of those sales—and the cost computed on some basis. I think that the simplest method of illustrating an inventory account kept on a first-in-first-out basis is to give you a very short hypothetical illustration—and if I might put this in the record—

MR. DE ROCHE: Q.—Yes?—A.—This is a very simple case. We have an inventory at the beginning of the period—

MR. DE ROCHE: Mr. Richardson, just a moment, might we file this as an exhibit at this stage?

HIS LORDSHIP: If you wish to, yes.

MR. DE ROCHE: I would like to have it filed.

HIS LORDSHIP: That will be Exhibit 22.

EXHIBIT No. 22: Filed by Mr. De Roche	Statement prepared by the witness Richardson headed "hypothetical illustration of first in, first out inventory method."

MR. DE ROCHE: Q. Yes.—A. We have here a very simple illustration. There is the inventory at the beginning of the period consisting of 100 units at $5.00—$500 is the value.

During the particular period 50 units of that item were purchased at $5.50—at a cost of $275; an additional 50 units were purchased at a cost of $6.00 each—or a total of $300. Then there was withdrawn from stock during the period—that is sales delivered to customers—125 units and they are valued as follows:

100 units at $5.00—that is a quantity equal to the opening inventory at the inventory price—$500;

25 units at $5.50—which is the balance of the quantity sold at the price of the earliest purchases during that period—$137.50.

Consequently the stock on hand would be taken as 25 units at $5.50, which is the balance of the purchases you will see—and 50 units at $6.00—that is the entire amount of the second purchase.

Thus the cost assigned to goods sold is the cost of the earliest open item in the account—and the cost assigned to the goods on hand is the cost of the items most recently received.

That I think illustrates the actual mechanics of the account—and if that is clear, I will proceed to make a few observations as to the effect of that type of account under certain circumstances.

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In the first place where the rate of inventory turnover is very rapid—and that is the situation, my lord, in which the inventory quantity is relatively small in relation to the annual turnover—the cost of sales will reflect material prices of relatively recent date; and the results of this method may even approximate the results on the last-in-first-out method which we will come to describe later.

His LORDSHIP: Q. Where the turnover is rapid?—A. Where the turnover is rapid, my lord,—that will be obvious because if you take, say, a very extreme case where the inventory—

Q. You turn it over as you get it?—A. Taking the case, my lord, where the inventory is equal to only two weeks' requirements—that would be a very unusual case, then obviously the cost of sales will reflect material prices not more than two weeks old in a case of that kind.

On the other hand, in the case of an industry requiring relatively large inventories where the turnover is slow, the cost of sales for a particular month will be based on the cost of raw material received into stock many months previously.

Taking the case of an industry in which the rate of the inventory turnover is every six months—the cost of materials charged as part of the cost of sales, let us say during the first six months of the year—I think we can demonstrate it a little better if we take a six months' period—under those conditions the cost of sales for the first six months will represent the cost of raw materials received into stock during the last six months of the preceding year—there is again a hypothetical case where the inventory at the end of the year represented or was exactly equal to the sales during the first six months of the following year.

Where considerable time elapses between ordering the raw material and the receipt of the material into stock, such as happens for example if you are purchasing hides from South America—or if you are purchasing jute from India—and in every-case or in other cases where delivery is slow either by reason of the remoteness of the supply or the length of the processing—your cost of raw material which will be included in the cost of sales, will reflect prices prevailing at a still earlier date—possibly nine months prior to the date of sale.

Again taking the case which I have assumed here, where the rate of turnover is relatively slow—every six months—the cost of sales in respect of a particular month will not reflect the prices prevailing exactly six months ago if, in fact, three months elapsed between the date of placing the order for raw materials and the date when the raw material is actually received into stock.

Possibly I can refer or can amplify that by going very briefly through a cycle. Let us say, during January a manufacturer or a jute broker—or let us say a tanner orders hides from South America. Let us assume—which is a fair reflection of the facts—that the hides he ordered will take about three months to be delivered. Therefore they will be received into stock about April. Let us assume again that the rate of turnover in that industry is every six months. It is probably, in many tanning industries, not as rapid as that, but that might be a fair sort of average. Under the first-in, first-out method the hides which were ordered in January, received in April, will be charged against the sales six months later—that is in the month of October or nine months after the date on which the costs of the raw material for that particular lot were fixed.

The illustration which I have given here on the application of the first-in, first-out method, and which I put in as Exhibit 22—is based on a business where a stock record is maintained covering each class of inventory—and I feel that I should perhaps make it clear that many companies do not keep stock records in detail—but the first-in, first-out method nevertheless may have application—and I thought that it might be worth while to indicate to you the method which is followed in such a case.

Where no stock record is kept, the cost of an inventory on a first-in, first-out method is determined by taking the inventory quantity and pricing that quantity at the laid down cost of the most recent purchases of an equal quantity of goods, arrived at by referring to your purchase invoices—the process being, as I think one of the previous witnesses explained—starting at the end of the fiscal period and working backwards until you have accumulated a quantity of purchases which is equal to the quantity on hand.

Let me put it this way—the quantity on hand is 300,000 pounds. During the month of December the purchases amounted to 100,000 pounds. During the month of November the purchases amounted to 50,000 pounds—and during the last twenty days of October the purchases amounted to 150,000 pounds—that is, by going back to the 10th day of October we have found the quantity of purchases exactly equal to the closing inventory and by using the prices of those purchases we have arrived at a valuation on the first-in, first-out basis, without having a stock record similar to Exhibit 22.

The result achieved in that way is identical with the result when stock records are used but the mechanics of these valuations are slightly different.

Proceeding then to discuss the second class of item in which there is a presumption as to the flow of cost—I come to the method known as "average cost." Now "average cost" may mean either of two things—and I think that that should be spelled out:

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It may mean, first of all, what is, in effect, the average cost of the items in stock, determined from stock records such as we have described previously. In that case the method of recording the inventory—or of recording the opening inventory and the items received into stock is the same—that is, we start the period with a balance in quantity and in value from the preceding period. We add purchases in quantity and in value as they come into stock. The difference between "average cost" as a method and the first-in, first-out method is found in the method of making deductions from the inventory account for what we take out of stock.

Now under the "average cost" method what is done is to strike a new average price at either of two times—that is, there are two minor variations of the method. Under one method, which is the simplest to visualize, I think, we strike a new average price each time a purchase is received into stock.

Alternatively—

His Lordship: Q. For the year?—A. No, my lord.

Q. The average price of what inventory you have left?—A. That is right, and I think my illustration will clarify that for you. Supposing we have a thousand items on hand and they are carried in the inventory account at $2.00 each—that is $2,000.

A purchase of 2,000 items is received into stock at a little higher price—$2.30 each—so that the cost is $4,600 of the 2,000 items purchased.

The new average is then calculated by adding the $4,600 of purchases to the $2,000, which we have in our account, making $6,600—and dividing that by the 3,000 items which are then on hand and we, thus, arrive at a new average price of $2.20;

And, subsequently, as goods are withdrawn from stock, they will be taken out of the account at their new average price of $2.20. A minor variation—

His Lordship: Q. That would be the cost factor of that particular stock?—A. That is right, my lord.

Q. Yes.—A. A minor deviation in the method is that, sometimes instead of arriving at a new average cost immediately that a purchase is received—a new average is struck at the end of the month but for practical purposes it is the same.

The average cost arrived at under this method is simply a running figure which does not represent the average price obtaining during any particular period. In fact, unless the stock at some point is completely exhausted, the influence on the average cost of the price of the earliest item which was ever received into stock and which might be years ago, is never completely lost. It continues to exert a diminishing influence on the average price—and of course after a period of years the extent of that influence, is relatively small.

The second method of arriving at an average cost is to arrive at a weighted average of the costs, for a given period of time—say for one month, three months or six months. In that case the finished product might be priced by taking the cost of production during the last three months or six months of the fiscal year—that is by arriving at what the total number of dollars were which were spent during that period, as the cost, and dividing that by the number of units produced—so that, for example, you have a certain production which costs a million dollars and the production was 20,000 units—and your average cost of production was, therefore, $50 per unit.

This method might approximate the first-in, first-out result in those cases where the amount of stock on hand—and which you are valuing in that way—corresponds roughly to the quantities purchased or produced—as the case may be—in the period for which you struck your average. In other words, if I price the raw material inventory at the average cost of purchases for the three months—for a three months' period—and if the quantity actually on hand at the inventory date was equal—or approximately equal—to the purchases for that three months' period then obviously I would have a result which would closely approximate first-in, first-out—but if the period which I selected to use for the determination of the average was either longer or shorter, then it would not necessarily correspond to the first-in, first-out.

So we have here the term "average cost" used in two different senses—it is used principally in connection with the first of those two senses—and I would like to make that clear—that is where you have the average determined from a running book record. That is a method which is frequently applied in valuation.

Coming then to the last-in, first-out method: This method, as its name implies, is based on making deductions from the inventory account in respect of issues from stock at the cost of the items most recently received into stock, rather than the cost of the earliest items, as is done in the case of first-in, first-out method.

And again I should reiterate that there is no implication that the method is intended to reflect a physical flow of goods, any more than under the first-in, first-out method. It represents rather an assumption made as to the order in which costs should flow from the inventory account into the cost of sales in the process of determining income.

The effect of the last-in, first-out method is that the cost of sales for any period reflects substantially the prices at which purchases were made during that particular period. It must be understood, of course, that this does not imply that the total number of dollars spent in purchases are treated as being the cost of goods sold during that period, regardless of the relationship of the quantity of what we have bought in relation to the quantity of what has been sold—that is, the purchases are not charged in the dollar amount of such purchases, but rather the effect of the method is that the cost of sales reflects substantially the prices of those purchased.

I think that will be clear as we develop the application of the method.

If the quantity purchased corresponded exactly with the quantity of material used in the sales, then the cost of raw materials charged against sales would be exactly the cost of the actual purchases for the year. This, of course, rarely happens.

Now where the purchases for the year exceed the quantity of materials actually used in sales, then the cost of sales is calculated only in respect of the quantity actually used—and the excess of the quantity purchased over the quantity sold, becomes part of the closing inventory—that is, to that extent the opening inventory is increased by these increments to which I think your lordship has already been directed,—and that amount which is added to the inventory is valued at the average cost of all purchases during the year.

Correspondingly, when the purchases for the year are less than the quantity actually used in the sales, that fact is not neglected or ignored. The cost of sales for the year is represented by the sum of two items—first, the year's purchases, plus, the amount calculated in respect of the shortage of purchases below the quantity actually used in the year's sales—that shortage is treated as a withdrawal of the most recent increase in the inventory which then remains in the inventory account.

That I think may take some actual amplification.

The first case which I mentioned, I think, is self-evident. Your purchases equal exactly the quantity of materials used in sales. Under those conditions, the cost of sales for the year, for your material, is exactly the figure of your purchases.

The second case, where the purchases for the year exceed the quantity actually used in the sales for the year, that fact has to be recognized, and it is recognized under the method, by taking the amount by which the purchases exceed the quantities actually used or consumed and pricing it at the average cost of the purchases for the year and adding it to the inventory account—and deducting it from the cost of sales for the year.

The third case is where the purchases for the year are less than the actual quantity used, in which case the entire dollar amount of the purchases becomes part of the cost of sales for the year—and it has to be supplemented, due to the fact that we have used more material than we bought during the year—consequently, the amount or a quantity equal to that shortage of purchases as compared with consumption, must be priced—and under the last-in, first-out method it will be priced at the most recent addition to the inventory account in the preceding year.

I think again that that process of accounting will become a little more clear when I give you the hypothetical illustration of it.

Under this method, if the closing inventory quantity is identical with the opening inventory, in quantity, it will be priced at exactly the same price as the opening inventory. If the closing inventory is greater than, as I have indicated previously, a quantity equal to the opening inventory quantity will be priced at the same price as the opening inventory—and the increase in the inventory quantity during the year will be priced at the average cost of the year's purchases.

The inventory at the end of the year will, thus, consist of what might be likened to a number of strata. Assume, for illustration, a simple case in which the inventory movement over three years, was:

The first year, the inventory increased by 2 million pounds;

The second year, the inventory decreased by 500,000 pounds.

In the third year—which we will say is the current year—the inventory increased again by 1,000,000 pounds.

Now the top layer in the strata will represent the increase in inventory during the current year—that is, the 1,000,000 pounds which was added to the inventory in the most recent year, priced at the average cost of purchases during the year—which we will say is 10 cents a pound.

The second layer from the top will be the million and a half pounds, priced at the average cost of purchases in the first year, which we will say is 8 cents.

Now the million and a half pounds in that case represent the 2,000,000 pounds which was added to the inventory in the second preceding year, less the decrease of 500,000 pounds which came out in the following year. To that extent the amount added in the second year—or in the first of those years—has been reduced.

The method can, I think, be best explained by putting in a table showing a hypothetical movement in an inventory kept on the last-in, first-out basis for a period of three years and may I produce this, my lord, as an exhibit.

His Lordship: That will be Exhibit 23.

Exhibit No. 23: Filed by Mr. De Roche — Statement prepared by the witness Richardson, showing hypothetical illustration of an inventory priced on the last-in, first-out basis.

Mr. De Roche: Q. Then you might continue.—A. This is the title:

"Hypothetical illustration of an inventory priced on the last-in, first-out basis."

We start with the first year:

Purchases 5,000,000 pounds at an average price of 8 cents per pound;

Sales 3,000,000 pounds; that leaves inventory at the end of the first year of 2,000,000 pounds, valued at 8 cents per pound.

The second year, the purchases amounted to 3,000,000 pounds at an average price of 9 cents a pound;

The sales amounted to 3,500,000 pounds;

So there has been a decrease in the inventory during the second year of 500,000 pounds, because the sales exceeded the purchases by that quantity.

The inventory at the end of the second year is, therefore, 1,500,000 pounds—that is the amount of the inventory of the first year—2,000,000 pounds, less the 500,000 pounds decrease—coming down to 1,500,000 pounds;

And it would be priced at 8 cents per pound—the same price as at the end of the previous year because the quantity on hand is not greater than but less than the quantity on hand at the end of the first year.

Now the third year: The purchases are 3,000,000 pounds at an average price of 10 cents per pound;

The sales are 2,000,000 pounds; so that there is an increase in inventory during the third year of 1,000,000 pounds;

And when that is added to the inventory of 1,500,000 pounds at the end of the second year, we have an inventory at the end of the third year of 2,500,000 pounds; and that inventory will be priced, as to 1,500,000 pounds at 8 cents a pound. In other words, a quantity equal to the quantity on hand at the end of the preceding year is priced at the same price as the inventory was valued at at the end of the preceding year.

As to 1,000,000 pounds, it represents an increase in inventory during the third year and it will be priced at 10 cents per pound, which is the average cost of purchases during the third year.

So much for the inventory value.

I think your lordship will be interested in following the figures given below on the same exhibit which deal with what the cost of sales amount to, in respect to each of those three years, following the same method.

In the first year: The cost of sales will be the amount arrived at by multiplying 3,000,000 pounds—which is the quantity sold—at 8 cents per pound, which is the average price of the purchases during the year.

In the second year: The cost of sales will be an amount equal to 3,000,000 pounds times 9 cents per pound, which is the average price of the purchases in the second year—plus 500,000 pounds at 8 cents per pound, which is the amount assigned to the quantity withdrawn from the inventory of the preceding year at the price of that inventory.

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In other words, the total quantity sold was 3,500,000 pounds—and it is valued as to the 3,000,000 pounds at the price of the year's purchases—and as to the addition of 500,000 pounds at the amount in the opening inventory.

The sales amounted to 2,000,000 pounds;

And the cost of sales for the year will be the amount arrived at by multiplying 2,000,000 pounds by 10 cents—the price of 10 cents per pound—since 10 cents per pound is the average price of the year's purchases.

I hope that that illustrates or that that illustration will in a practical way indicate the application of last-in, first-out, in a simple set of circumstances such as I have outlined here.

I think it might be well at this point to proceed to contrast the resulting cost of sales and inventory values under the three methods; and for this purpose, I propose to, first, contrast the last-in, first-out method with the "average cost" method, when that average cost is arrived at by a running book record—which, as I have indicated, is the principal usage of average cost—of the running average cost.

When market prices fluctuate substantially the results to be shown by the first-in, first-out and the "average cost" methods may differ very considerably. The result of the method will, of course, depend upon the extent of the price fluctuation —and also on the size of the inventory.

As to the first of those two statements, it will of course be obvious—that is, the extent of the price fluctuation has a very obvious effect on the effect on the difference of the two methods.

As to the effect of the size of the inventory—or more correctly—the rate at which the inventory turns over, it will be obvious that if inventories turn over rapidly—that is where they are small in relation to sales—the influence of the current purchases will be considerably greater—and for that reason the "average cost" method will more nearly approximate first-in, first-out—than if the inventory is large in relation to the quantity purchased annually.

In the comparison which I propose to submit in a minute—that illustration given would be relevant in an inventory in which the rate of turnover is relatively slow. In the case which I have assumed, it is twice a year.

Then the illustration given deals with a situation where there was a sharp increase in inventory prices about half way through the year and for the sake of simplicity, I have assumed that the inventory at the beginning of the last half of the year was the same under either of the two methods. And if I may produce this as an exhibit.

His LORDSHIP: That will be Exhibit 24.

EXHIBIT No. 24: Filed by Mr. De Roche

Statement prepared by the witness Richardson showing hypothetical comparison of f.i.f.o. and "average cost" basis of valuing inventory during the last six months of a company's fiscal year.

Mr. DE ROCHE: Q. Yes?—A. This comparison involves a considerable amount of detail and I think requires some explanation.

You see that it is headed:

"Hypothetical comparison of f.i.f.o. and average cost basis of valuing inventory during the last six months of a company's fiscal year."

And there are a number of columns here.

His LORDSHIP: Q. This is on the assumption that the inventory turns over at any particular rate?—A. Twice a year, my lord. You will see that from the figures which I will explain here.

The first column is the quantity received during the month—and you will see that the first item in that column is the inventory at the end of the six months.

His LORDSHIP: Q. Yes?—A. 6,000,000 units—or pounds—or anything you like.

Then in the seventh month a million units are received and a million units in each succeeding month for the balance of the 12 months period; so that the quantity received during the last six months of the year, say 6,000,000 units exactly equals the opening inventory and conforms, as I have indicated, to a particular situation where the turnover is twice a year.

In the next column you have the quantity sold during the month—and there again there are 1,000,000 units sold in each of the last six months of the year—a total of 6,000,000 units—so that at the end of the 12 months you have 6,000,000 units on hand—that is, 6,000,000 opening inventories—adding 6,000,000 purchases—deducting 6,000,000 units sold—leaves 6,000,000 units at the end of the period.

Now the next five columns—I beg your pardon, my lord—in the next column is the "unit price" at which the purchases received during this period were made—and also the opening inventory valuation—that is, the items which you will see at 10 cents is the opening inventory value on the first-in, first-out method.

The next item of 15 cents is the cost of the 1,000,000 units purchased—or rather is the price at which the 1,000,000 units were purchased during the seventh month—and so on down. 18 cents is the price at which the units were purchased in the eighth month.

Then in the next four columns you have, the inventory account on the f.i.f.o. basis. And it starts out with an assumed valuation of $600,000, for the six million units which are on hand at the beginning of the period. That is, 6,000,000 units at 10 cents, comes to $600,000.

Following down that column you have the cost of the purchases in each succeeding month. The million units at 15 cents comes to $150,000; the million units in the eighth month at 18 cents, comes to $180,000; and so on.

In the next column you have the "cost of sales" on the f.i.f.o. basis—which, under the method of applying that must always be computed by reference to the earliest found item in stock.

His Lordship: Q. That is the 6,000,000?—A. That is right, my lord.

But since, in the illustration which we have here, the number of units sold during the six months' period, is exactly equal to the opening inventory, then under the first-in, first-out method, all of the deductions for cost of sales will be computed at 10 cents per unit—and the total of that column, as you will see, is $600,000—6,000,000 units at 10 cents;

The resulting balance in the inventory account on the first-in, first-out basis is shown in the next two columns. The unit cost shown there has no particular significance. It obviously rises as more higher priced material comes into stock.

The dollar amount in the last column under the "f.i.f.o. basis"—the first item is $650,000. That of course represents the inventory at the end of the six months—$600,000 plus purchases during the seventh month, $150,000—less deductions for the cost of sales $100,000 shown in the preceding column—making the balance of $650,000; and the same process is followed in the succeeding months; so that when you come to the last item, $1,130,000, you have an item which consists of the opening inventory of $600,000, plus the purchases for the six months' period of $1,130,000, making a grand total of $1,730,000, as shown in the first column which is described as "received" on the f.i.f.o. basis, less a deduction for the cost of sales of $600,000—and that leaves a balance of $1,130,000.

Now because of the fact that in this simple illustration which I selected, the closing inventory of 6,000,000 units is exactly equal to the number of units purchased during the last six months of the year, the valuation of the closing inventory on the first in, first out basis comes to exactly the amount of the purchases during the six months' period—in other words, my lord, the total of $1,730,000, in the column marked "received" less the amount of the opening inventory of $600,000 gives you the total of the purchases of $1,130,000—and that is the valuation of the closing inventory.

Now if that is—if I have made that sufficiently clear—going on to describe the "average cost basis", which is shown in the last four columns:

I predicated this illustration on the assumption, which I stated earlier, that for simplification we would take a case where the opening inventory was the same amount in either case—$600,000—and that is the first item in the column marked "received" under this fourth column group which is described as "on average cost basis".

To that figure of $600,000 is added the actual purchases for the year during the seventh month—$150,000;

In the next column, which is described as "cost of sales" is an item amounting to $107,142. That item represents the cost of sales computed on the average cost basis and it is arrived at in this way:

If I take the $600,000 of opening inventory—and add $150,000 for the purchases during the seventh month—I have a total of $750,000;

And at that point I have in the inventory account, before making any deductions for the month, 7,000,000 units. I divide that 7,000,000 units into $750,000—and I arrive at an average price of 10·7142 cents per unit.

Then I make a deduction—

His Lordship: Q. Would you repeat that again?—A. I take the $600,000 of opening inventory—

Q. At what price?—A. First of all I take the dollars, my lord—I take $600,000 —and I add $150,000 to it.

Q. Yes?—A. And that gives me $750,000—and then I look at my units and I have 6,000,000 units plus 1,000,000 units received, making 7,000,000 units; so I strike an average by dividing 7,000,000 units into $750,000; and that gives me 10·7142 cents per unit.

I then arrive at my cost of sales by taking the 1,000,000 units which were sold during that month, and multiply it by that average cost, which comes to $107,142.

The balance of the inventory at the end of that period thus comes to—excuse me—is arrived at by a process of addition and subtraction; $600,000 opening inventory—add $150,000 for purchases—deduct $107,142 for cost of sales—and what I have left is the balance shown in the last column—that is $642,858—representing the 6,000,000 units.

Then the procedure under each subsequent month is identical. I strike a new average cost at the end of each month and possibly that is worth following through; in the eighth month I take the opening inventory—that is, what is the closing inventory at the end of the seventh month—or the $642,858.

I add to it the $180,000 for the purchases made during the eighth month; that gives me a total of $822,858. At that point I have on hand, before making deductions for the month's sales, 7,000,000 units again—that is, 6,000,000 units representing the closing inventory at the end of the seventh month, plus 1,000,000 units purchased, and I divide that 7,000,000 units into the total which I have just given you of $822,858, and I arrive at a new weighted average—or a new average price—which is approximately 11·8 cents—or more exactly 11·7551;

And I proceed then to determine cost of sales for that eighth month by taking the 1,000,000 units which have been sold, multiply it by 11·7551 cents—and I come to a cost of sales of $117,551;

And I then arrive at the value of the inventory at the end of that eighth month by taking the opening inventory—or rather by taking the inventory at the end of the seventh month $642,858—and adding the purchases during the month, $180,000—deducting the cost of sales for the month, $117,551;

And I have the inventory at the end of the eighth month $705,307;

And that process is repeated continuously from month to month and arrives, in this illustration, at an inventory value of $932,978;

So that what we have in this particular set of facts which we assumed in this case—where we had a starting inventory of 10 cents and purchases made at various prices running up to a high of 20 cents—we have, on the f.i.f.o. basis, a closing inventory value of $1,130,000; and on the average cost, we have a closing inventory of $932,978.

It will be quite obvious of course that there is a corresponding difference in the cost of sales because, as I have stated previously, the cost of sales and the inventory values are interdependent. The cost of sales, as you will see, on the f.i.f.o. basis is $600,000; on the average cost basis the cost of sales comes to $790,022.

The difference between the cost of sales for these two periods amounts to $197,022—which would be a very significant amount. For instance—and again hypothetically—if it were reasonable to assume that the sales of these 6,000,000 units were made at prices totalling $1,500,000—this difference, which I have described here, would represent over 13 per cent of sales—which is considerably greater than the average net profit margin in many industries.

His LORDSHIP: Would this be a convenient time to adjourn?

The WITNESS: Very convenient, my lord.

Mr. DE ROCHE: I thought Mr. Richardson might continue and finish this exhibit, which will take only a minute or so.

The WITNESS: I think two more minutes would dispose of it.

His LORDSHIP: Q. Then we will finish this exhibit.—A. The possibility of showing even greater differences between profits on last in, first out, and first in, first out, is, of course, greater than the probability of showing substantial differences between first in, first out, and average cost.

His LORDSHIP: Q. Is that another aspect of this exhibit?—A. Well I was going on—yes, my lord, I was going on to merely point out one or two facts here as to what the cost of sales would be in the same circumstances of last in, first out—and showing that the difference is even—in this state of facts, is even greater in comparison.

Q. And would that be shown by another exhibit?—A. No, I am adducing that from the total here, my lord.

His LORDSHIP: Then I think you can do that tomorrow morning.

Now, gentlemen, I would like to adjourn tomorrow at 12.30 and I wonder whether, it would suit counsel if we started tomorrow at 10.00 instead of 10.30?

Mr. PICKUP: Quite so, my lord, that suits me.

Mr. PATTILLO: And that suits me also.

His LORDSHIP: Then tomorrow we will start at ten and we will adjourn at 12.30.

(At 5.07 P.M., the court was adjourned until 10.00 A.M., Thursday, June 22nd, 1950).

Toronto, Ontario,
June 22, 1950.

MORNING SESSION

Examination of Mr. George Richardson (Continued)

Q. Mr. Richardson, at adjournment last night, you were just concluding your remarks about Exhibit 24, I believe. Would you just carry on?—A. Yes, sir. I was on the point of referring to the fact that there is a probability of showing even greater differences between the profits computed by the f.i.f.o. method and the profits computed on the l.i.f.o. method than there was in showing substantial difference in profits between f.i.f.o. and average cost. I had just finished going over a table in which the difference in the computing of profits on the f.i.f.o. and average cost had been illustrated.

HIS LORDSHIP: You had explained what you had put down in Exhibit 24?

A. That is right, my Lord. I would like to state the difference which would be shown on the same assumed set of facts as in Exhibit 24 on a l.i.f.o. basis—

Q. Have you an exhibit for that?—A. No, my Lord. I can do it very readily from Exhibit 24.

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Examination-in-Chief by Mr. De Roche (Cont.)

Q. It might have been convenient to have had a set of columns?—A. My Lord, I think I can just point to one figure which can explain it.

Q. That may be.—A. In the entire six-month period, the cost of sales on a l.i.f.o. basis would be $1,130,000 which is the amount of the purchases during that year, that is, the total that you will see in this "received" column of $1,730,000 less the opening inventory, which is included, of $600,000. Those purchases in the assumed set of facts here were equal to 6 million pounds and were exactly equal to the sales for that period, so that the cost of sales on a l.i.f.o. basis would be the exact cost of the purchases.

MR. DEROCHE: Q. And that figure would be?—A. $1,130,000 and that would compare with cost on the other two bases as follows:—last-in-first-out cost of sales $1,130,000—

Q. As against?—A. As against cost of sales on an average cost basis of $797,022 and the cost of sales on a first-in-first-out basis $600,000.

HIS LORDSHIP: So on the basis of last-in-first-out, the cost of sales would be $1,130,000?—A. Yes, my Lord.

Q. On the first-in-first-out basis, the cost of sales would be $600,000?—A. Yes, my Lord.

Q. And on the average basis, the cost of sales would be $797,022?—A. That is right, my Lord.

Q. That is, the l.i.f.o. basis would use the last prices, would it?—A. It would use the purchases—

Q. The last purchases?—A. The last purchases on an equal quantity, that is right. That completes my reference to comparisons of the various methods and I would like to proceed to say something about the development of the last-in-first-out method and, to some extent, criticisms which have been made from time to time of various methods.

The universal application of first-in-first-out or average cost would be open to a series of criticisms in certain cases. The principal criticisms made of those methods were these: first, that when the rate of turnover was slow, the method resulted in including in the figure of net profit so-called inventory profits or losses. By the term "inventory profits" is meant the amount which would be included in income under such a method arising out of the sale at current higher price level of inventory acquired maybe many months ago at lower levels.

Q. That would be on the assumption that the inventory was sold?—A. Yes, my Lord. The so-called inventory profits arise, for example, under the first-in-first-out method when, having started the period with a certain quantity at a lower price and ended the period with, let us say, a smaller quantity at a higher price and there have been substantial sales in the intervening period, the inventory profit is the term applied to the amount included more or less fortuitously as a result of the change in the price level.

Q. But there would be an actual profit only if the inventory were sold?—A. That is right.

Q. And, of course, the inventory is not going to be sold; it is going to be used?—A. I wonder if I could just go on with my explanation and possibly it will clear up your question. The criticism of that method and of the result which followed from it was particularly strong when current sales were being made on the basis of selling prices that had no relationship to opening inventory prices or the inventory prices at the time when the sale was made. It was argued—and it can be argued very strongly—that when there has been a substantial rise in price—

Q. Rise in price of what?—A. Of your raw materials—that there is very little justification for claiming credit for a profit to the extent that the existence of that profit is due to pricing an identical quantity of goods in the closing inventory at a higher price than the same quantity of identical goods were priced at in the opening inventory and to that extent it was argued that these profits are, in a sense, fictional.

The second criticism is that in an industry in which a continuous and substantial investment is required in inventories, that inventory profits of the character which I have described which are shown by the first-in-first-out method are actually unrealized and, furthermore, that they cannot be realized without liquidating the business.

In the third place, the fictional character of these so-called inventory profits was further alleged from the fact that on a subsequent fall in the market prices the inventory profit disappears and is offset by inventory losses which are equally fictional, that is, the argument resolves itself down to this: that if you have an opening inventory of 1 million units which cost on a first-in-first-out basis .10 cents and you close the year with 1 million units and because of the rise in the price of your raw material in the meantime the closing units would be valued on a first-in-first-out basis at .15 cents, the argument is that the notion of a profit including that difference in value when you have got exactly the same things on hand in terms of the utility, character, quantity and so on as you had at the beginning of the year, is a fictional sort of profit.

Now, the last-in-first-out method developed, to a large extent, as a method of meeting these criticisms and in an effort to obtain greater reality in the determination of income. The method rests on two rather different bases of approach.

Q. How did it come to be devised?—A. Well, it is a method which was devised a good many years ago and it was developed by accountants in an effort to reflect the thinking of many practical business men in their approach to income determination.

The approach, as I have said, is based on two different avenues of reasoning, the first of which, in my opinion, is much stronger than the second. The first is this: that when certain trading conditions obtain, the most important of which is the fact that a business is carried on in such a way that your selling prices respond very quickly to changes in your replacement costs, then it is argued that it is only by a method of this kind that the income for the period can fairly be determined to reflect the actual trading conditions; in other words, if your selling prices are being fixed today by the raw material costs which obtain today, then you are not going to arrive at your profit correctly if you charged against those sales some historical costs that obtained many months ago arrived at by the first-in-first-out method.

Last-in-first-out method meets that criticism because essentially what is charged against your sales in the process of arriving at income are your current purchases and the first of these two bases of approach to the proposition which I mentioned is that if your sales are being made from day today reflecting very closely and responding very quickly to changes in replacement costs, then you must, in order to arrive at your true profits from trading, charge current prices against it and not some prices that prevailed a long time ago.

The second of these two approaches is rather from the economic point of view and represents to some extent a more recent development, that is, that regardless of the policies or factors which affect the establishing of selling prices; in other words, whether or not your selling prices respond quickly to changes in the replacement costs of your raw materials, the use of the method is more realistic than other methods because it results in bringing costs into account at more nearly the level of current selling prices and, in an economic sense, the result of that is to protect your capital in terms of quantities rather than merely to protect it in an economic way.

Putting that in another way, if a firm is determining profits on first-in-first-out and it starts with 1 million units at 10 cents and it finishes the year with 1 million units which, on a first-in-first-out basis would be valued at 15 cents and the entire profit for the year is represented by that increase which is attributable to the inventory value, then it is argued that on a proper distinction between capital and income, the capital has only been preserved in monetary terms but not in terms of physical units.

These are the two main approaches. I would say that in the application of the last-in-first-out method, in those cases where selling prices do not respond quickly to changes in replacement costs, the propriety of the method must rest entirely on the second of these two considerations whereas in the case of a company where selling prices are altered rapidly as replacement costs change, then the first of these two or even both of them might be said to provide the reasons for following the method.

Again I would like to say that from what I have said it is quite clear that there is no presumption here as to physical flow of goods but we have instead an objective of charging against the sales in any period the costs which can be considered to be properly related to those sales; in other words, it is designed to provide what we accountants refer to as a "proper matching of sales and related costs".

The use of the last-in-first-out method developed gradually over a period of years. It represented, of course, a fairly radical change in accounting practice and it resulted in considerable discussion and criticism. I think it is fair to say that the criticism of the method has largely died out and that there are very few accountants who today oppose the use of the method as a method. There are still differences of opinion as to the circumstances in which it should be applied but it is admitted that it has fairly wide application.

The accounting profession generally is agreed that there is no single inventory method which can be applied in all circumstances; rather each method—physical identification in some cases, first-in-first-out in some cases—average cost in some cases—last-in-first-out in other cases—has its proper place and the method to be selected should be dependent upon the circumstances of the case. That, I think, clearly reflects the views of the profession.

Well, as I have suggested that the last-in-first-out method is now well-established as an acceptable method, it may be useful to examine some of the criticisms of the method which have been advanced—particularly in the years in which the method was being developed—and these criticisms include the following:—first, that it does not reflect physical realities, that is, that only in most exceptional circumstances would the physical flow of goods be on a last-in-first-out basis; second, that what was claimed by advocates of the last-in-first-out method to be an unrealized profit was in fact a realized profit which had been reinvested in the business, that is, in this case the realized profit was being reinvested in the form of a higher priced inventory and it was contended that such a profit was no less realized than a profit which has been realized and reinvested in additions to a company's plant, for example.

Q. On the ground, I suppose, that although you have not actually got the money, you have got the goods that represent that much money?—A. The argument was that the realization was there because of a presumption as to the physical movement—the old goods must have been sold and a profit must have been realized and that it should not be contended that the profit was unrealized merely because you had the same quantity of inventory on hand at a higher price. The proposition was that realization nevertheless occurred and the situation was analagous to a realized profit about which there was no dispute where the funds were ploughed back into plant. They were not available in cash because in one case it was in a higher priced inventory and in another case because it was reinvested in plant.

The third criticism was that it resulted in a valuation of inventory which was meaningless from the point of view of the balance sheet which was not related to current prices and that, consequently, the balance sheet valuation of inventory was dependent partly upon the date when the method was adopted and partly upon the timing of the increases in the inventory from year to year.

As to the first of these criticisms, that is, that last-in-first-out fails to reflect physical realities, I would like again to refer to my earlier evidence as to the case for physical identification when dealing with inventories which are of identical character and utility. I indicated at that time, first, that physical identification was frequently, if not usually, impossible; second, that even where it is readily possible if we are dealing with an inventory of the character which I have described, that is where the characteristics and utility are identical, it does not necessarily produce the most accurate determination of the income and is open to serious abuse, that physical identification is, therefore, no longer considered necessary or even desirable by the accounting profession in most cases; that, in the third place, except in industries where goods deteriorate rapidly any assumption that goods will move on the first-in-first-out order is unwarranted, that there are other important factors which operate against such a movement in many industries and in many classes of inventory.

Under these circumstances, accountants generally reached the conclusion that there was no virtue as such in a method of inventory merely because it was based on a flow of costs through the inventory account which correspond with a reasonable presumption as to the physical flow of goods even if in fact any such presumption could be made at all.

A particular method might be commended for other reasons but it is not entitled to commendation merely because the flow of costs correspond reasonably with a presumption as to the physical flow of goods when profit determination based on physical identification was largely regarded as fallacious. It follows from this that a presumption that certain goods have finally physically been disposed of does not inevitably lead to a recognition of profit based on the presumed cost of those goods when they have in fact been replaced with identical goods acquired at other prices in a continuous movement of inventory.

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Then, coming to the question of the selection of an inventory method, the question is: what are the factors which the accounting profession in general feel should be taken into account in the selection of an inventory method.

It is perhaps unnecessary to state that if inventories are very small in relation to sales, that is, where the turnover is rapid, the selection of the method may not have any great effect on results. On the other hand, where the rate of turnover is slow, the selection of the inventory method becomes important.

In recent years accounting authorities have come to recognize that the prime factor in the selection of an inventory method should be that the method as nearly as possible reflects the income from the business. Various methods are recognized as proper including the three principal ones—first-in-first-out, average costs and last-in-first-out. Each is recognized as having its proper place in appropriate circumstances.

Earlier I pointed out that the place of an inventory in accounting is part of the process of allocation of costs between those applicable to the current period and those applicable to future periods. The determination of an inventory is not primarily an attempt to determine value in the sense of what the inventory is worth at the moment. If it were, the accounting rule would be simple; all inventories would be valued at market.

Consequently, the accounting profession has agreed that when there is a conflict between a method which would lead to a more correct determination of income as compared with a method which might be preferable from the balance sheet point of view, the balance sheet must give way to the income account.

When it comes to applying the principle stated above, that the method should be the one which most nearly reflects the income, it is recognized by accountants generally that the method should be found by reference to the whole course of trading and the genius of profit-making in the particular industry.

I would like to illustrate that by an example. In a business in which the usual method of dealing is to alter prices only when the previous stock acquired at early prices has been exhausted, there will probably be no controversy on this point. First-in-first-out will probably give the best reflection of the actual course of trading in those circumstances.

These trading conditions are commonly found in many businesses. The management of many firms pride themselves on the fact that they would not mark-up goods merely because the replacement cost has risen and the customer gets the benefit of the lower price on existing inventories when an increase in replacement costs occurs. That, my Lord, is a common situation in the retail trade.

Q. That is so only when the prices are rising?—A. That is right.

Q. It might not be so easy to apply when they are falling?—A. Quite frequently the retailer in those circumstances neither gains on the upswings nor is he protected against losses on the downswings although the pattern is not entirely uniform; that is, if his principle is that he will not mark up his goods as the market rises and take advantage of the higher replacement cost, he will undoubtedly resist mark-downs on a falling market and will do the best he can to realize on his stock on the basis of the cost to him of those particular goods.

Q. But he will lose out in that case against competitors, will he not?—A. If they are able to obtain supplies at the new lower prices but there will be some time-lag and during that period he will do the best he can to move his stock.

On the other hand, there are a number of industries where the custom in the trade is to reflect changes in replacement costs immediately by increasing or decreasing selling prices. In some cases the reason for the practice is found in the fact that hedging facilities are available and prices can be changed from day to day or even from hour to hour without risk by keeping the existing inventories hedged.

For example, when there is an open wheat market in Canada, the price of flour changes as the wheat market changes. If the price of wheat drops 10 cents a bushel, there will be corresponding adjustment in the flour price and the flour miller will be prepared to deliver flour at once out of his stock notwithstanding the fact that it might be weeks before he could obtain stocks of wheat at the new lower price and mill it into flour.

The same course of trading is also found in other businesses in which hedging facilities are not available. In these industries the inventory is frequently looked upon as something which must be maintained so long as the business is to continue and changes in the value of the inventory are not regarded as having any significance since the inventory price level does not, in any way, influence the course of trading.

The philosophy of the manufacturer in such a case is that he can make a profit so long as he obtains a price for his product greater than the replacement cost of his raw material and the price of processing, selling, distributing and so on.

As I have stated previously there is little doubt as to the best inventory method to be followed where selling prices are not altered until the existing stock is exhausted. The first-in-first-out method is eminently suitable. I believe that I am stating the position of accountants generally in saying that the same method must not necessarily be followed under entirely different trading conditions where selling prices closely reflect changes in replacement cost. If the converse were true, profit would have to be measured in the case of a business where prices are sensitive to changes in cost not by reference to the price of the raw materials which led to the determination of those selling prices—not by reference to the cost of purchases which the management is currently making to match those sales—but by reference to prices obtaining during some earlier period when the inventory now on hand might be considered to have been acquired on a certain presumption as to physical movement.

The problem as to which of the two methods—that is, first-in-first-out or last-in-first-out—is the proper one in circumstances of this kind, that is, where selling prices respond quickly to changes in replacement cost, can best be illustrated in the case of a falling market. Assume that for a considerable period, say a year, the market price of raw materials used in the product has been relatively stable, say, 20 cents a pound and that on a calculation of inventory value on the first-in-first-out method, the value assigned to the inventory at that point is 20 cents a pound; this is followed by a sudden reduction in raw material prices so that within a month the raw material price has fallen to 15 cents a pound; the manufacturer in accordance with his established custom of selling at prices based on replacement costs, adjusts the price as the drop in the raw material price occurs and at the end of the month his selling prices reflect the lower cost which now prevails. On this basis his product is offered for sale at 25 cents a pound which includes the 15 cents for raw material, the current market price, 8 cents for processing and any other expenses and 2 cents for profit. If the first-in-first-out method of inventory valuation were followed, the transaction would show a loss in his books of 3 cents a pound, that is the selling price of 25 cents would be less than the 20 cents raw material inventory value plus the 8 cents of expenses.

On the other hand, the manufacturer is making current purchases of raw materials and they are being received into stock at 15 cents a pound and, as a result, on the last-in-first-out method the transaction would show a profit of 2 cents a pound which is what the manufacturer intended to obtain when he fixed his selling price at 25 cents. The manufacturer is prepared to sell up to the capacity of his plant on the basis of these new lower prices and he is also prepared to make deliveries out of finished stock which he has on hand at the new lower price.

Maybe I have not put that clearly. He is prepared to sell out of his stock at the reduced price any finished goods which he has on hand notwithstanding the fact that because the processing requires several months to complete, it would be quite impossible for him to buy a new lower-priced raw material, fabricate it, and deliver it to the customer on that sale. If the customer wants delivery within a week, the manufacturer is quite content to deliver out of stock.

In circumstances of this kind, accountants agree generally that the inventory method should be based on the actual course of trading in the business and the whole genius of profit-making in that enterprise rather than on any presumption which would inevitably be inaccurate in any event as to the physical flow of goods; in other words, in appropriate circumstances profits are not to be arrived at by charging the items of cost in first-in-first-out order in preference to charging the purchases which the manufacturer is currently making as he makes his sales based on the same level or approximately the same level of raw material prices as have been taken into account in fixing his selling prices.

I can, at this point, illustrate the proposition further by showing the results which would follow on a last-in-first-out method as compared with a first-in-first-out method in a set of circumstances such as we have been discussing. I will use first the illustration of a falling market—

EXHIBIT No. 25: Filed by Mr. De Roche
Hypothetical illustration comparing first-in-first-out and last-in-first-out on a falling market.

In this illustration the two methods are compared—first-in-first-out in the first three columns, last-in-first-out in the last three columns. Now, under the heading of "sales" I have arbitrarily broken the sales dollars into two parts based on what the manufacturer had in his mind when he made these sales, the first item being "material content". He has sold 6 million pounds and the material content—let me put it this way, my lord—the material element in his selling price averaged 15½ cents a pound, the proportion of the selling price which was included to cover his processing charges including profit 10 cents a pound, making an average price for the 6 million pounds of 25½ cents per pound. That illustration, of course, carries through on both last-in-first-out and first-in-first-out.

The sales dollars are the same in either case and the philosophy on which those sales prices were set was the same.

Now, the cost of sales per f.i.f.o. method here is computed under the assumption as to a falling market. The opening inventory was 4½ million pounds costing 22 cents a pound on the f.i.f.o. basis. The purchases were 6 million pounds made at declining prices running from 22 cents down to considerably lower prices and averaging 15½ cents throughout the period. The closing inventory on the f.i.f.o. basis comes to 14 cents a pound, that being the cost of the most recent purchases of that quantity, so that the cost of materials sold on the f.i.f.o. basis comes to 21½ cents. To that we add the manufacturing costs and other costs which work out, as illustrated, to 8 cents a pound and the total costs on that basis comes to 29½ cents as against a selling price of 25½ cents and, as a result, there is a loss shown of $240,000 which is 4 cents a pound on 6 million pounds.

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Q. On the copy I have got it does not show that.—A. The minus sign, my lord, is intended to indicate a loss.

Q. Oh, I beg your pardon.—A. Looking at the costs on a l.i.f.o. basis, the opening inventory we have assumed stood in the account at 13 cents a pound, the purchases for the period 6 million pounds which are, of course, identical with the purchases under the f.i.f.o. method. The closing inventory is priced at the same price as the opening inventory because in this simple set of circumstances which I have assumed here, the quantities are identical—13 cents a pound. The cost of sales consequently is exactly equal to the cost of the purchases during the period that is, $15\frac{1}{2}$ cents a pound. Adding to that the manufacturing and other costs of 8 cents a pound, makes a total cost of $23\frac{1}{2}$ cents a pound and a profit is shown on the transaction of 2 cents per pound or $120,000 on the 6 million pounds sold; in other words, the l.i.f.o. method here reflects what the manufacturer set out to do. His objective was to recover his processing costs of 8 cents a pound and to make a profit of 2 cents a pound over and above that and he was able to do that by setting his selling price at a figure which would include 10 cents a pound for processing and profit and would cover the current purchasing cost of his raw material from time to time.

That illustration, I hope, will illustrate the remarks which I have made to indicate that in circumstances of this character the use of the l.i.f.o. method will reflect income based on the whole conception of profit-making in the enterprise in a way that the f.i.f.o. method obviously cannot do.

Mr. De Roche: I am sure his Lordship understood you but to get the record clear, may I ask one question. You have referred to your opening on the l.i.f.o. basis with an arbitrary price of 13 cents. Would it have made any difference in the example if you had allocated to that the same figure of 22 cents as was used in f.i.f.o.? —A. No, none whatever. If the circumstances in the preceding years had been such that on l.i.f.o. method the inventory came to 22 cents it would make no difference because we would have a larger opening inventory, that is, a higher value attributed to the opening inventory and the closing inventory would have a higher value. It would also be valued at 22 cents. The cost of sales would be exactly the same.

His Lordship: But this is on the basis of a falling market and, therefore, I assume that your 13 cents would represent the price to which the material had fallen in the course of a year, would it?—A. No, the 13 cents inventory value in the case of the l.i.f.o. method would represent the cost on that method built up over a period of years on the formula which I gave your lordship yesterday, that is, if you started at the inception of the business, the inventory at the end of the first year will be valued at the average cost for that year and from there on you have this number of strata, as I mentioned, which builds it up.

Q. That is, the opening inventory price would be a price some years back perhaps?—A. Influenced to a large extent, my lord, by prices obtaining in earlier years—possibly quite a long way back. I have also a similar hypothetical calculation on a rising market.

EXHIBIT No. 26: Filed by Mr. De Roche	Hypothetical illustration comparing first-in, first-out and last-in, first-out on a rising market.

Mr. PICKUP: Here apparently you have different prices than in the last illustration?—A. Yes, this is in a different set of circumstances where we are dealing with a rising market. Your selling price is 30½c on an average for the period. On the f.i.f.o. basis the opening inventory is 14c. The sales, my Lord, are 6 million pounds at 30½c—a somewhat higher average sales price because we are on a rising market. Cost on the first-in-first-out method is arrived at from an opening inventory at 14c adding purchases at 20½c, deducting the closing inventory at 22c. You will see that that closing inventory price here is a little higher than the average purchase price because the market is rising.

Cost of materials sold comes to 14½c, manufacturing and other costs are 8c and the total cost comes to 22½c so that the first-in-first-out method shows a profit of 8c a pound and includes accordingly what we commonly refer to as "inventory profits" of the nature that I have described.

His LORDSHIP: Yes, because there could not be any greater processing profit?—A. That is right.

Q. The additional profit, if any, must be in the inventory?—A. The l.i.f.o. method, on the other hand, shows the processing profit. The opening inventory was 13c, the purchases are at the same price—20½c, the closing inventory is 13c, the cost of sales is thus exactly the cost of the purchases—20½c, the manufacturing cost is at 8c and the total cost comes to 28½c and the profit shown is 2c a pound which is the processing profit which the manufacturer set out to obtain.

Q. So that the profit is the same regardless of whether the market falls or rises as far as the raw materials are concerned?—A. That is right.

Mr. DE ROCHE: May I again, for the purposes of the record, make the same comment on Exhibit 26, that it would not have affected the results of the l.i.f.o. method if some other figure than 13c had appeared as opening and closing inventories?—A. It would not.

Q. May I also, for the purposes of the record, perhaps tie these two a little bit better together? Exhibit 25 and Exhibit 26 could be considered as being one year and the following year of the same company; in other words, your opening inventory in Exhibit 26 is your closing inventory in Exhibit 25?—A. That is right.

Q. I just want to tie them together, my Lord, but it does make a falling picture and a rising picture.—A. In earlier testimony I also referred to criticisms which have been advanced, particularly in the earlier stages of the development of the l.i.f.o. inventory method because of its effect on the balance sheet and it may, therefore, be useful to discuss briefly the accounting conception of the balance sheet.

Modern accounting practice has developed a long way and on different lines from the earlier statements which were designed to show the financial position of a company. The earlier statements of financial conditions, usually referred to as Statements of Assets and Liabilities, were largely based on the concept of liquidating value. Figures of the inventory, plant, equipment, marketable securities and so forth were primarily included not by reference to cost but by reference to their current value. In present-day accounting, cost has come to play a dominant role in practically all phases as distinct from value. The balance sheet has thus come to represent not a statement of values so much as a statement of unabsorbed costs and liabilities, whether those costs are with respect to current trading such as your inventories or whether they are with respect to fixed assets, that is, for example, in modern accounting fixed assets are not revalued from year to year or even for longer periods merely because there has been a change in reproduction costs or other changes affecting value.

The conception of present accounting is that costs of those fixed assets should be recorded and they should be allocated on a rational basis over the useful life of those assets and in fact absorbed in the Income Account on such a rational basis through a system of depreciation allowances.

Many illustrations can be given of the changes which have occurred. To give you one example, many years ago it was almost universal practice to write off the discount and expenses on an issue of bonds as a charge against accumulated profits, that is, not by charging it to any expenses of any particular year but as a deduction from the total of accumulated profits which had been brought forward. This was done at the time that the issue was made and the argument was that there was no tangible or realizable value to an item of bond expense and, therefore, it was not a good idea to include it in the balance sheet or at least an undesirable item to include.

This proposition has given way largely to the proposition that the discount and all expenses of the bond issue represents part of the cost of borrowing the money in addition to the interest which has to be paid and is, consequently, an item which should be included in expenses over the life of the bond issue in order that the Income Account will reflect the true cost of borrowing the money.

Consequently, the portion of that bond discount and expenses which has not yet been absorbed is carried in the balance sheet on the assets side from year to year in a constantly diminishing manner notwithstanding the fact that it has no tangible or realizable value whatever.

It has long been realized that in the case of inventories, the balance sheet is not intended to reflect value but rather that portion of incurred expenditures which is properly applicable to future periods. For example, a company which keeps its accounts on f.i.f.o. has an inventory the cost of which, determined on that basis, amounts to, say, $1 million. Due to increases which have occurred in the price of raw material between the actual dates of purchase and the balance sheet date, the market value of the inventory at the balance sheet date is $1,250,000.

While this might be said to be its value on the lower of cost or market concept applied on the f.i.f.o. basis, it would still appear in the balance sheet at the cost of $1,000,000, not at its value. This basic fact, that the balance sheet does not and is not intended to represent value, should be kept in mind when considering the criticism that on the l.i.f.o. method the valuation may be substantially different from current price.

While this may be true, it is also frequently true that other inventory methods, particularly average cost, and to a lesser extent f.i.f.o., do not reflect market values nor do they necessarily reflect current values. Admittedly l.i.f.o. may frequently arrive at a valuation of inventory which is further removed from current prices, than other methods. This is well recognized. Some accountants feel that it is a serious objection, but in my opinion, the great majority of accountants concede that the resulting weakness in the balance sheet is not peculiar to inventories determined on the l.i.f.o. basis, but applies to other classes of assets as well, and is well worth accepting in the interests of the more important objective of more accurate determination of income.

His Lordship: Would this be a convenient time for us to recess for ten minutes?

The Witness: Yes, my lord.

(A short recess was here taken.)

Mr. De Roche: Q. Mr. Richardson, throughout your evidence you have made several references to the accounting profession in general. In your opinion are the views which you have expressed,—the generally accepted views of the accounting profession in Canada and the United States?

Mr. Pickup: Surely the witness cannot say that.

His Lordship: An expert cannot say what the expert opinion of others is?

Mr. De Roche: I would suggest, your lordship, that Mr. Richardson is not only an expert accountant but in qualifying him I asked him if he had done this kind of work and was familiar with it—

His Lordship: I am only interested in his opinion. We cannot have him bolstering up the opinion of others in absentia.

Mr. De Roche: Mr. Richardson, the opinions you have expressed are your own at least?

His Lordship: Of course they are.

Mr. De Roche: And were they your opinions in 1946 and 1947?

His Lordship: What difference does that make?

Mr. De Roche: We are confined here, my lord, to those two years and, as I understand it, it is in those years we have to ascertain the income.

His Lordship: I do not care what his opinion was in 1946 or 1947.

Mr. De Roche: Very well. Mr. Richardson, what is the Dominion Association of Chartered Accountants?—A. It is a professional body which is in fact a co-ordinating body co-ordinating the activities of the various Provincial Institutions of Chartered Accountants in Canada.

Q. And does the Dominion Association of Chartered Accountants make pronouncements which carry weight in the accounting profession?

His Lordship: It does not matter whether they do or not. I cannot attribute any expert opinion to a corporate body, can I?

Mr. De Roche: Well, I suggest, my lord—

His Lordship: The question is not admitted. Proceed with your questioning.

Mr. De Roche: Mr. Richardson, is the Dominion Association of Chartered Accountants generaly accepted in the accounting profession of Canada as having the right and authority to speak for the profession in Canada?

His Lordship: In matters of discipline, I suppose?

Mr. De Roche: No I am asking the question in matters of accounting and auditing practices.

His Lordship: No, not admitted.

Mr. De Roche: I am sorry, my lord, I have to go a little further along the same line. Mr. Richardson, what is the American Institute of Accountants?—A. It is a professional body in the United States which stands on a somewhat different footing from the Dominion Association in Canada. There are, in the United States, various State Societies and the American Institute is a national organization which admits to its membership accountants who are qualified in various State Societies and it carries on various activities—educational, research and so on.

Q. Now, Mr. Richardson, does the American Institute of Accountants issue bulletins on accounting and auditing problems?—A. Yes.

Q. And do these bulletins— —A. The Accounting Procedure Committee of the American Institute issues such bulletins.

Q. Do these bulletins carry weight as describing correct accounting and auditing methods with the various State Societies?

His Lordship: Same objection.

Mr. De Roche: Then, Mr. Richardson, I show you a tabulation which is headed "Anaconda American Brass Limited" and the words "The results of the method for the Company's operations in 1946 and 1947 in regard to copper are as follows:". It is a re-statement of Exhibits 7 and 8 in a different form.

Mr. Pickup: May I have a copy?

Mr. De Roche: Certainly. Mr. Richardson, is that a re-statement of the calculation of the cost of copper sales of the Company for the years 1946 and 1947 made from the data on Exhibits 7 and 8 in this case?—A. Yes, I have examined Exhibits 7 and 8 and this correctly summarizes the cost of copper sales as shown on those Exhibits.

Exhibit No. 27: Filed by Mr. De Roche	Statement entitled "Anaconda American Brass Limited—The results of the method for the Company's operations in 1946 and 1947 in regard to copper."

Q. Then, Mr. Richardson, if I may take you back to one of the earliest remarks you made which I believe was that the—I do not know whether the correct accounting word was "income" or "revenue" or "gross income" or "gross revenue" of the company—is the figure representing sales of the Company following the usual accounting practice of recognizing income when sales are made. In expansion of that may I ask you in general accounting practice at what point of time are profits deemed and treated as realized?—A. In the case of a trading or manufacturing concern usually when sales are made.

Q. When sales are made?—A. That is right.

Q. And if I put the question to you this way—at what point of time in proper accounting practice are profits received?—A. Well, the word "received" is not a very happy word to use in connection with the word "profits".

His LORDSHIP: They use it in the Income Tax Act?—A. Yes, my lord.

Mr. DE ROCHE: That is why I asked the question in that way, Mr. Richardson. When in accounting practice are profits received?—A. Well, the word "received" is frequently but not necessarily used in relation to cash transactions. For instance, you may receive income by other routes—for example, a stock dividend, a dividend in kind and so on.

His LORDSHIP: It could still be received?—A. Yes, my lord. If, as an accountant and simply attempting to answer your question as an accountant, I were asked when a profit was received and I had to attribute some meaning to the word, I would say when the profits were realized by the making of sales; in other words, they would be received in the sense in which they were realized either by making a sale for cash or by taking something back in the way of a debt for the unpaid sale which might be the equivalent.

Q. You might be stretching the meaning of the word "received" in that case?—A. I might be, my lord. I prefaced my answer by saying I did not think it was a very happy word and, therefore, I cannot give too explicit a meaning.

Q. It does not mean "receivable" because the two words cannot mean the same thing. It might be as well, as a matter of accounting practice, to regard a "receivable" as something that has been received because it is going to be received but if you have got the word in the Act which says "received" it cannot mean "receivable". At least, I have so held.—A. Ordinarily we would not use the words in that combination, my lord; we would not talk about a profit being "received".

Cross-examination by Mr. Pickup:

Q. Now, Mr. Richardson, as I understand your evidence the l.i.f.o. method is not intended to indicate physical flow of goods?—A. That is right.

Q. But it is l.i.f.o.—last-in, first-out—that is the meaning of it literally?—A. It means that the cost of the last items entered into the inventory account are the first to be removed and charged against income.

Q. What is it that is last in and first out if it is not the raw material?—A. The cost.

Q. The cost of what? Something is last in and first out?

His LORDSHIP: I believe it is a convenient way of describing a principle but it may not be precisely accurate.

Mr. PICKUP: Then there is nothing that is last-in and first-out of a physical kind?—A. Nothing of a physical kind.

Q. It is not a presumption of any fact?—A. That is right.

Q. It is a theory?—A. It is not a theory; it is a statement of an assumption as to the order in which costs should flow in and out of an inventory account on the calculation under this method.

His LORDSHIP: Would you describe it as a principle?—A. I would think so, my lord—yes, or better still as a method.

Mr. PICKUP: And I take it that you would apply the same principle even if you knew that in fact the raw materials were not the last in which were used? If you knew in fact that you had not used them at all, you would still apply the principle?—A. In appropriate circumstances I would apply the principle because, as I indicated, I do not think that physical identification of goods has anything to do with proper determination in certain circumstances.

Q. In other words, if you bought in the latter part of the year or later in the year raw materials at higher prices and in fact used and sold the materials at lower prices, you would still apply the last-in-first-out method to arrive at profits?—A. In appropriate circumstances.

Q. And the appropriate circumstances are the ones which you have spoken of where you have a homogeneous raw material and a substantial or large inventory moving slowly?—A. And where selling prices reflect very closely changes in replacement costs of the raw material.

Q. Given those circumstances which you have described, you would apply it although you knew factually different inventories were used which had cost the company less and had been sold at higher prices?—A. Yes, in the same way as I might use a f.i.f.o. method of valuation in appropriate circumstances even though I knew that the f.i.f.o. method did not reflect the physical flow of goods.

Q. But for tax purposes, if it does not reflect the physical flow of goods, then a taxpayer can always show what the physical flow was, can't he?—A. Are you asking me a question on Income Tax law?

Q. No, but you were likening it to f.i.f.o. Let me put it this way. Is not f.i.f.o. a presumption of an existing fact?—A. I thought I made it perfectly clear in my evidence that it was not.

Q. You said it was unlike l.i.f.o. and you said it was not a presumption but an existing fact but I am putting to you whether f.i.f.o. is not in fact a presumption that the first goods in were the first goods to go out?—A. In my opinion it is not. In my opinion, first-in, first-out again is a description of a costing method and refers to the order in which items of cost recorded through the inventory account should be taken out of the inventory account.

Q. But it is relating to a past period and not a future one?—A. I do not follow that.

Q. If you have first-in-first-out you are referring to goods which have come in and which could have been used in making the sales, are you not?—A. I am not referring to goods at all; I am referring to the cost of items entered through the inventory.

Q. Well, do you mean that you have never regarded the f.i.f.o. principle as meaning that inventories were to be valued on the basis of the inventories, first-in ones being the ones to come out first? Have you never so regarded it?—A. No. If had, then I would feel that it would only be applicable in a case where there was a justified presumption that the goods did in fact move in that order and, obviously, in that case it would not be applicable.

Q. Quite—and I thought that it was a presumption and a presumption which could be rebutted if the circumstances were otherwise, but apparently you do not agree with me?—A. No.

Q. Then this much was right, however, that in valuing the inventory, it was done, when you used the f.i.f.o. basis, by treating the raw materials which came in first as being the raw materials which went out first, was it not?—A. It is done by assigning to the items taken out, the cost of the items which were first received.

Q. As you would have done if the items first received were the ones which first went out?—A. As you would have done if you followed a presumption as to what the physical flow was.

Q. And as you would have done if that were the fact, would not you, and you are following the fact?—A. I thought I had made it clear that the question of physical identification is not, in my opinion, a factor which governs the determination of income.

His LORDSHIP: Then, from the point of view of physical flow, both terms f.i.f.o. and l.i.f.o. are mis-descriptive?—A. That is right. They are not intended, in my opinion, to convey any sense of physical flow.

Q. Not intended to convey any sense of actual physical flow of the goods in the inventory?—A. No, my lord.

Mr. PICKUP: And yet they have the effect or result which would be exactly the same if the physical flow was first-in-first-out. Is that not right?—A. What I think you are saying now is that if the physical flow corresponded to the assumption you were making in the recording of your costs, then the two would be on exactly the same basis. That is self-evident.

Q. Answer if you can without trying to describe what you think I am saying?—A. Would you repeat the question please, Mr. Pickup?

Q. The Reporter will read it.

The REPORTER (Reading): "And yet they have the effect or result which would be exactly the same if the physical flow was first-in-first-out. Is that not right?"

The WITNESS: Would you read the preceding question?

The REPORTER (Reading): "Q. Not intended to convey any sense of physical flow of the goods in the inventory?—A. No, my lord."

The WITNESS: I think my answer to your question is yes in the sense in which I have just made it, that obviously if the physical flow is first-in, first-out and you were applying the first-in-first-out method of cost determination, then the two are on all fours; they are the same.

Mr. PICKUP: Then I was wondering if in applying l.i.f.o. you are really trying to determine monetary profits or economic profits in a period?—A. I would answer that by saying in a limited application under the second of two approaches which I mentioned to you, an attempt is at times made to arrive at what you call economic profits.

His LORDSHIP: And which you called yourself "economic profits"?—A. Yes, which I referred to as economic profits but that, I think, is not true in the sense in which the method is applied in industries where there is this close relationship between costs and selling prices and where the selling prices are sensitive to costs.

Mr. PICKUP: How do you get a monetary profit in a year if you carry over some part of the incurred cost to a later year?—A. Well, you are faced with making an allocation of your incurred cost between the income for your current period and the income for future periods and if, once you get away from physical identification you do that on one of a number of assumptions and when the l.i.f.o. method is applied in circumstances where it reflects what I call the course of trading or the genius of profit-making, then I think that, in those circumstances, the profit which is arrived at is not what I would term an economic profit.

Q. It is not an economic profit?—A. I would call that a monetary profit.

Q. But a monetary profit defers or carries over to a future year part of the costs incurred in the current year?—A. Of course, all inventories carry forward costs incurred in the current year to a future period in any of these different methods; it is a question of how much of the cost you carry.

His LORDSHIP: You say all of those methods carry forward costs?—A. Yes, that is the purpose of the inventory.

Q. To carry forward costs into a future period? And you say that all of those methods carry forward some cost into a future year?—A. Well, my lord, the whole value attributed to the inventory on whatever basis you may value it is a process of carrying forward costs into the future period.

Q. It is just a question of how much?—A. That is right.

Mr. Pickup: How can the f.i.f.o. method carry over costs into a future period if it be the fact that the first raw materials in were the first out and went out in the year? It that be the fact, how can that be carrying over any costs into the future?—A. We are probably talking about two different things when we refer to costs carried forward to a future period. I say that the total dollar value of an inventory arrived at on a f.i.f.o. basis is an amount of costs carried forward to the future period.

Q. The total dollar value of the inventory carried forward is part of costs?—A. I say those are costs incurred which you are carrying forward to a future period.

Q. How is that incurred? Assume, for instance, a company has bought a new inventory or new materials in December or November and carries that over to the new year; how does that carry forward any costs incurred?

His Lordship: You have paid for it.—A. You have laid out the money.

Q. You have paid for the inventory in December and you are not going to use it until January of the next year. Actually there is some cost carried forward into the next year.

Mr. Pickup: The cost of that inventory but I am speaking of costs of sales made during the year.

His Lordship: The sales won't be made out of that material until, say, January or February of the next year but you have bought the material in December of this year.

Mr. Pickup: But, my Lord, I am speaking of incurred sales costs in the current year being carried forward and I think that was what the witness was talking about. We might be at cross-purposes there.—A. I think we were, Mr. Pickup. You are asking me—

Q. Let me put it this way—whether in f.i.f.o. if it be a fact that the raw materials which first came in in a year were the materials which first went out in a year—if that be the fact, how can there be any of the incurred costs of that year carried forward into the following year?—A. I do not know how to answer your question because I am afraid I do not understand it. We have an inventory on a f.i.f.o. basis which is so much in dollars and that inventory value is carried forward against the succeeding year. I am not suggesting that on a f.i.f.o. basis you are carrying forward in your inventory something that should properly have been treated as cost of sales in all circumstances. You may carry forward in a f.i.f.o. inventory something which, if you had determined your inventory on average cost or l.i.f.o., would not be included in inventory but would have been included in cost of sales for the year. That is quite obvious. Wherever there is a difference between the valuations that will occur.

George Richardson (Appellant)
Cross-Examination by Mr. Pickup (Cont.)

Q. Well, do you consider that l.i.f.o. tends to level off the hills and valleys of profit over a period?—A. Not in the sense that there is any arbitrary levelling off. I think in circumstances in which l.i.f.o. is properly applicable, it may be reflecting the true course of trading, showing a more constant result and may avoid unrealistic profits and losses that might be shown by other methods. To that extent it is not a process of levelling but the result might be more level than on some other basis.

HIS LORDSHIP: The hills and valleys might be fictional?—A. Exactly, my Lord.

MR. PICKUP: But does it not have that effect of preventing, shall I say, the hills and valleys of profits and losses?—A. Not necessarily. The objective is to arrive properly at profits or losses and in the sort of illustration which I gave you on Exhibits 25 and 26 it may arrive at a more stable result by avoiding the showing of fictional profits or losses; it is not a process of levelling for the sake of levelling. There is nothing arbitrary about the process about which you could say: "This is something which a prudent business man might feel that he should do in the interests of conservatism" or anything of that kind.

Q. But it does not show the actual money profit or monetary profit made in a year if a company uses an inventory which costs .10 cents and sells it in that year at price of .20 cents—last-in, first-out does not show the actual monetary profit, does it?—A. I do not agree with that statement. To arrive at profit on any other basis than physical identification you have to select a method and you select your method properly and your costs flow on some assumed basis and on that basis you determine your profit.

Q. Well, do you agree with this, that above all any assumption adopted should not be unduly out of line with the ascertainable unquestioned physical facts?—A. No, I do not agree with that, Mr. Pickup.

Q. You do not agree with that?—A. No. If you accept that presumption as valid, then you say: "We must either use physical identification as our method or we must do everything we can to find a method which corresponds as closely as possible with a reasonable presumption as to physical flow" and that is not the position which the accounting profession takes.

Q. Now, when you say that do you know Mr. W. A. Paton?—A. I know who he is, sir.

Q. A recognized Chartered Accountant—qualified?—A. He is a very well-known eminent authority in the United States, a professor, I believe—a Certified Public Accountant.

Q. I wondered if you had in your answer had it in mind that he used the word "unduly".

HIS LORDSHIP: That is always a good phrase to put in.

Mr. Pickup: "That any assumption adopted should not be unduly out of line with the ascertainable unquestioned physical facts".—A. I have read what Mr. Paton said and I think it represented exactly what he thought at that time which was in 1941. I think you are reading from Paton's "Advanced Accounting".

Q. I am reading 1948 as a matter of fact.—A. If you will read Paton's Accountants' Handbook—

Q. That is what I am quoting from.—A. Published in—it was later. I thought Mr. Pickup was reading from the 1941 edition.

His Lordship: No, he is reading from the 1948 edition.

Mr. Pickup: I am quoting from the Third Edition, W. A. Paton, 1948, pages 553 and on.—A. Well, if the essence of your question is what do I think of Mr. Paton's opinion on that point, my own impression was that since Mr. Paton is one of the Committee who subscribed to the bulletin issued by the American Institute of Accountants in 1947 in which they make it perfectly clear that—

Q. Now, I do not think we should go into that because I think you and I will be at very great variance.—A. May I say that I think Mr. Paton has probably changed his opinion over the course of years.

Q. Since 1948?—A. I do not know whether he has changed it since 1948 or not.

Q. Then, that is the most I can get from you, that you disagree with this statement?—A. Yes.

Q. Then, let me put another one to you. Is it not dangerous in accounting to wander very far from objective determinable data?—A. Well, that could have a great many meanings. I suppose it is in a general sense.

Q. Then, is not l.i.f.o. a variation of the former basic inventory theory?—A. It is a method which produces a result approximating the base stock method in many cases.

His Lordship: Did you describe that?—A. It does not have very wide application at the present time, my lord. There are many other minor methods which I did not describe such as, for instance, the method that retailers employ and so on.

Q. There are other methods than the three you refer to?—A. Yes, the ones I referred to were the most widely used ones.

Mr. Pickup: Well, that was not the question which I put to you. My question was whether it was not a variation of the basic stock method. I thought I was quoting from yourself, Mr. Richardson.—A. It is a distinctly separate method which is, let us say, in the same family, if you like, Mr. Pickup.

Q. And followed the basic method?—A. Yes, the basic stock method was used in years preceding the introduction of the last-in, first-out method.

Q. But never adopted, I suppose, for tax purposes?—A. The basic stock method?

Q. Yes.—A. My understanding is that it has in limited degree been used in England but it is very difficult to make any positive statement on that point. I would not like to do it because the revenue authorities do not publish any positive opinion on the point.

Q. Is the basic stock method the same as the normal stock idea?—A. Yes.

Q. When did you first, if at all, ever advise any company to adopt l.i.f.o.?—A. About 1939 or 1940.

Q. Was that after the change of the law in the United States?—A. Yes.

Q. Am I right in understanding you as advising l.i.f.o. for the purpose of determining cost in relation to cost or market whichever is lower?—A. Not exactly, Mr. Pickup. The position of market in relation to the application of the l.i.f.o. method is this, that no recognition whatever is taken of the fact that market may be lower than cost so far as determination of income is concerned but should the circumstances arise in which market is less than cost, I think that the usual practice would be to create not out of income but out of accumulated profits a reserve which would be deducted from the l.i.f.o. inventory value on the face of the balance sheet in order to reduce it to not more than the market price.

Q. You would agree with me that for many years accountants and corporations have proceeded generally on the basis of cost or market whichever is lower?—A. Yes, that has been a broad principle.

Q. Which has stood the test of time over many years?—A. Yes.

Q. And I did not regard your evidence as departing from it now or am I wrong in that?—A. Let me put it this way. Lower of cost or market means the lower of cost determined on one of a number of different bases.

Q. I understand. That is the way you have put it.—A. But last-in, first-out can be applied on a lower of cost or market basis in which the market valuation would be brought in after cost computed on the l.i.f.o. basis in computing your income. I do not think it would be too logical to write down an inventory arrived at on the l.i.f.o. basis to market if market were lower because of the whole underlying conception as to the objectives in l.i.f.o.

Q. What I was coming to, Mr. Richardson, is this, that if this company is to be taxed on the theory of l.i.f.o. and l.i.f.o. is used to get at cost in order to apply cost or market whichever is lower, then if you find that the cost on a li.f.o basis is higher than market, the taxpayer would always have the right to take the alternative of market, would he not if you are not going to discard cost or market whichever is lower?—A. You are asking me again as to what my opinion would be of the income tax law.

Q. No, I am asking you how you would apply cost or market whichever is lower if that is the guiding factor.

His LORDSHIP: For tax purposes.

Mr. PICKUP: For tax purposes.—A. Well, if we are dealing with an inventory kept on a l.i.f.o. basis I would say that income should be determined strictly by the calculation of costs arrived at on a l.i.f.o. basis, that any reflection of market or a consideration of market would be merely extraneous to your income determination and would merely be in the interests of presenting a conservative balance sheet and would result in making a charge against your accumulated profits and not against your income, to write down your balance sheet value to something which is not more than market.

Q. That is what I thought you meant and may I put it this way, that if you are going to be consistent, if you have adopted the l.i.f.o. principle, then if the market drops you must drop the alternative of market price?—A. That is my view used in income determination.

His LORDSHIP: In income determination?—A. That is right, my lord.

Mr. PICKUP: So that really if we adopt your view or the view that has been expressed by you, then we have got to depart from the market idea which we have universally used as an alternative to cost?—A. Well, generally but not necessarily used; in other words, there are methods which are straight cost methods into which market does not enter but it would not be strictly a lower of cost or market method in the ordinary sense.

Q. Now then, in giving your evidence, you spoke of (and I think I am quoting you correctly)—in discussing f.i.f.o. you said you thought the result would be about the same as l.i.f.o. if the turnover is rapid and I believe, conversely, you mentioned a different result if the turnover was slow. Now, my question was what did you mean by a slow turnover?—A. Well, it is a question of degree. If your inventory turns over every few days, every week, every couple of weeks, then obviously it is very rapid and somewhere between there and the more or less extreme case where the inventory, we will say, turns over once every year or year and a half, as is occasionally found, that is a very slow rate of turnover and somewhere in between you have slow turnover. Nine months is slow; six months is slow; three months is reasonably slow.

Q. That is what I was coming to. You say six months is slow. What about four times a year?—A. I would not call it a rapid turnover.

Q. Would you call that slow?—A. Reasonably slow.

Q. Well, is the point at which you advocate l.i.f.o. then when it is reasonably slow or slow or how do you tell when you get to a point where l.i.f.o. could be used? —A. First of all, I look to the trading conditions. That is obviously one of the tests. Then, assuming that from the standpoint of trading conditions the l.i.f.o. method may be the more suitable, is it from a practical viewpoint worth while to apply it particularly if there happens to be more trouble involved. Well, if you are dealing with an inventory that turns over every couple of weeks you may still have the factor of a responsive selling price but at that point you study this other method. One will probably arrive at as good a result as the other. So that you cannot draw a line and say you would apply it if the inventory turned over every two months or slower and you would not apply it if it were less than two months. There is no hard and fast dividing line.

Q. And I suppose the opinions of accountants would differ on the facts of any particular case?—A. They might.

Q. I notice that in Exhibit 24 you illustrate on a basis of a six-month turnover. The figures would have been quite different, of course, if you had prepared this Exhibit on the basis of a three-month turnover?—A. Quite so.

Q. And in fact the gap between the figures produced on the f.i.f.o. basis and the figures produced on the average cost basis would be much smaller?—A. Yes, I prefaced my evidence by pointing that out, Mr. Pickup.

Q. I was wondering why you did not give us an exhibit based upon a three-month turnover or approximately four times a year turnover such as the evidence shows we have in this case?

His Lordship: I suppose you could do that?—A. I could quite readily but I did not come particularly to speak to the facts of this particular case but to demonstrate the method and particularly its application and whether turnover was relative as well.

Mr. Pickup: Then this exhibit may have been prepared for some other purpose and you just happened to use it for illustration of this principle?—A. It was a very simple way of demonstrating a rather complicated subject. It was not intended to represent this case. I think the court has the evidence as to what the differences are in this case.

His Lordship: If you had prepared this exhibit on the basis of a turnover of, say, three months, what difference would there have been in kind?—A. Other things being equal, the difference would have been narrower.

Q. The gap would have been less?—A. That is right, my lord.

Q. But would there have been any difference in kind?—A. The operation of the method would have been the same; it is only a question of degree.

Q. It would only be a question of degree?—A. That is right, my lord.

Mr. PICKUP: May I put it this way? In essence the higher the rate of turnover of stock the less important becomes the method of valuation adopted?—A. That is right.

Q. Then, you spoke of the difficulty or, in some cases, impossibility of identifying inventory which you were using. I was wondering if in saying so you were not trying to identify the raw materials with particular sales?—A. No, I meant that it is frequently impossible to identify items of an inventory whether they are in raw materials, in work in process or in finished goods with the laid-down cost of this material component by reference to specific invoices.

Q. Maybe you will help me on this. Given certain facts—first, that your turnover is in about three months and your goods are maybe in process for not more than two months and that you identify the material up until the time that it goes into process and you have not got a price change of any kind over the whole six months, where is the difficulty in arriving at the cost of the raw materials which were used or identifying them as a whole? I know you could not identify it with a particular sale but to identify it at the end of the year what you had used given those facts—no change at all in the last six months of the year, turnover every three months and two months to process.—A. You are asking me, as I understand it, the difficulty of determining what is the cost of the items that were physically used and I do no know what items are physically used. That is my difficulty.

Q. Well, if you know the items that go into the processing on the 1st of January and you would know when those items came out and that they stayed in about two months wouldn't you?—A. I disgree with that premise though. You say if you have a certain opening inventory, you know that that inventory has been used and that is the fact that I do not know. I can think of cases in practice where, for instance, a case in which an inventory is valued by actual physical identification and I know I have seen instances of where the same item has turned up physically identified as having been on hand for several years when the rate of turnover was actually three or four times a year.

Q. I am trying to stick to this case for a moment.—A. I get back exactly to my answer to your question. You asked me what is the difficulty in arriving at the actual cost of what has physically been used and I say that if you will tell me what physically has been used and what physically remains on hand, then it is a matter of going to the records and finding out what those costs are.

George Richardson (Appellant)
Cross-Examination by Mr. Pickup (Cont.)

Q. Well, let us put it this way. We have had evidence in this case that the inventory or the raw materials could be identified and are identified up to the time when they go from stock into process but cannot be identified beyond that. We have had that in evidence. Now then, we have also got in evidence that the processing might be from one month up to two months—maybe a little longer, and we have also in evidence—

His LORDSHIP: It might be a good deal longer than that.

Mr. PICKUP: It might be. I think one witness put it at eight weeks but it would not go beyond that unless something special happened, but given then the fact that you have no inventory price change in the six months, I am wondering where the difficulty is or maybe you can't help me?—A. I do not think I can help you beyond what I have said.

Q. Now, you said, Mr. Richardson, that only a small minority today opposed the use of l.i.f.o. as a method. I wonder if you would just enlarge upon that and let me know what you meant?—A. I feel that only a small portion of the accounting profession would take the stand that l.i.f.o. has no application in any circumstances. What I was trying to convey was that any doubt which exists is rather as to where it is applicable and whether it is or is not applicable in circumstances of individual cases.

Q. You did not intend it to mean that it was only a small minority that considered l.i.f.o. unsuitable for tax purposes?—A. No, I did not mean anything about tax purposes.

Q. Now then, you spoke this morning, I think it was, on some criticisms that had been made on l.i.f.o. and the first one was that it does not reflect physical realities. Now, you have discussed that but my question is that the criticism that it does not reflect physical realities is true, is it not?—A. It does not reflect—It is not a valid criticism, in my opinion.

Q. But the fact is true?—A. The fact is that it does not reflect physical realities any more than other methods necessarily reflect physical realities other than specific identification.

Q. But the statement which you made, Mr. Richardson, was not that it did not reflect physical realities more than some other method; the statement you made was that it did not reflect physical realities and that is the statement I am asking you if it is a true statement and I think you have said yes?—A. Yes.

His LORDSHIP: Does f.i.f.o. reflect physical realities?—A. It may but it does not necessarily, my lord. It may be considerably removed from actual physical realities.

Mr. PICKUP: Is not the difference this on that one point—that l.i.f.o., as you say, does not reflect physical realities; f.i.f.o. may or may not?—A. It may approximate them. I would doubt if you would ever have a case where it could be said that it exactly reflected physical realities.

Q. But in many cases you would have it where it substantially reflected physical realities. That is true, isn't it?—A. That is right.

His LORDSHIP: Would it be possible for the l.i.f.o. method to reflect physical realities?—A. It would be possible to be a reasonable reflection of the movements in a particular year but cumulatively you would get probably further and further from reality. That is, at the end of ten years on the method you would probably not have at that stage the quantity of material on hand ten years old corresponding to the quantity which was priced at the prices of ten years ago, for instance.

Mr. PICKUP: Well, if we look at Exhibit 7, we find that the exhibit is showing that in 1947 at the end of the year the company is still, so far as reality is concerned, operating on the basis of having an inventory that it had prior to 1936 and some more raw copper that it got in 1936, 1937, 1938 and 1939. Is that what you mean (and I think it is) when you say it is actually further and further away from the reality if you use l.i.f.o.?—A. Well, I cannot speak as to the realities in this particular case but I do not imagine that any of the company witnesses would claim for a minute that there is a quantity of metal now on hand acquired in the year 1936 equal to the quantity which is priced at that price. I did not hear their evidence.

Q. Then, another criticism that you spoke of as having been levelled at l.i.f.o. was that what was claimed by the advocates of l.i.f.o. to be an unrealized profit was in fact a realized profit which had been reinvested in the business. Now my question again to you is that while you criticize or may not have agreed with that criticism, do you agree with the fact of its truth?—A. No. It depends upon what you mean by "realization". I think you are in fact asking me to agree that a test of realization must be determined by reference to the physical flow of goods.

Q. I understand you now. You have described that before and that is the sense in which you disagree with it?—A. Yes.

His LORDSHIP: Any re-examination?

Mr. DE ROCHE: No, my lord.

His LORDSHIP: We will adjourn until 2.45.

(At 12.25 p.m. court adjourns until 2.45 p.m.)

AFTERNOON SESSION

Mr. PATTILLO: I am calling Mr. Peloubet, my lord.

Mr. MAURICE PELOUBET, called, sworn.

Examined by Mr. Pattillo.

Q. You are a member of the accounting firm in New York City of Pogson, Peloubet and Company?—A. That is right.

Q. And you are the senior partner of that firm?—A. That is correct.

Q. When did you first begin practising as a Public Accountant in the United States?—A. With Price, Waterhouse & Company in October of 1911.

Q. And you remained with Price, Waterhouse & Company in the United States until 1914?—A. Yes.

Q. And then you went with the English Branch of that firm from 1914 until when?—A. 1919.

Q. And then you returned to the United States in 1919 and joined your father's firm which was Pogson, Peloubet & Company?—A. That is correct.

Q. And ever since that date you have been practising with that firm?—. That is correct.

His LORDSHIP: What is the name of the firm?

Mr. PATTILLO: Pogson, Peloubet and Company. And, Mr. Peloubet, you are a Member of the American Institute of Accountants?—A. That is correct.

Q. And a Member of the Procedure Committee of that Institute?—A. The Accounting Procedure Committee, yes.

Q. You are the president-elect of the New York State Society of Certified Public Accountants?—A. That is correct.

Q. And a Member of the New Jersey Society of Certified Public Accountants?—A. Yes, that is right—past-president, yes.

Q. A Member of the National Association of Cost Accountants?—A. Yes.

Q. Have you held any office in that Association?—A. National Director.

Q. And from 1926 up until now am I correct in thinking that you have given seventy-eight recorded speeches on accounting problems throughout the United States?—A. It must be something like that; I never counted them up.

Mr. PICKUP: Not all alike though?

Mr. PATTILLO: And have had since 1919 to date ninety-three articles published on accounting problems?—A. I think that is right.

Q. In addition to that you have published textbooks on accounting problems?—A. That is correct.

Q. Now, Mr. Peloubet, your firm have been the auditors of the American Brass Company for many years?—A. Since its acquisition by Anaconda Copper Mining Company in 1922.

Maurice Peloubet (Appellant)
Examination-in-chief by Mr. Pattillo (Cont.)

Q. And, as such, have you become familiar with the operations of the American Brass Company and also the operations of Anaconda American Brass Limited in New Toronto in the Province of Ontario?—A. That is correct—yes.

Q. Now, in your capacity as auditor for the parent company did you have any occasion in the 20's to make any recommendations as to its method of valuing its inventories?—A. There were many discussions about that in the 20's and I was consulted and was in discussion with both the operating and the financial advisers of the company on that subject.

Q. And in the early 20's what method was being used by the parent company?—A. In the early 20's—When you say "parent company" do you mean the American Brass Company?

Q. Yes.—A. In the early 20's American Brass Company were running on what you might call a sort of dual system. They kept their financial books on a first-in-first-out system; they also kept a set of what you might call unofficial operating figures and records on a position basis which was substantially what we now call a l.i.f.o. basis, that is, a position or commitment basis. They could not operate their business on the f.i.f.o. books they had to keep for tax reasons and they kept this other more or less unofficial memorandum book for their own operating purposes.

Q. Now, was there any change made in the 20's?—A. Yes.

Q. And what was the change made?—A. After some discussion along in 1924 and 1925 (Now this, of course, relates to the policy of the entire company. The Anaconda really directed the policy) but it was perfectly clear to the management at that time that the inventory method in use then did not correctly portray the realized business profits of the organization and that was true both for the Anaconda Copper Mining Company and the refining subsidiaries as well as the fabricating subsidiaries of which, of course, the American Brass Company was the chief.

Q. Now, have you prepared any charts that show the situation which was then existing?—A. I have prepared some charts which indicate the disturbed condition of prices and which I think form a background which I know was the background that was in the minds of the management at the time these discussions were taking place.

Mr. PICKUP: Does this just relate to the American Company? I was wondering, my lord, whether we were not getting a little bit afield if we are going into past history as far back as 1924 in regard to the situation in the United States.

Mr. PATTILLO: I am not going to spend very long on it, my lord. I am going to come quickly up to the present situation.

His LORDSHIP: I think we had better have it.

Mr. PATTILLO: I have a reduced copy, my lord, of the Exhibit.

His LORDSHIP: Can you file the reduced one? That is a huge thing to file.

Mr. PATTILLO: All right, I will have the small one marked.

The WITNESS: I was not familiar with what the facilities were in court and sometimes these large ones are easier to talk from than small ones.

His LORDSHIP: Well, you can talk from the large one but this small one will be filed. What is this chart?

The WITNESS: This chart is a chart of prices showing principal commodities from 1900 to 1930 and the point of this chart is to show the background of the disturbed price conditions, to show why the management of the company realized in the middle and late 20's that their accounts were not on a correct profit basis, that they were not correct for dividend purposes. Of course, it had no relation at that time to taxation because no one even thought of taxation in connection with this but the company was definitely disturbed about their profit showing and they were definitely disturbed about the amount of inventory profits that were shown.

Now, if you will look at the dotted line, that is, the line for prices from 1900 to 1915—

Q. The dotted line is—A. The prices from 1900 to 1915. Now, we see that while the lines are not straight, that the fluctuations are not violent; they are not big enough to throw profits out completely but when we get into the heavy line which shows prices from 1915 to 1929, now that line shows the violent disturbance in prices which occurred during and after the first World War.

Now, we all know that accountants and business men do not move quickly; they are slow; they are conservative and it took several years before this condition really began to force itself on the management, not only of Anaconda but of other companies. But along in the middle 20's the management began to realize that the accounts did not properly show the profits. Now, at that time about the only inventory method that would take care of this was the base stock method.

Mr. PATTILLO: And was that introduced into the records of the American Brass Company in the 20's?—A. Yes, in 1926 the entire Anaconda Group including the American Brass Company adopted for corporate purposes and, of course, for corporate purposes only, the base stock method. Now, that method eliminated the inventory profits.

Q. Now, you have been speaking about Anaconda. You do not mean the Canadian Company?—A. No, not at that time.

Q. That is the parent company, the American Brass that you are speaking of?—A. Yes, the parent company of the American Group. The Canadian Branch was small then. Its profits were negligible. It was beginning to operate and it was not a matter of great concern in the profit picture at that time.

Q. Now, you have told us that the parent company introduced the base stock method in 1926. Did it subsequently at a later date—

His LORDSHIP: What is the base stock method? We have never had it explained. —A. The base stock method briefly is this; in an industry which must carry a large quantity of raw material at all times, in the base stock method the management determine the amount which they think is the minimum that must be carried at all times and that amount is then carried permanently at a fixed price. The additions to it are carried at current prices and the principal distinction between base stock and l.i.f.o. is that if you temporarily sell part of your base stock, it is replaced at the same price; in other words, when you sell into your base stock you reserve to fill it up.

For instance, if you had a base stock at .10c a pound and you sold into it at a time when prices were .20c a pound, you would not take the profit on the .10c; you would take the profit on the .20c and put the difference in a reserve to replace your base stock as and when it happened.

Now, that is a very old method in England. I first ran into it in England in an iron works in, I think, 1916 and it was an established method then, limited to a few industries but allowed for tax purposes in England and that method was used largely in the iron and steel and base metal industries in England. There was very little literature about it but I was fortunate to run into an actual example of it and when we came up to this problem in Anaconda, several methods were canvassed and I think I was the one that suggested the base stock method. Of course, it is hard to remember conferences that far back but I believe it was my suggestion and a form of that method was adopted.

Mr. PATTILLO: Now Mr. Peloubet, subsequent to this decision that was reached by American Brass—

His LORDSHIP: Had you developed this Exhibit yet?

Mr. PATTILLO: As far as I want to go, my lord. May I have it marked?

EXHIBIT No. 28: Filed by Mr. Pattillo } Chart entitled "Fluctuations of Commodity Prices—1900-1929."

Q. Now, subsequent to 1926 did the American Brass Company shift from this base stock method which was adopted in 1926?—A. Yes, in 1933 they went on the last-in-first-out method. In fact, it was not described by that name at that time. The method was just coming into use but it was the last-in-first-out method.

His LORDSHIP: What was it called?—A. It was not called anything. What they did in the accounts was that they simply spelt out how it operated. Now, I can read to you from the published accounts how it was described but it was simply described as a method which charges current cost against current sales and carries forward the beginning inventory to the end at the same price and in the years when we sold into the beginning inventory it was stated that we sold into it. The Company's counsel thought it was better to merely describe it in the company's accounts because the term l.i.f.o. had not gained any great currency and was not thoroughly understood but it was the l.i.f.o. method.

Q. Have you got the description?—A. Yes, I would be glad to read it to you.

Q. Read the description, would you?—A. This is in the 1934 accounts of the consolidated accounts of Anaconda in which the American Brass are incorporated:

> "Metals in process are carried at normal cost, at approximate current production cost. Silver and gold are carried at market quotations or less. In accordance with the principle used in the preparation of the accounts for the year 1933 finished metals have been valued at current production costs to the extent of metal produced during the year. December 31, 1933 inventory costs have been applied to sales made in excess of production and inventories now on hand being smaller than those at December 31, 1933 are valued at prices used in those inventories which are below current market"

And that description was continued in subsequent accounts.

Mr. PATTILLO: Now, when did you first refer to this method which was begun in 1933 by the name of l.i.f.o. in the accounts of Anaconda?—A. In 1937.

Q. Now up to this time you have told us about the situation in the American Company up to 1937. Was any of this done for the purpose of taxes in the United States?—A. No, I think there was very little hope that we would get satisfactory tax treatment either by legislation or regulation. There was an attempt made in 1936 to get some legislation but that attempt failed.

Q. Did you take part in that attempt in 1936?—A. I appeared before the House Ways and Means Committee.

His LORDSHIP: Of the United States?—A. Of the United States, yes, sir.

Mr. PATTILLO: And then did you have anything whatever to do with the decision made to put the Canadian Company's corporate accounts on l.i.f.o. in 1936? —A. Yes, I was consulted on it. I was in agreement with it.

Q. Now, you have told us about your appearance in 1936 in connection with possible legislation. Did you have any subsequent appearance in connection with the legislation that was subsequently passed in the United States?—A. Yes, in 1938 I appeared before both the House Ways and Means Committee and the Senate Finance Committee advocating some legislation which would permit the last-in-first-out method. I appeared as a representative of what was then known as the Copper and Brass Mill Products Association which is now known as the Copper and Brass Research Association.

Q. And was there some legislation passed in the year 1938?—A. There was. In the Revenue Act of 1938 there was an attempt to put legislation in which would make the last-in-first-out method effective. The legislation was defectively drafted and was never operative in that Act.

Q. And then what happened in the following year?—A. In the summer of 1938, as I remember it, there was a group of three consultants appointed—Mr. Kracke, who will be a witness later, Mr. Carman Blough who is now the Research Director of the American Institute of Accountants and Professor Roy Kester who has lately retired as the Head of the School of Business Administration of Columbia University, New York.

Those three men worked with the Treasury throughout the summer and finally succeeded in drafting legislation which seemed to be workable and which was satisfactory to the Treasury and which was included in the Revenue Act of 1939.

Q. And that is the legislation that is in force today?—A. The basic statutory provisions have never been modified.

Q. Now, Mr. Peloubet, you heard this morning Mr. Richardson describe what the American Institute of Accountants was in the United States?—A. Yes.

Q. Were you a member of the Accounting Procedure Committee of the Institute which issued Bulletin No. 29 in July, 1947?—A. Yes, I was a member of the Committee during all of the discussion on that bulletin.

His Lordship: What is the number of the Bulletin?

Mr. Pattillo: No. 29, my lord.

His Lordship: July when?

Mr. Pattillo: July 1947—and dealing first with the introduction and Statements 1, 2—

Mr. Pickup: Was my friend proposing to put in some bulletin?

Mr. Pattillo: I am trying to lay the groundwork for the reception of it by his Lordship. If you would just let me finish my question perhaps I might be able to satisfy his Lordship and yourself that it is properly admissible—what I want to admit.

His Lordship: You were a member of the Accounting Procedure Committee of the Institute?—A. Yes, during the entire time when this bulletin was under consideration.

Mr. PATTILLO: Dealing first with the introduction, Statement No. 1 and the discussion applicable thereto, Statement 2, the discussion applicable thereto, Statement 3, the discussion applicable thereto and Statement 4 and the discussion applicable thereto, does what is contained in Bulletin No. 29 represent your own personal opinion on the matters discussed in those four Statements?—A. Yes, it does.

Q. My Lord, I would like to put the Bulletin in.

His LORDSHIP: As representing his opinion?

Mr. PATTILLO: As representing his opinion and I have limited it, as you have seen, my Lord to the first four Statements (they are numbered) and the discussions relative thereto.

EXHIBIT No. 29: Filed by Mr. Pattillo — Accounting Research Bulletin No. 29, July, 1947 relating to "Inventory Pricing".

Q. My Lord, there may be some objection to a couple of other questions which I would like to address now. I want you to look at the very last page of the Bulletin which shows a list—I assume it is a list—"Committee on Accounting Procedure 1946-1947". Are those the names of the members of the Committee on Accounting Procedure of the Institute of which you were a member?—A. They are.

Q. And I see in the second column in the sixth line down the name "William A. Paton"?—A. That is correct.

Q. Is that the same Mr. Paton to whom Mr. Pickup referred this morning as the author of a handbook on accounting?—A. That is the same man.

His LORDSHIP: Did Mr. Paton favour the issuance of the Bulletin or did he oppose it?—A. Mr. Paton assented to all but one section of the Bulletin which is not one of the sections we are discussing. As a matter of fact Mr. Paton dissented on the question of the definition of "market price". He assented to everything else and, to the best of my recollection, took part in the discussion and was at practically every meeting where this was discussed.

Q. I just asked this question because I see on page 243 "Mr. Paton opposes the issuance of this bulletin—"—A. Yes, "—because he objects to the retention of the phrase 'cost or market' as confusing—" but he took no exception to the sections which counsel has mentioned.

Q. He took no exception to the first four Statements?—A. No, which are the only ones which concern us on this. As a matter of fact, I dissented to part of it.

Mr. PATTILLO: But you did not dissent from any part of the first four Statements?—A. No.

Q. Now, I notice here on page 243 under the heading "Notes" that it says: "Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure". Is that the usual practice in a bulletin issued by the Accounting Procedure Committee?—A. Yes, no bulletin is issued with less than a two-third majority.

Q. Now, Mr. Peloubet, you were at the meeting when this Bulletin was finally approved, were you?—A. Yes, I was.

Q. Was there any dissent by any of the members of the Committee to any of the Introduction, Statement 1, the discussion applicable thereto, Statement 2, the discussion applicable thereto, Statement 3, the discussion applicable thereto and Statement 4 and the discussion applicable thereto?—A. I remember no dissent. There were, of course, the usual discussions and explanations but I remember no dissent expressed in the Committee and there were no formal dissents expressed.

Q. I see the third name on this Committee for Accounting Procedure at the bottom of page 243 in the first column is "Samuel J. Broad". Who is Mr. Broad?—A. Mr. Broad is a partner of the New York Office of Peat, Marwick, Mitchell & Company and is now Chairman of this Committee.

Q. Mr. Peloubet, from your experience as an Accountant practising in the United States, what is your opinion as to l.i.f.o. being or not being a generally accepted accounting method used and recognized by the accountants in the United States?

Mr. Pickup: Is not that what was ruled out before, my Lord—this man's opinion as to the views of other people?

His Lordship: It is the same question that we had yesterday but in slightly different form.

The Witness: Shall I answer?

Mr. Pattillo: Would you please answer the question?—A. As a matter of fact, I would say that it is more a matter of knowledge than opinion that is accepted because it is a matter of my own personal knowledge that a large number of published accounts for companies where their securities are listed on registered stock exchanges and which must make reports to the Securities and Exchange Commission use this method and these accounts are signed by the main and most reputable firms in the United States so that I think it is a matter of fact rather than opinion that it is a recognized method. It is, of course, my opinion that it is a recognized and accepted method in the cases to which it applies.

His Lordship: A recognized method in the cases to which it applies?—A. Yes, and we all know it is not a universal method.

Mr. PATTILLO: Now, Mr. Peloubet, you have been continually in court since the commencement of the trial of this action?—A. That is correct.

Q. On the basis of the evidence that you have heard offered here in the courtroom, what is your opinion as to the use of l.i.f.o. by Anaconda American Brass Limited to reflect its periodic income?—A. I think, if I knew nothing whatever about it beyond what I have heard in court and, of course, coupled with my general knowledge and experience, that I had before I came into the courtroom, that I would say that the application of l.i.f.o. to a primary producing brass mill such as the Anaconda American Brass Limited is probably the clearest, simplest and most easily operated application of l.i.f.o. that could be found.

The brass industry has always been—I won't say the industry most suited to it but it has always been the industry where it is most easily explained, where it is most clearly evident, where there are the fewest mechanical difficulties in the application, so I would say on the basis of the evidence I have heard here—I would say that l.i.f.o. is the proper method to be used for a business such as Anaconda American Brass Limited.

Q. And what is your opinion as to whether l.i.f.o. more accurately reflects the periodic income of Anaconda American Brass Limited than any of the other known methods such as f.i.f.o. or average?—A. I think l.i.f.o. of all the accounting methods and devices known to us at the present time would more clearly reflect the periodic income of an enterprise such as Anaconda American Brass Limited than any other of which I have knowledge.

Q. When you use that word "clearly", what do you mean by that, Mr. Peloubet? —A. Perhaps I should have said "fairly".

His LORDSHIP: Or "accurately"?—A. It is a close approximation.

Q. Do you mean "fairly" or "accurately"?—A. Of course, no accounting statement can be said to be accurate. We approach accuracy. If we ever hit it we do not know it and I think l.i.f.o. approaches accuracy more closely.

Q. Then "most nearly accurate" is a fair statement?—A. Yes, most nearly accurate.

Mr. PATTILLO: Mr. Peloubet, do you know Professor J. Keith Butters of the Graduate School of Business Administration at Harvard?—A. Yes, I am acquainted with him.

Q. And have you read his book published in the year 1949 and entitled "Effects of Taxation—Inventory Accounting and Policies"?—A. Yes, I am familiar with the book.

His LORDSHIP: What is the name of the book?

Mr. Pattillo: "Effects of Taxation" and the sub-heading is "Inventory Accounting and Policies". And what is your opinion of Professor Butters' book? A. I think it is a very—

Mr. Pickup: Surely that is in the first place a question that is so terribly wide that the answer, I don't think, will be of much assistance to us. It involves some three hundred odd pages and for any witness to say that all those three hundred odd pages are all right—I don't see how he can and, secondly, I would have said that this is the wrong way to introduce the statements made by some writer in the book.

Mr. Pattillo: Now, I am trying to—I am bringing the writer here to introduce the book himself. I merely want to get an opinion from an expert on the book.

His Lordship: Well, you can ask.

Mr. Pickup: I am certainly objecting to the book going into evidence. Of course, my friend is probably not tendering it in evidence but if he is not why does he need to ask the witness about it?

His Lordship: If certain views expressed in the book are generally accepted or have a wide acceptance would not that be proper?

Mr. Pickup: Well, I would have thought that the witness could be asked as to his own view on anything that might appear in the book.

His Lordship: Then could he be asked this: "Do you know so and so? Is he a recognized authority in the field? Do you know his book? Do you subscribe to the views that he expresses in such and such a place?" Isn't that how you would introduce books or opinions of writers?

Mr. Pickup: I do not think, my Lord, that you could introduce a book giving the opinion of the writer except possibly in cross-examination. I can, in cross-examination of this witness, refer to just what my friend is doing and ask him if he agrees with that, if it is inconsistent with a statement he has made but for my friend in chief to prove the opinion of somebody else by introducing the book and asking the witness if he agrees with it, I submit is wrong and that that is not admissible.

His Lordship: I must say I never liked the idea of bolstering up the opinion of one expert by the opinion of another expert as to the previous expert.

Mr. Pattillo: Perhaps I phrased my question badly, my Lord.

Mr. Pickup: Might I just say this. My objection will still be made to the reception of the book for the purpose that my friend has suggested. To introduce a book which has an appendix to it showing that certain letters have been sent out or certain inquiries made by someone and certain replies by someone received, does not prove the truth of those replies. It does not prove the contents of the factual statements contained in the book.

A principle a witness may speak to and this witness may speak as to his own opinion on any matter in this book but I submit that he cannot say that this book has been generally accepted by accountants in the United States or in Canada. How could he know?

His Lordship: Mr. Pickup, would not he know whether the views expressed in that book have a wide general acceptance if that is so? This is a Chartered Accountant of wide practical experience.

Mr. Pickup: I do not know how he would, my Lord any more than I might be asked whether as a lawyer I knew that all other lawyers adopted a report made by some Association.

His Lordship: You would know with regard to certain law books that they were commonly accepted as being reasonably authoritative expositions?

Mr. Pickup: Yes, my Lord.

His Lordship: Well, why would not the same be true of a textbook on accounting?

Mr. Pickup: I would like, my Lord, to take, for instance, a report that might be made by the Canadian Bar Association. They are always published; all lawyers in Canada get them. How this witness can say that some book that has been published represents the view of somebody else than himself and somebody he may have talked to is something that I submit does not exist. I hope we are not going to agree with everything we read in this world but still we want to know what the other fellow says.

His Lordship: It seems to me that the opinions—Mr. Peloubet has expressed his own opinions. I imagine he could say whether the opinions that he has expressed are widely held in the United States but, of course, that would be so of other experts. Every expert would say: "Yes, my opinions are widely held". You are going to call this person?

Mr. Pattillo: Professor Butters—yes. Mr. Peloubet, in reading this book of Professor Butters have you carefully studied Appendix A to the book?

His Lordship: Just a minute. What is Appendix A about?

Mr. Pattillo: That is a statistical appendix.

His Lordship: That is compiled from public documents and so on?

Mr. Pattillo: Yes, it is compiled from public documents and also from some information which he got from balance sheets and things of that nature which were loaned to him for the purpose. He states in his Appendix at page 269 that:

> "The 73 companies in this sample were selected from Moody's Industrials listing of 'Petroleum producing, refining, transporting and distributing' com-

panies. All companies listed were included in the same with the following exceptions: foreign companies, companies engaged mainly in transportation (including pipeline companies), and companies for which no method of inventory valuation was reported. Financial data were obtained mainly from stockholder reports and prospectuses, but Moody's was used for the year 1947 for five companies, and, in the absence of other data, for most of the companies with total assets of less than $10 million. (The same general procedure has been followed in selecting the samples for the nine remaining industries.)".

Now, he explains right in the foreword where his material comes from.

His LORDSHIP: Yes, as information that he himself obtained.

Mr. PICKUP: Not this witness, of course. Then he has a table, Table 29 on the back of 285 which is "Data on Companies on Lifo in 1947: Nonferrous Metals" and he sets out a good deal of data in connection with them.

Mr. PATTILLO: Now, what I would like to ask this witness is whether he has studied this Appendix A, whether he has studied Table 29 in Appendix A relating to industries dealing in non-ferrous metals, and whether he has accepted this data in this Table as being authoritative.

His LORDSHIP: As being authoritative?

Mr. PATTILLO: Yes.

Mr. PICKUP: Does it matter to us whether he has accepted it or not as being authoritative? Surely the question is of fact, is it true.

Mr. PATTILLO: Well, I want to get first what acceptance it has had by this individual and then when Professor Butters comes on I do not want to be confronted by my learned friend saying—

His LORDSHIP: "This is only your opinion"?

Mr. PATTILLO: Yes.

His LORDSHIP: This is a statement of a number of companies that adopted the l.i.f.o. method in the non-ferrous metal industry?

Mr. PATTILLO: Yes, he gives their names; he gives their assets.

His LORDSHIP: Well, what about Mr. Pickup's question: what difference does it make whether Mr. Peloubet has accepted this table as authoritative or not?

Mr. PATTILLO: Well, my Lord, I was just thinking of the case that once arose in England where the question arose as to the admissibility of Charlisle's Tables and it was proved that the tables were generally accepted as being authoritative and used and once that was proved, the court said that it was perfectly admissible although they did not call the compiler of the table.

Now, I intend to call the compiler of these statistics but I am going to be met with, as Mr. Pickup has indictated, his suggestion that he has compiled data which he got from some sources and which may or may not be true. Now, I wish to have the evidence accepted as good evidence of the conditions in the United States in this particular industry.

His LORDSHIP: Or belief in the table by an experienced person in that particular craft or subject?

Mr. PATTILLO: That is it, my Lord.

His LORDSHIP: Well, I will let you ask the question.

Mr. PATTILLO: Thank you, my Lord. Now, Mr. Peloubet, you did say that you had studied Appendix A in Professor Butters' Book?—A. I have read it with great interest.

Q. And you have studied Table 29 which is headed: "Data on Companies on Lifo in 1947; Nonferrous Metals"?—A. Yes.

Q. And from your knowledge gained in the accounting profession, do you accept this table as being authoritative?—A. May I see it? I have a considerable acquaintance among the non-ferrous metal industry beyond our own clients. I have that from several sources. Some years ago our firm made a general investigation into the whole industry for a Trade Association. I have advised the Copper and Brass Research Association and in the course of that I have had to visit and other times discuss things with members of the industry so that, apart from any accounting knowledge, I have a pretty good general acquaintance with that industry.

When I look this table over I find that most of these companies on Table 29 I have a personal acquaintance with and I am absolutely convinced that this is a careful and exact compilation.

His LORDSHIP: Are you putting that Appendix and Table in?

Mr. PATTILLO: Yes, my Lord.

EXHIBIT No. 30: Filed by Mr. Pattillo — Appendix A of book by Professor Butters entitled "Effects of Taxation—Inventory Accounting and Policies" with particular reference to Table 29 on page 285 (back).

Mr. PATTILLO: Shall we mark the table itself, my Lord?

His LORDSHIP: Just as you say. The Appendix and Table start at what page?

Mr. PATTILLO: Page 269, the Appendix and Table 29 at the back of page 285.

EXHIBIT No. 31: Filed by Mr. Pattillo — Table 29—"Data on Companies on Lifo in 1947: Nonferrous Metals" on back of page 285 of Appendix A of book entitled "Effects of Taxation—Inventory Accounting and Policies".

Q. Now, we put in Exhibit 28 a short time ago showing the fluctuations in commodity prices from 1900 to 1929. Now, I show you this chart. Does that present the fluctuations of commodity prices bringing them up to date from 1930 to 1950?—A. Yes, that brings it up to the present time.

Q. And the dotted lines indicate the period from 1930 to 1944?—A. Yes, that is correct.

Q. And the heavy black line from 1944 up to the present time?—A. That is right.

Q. And you had this chart prepared?—A. I had this chart prepared from public sources.

Q. And the sources are disclosed?—A. The sources are discussed on the bottom of the chart—Cotton Exchange, Chicago Board of Trade, Bureau of Labour Statistics.

Q. May I have this marked, my Lord?

His LORDSHIP: It has been marked.

Mr. PATTILLO: This is the new one from 1930 to 1950.

EXHIBIT No. 32: Filed by Mr. Pattillo — Chart entitled "Fluctuations of Commodity Prices—1930-1950"

Cross-Examination by Mr. Pickup

Q. Now, Mr. Peloubet, you referred to a period in the 20's when the American Company had what you called a dual system and kept an unofficial record on a commitment or position basis. Tell me what you mean by that?—A. They operated then as they do now, that is, they sold for delivery and then bought their metal for delivery at the same time. At that time there was, of course, a free open metal market and it was possible to buy metal sixty or ninety days ahead and they would make sales commitments and then cover their sales commitments by purchase commitments.

Now, their business operated then exactly as it does now. They had to have a stock in works and they bought and sold their material above that. Now, what they were interested in was to be sure that they had their position covered all the time. If they happened to receive a little more metal than they shipped out it didn't make any difference as long as their commitment position balanced and they always kept that position balanced because then, as now, it was their policy not to speculate and to sell the metal for what they bought it for. So that as they did business exactly then as they do now except for the difficulties with suppliers, they had to keep what were, in effect l.i.f.o. records in order to limit their business.

Their financial records were kept on the basis of their tax returns which was f.i.f.o. at that time.

Q. Can you tell me what kind of record they kept apart from f.i.f.o.?—A. They kept a book with these commitments in it, that is, a book which showed their commitments. It showed their position, as I remember it. I think they got their position out weekly.

Q. You mean by that that they kept a book or record which, apart from the f.i.f.o. system, showed what their week to week or month to month position would be if they were operating on the basis of replacement costs?—A. That is right—yes; in other words, they kept a record which showed that their sales and purchase commitments were covered both in quantity and amount which was their guide to prevent speculation.

Q. Then you said that in 1924 or 1925 it became clear that the inventory method in use did not correctly portray the business profits of the company?—A. Yes.

Q. Tell me just in what respect they did not correctly portray the business profits?—A. Well, they had these large apparent profits which were caused by carrying inventory in the same quantity at one end of the year at a higher or lower price than the identical inventory was carried at the other end of the year.

Q. Is what you mean illustrated by Exhibit 28 which was after the period of the first war and showed the rise in prices in 1916 and 1917?—A. It was the conditions portrayed there which made the management conscious of the fact that they were showing in their f.i.f.o. books and which were also their published statements at that time and their tax returns—it made them conscious that they were showing profits that were merely marking up and marking down inventories which they did not sell and could not sell.

They realized that from a business point of view and, of course, like most business men they realized it sort of dimly and their methods of arriving at it were awkward but there is no doubt they knew they were showing profits that were not there and it disturbed them greatly.

Q. Was not the situation then that prices had risen, large stocks were on hand and sales were being made at higher prices than the inventory was being carried at?—A. I don't think that was what bothered them. I think what bothered them was more the fluctuations than it was the rise in the price. I do not think a continued steady rise would have been nearly as alarming but what they did not like was the fluctuation and the idea: "If we end the year with a higher price, we are going to show a terrific profit which is not there and if we end it at a low price we are going to show an apparent shortage which is not there". It was the fluctuation rather than the mere rise in price that bothered them.

Q. Would I be correct in putting it this way, that they looked upon the position at that time as showing abnormal profits on a rising market?—A. No, I do not think it was abnormal; it was the fact the profits were not there at all—they did not exist. They would not have been averse to abnormal profits if they existed.

Q. If, say, in 1925 or 1924 they were disposing of inventory at higher prices than they paid for it, there would be actually higher profits there, would there not in fact?—A. If that were true on the basis on which they operated their business, yes. It was not true on that basis. It was not true on the basis on which they actually bought and sold.

His LORDSHIP: Were they dealing in their inventories?—A. They definitely were not dealing in their inventories. They were buying to cover. Every time they bought they bought to cover. If they speculated it was entirely inadvertent and there was very little of it that was inadvertent.

Mr. PICKUP: Then you spoke of a base stock method and you described that, I think, to His Lordship. That method was never adopted in the United States for tax purposes?—A. No, it was not. It has technical faults. Properly administered it would be a good method but it has technical faults.

Q. Then you spoke of the American Company, I think, in 1933 going on what you call the l.i.f.o. basis but not adopting the name of l.i.f.o.?—A. Yes, as a matter of fact they adopted—in their own internal operations they used the name l.i.f.o. but they did not use it in their statement.

Q. That was for corporate purposes only and not for tax purposes?—A. It was not for tax purposes, no.

Q. Then, in 1938 I think you told us they adopted the l.i.f.o. method—A. They adopted the name in 1937 but there was no change in method.

Q. Then you spoke of the efforts made in the United States, first in 1938 and then in 1939 to have the Government or legislative authority adopt the l.i.f.o. principle?

His LORDSHIP: Yes or "permit".—A. It was a permissible method. It was always permissible.

Mr. PICKUP: There were some conditions surrounding it?—A. Oh yes, definitely.

Q. And, just speaking generally, you first had, before you went onto it at all, to get onto a proper basis of some sort of historical cost, didn't you?—A. Yes, there really were three conditions.

Q. I was going to give them to you. The first was you had to get onto a proper basis of cost to start with?—A. You had to start with a cost inventory which was on the same basis as you ended your last f.i.f.o. period of cost or your other method.

Q. Then, as His Lordship has already indicated, it was something permissible. You had to elect to do it?—A. It was an elective method. That is the name in the Statute.

Q. And once you got on it you could not get off it without the consent of the Revenue?—A. That is correct.

Q. Nor, having once gone on the l.i.f.o. principle you could not take advantage of market, for instance, if the scale swung the other way and prices started to drop? —A. That was definitely a condition and there was one more condition which was that you had to keep your corporate accounts on the same basis as your tax accounts.

Q. Now then, you said that in your opinion l.i.f.o. was the proper method for the present Appellant Company. Now, are you referring to l.i.f.o. in the way in which it is used in that l.i.f.o. method in the United States?—A. Yes, I would say that what the company does here would definitely be permitted. We have a special regulation for companies which treat their raw material the way Anaconda American Brass Limited does, that is, where they treat one material, you might say, in a lump no matter where it is in the plant.

In 1943 there was a special Treasury decision on that and I am quite certain that this company (I would agree it makes no difference for Canadian purposes) but as an accountant I am quite certain that this company is following precisely the method which would be permitted in the United States.

Q. And would you say it would be proper for this Company to go on that principle and that, in your opinion, you mean to adopt l.i.f.o. in such a way whereby if it once elected it would have to stay on it and not take advantage of market without the consent of the Revenue in Canada?—A. Oh yes, and I think the Revenue would be—if I might be permitted to have an opinion on Canadian tax matters—I think the Revenue would be very, very wrong to permit any such things.

Q. Maybe they could not help themselves if the tax payer could do as he likes. Now, just a word with regard to Exhibit 29. I think you agree with the first four Statements in that Exhibit?—A. Yes.

Q. I think I only want to bring one of them specifically to your attention and that is Statement 3. I am reading the second sentence of it:

> "As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."

Do you agree with that?—A. Yes, I think that is a good basic principle.

His LORDSHIP: That is what Mr. Richardson said.

Mr. PICKUP: That is all, thank you, my Lord.

Mr. PATTILLO: My Lord, there is one question I overlooked in my direct examination. May I be allowed to ask it?

His LORDSHIP: Yes.

Mr. PATTILLO: You heard Mr. Richardson give his evidence yesterday afternoon and this morning where he explained his understanding of the f.i.f.o., average and l.i.f.o. methods?—A. Yes, I heard the evidence.

Q. And do you agree with what he had to say as to each of them and how they worked?—A. I think what he said is my opinion and generally accepted practice.

Re-examination by Mr. Pattillo:

Q. Now, just a question on re-examination. If a company such as Anaconda American Brass Limited was on l.i.f.o. and continued to carry on business in the manner which has been described in this court it does carry on business, would it be good accounting practice to change from l.i.f.o. to f.i.f.o.?—A. Well, I do not think it would be good. I think it is one of those things that if it was done, if after the accountants had advised against it, it was still the judgment of the management that it should be done, it would be one of those things which would have to be reported on and it would have to be disclosed but you would have to disclose it fully. You would have to show the monetary effect of the change. Everyone would have to be put on notice as to what had happened so that they could form their own opinion on the wisdom and propriety of the change. I think that it is an almost impossible thing to happen.

His LORDSHIP: Unless there were changing conditions of business?—A. Unless their business changed, yes, but as long as business conditions remained the same, I know of very few people who went on l.i.f.o. and reverted to f.i.f.o. I can only think of one or two instances which were comparatively unimportant.

Mr. PICKUP: I was going to ask the witness as to these companies in the Appendix going on l.i.f.o. after the legislation in the United States but I think the Appendix shows that on its face.

Mr. PATTILLO: Now, my Lord, I have here a document which is the D.B.S. Reference Papers 1949. Now, prior to trial, my Lord, we spoke to my learned friend as to the method of proving this document which is issued by the Dominion Bureau of Statistics at Ottawa and which has statistical data in it relating to the companies in Canada which are on the l.i.f.o. method of valuing inventories and other data.

In the Appendix there is a sample of the survey that was sent out and there is a survey of the manufacturers inventory accounting methods showing the number of firms reporting and the number that were on the various methods. It is merely part of the proof that I am tendering to show that this is a method which is generally accepted in Canada.

Now, my learned friend agreed that I need not bring any witness from the Department for the purpose of tendering this document but he reserved all his other rights of objecting so I am simply now tendering the document and asking that it be marked and I will leave it to my learned friend to state his objections.

His LORDSHIP: What is it called?

Mr. PATTILLO: It is called "Inventory Accounting Methods of Canadian Manufacturers".

Mr. PICKUP: I am not objecting to this, my Lord.

I should have said, my Lord, that I agree with my friend that this should go in evidence but it is to go in evidence for the purpose of getting in this survey.

His LORDSHIP: Only for the purpose of the survey and statistics?

Mr. PICKUP: Yes, there are a number of other introductory statements made which I do not agree with and he said he had no intention of putting in the statement as evidence of the introduction.

His LORDSHIP: Do you want to identify what goes in?

Mr. PICKUP: What goes in is on pages 6 and 7 and it is called "Survey of manufacturers' inventory accounting methods—number of firms reporting in each category, classified by sizes of firm". That is correct?

Mr. PATTILLO: Yes.

EXHIBIT No. 33: Filed by Mr. Pattillo — Pages 6 & 7 of D.B.S. Reference Papers, 1949 entitled "Survey of Manufacturers' Inventory Accounting Methods."

Mr. PATTILLO: I will call Mr. Kenneth Carter.

Mr. KENNETH CARTER, called, sworn:

Examined by Mr. Pattillo:

Q. Mr. Carter, you are a Chartered Accountant practising your profession in Toronto in the Province of Ontario?—A. I am.

Q. And you are a partner in the firm of McDonald, Currie and Company which has offices throughout Canada?—A. I am—that is right.

Q. How many years have you been a partner of that firm?—A. Approximately fifteen years. I came to Toronto fifteen years ago and became a partner at that time.

Q. And prior to coming to Toronto as a partner in the firm for how many years had you been practising accountancy before that?—A. The previous ten years—since 1925.

Q. And you are a graduate of McGill University?—A. I am.

Q. Now, from your experience as a Chartered Accountant carrying on practice in Toronto, what is your opinion as to l.i.f.o. being a generally acceptable accounting method in Canada?—A. I think it is an acceptable accounting method of determining cost. My views on it are well represented by the American Bulletin No. 29 which has already been submitted to this Court.

Q. And do you adopt the statements contained in Bulletin No. 29 as being your views?—A. I do.

Q. That is, in relation to the first four Statements?—A. Correct.

Mr. PICKUP: He apparently adopts them all?

The WITNESS: I am pleased to.

Mr. PATTILLO: Now, my Lord, Mr. Carter and two other experts whom I hope to call, have not been here throughout the whole of the trial. My associates and myself have prepared (we had prepared it in draft prior to the trial) a Statement of Facts. We have now very carefully gone over it and checked it with our notes as to what we have put in and revised it.

I would like to put in my Statement of Facts as an Exhibit and have Mr. Carter give his expert evidence on the basis of the facts contained in the Statement of Facts.

His LORDSHIP: You mean you are making a precis of the evidence to take the place of a Statement of Facts?

Mr. PATTILLO: I have made very certain that we have not said anything in here that has not been brought out in evidence and I realize, of course, when I ask him to give his opinion based on the facts in the Statement of Facts that if I am wrong in what I have said, then his opinion is not of much value but I do not see how else, without having these experts remain here throughout the whole of the trial, (and they are busy men) to do this. The only other way I can do it is to put it in the form of a long hypothetical question assuming that the facts are so and so and so and so.

His LORDSHIP: And that is really what you are doing.

Mr. PATTILLO: Yes, that is really what I am doing.

His LORDSHIP: The weight of the opinion stands or falls on the accuracy or otherwise of this precis, or whatever you like to call it?

Mr. PATTILLO: That is right.

Mr. PICKUP: My friend is then not proposing to put it in except for the purpose of identifying the evidence or directing the attention of this witness to it. I would, of course, object to a statement going in—

His LORDSHIP: It cannot go in as a precis of the evidence.

Mr. PICKUP: Nor as any statement of fact.

His LORDSHIP: No, it cannot go in as such but it can go in as a hypothetical question—"Assuming such and such a situation to be thus and so, what is your opinion?".

Mr. PICKUP: Just as if Mr. Pattillo had simply framed a question now to the witness and read the whole Statement of Facts.

His LORDSHIP: Yes, and then: "On that assumption, what is your opinion?". It seems to me there can be no objection to that. It does not go in as a Statement of Facts. The facts are not before the court subject to any cross-examination there may be. Then maybe it ought to go in just for identification or something of that sort. How would that be?

Mr. PATTILLO: Mark it merely for identification.

His LORDSHIP: All right it will be Exhibit "A" for Identification.

EXHIBIT No. A for *Identification only:* Filed by Mr. Pattillo — Summary prepared by Counsel for Appellant of preceding evidence.

His LORDSHIP: And you might perhaps preface your question to the witness.

Mr. PATTILLO: Yes, my Lord, I will try to do that. Mr. Carter, have you at my request read a document headed "Statement of Facts describing the operations of Anaconda American Brass Limited" and the schedules attached thereto, being three in number?—A. May I see that?

Mr. PICKUP: There are four attached to the copy I have.

Mr. PATTILLO: Yes, I am sorry—four in number.

The WITNESS: Yes, I have.

Q. Now, assuming that this Statement of Facts, which has been marked Exhibit A for Identification Purposes only, correctly states the method of operation of Anaconda American Brass Limited, then what is your opinion as to the use of l.i.f.o. by that company for the purpose of determining its periodic income?—A. In my opinion l.i.f.o. is the best method of arriving at a fair measurement of annual income under the circumstances described in this statement.

HIS LORDSHIP: A fair measurement of annual income?—A. Yes, sir, or annual net profits.

Mr. PATTILLO: And we are dealing here particularly with the years 1946 and 1947?—A. That is right.

Cross-examination by Mr. Pickup:

Q. Just one question, Mr. Carter. Referring to Exhibit 29, that was this Accounting Research Bulletin, you said in answer to my friend that you agreed with the whole bulletin?—A. Yes, sir.

Q. And then you sort of qualified it by adding "the first four statements"?

His LORDSHIP: Only the first four statements are in.

Mr. PICKUP: But the witness said he agreed with the statements in the book.—A. That is quite right.

Q. You do, do you?—A. Yes.

Q. You do not limit it to the first four Statements?—A. The balance of the Bulletin pertains to market and the determination thereof and, while I do not think it pertains to the matter in hand, I have no reservation with regard to the Statements therein contained.

Q. That is all, thank you.

Mr. LESLIE MCDONALD, called, sworn.

Examined by Mr. Pattillo:

Q. Mr. McDonald, you are a Chartered Accountant practising your profession in Toronto in the Province of Ontario?—A. I am.

Q. And you are a partner of Price, Waterhouse and Company?—A. I am.

Q. And have been for how many years?—A. Eight years.

Q. And you have been practising as an accountant for how many years?—A. Since 1925.

Q. Now, Mr. McDonald, you have had practical experience with the use of the method known as l.i.f.o.?—A. Yes, I have.

Q. Would you explain to the court your reason for expressing an opinion of dislike to l.i.f.o.?—A. My dislike for l.i.f.o. is based on the fact—

His LORDSHIP: Is based?—A. Yes—based on the fact that if it has been adopted and in use for a considerable number of years, the inventory figure in the balance sheet becomes relatively meaningless.

Q. Is that your objection to l.i.f.o.?—A. That is my objection to l.i.f.o.

Q. Now, although you have said that you do not like l.i.f.o. for that reason, as a practising accountant what is your opinion as to l.i.f.o. being a generally accepted accounting method by the profession in Canada?—A. I think I would say it is an acceptable method but it has not had much use because of the attitude of the Tax Department towards the matter but I believe it is acceptable.

His LORDSHIP: If the attitude of the Department were to change, do you think there would be a greater acceptance of the l.i.f.o. method?—A. I honestly believe there would, your Lordship.

Q. That there would be?—A. Yes, there would be.

Mr. PATTILLO: Mr. McDonald, at my request did you study this Statement of Facts which has been marked Exhibit A for identification purposes only and the four exhibits attached thereto?—A. Yes, I did.

Q. Now, assuming that the facts set out in this Exhibit A for identification only are true as to the manner in which Anaconda American Brass Limited carried on business in the years 1946 and 1947, what is your opinion as to the use of l.i.f.o. by the Company in those years, 1946 and 1947, for the purpose of arriving at its periodic annual income?—A. I think that under the circumstances outlined in that Statement of Facts, l.i.f.o. would be a preferable method of determining periodic profit or loss.

His LORDSHIP: Would be a preferable method of determining periodic profit or loss?—A. Yes.

Mr. PATTILLO: When you use that word "preferable" it would be preferable to what?—A. To f.i.f.o. or average.

Q. Now, are you familiar with Bulletin No. 29 of the Committee on Accounting Procedure of the American Institute of Accountants which was issued under date of July 1947?—A. Yes.

Q. And are you familiar with the introduction and Statements 1, 2, 3 and 4 contained therein?—A. May I refresh my memory? Yes.

Q. And do you agree with those Statements 1, 2, 3 and 4?—A. I do.

Q. Now, Mr. McDonald, you were here all morning and heard the evidence of Mr. Richardson given this morning?—A. Yes.

Q. And did you hear him earlier giving evidence yesterday when he was dealing with the methods of valuating inventories and explaining the different methods to the court?—A. I do not think I was here for the whole time that Mr. Richardson was on the stand yesterday.

Q. Well, dealing with what you heard him give evidence about this morning—

Mr. Pickup: Was he here all morning?

Mr. Pattillo: You were here all morning?—A. Yes, I was here all morning.

Mr. Pickup: Of course your Lordship has the record before him. You can tell where the morning began.

His Lordship: It will be in the record which is morning.

Mr. Pattillo: Do you agree with the opinions that were expressed by Mr. Richardson this morning as to the methods of inventory valuation?—A. Yes, I agree except for some minor variations which are unimportant and have no bearing on this case.

Cross-examination by Mr. Pickup:

Q. Just a couple of questions, Mr. McDonald. You mentioned your objection to l.i.f.o. because it got to a position where the balance sheet was meaningless?—A. Where that inventory item in the balance sheet was meaningless.

Q. And I take it that you would not care to certify a balance sheet on the l.i.f.o. basis unless you called specific attention to the fact of l.i.f.o.?—A. Well, that is the common practice—to indicate on the face of the balance sheet the basis of valuation of the inventory if it is under l.i.f.o.

His Lordship: That was done on the annual statements.

Mr. Pickup: Just one other question. You spoke of l.i.f.o. as applied to this Exhibit A, Statement of Facts, as being preferable—"a preferable method". Had you in mind some purpose for which it would be preferable?—A. For determining periodic income.

His Lordship: Determining periodic profit or loss?—A. Yes.

Mr. Pickup: Any particular reason why you consider it preferable?—A. I think it more clearly reflects periodic income in the circumstances in this case.

Q. What circumstances have you in mind?—A. Well, I have in mind the circumstances that selling prices closely reflect changes in costs of raw material, that the inventory is interchangeable, that inventory is important in relation to turnover and all the other conditions which have been detailed by other people here as conditions which should be present before l.i.f.o. is an acceptable method.

His LORDSHIP: Including slowness of turnover?—A. Yes.

Mr. PICKUP: And are you assuming that once adopted the Company would have to stick to it?—A. I do not think you can bind the future at all, Mr. Pickup. You have to face circumstances as they arise.

Q. I was wondering in describing it whether you were assuming it won't be changed next year?—A. I think that in determining periodic profits a Company should be consistent in its practices. I would not advocate a change to any method that could only be adopted for a year or two, to have circumstances change and the matter become inapplicable and you have to abandon that particular method.

Q. You have never recommended any company adopting l.i.f.o. when market prices were dropping, have you?—A. No.

Mr. PATTILLO: Now, my situation is this, my Lord, that Mr. Jephcott who is my last accountant witness (Mr. Butters will be here in the morning) but Mr. Jephcott unfortunately is at an annual meeting of their partnership of P. S. Ross & Sons in Montreal and he is the senior partner and had to attend that meeting and I was quite certain I was not going to need him until tomorrow morning so I consented to his going on the understanding that he would be here tomorrow morning. So I was wondering if we could adjourn now.

He will be a very short witness like Mr. Carter and I would rather call him before I called Mr. Kracke. I do not want to disrupt the order of the case with your Lordship's permission.

His LORDSHIP: What about starting tomorrow at ten just to make sure?

Mr. PATTILLO: That would be quite convenient, my Lord.

His LORDSHIP: Get in as much time as we can. Perhaps now we will sit until five. If necessary, we might have to sit on Saturday morning. I want to make sure that we will hear all the cases on the docket including your own which is the last one.

Mr. PICKUP: I wondered what your Lordship's thought was on that. If we finished argument Tuesday night that would leave you enough time?

His LORDSHIP: I have another Income Tax case following this one. I do not know how long that will take.

Mr. PATTILLO: Counsel told you two days.

His LORDSHIP: I do not see why it would take two days but I thought it might easily take one and a half days and then, I suppose, your last case will take a day. You have very little in the way of rebuttal evidence?

Mr. PATTILLO: That is right.

His LORDSHIP: Well, that would consume three days—those two cases, I think. If possible I would like to take the afternoon train on Friday.

Mr. PATTILLO: Then we should be setting our sights to try and finish this case Monday night.

His LORDSHIP: That would be more satisfactory if that would be possible but I am not going to hurry counsel. It might just not be possible but I should think if you were to finish this case on Monday night or Tuesday at noon, that we ought to be able to run off our schedule pretty well.

Mr. PICKUP: I was thinking—

His LORDSHIP: It might be wise under the circumstances perhaps to sit on Saturday morning.

(Court is Adjourned at 4.45 p.m. until 10.00 a.m. Friday 23 June 1950).

Toronto, Ontario,
23rd June, 1950.

MORNING SESSION

Mr. PATTILLO: My Lord, before resuming this morning, I want to speak about a matter that relates to this D.B.S. Survey which we put in evidence yesterday.

Mr. PICKUP: What is the Exhibit number?

His LORDSHIP: Exhibit 33. That is the Bureau of Statistics Record?

Mr. PATTILLO: That is right, my Lord. I would like to call your Lordship's attention to Page 2 of the printed matter. Yesterday my learned friend spoke to you of the printed matter not being part of the exhibit but on page 2 the series of paragraphs under the subject-matter "Methods, definitions and results" I think should go in to explain the nature of the survey that was made and who was canvassed. Would you have any objection to that?

Mr. PICKUP: May I just look at it please? You must just mean the first heading "Valuation of Inventory"?

Mr. PATTILLO: I want to go down to the first heading "Valuation of Inventory for balance sheet".

His LORDSHIP: You want "Methods, Definitions and Results" and then up to the end of "Valuation of Inventory for Balance Sheet". You want that in?

Mr. PATTILLO: No, just up to that.

Mr. PICKUP: Just the explanatory part of the survey.

His LORDSHIP: Then it is understood that that becomes part of Exhibit 33.

Mr. PATTILLO: Thank you, my Lord, I will call Professor Butters.

PROFESSOR J. KEITH BUTTERS, called, sworn

Examined by Mr. Pattillo:

Q. Professor Butters, you are presently an Associate Professor of Business Administration at the Harvard School of Business Administration?—A. Yes, at the Harvard Graduate School of Business Administration.

Q. And you have been since July 1st, 1949?—A. That is correct.

Q. You are a Graduate in Arts from the University of Chicago?—A. That is correct.

Q. And you have your Master's Degree from Harvard?—A. Yes, sir.

Q. And your Doctor of Philosophy from Harvard?—A. Yes, sir.

Q. And prior to joining the staff of the School of Business Administration, you had professional experience in the Department of Economics at Harvard for a number of years?—A. Yes, I was an instructor in the Department.

Q. And at the present time you are Senior Economist and Consulting Expert with the Treasury Department of the United States in the Division of Tax Research?—A. I believe my appointment as a Consulting Expert is still on the books; it has been inactive most of the time for the last year or so.

Q. Now, commencing with the year 1939 up to the present time, you have either published alone or in co-operation with some other person fifteen articles or books?—A. I believe that is correct—yes, sir.

Q. And am I correct in thinking that the last of those is the book headed "Effects of Taxation—Inventory Accounting and Policies" which was published in 1949 and on which you were assisted by Mr. Powell Niland?—A. That was published in 1949. There was another one written earlier that was published at approximately the same time. I am not sure which was the later.

Q. Now, this book consists of 265 pages of text in the information-matter; is that correct?—A. Yes, sir.

Q. And then thereafter consists of an Appendix headed "The detailed data on use of l.i.f.o." which extends from page 269 to page 299 inclusive?—A. Yes, sir.

Q. Now, dealing first with the Appendix—

J. Keith Butters (Appellant)
Examination-in-chief by Mr. Pattillo (Cont.)

Mr. Pickup: May I ask my friend what his intention is with regard to this book because I will be objecting to introducing the book in evidence but my friend may not have any such intention. I do not want him to get too far into it on some theory that the book itself is going to be produced in evidence instead of the man's own opinion but my friend may not have the intention of doing that.

Mr. Pattillo: I am particularly concerned with getting in the Appendix of the Book. I had intended to ask Professor Butters whether the first 265 pages represented his opinion on the subject of l.i.f.o. after his study of the matter.

Mr. Pickup: I submit that is most unfair to me. It is true I saw the outside of the book yesterday but I have not yet read the book and I do not think I should have to read a whole book to find out what a man's opinion is and my friend has no right to just bring 260 odd pages of book and put it to the witness and say: "Do we find your opinion expressed in this book?" and then leave it to counsel cross-examining to go through the book and find out what his opinions are. If the witness has any opinions which affect this matter—

His Lordship: It may take 265 pages to express his opinion.

Mr. Pickup: I hope it does not take that long but you will see how utterly impossible it is for me to cross-examine.

His Lordship: I see practical difficulties in the matter but that can be got around by giving you an opportunity to read the book.

Mr. Pickup: I have never seen it done, my Lord.

His Lordship: Well, it might be a very convenient way of having it done. As a matter of fact Mr. Richardson gave evidence and he read through a prepared text.

Mr. Pickup: I know and I was going to object at the time but I thought I would not do it with Mr. Richardson and I did not object. I know that Mr. Richardson had nineteen or twenty-five pages—something like that and he did read it through so I had an opportunity while he was giving his evidence of seeing what it was.

His Lordship: Well, Professor Butters could do the same thing.

Mr. Pickup: Well, I hope I am not suggesting that he read it through.

His Lordship: Well, he could do the same thing. He could read the book and would be in exactly the same position as Mr. Richardson except that Professor Butters' evidence would take longer than Mr. Richardson's—exactly the same thing because Mr. Richardson read through a prepared text.

Mr. Pickup: I am certainly not going to ask this witness to read 265 pages of his book.

His Lordship: I think I will allow the book in in the form in which it is proposed.

J. Keith Butters (Appellant)
Examination-in-chief by Mr. Pattillo (Cont.)

Mr. PATTILLO: Professor Butters, dealing first with your Appendix A—and I am particularly interested in Table No. 29 which has been marked as Exhibit 31 and which appears on the back of page 285 of your book—

His LORDSHIP: The Appendix and the Table were marked as exhibits.

Mr. PATTILLO: Yes, the Appendix is marked Exhibit 30. The Table related to the non-ferrous metal industry. Now, would you please explain the data that you used for the collection of the material contained in Table 29?—A. The statistical data in Table 29 were compiled insofar as possible from reports of the companies concerned. These are companies in the non-ferrous metal industry. I used company annual stockholders reports and prospectuses. When these were not available listing statements with the New York Stock Exchange, registration statements with the Securities and Exchange Commission and, in some instances, data on the company in the financial publications such as Moody's Investments Manual were used. Most of the data, however, were taken from the companies' annual stockholders reports.

Q. And did you satisfy yourself that the information contained in Table 29 marked Exhibit 31 was as accurate as it was possible to be from the sources which you investigated?—A. Yes, sir, this statistical data for the most part were not compiled by me personally but they were all compiled under my immediate direction by professional members of our research staff at the Business School. They were all compiled by one person and independently checked by a second person and any doubtful matters were referred to me for my own decision.

Q. Now, as to the text in Appendix A relating to the survey of the non-ferrous metal industry which is contained on pages 284 and 285 and in part of page 288, that is, the explanatory text relating to Table 29 which has been marked Exhibit 31, is that correct?—A. Yes, that is correct. The material in those pages includes data obtained by interview from a number of the companies listed on Table 29 as well as the statistical source.

Q. Now, coming back to the book itself and the text part of it—page 265, does it contain your views on the matter of inventory accounting and policies and the effects on taxation of it?—A. Yes, sir.

Q. May I have the book itself marked, my Lord.

EXHIBIT No. 34: Filed by Mr. Pattillo } Book entitled "Effects of Taxation—Inventory Accounting and Policies."

Mr. PICKUP: Then, my Lord, in the course of the cross-examination at this time —there may be no cross-examination but all I can do is to ask one of my colleagues, if I do not see fit to do it myself, to read the book over the week-end and see what opinions this witness has expressed and then, if there are any questions I want to ask him, I will ask them on Monday morning.

His LORDSHIP: At the moment, then, you request that Professor Butters stand down?

Mr. PICKUP: Yes, my Lord because it is quite impossible for me to cross-examine him without going through the book in my cross-examination.

Mr. PATTILLO: That is all for the moment, Professor Butters.

His LORDSHIP: Then if you will please stand down and hold yourself available for cross-examination and that will be Monday.

The WITNESS: That will be personally very difficult for me.

His LORDSHIP: I am afraid we will have to ask you.

The WITNESS: Would it be possible for me to appear later?

Mr. PICKUP: No, this case will be over Monday.

His LORDSHIP: Would it be possible, Mr. Pickup—if it is difficult for Professor Butters, would it be possible to deal with him tomorrow morning for just a short time that might be required? I would be preparèd to.

Mr. PICKUP: The difficulty is, my Lord, in getting ready to do it. There is the whole trouble. I imagine when we do it it will be fairly short. It is just to see what there is there.

His LORDSHIP: Well, I think he had better wait until Monday.

MR. GERALD JEPHCOTT, called, sworn

Examined by Mr. Pattillo:

Q. Mr. Jephcott you are a partner in the accounting firm of P. S. Ross & Sons?—A. That is right.

Q. And that firm carries on business throughout Canada?—A. Yes.

Q. And you have been a partner of the firm for how many years?—A. I was admitted to the partnership in 1928.

Q. And you have been practising as an accountant for how many years?—A. Well, I entered the same firm as a student in 1916.

Q. And became a full-fledged accountant when?—A. I was admitted to the Quebec Institute of Chartered Accountants in 1923.

Q. You are presently practising in Toronto in the Province of Ontario?—A. I have been here since 1924.

Q. And you are the senior resident partner of the firm in this district?—A. Yes, I think you may say that.

Q. Mr. Jephcott what do you say as to l.i.f.o. being a generally acceptable accounting method in Canada?—A. In my opinion it is a fully acceptable method and the most desirable method of determining cost in relation to certain types of industry.

Q. Now, I show you a document headed "Statement of Facts describing the operations of Anaconda American Brass Limited" which has been marked Exhibit A for identification purposes only. At my request have you studied this Statement of Facts and the four exhibits attached thereto?—A. I have.

Q. Assuming that the facts contained therein are true, what is your opinion as to the use of l.i.f.o. in the years 1946 and 1947 by Anaconda American Brass Limited for the purpose of arriving at its annual profit or loss?—A. I think that the l.i.f.o. method of determining cost as employed in this set of circumstances is entirely acceptable and I think it is the most desirable plan that could be utilized.

His LORDSHIP: Why?

Mr. PATTILLO: Would you explain to His Lordship why?

His LORDSHIP: Why desirable?—A. Because I think that through the use of the l.i.f.o. system, my Lord, it produces most accurately what may be described as a periodic income.

Q. Then I suppose you mean by "periodic income"—profit?—A. Yes, sir. I might just enlarge on that, if I may. This it does through the process of matching costs against sales currently; in other words, I mean current costs against current sales and I refer to the term "costs" in the sense that I have studied that term and the interpretation of that term in the various texts and articles which I have mentioned.

I would like to make it specific, however, sir, that I have not actually seen personally l.i.f.o. in operation and that my opinion has been gained through a study of the text and writings that have been made on the subject and on considerable discussion which I have had with other professional accountants, both those inside and outside of my own firm.

Cross-Examination by Mr. Pickup

Q. I take it from what you have just last said that you have not advised the adoption of l.i.f.o. for any particular manufacturer who has adopted it, to your knowledge?—A. No, sir.

Q. And when you speak of "matching current costs against sales" are you really talking about replacement costs?—A. Yes, I am.

Gerald Jephcott (Appellant)
Cross-examination by Mr. Pickup (Cont.)

Q. Then, when you spoke of this method as being one which in your opinion was an acceptable method, did you mean an acceptable method for valuation of an inventory?—A. I do not know that I quite follow that question. I am slightly confused having regard to the variations between an income statement and a balance sheet. I think that it is acceptable from both points of view when both requirements are valid in the sense that disclosure is made as to the system utilized and that consistency is also practised from period to period both as regards the income statement and the balance sheet.

Q. I take it from what you have just said that you would not approve of l.i.f.o. for adoption today and for some years and then be changed to some other system?—A. No, I would not approve of that, I think, except under very special circumstances and where a full disclosure was made. From time to time the system of accounting employed with regard to various aspects of a company's books is valid according to what the current demands may be and I certainly think that it is proper to make changes from time to time under those circumstances and where the change is material that that change is accompanied by disclosure in the statements so that the shareholders and others that read the statements know exactly what has taken place.

Q. Generally it is true, is it not, that a company operating on l.i.f.o. on a rising market shows less profits than a company that operates on an assumption such as f.i.f.o.?—A. Yes, that is true.

Q. And, likewise the reverse is true, that if that company runs into a falling market and has been operating on l.i.f.o., it will show higher profits to continue on l.i.f.o. than it would if it switched to f.i.f.o.?—A. Certainly, it does that by elimination of what we accountants refer to as "inventory profits".

Q. Is that the same thing that I referred to as the abnormal profits or the hills and valleys of profit and loss?—A. It probably is, sir. I have not had the privilege of hearing previous evidence except for one afternoon. I have been out of town and I cannot answer it. Yes, that is a common terminology that is used in texts.

Q. You have already, in your studies, met certain accountants who have referred to this method as being one that levelled off the hills and valleys in the profits and it has that effect, of course?—A. Yes, sir.

Q. Do you not consider it necessary to value the inventory in order to get profits for purposes of taxation both at the beginning of the period and end of the period?—A. Certainly, sir. I consider it essential to value the inventory as a means of arriving at cost of sales, the inventory being one of the important factors which enters into the derivation of the figure constituting the cost of sales.

Q. And don't you agree with me that the value placed upon the inventory should be some value that is primarily a true valuation of the inventory?—A. I consider that a valuation arrived at through the l.i.f.o. method with disclosure, as I have said, is a true value.

Q. That is not quite the question. I asked you whether you did not consider it proper and right that the value of the inventory should be primarily a true value?—A. A true value?

Q. I mean by "true value" to be primarily representative of what the inventory is worth?—A. I do not think that from that point of realization and liquidation that it is essential that the inventory be valued at what it will produce, if that is what you mean by true value, Mr. Pickup.

His Lordship: You mean what it would produce if it were sold?—A. Yes. I think, if I may explain further, that we accountants regard inventories more from the point of view of a going concern. We do not contemplate that the company is going to be liquidated and the inventories immediately realized upon and the company cease its operations.

Mr. Pickup: Then the effect, I take it, is that if it levels off a little bit of the hills of profits in one year, it carries them forward into the next year?—A. I think that is one of the effects.

Q. All right, thank you.

Mr. Pattillo: That is all, thank you.

Mr. Edward A. Kracke, called, sworn:
Examined by Mr. Pattillo

Q. Mr. Kracke, you are a Certified Public Accountant of the States of Illinois, Minnesota, New Jersey, New York and Wisconsin in the United States?—A. I am.

Q. And you are a partner in the firm of Haskins and Sells in New York City?—A. I am.

Q. And that is a national firm of Chartered Accountants in the United States?—A. Certified Public Accountants, as we call it in the United States.

Q. And you became a partner in that firm in 1921?—A. That is correct.

Q. You joined that firm in 1912?—A. That is correct.

Q. You are a graduate of Harvard University?—A. I am.

Q. You are a Past-President of the New York Society of Certified Public Accountants?—A. I am.

Q. And a life Member of the American Accounting Association?—A. That is correct.

Q. And a Past-Vice-President of it?—A. That is correct.

Q. You are a Member of the American Institute of Accountants?—A. I am.

Q. And in the years 1933 to 1936 served as Chairman of the Inventory Committee that collaborated with the American Petroleum Institute on the subject of inventory valuation in respect of the l.i.f.o. procedure?—A. That is correct.

Q. You are a Past Member of the Accounting Procedure Committee of the American Institute of Accountants?—A. I am.

Q. And in 1938 and 1939 you served in an advisory capacity to the Treasury Department in connection with revising the Income Tax law upon the subject of inventory valuation in respect of the l.i.f.o. procedure?—A. That is correct.

Q. Now you told us, Mr. Kracke, that you served as Chairman of the original Inventory Committee that collaborated with the American Petroleum Institute on the subject of inventory valuation in the years 1933 to 1936. Would you explain why that Committee was set up and what it did?—A. The Committee was set up at the request of the American Petroleum Institute addressed to the American Institute of Accountants for the appointment of a Committee of the latter to work with an accounting committee of the former in discussing the whole field of inventory valuation as it then had evolved, with particular reference to the then new method of l.i.f.o. which had been initiated by certain members of the American Petroleum Institute.

Q. Now, would you, just at that point, Mr. Kracke, explain what happened leading up to the formation of this Committee?—A. Briefly, from the turn of the century on the situation in connection with inventories in industry was like this. At the beginning of the century when the balance sheet was preponderantly the important financial statement, they had evolved over the preceding years the concept of cost or market whichever is lower which was predominantly a balance sheet concept. In that earlier period of a simpler day in industry, there had not been the same attention given to the determination of income or profits as there had been to the balance sheet.

Moreover, the viewpoint with regard to the balance sheet was one that largely took into account the needs of the banker, for example, who wished to know more closely what the assets might be from a short-range viewpoint to protect his loans.

His Lordship: That is, if he had to realize on the assets?—A. If he had to realize —so that at that time the injection of the market adjustment, if the market had declined, was in the interests of a conservative portrayal of those assets for the protection of the banker.

Edward A. Kracke (Appellant)
Examination-in-chief by Mr. Pattillo (Cont.)

At the same time, in the earlier days preceding the turn of the century in that simpler industrial state from the point of view of the earnings—the profit and loss account—the inventories of a concern lent themselves more readily to a specific identification and that was generally the desired objective in that earlier, simpler day.

As we moved on into the Twentieth Century with the coming of the industrial era and growing corporate structures, the income account slowly began to assume some importance and, along with that, the complexity in business operations gave rise to the need of assumptions with regard to the inventories—the assumptions which Mr. Richardson has well set forth.

The earliest of those assumptions, the first-in-first-out, now called f.i.f.o. for brevity's sake, was predicated largely on perishable goods at that time, the condition before the development of the durable goods industries.

Not so long after that the average cost also developed in connection with inventories as a convenient or, in some cases, a more convenient method and that largely prevailed during the first decade and a half of this century.

I would like to refer at this point to the chart introduced yesterday by Mr. Peloubet which showed that in that first decade and a half, it selected, I believe, just four major commodities or goods. In the first decade and a half, or 1900 to the beginning of World War I in 1914, market fluctuations were relatively minor.

Beginning with World War I, through that War and in the post-war period, those fluctuations no longer were of a minor character. This condition bore heavily in respect of the older methods of inventory valuation—the assumptions of first-in-first-out and average cost—it bore heavily on industries that had the characteristic of the sales prices being determined by the replacement cost of materials content involved in the products.

Those industries at that time and largely now might be viewed as of two kinds. There were those—textiles using cotton and milling industries—cereal milling using grains, that could protect themselves even with the continuing use of an assumption of first-in-first-out by resort to the futures market.

Q. And the system of hedging?—A. Yes, whereby if they were long in actual inventories they could sell as futures or vice versa. Studies made will easily show that where an industry of that kind with that price characteristic—the sales price governed by the current replacement cost—that where the profit or loss on the futures transaction is brought into the account with the operating results on the first-in-first-out basis, it will very closely approximate what we now determine under the last-in-first-out or l.i.f.o. method.

Q. Perhaps I ought not to interrupt. I meant to ask one of the other witnesses whether the adoption of the l.i.f.o, method served the same purpose as hedging.—A. In the income account in these industries—

Q. Where there is, let us say, a market such as there is for cotton or wheat or something like that?—A. That is true.

Q. There is a market which is always ready to receive everything that is fed into it?—A. That is true. That protection affords those industries the means of having their resultant profit or loss reflect those industries' conditions of sales prices predicated on current replacement costs.

However, these other industries that had not that protection were deeply concerned with the continuing very disturbing fluctuations in the market and combined with the importance of those effects in their distortion depending upon the size of the inventories relatively in that business and the slowness of turnover, that made for a situation that very definitely could not be disregarded.

The earliest effort in those industries—I am speaking of post-World War I now, 1919 through 1929—in that decade—the earliest effort to correct this situation in their accounts was by the use of the base stock, base inventory, sometimes called normal inventory which is an approach rather more from the balance sheet point of view but accomplishing generally the same objective as last-in-first-out by a resulting correlation in the earnings account of that sales revenue with the replacement costs that have guided that sales revenue.

However, the base stock method failed to generate much enthusiasm. It had difficulties, it ran into obstacles of one sort or another and made no progress and at that point the oil industries, several of the larger companies, in grappling with the problem evolved the concept of the last-in-first-out as the proper assumption for the flow of costs in their industry.

At that point our Committee of the American Institute of Accountants began deliberations with them. Those deliberations stretched over a period of more than two years. We surveyed all the aspects of the problem and finally, in the early part of 1936, we rendered our report which was unanimous, approving the last-in-first-out, the l.i.f.o. method for those industries of these characteristics, namely, the quantum of communication of the replacement cost of the material and the sales price of the product and also where the importance of the turnover and size of inventory made this situation critical.

It might be interesting to note that in arriving at our report, our bases, our findings were that this method in those industries was in no wise an attempt to deal with an assumed physical flow of goods as such but rather of the costs in the books that were related to the revenue of the books—a true matching of revenue with the related costs.

Edward A. Kracke (Appellant)
Examination-in-chief by Mr. Pattillo (Cont.)

I remember that it was instanced in the case of a refinery, for example, that it might one day derive its crude oil from pipelines. On another day it might draw it from tanks where the oil had been stored for a year or two years. There might thereby be easily quite a mixture. If you think of the cost price attached to invoices for one oil or another there may be quite a range and it was brought out for one thing that there was, if one attempted to follow through this physical identity, there was also the danger of evaporation. A Company, if it wanted to favour its earnings might utilize cheaper oil in the tanks instead of more expensive oil in the pipeline and thereby, if that were the influencing factor, lead to monopoly earnings.

From our committee's point of view that would not be desirable but a rigid last-in-first-out system that based itself on the flow of costs rather than any attempt to follow through a physical flow of goods was the only method that could make for a real, defensible earning or profit or loss in those industries.

Q. Did I understand you to say last-in-first-out?—A. Yes, last-in-first-out. Does that answer your question?

Mr. Pattillo: Yes. There are just a few questions I would like to address on that matter. You mentioned having a flow of costs rather than a flow of goods. Would you explain are f.i.f.o. or average as well as l.i.f.o. in any way related to the flow of goods or are they all on the assumption as to flow of costs?—A. Our concept today in the profession and in industry is that that determines the flow of relative or related costs irrespective of the physical flow of goods. We are concerned with the proper measure under the varying circumstances in this or that or the other industry—the proper measure of profits under the respectively prevailing conditions in those industries.

Q. And when you are valuing inventories that are kept on specific identification and are valued from that point of view, are you identifying goods or are you identifying costs?—A. You are really identifying costs. Accounting deals with costs and revenues.

Q. Now, you have told us, Mr. Kracke, that you were one of the consultants to the Treasury Department in the years 1938 and 1939 at the time when that Department was giving consideration to bringing in l.i.f.o. Can you tell us something of the problem that, as a consultant, you were met with there and how you coped with it?—A. The 1938 Revenue Act (Mr. Peloubet spoke about that yesterday) first introduced mention of the last-in-first-out or l.i.f.o. method. Mr. Peloubet had a very important part in the recognition by Congress of the method at that time. However, in the Bill which finally became the Act the description of the method left very much to be desired, so much so that it was admittedly unworkable.

For one thing it merely recited, as I remember, two industries—the copper industry and the leather industry—and made a very confused picture as between finished product and goods in process and raw materials in those two industries. At all events, everybody agreed it was completely unworkable.

At that time the Secretary of the Treasury recognized that the method, nevertheless, had come to recognition and that the problem now was its proper incorporation in the Revenue Law and at that point his legislative Council appointed three of us—Mr. Carman Blough who had been Chief Accountant to the Securities and Exchange Commission and is now Research Director of the American Institute of Accountants, Professor Roy Kester of Columbia and myself, largely because of my activities with the prior Committee.

Our deliberations in Washington stretching over some months, addressed themselves first of all—it was recognized that the method found a proper place in business. The question was how to apply it. The desire was expressed by the Treasury Department that we, the three of us consultants, submit a list of the industries that would be entitled to use this method. We answered that while we could name a number—copper, leather, oil and a few others—that it might operate an inequity in excluding some that might well demonstrate the right to use the method and our strong preference, addressed to the Treasury Officials, was that the law recite the specific conditions which we had dealt with in the prior joint deliberations with the Petroleum Institute.

Q. What were those conditions?—A. Those conditions were this quickness of communication of replacement costs of the raw material to the prevailing sales price of the product and the further factors of slow turnover and size of inventory which would aggravate the use of any other method than l.i.f.o. in those cases.

His LORDSHIP: Those were the three conditions?—A. Those were the principal ones with the No. 1 condition being this price factor.

Q. And the quick correspondence between sales and finished product?—A. The others were factors which made for an aggravation of the difference. A fast turnover would not be so bad as a slow turnover.

The Treasury, agreeing that these conditions were important did not like to have them put into the law as such because they felt it might make for a difficult job for the Commissioner of Internal Revenue who might not be able to determine those entitled and those not entitled too easily.

The final agreement between all of us was on this basis—that if a taxpayer of his own volition, before he thought of his tax problem, went over on this method or had gone over on this method because he was convinced that it was the only method that would give him his proper operating results, that then he would be entitled to the use of this method for taxation unless (and the Commission still have that power) the Commission felt that there was an effort of somebody who was a complete misfit in this effort and the Commissioner, of course, could deny him the right.

It is interesting that in the regulations that were evolved after the law was passed, there is a specific disclaimer as to the identity of the goods, the regulation reading something to the effect—

> "That the use of the method is not dependent upon identity or want of identity of the goods involved".

It put the thing completely on the basis of the costs and not the goods.

Mr. PATTILLO: Now, did you do any further work on this question of l.i.f.o. while you were a Member of the Accounting Procedure Committee of the American Institute of Accountants?—A. Somewhat after our work done for the Treasury (I have forgotten the year) I was a Member of the Accounting Procedure Committee of the American Institute of Accountants and was designated as the Chairman of its Subcommittee on Inventories to continue the exploration of the inventory problems which eventually led to Bulletin 29 in July 1947.

The work that was done by our sub-committee was determined largely by a questionnaire, a very carefully and thoroughly prepared questionnaire, addressed to one hundred of the largest companies in the United States in the various industries. We wanted to survey a large substantial bulk of industry in its various aspects and the results of the questionnaire were very enlightening and encouraging to us in that it very convincingly showed that industry as a whole—I am not talking of those cases where identification of costs might well be the rule to follow, for instance in jeweller's shops with diamonds and other valuables or an art dealer or an antique dealer and who would still be guided by the specific identification of specific amounts he paid for this picture or that antique—but insofar as industry was concerned, with these three assumptions—and again those assumptions were all-in-all—any flow not having regard to the flow of goods but rather the related costs in those industries in order to get a true picture and that questionnaire produced a pattern which showed that eventually we can safely look for a condition whereby the various industries can be allocated into these three groups—the first-in-first-out flow of cost factor, the average cost and the last-in-first-out.

The intermediate zone of average cost would take care of a large field of industry which did experience a relationship between the prices that produced the revenue —sales prices—and the replacement costs but only after varying lags of time— where there was a lag in there and there was no immediacy of communication— where the average method would more nearly fit their cases.

An instance of that, and one of the important industries in that average cost field, is the tobacco industry where it is usual to have two or three years lapse for maturing of tobacco (green tobacco is not desired) but the matured crops of tobacco are mixed and there the average method was ideal.

It is interesting at that point to also bring to mention that while in our deliberations before the Treasury Department we pointed out that our view was that the powers of the Commissioner were so broad that he could allow any method that fairly represented income but that, nevertheless, he had been slow in even recognizing the average method until around 1922 or 1923—somewhere around there—when the tobacco industry showed so clearly that that was, for its industry, the only method that gave a fair and dependable operating result and that was allowed by the Commissioner of Internal Revenue.

His LORDSHIP: Without any permissive legislation?—A. No, he did it on his own which really was a precedent whereby he could have allowed anything.

Q. He could have allowed the l.i.f.o. method without any legislative action?—A. There is no doubt whatever in our minds but it was because of their opposition, they wanted it into the law by Act of Congress and that then followed.

I am not presuming to interpret law but from my reading of it as an Accountant, I could easily see that the Commissioner's powers were broad enough to recognize that method without its being judicially put into the Statute.

Q. In your opinion, it did not require an Act of Congress then?—A. No, because the law said that the Commissioner could determine whatever method fairly reflected the income.

Q. The test was fair reflection of income?—A. That was it.

His LORDSHIP: This would be a convenient time at which to recess for ten minutes, Mr. Pattillo?

Mr. PATTILLO: Yes, thank you, my Lord.

(A short recess was here taken)

Mr. PATTILLO: Mr. Kracke, at recess-time you were dealing with average cost and explaining a bit about it. Would you care to go on and develop it?—A. I would. I was illustrating what our objective was in the promulgation of the Institute's pronouncement with regard to the effort to bring industries into their respective profit determinations—where they belonged by reason of the operating characteristics of the industry.

I might illustrate there that the first-in-first-out method, I would say, was suited—I am talking always of cost determination rather than the thing itself—the costs which are the important things to our mind—

His LORDSHIP: The name, insofar as it might indicate the actual physical flow is perhaps mis-descriptive?—A. Yes. I thought, after I had finished this, I would ask your Lordship if a certain other example might not clarify a bit more this concept of completely departing from physical identity. But on this point, the first-in-first-out, it would be well-suited to the liquor industry where the liquor produced or sold in this year had nothing to do with the price of grain in this year; it was the grain of many years back—five or six years ago depending on the age of the liquor and the maturing of the liquor. The cost of that would determine it.

I think even more clearly perhaps—and this case is somewhat interesting—I would say the Department Store. Largely they operate under what they call the "retail method". Of course, they handle so many things that they have to use some sort of an assumption method but in what is called the retail method the invoice cost as the goods are bought appears in one column and the retail price of those goods in another column with retail prices representing what is familiarly known as the "mark-on" and then, from the averaging of each column of figures, they will then produce the month's cost of sales.

I have been consulted by Department Stores back eight or nine years ago when the price situation was getting more acute and I had always given my opinion that they were not of the type of business that would fit in under the l.i.f.o. for the reason that an examination of their own accounts of this retail method showed that after the original mark-on of the goods as bought on the invoices they were almost always sold on that basis because the revealed subsequent so-called mark-ups or mark-downs were relatively small as compared with the bulk of the goods moved; in other words, there is a case where preponderantly the goods moved out on the original invoice tag basis. Again I am talking about price allocation or cost allocation.

That situation resulted in rather an interesting case a few years ago in Baltimore and, if I may say, both Mr. Peloubet and I were asked to testify as experts and did not because our views did not agree with that treatment. The company sought the last-in-first-out and we did not think it came in under that price group.

Nevertheless, because of the wide description in the law as to industries if they go over on the method, this store went over on the method and the court finally allowed it. I think there is a case that had the Commissioner used his own powers irrespective of what the law said—if he used his own power which was a wide one—that he might have denied that successfully whereas under the law as it was put through, it was made wide in order not to deny equity to anybody and somebody else got in.

The illustration of the—shall I call it—the fetish of trying to follow through physical identity (to my mind, I have used this in talking with groups) is illustrated, for example, in the case of an investment trust. It is true its portfolio of securities is its stock in trade, so to speak, but the New York Stock Exchange has frowned on an earlier practice of taking these trade certificates as representative of shares bought on a certain day at a certain price and delivering it against the subsequent sale. Where, for instance, they had 1000 shares and sold 100 or 200 and sold certain ones, it opened the door to profit manipulation where an investment trust could just show profits which were most attractive where, from a real point of view, from looking at the cost of the thing, that would be deceptive.

Q. That is, the cost that is truly applicable?—A. Well, the stock exchange has said that for its purposes (and it speaks with authority for those bodies in New York) the average method alone will give that proper result. If you have 1000 shares and you bought some at last night's prices and some at today's prices then you sell them at the average cost because it is not subject to manipulation and that is a Stock Exchange laid-down rule and it is, to my mind, an illustration of how this matter of an attempt at physical identification may lead us in wrong paths.

Mr. PATTILLO: That is fine, thank you, Mr. Kracke. Now, Mr. Kracke, I show you Exhibit No. 29 which is Bulletin No. 29 issued by the Committee on Accounting Procedure of the American Institute of Accountants and dated July, 1947 having particular reference to the Introduction, Statement 1, the discussion applicable thereto, Statement 2 and the discussion applicable thereto, Statement 3, the discussion applicable thereto, and Statement 4, and the discussion applicable thereto. It is that part of the Bulletin which I draw to your attention and I would ask you if that fairly represents your views?—A. It does.

Q. Now, Mr. Kracke, you have been in court throughout the whole of this trial? —A. I have.

Q. And you have heard the entire evidence given by Mr. Richardson when he explained the various methods of calculating costs where he dealt with f.i.f.o., average and l.i.f.o.?—A. I have.

Q. And do you agree with the evidence that Mr. Richardson gave?—A. I do.

Q. Now, based on the facts that you have heard brought out in court as to the manner in which Anaconda American Brass Limited carries on business at its plant in New Toronto in the Province of Ontario, what is your opinion as to the use of l.i.f.o. in the years 1946 and 1947 for the purpose of arriving at the profits of the company for those years?—A. I think it is definitely the proper method.

His LORDSHIP: And might I ask you why you say it is the proper method?— A. Because if a concern were on another method, I would feel myself constrained, in my so-called opinion, to bring to attention the fact that it was not on this definitely preferred method and the amount involved in the way of departure in profit determination represented. Because otherwise I would feel that with an assumption that this is the proper method for that industry, somebody might otherwise attach to it importance or an importance which I would not wish to, a profit which was higher than that profit.

Q. Am I to understand you to consider it to be the proper method because it most nearly accurately reflects the true profits of the Company in the two years?—A. That is true.

Cross-examination by Mr. Pickup:

Q. Mr. Kracke, you spoke of the importance of the balance sheet in earlier years and that the cost or market rule or principle was one which you described as a "balance sheet concept". Am I correctly quoting your view?—A. Yes.

Q. And does that mean that you have departed in your view from the cost or market basis?—A. No, in my view, the cost or market whichever is lower concept is a generic one applicable to both the balance sheet and the income account and covering in its scope all those acceptable methods of profit computation under the various methods as Mr. Richardson has set them forth.

His Lordship: It is a matter of what you mean by "cost"?—A. That is it.

Mr. Pickup: Then you spoke of the first move towards a base stock method. I think you said that was fairly early in the century or just after the first war?—A. Post-World War I.

Q. And you say that that failed to generate enthusiasm and ran into difficulties. What difficulties are you referring to—tax difficulties?—A. Well, I had considerable to do with the endeavour to get the Treasury Department (this was in 1919 and 1920) to recognize the base stock method in those industries where this condition prevailed. It is interesting that after a long hearing the Tax Appeals Board, I think it was (five men who were on that Board) finally rejected the request in December 1920, as I remember the date, on what was afterwards an unbelievable ground, namely, that the Board felt that the Post World War prices had generally come to stay. Within the next twelve to twenty-four months we all know what happened to those prices.

Q. Is that the difficulty that you are referring to?—A. That is one of the difficulties.

Q. Let me finish my question, please. That is one of the difficulties that you had in mind when you said that the base stock method failed to generate enthusiasm because it ran into difficulties. That is one of them. Were there any others?—A. Well, from the point of view of—shall I say—bookkeeping mechanics of operation it had had some difficulties which perhaps in some cases might be magnified but they apparently appeared to some to be difficulties that would militate against adoption.

His LORDSHIP: What were they? Can you indicate the kind of difficulties you have in mind?—A. Well, there was the question of the treatment of an invasion of the base stock when it was eaten into and how that would be handled and which would produce the case of the necessity for specific reserves to fill those voids again and it ran afoul of the general feeling against that type of inventory reserve. The method itself had not had a lack of friendship from an accounting point of view. In my own opinion, I do not think that those difficulties should have militated at that time. I would have been prepared at that time to recommend its use where the entitled companies were of a type requiring it even though there were these largely fancied difficulties. And the thing, of course, as far as base stock was concerned, was definitely ended by the United States Supreme Court's rejection of the method in 1930 in the Kansas City Structural Steel Company case.

Mr. PICKUP: Then we have the difficulties that you had in mind, first, the tax difficulty which caused people not to be very enthusiastic and the second one, a bookkeeping or accounting difficulty which involved the setting up of reserves?—A. Just to instance those and no more.

Q. Well, those are the material ones, I take it. If you have anything else that you have in mind that is of consequence I am giving you an opportunity of giving it? You spoke of the tax matter—A. May I there, in that connection, say only from the point of view that it had, at that early point, been brought up to the Treasury Department, the Internal Revenue Bureau by various companies for its judgment and that that has caused the later adoption of the l.i.f.o. by the Petroleum Industry after our report in 1936 which was done without regard as to whether the Treasury would follow the method at that time or not. They wanted it for their books, for the correct determination of profits as reported to their stockholders.

Q. Anyway, the method did not generate enthusiasm. Now, was not the l.i.f.o. method a method which might be called a variation from the stock method?—A. Well, the l.i.f.o. method was more of an approach strictly through the income account or the cost of sales bracket. Instead of an approach from the residual inventory, it was more specifically a view of the last-in-first-out. It carried its thinking more to the door of the income account rather than the balance sheet.

Q. Would you enlarge on that? Would you give us the two viewpoints there? What do you mean by "residual"?—A. While in its easy determination the old inventory is regarded as the closing inventory together with any changes in inventory by reason of accretions or the reverse, the concept is more specifically one of comparing the sales with the cost of products that have been instrumental in determining the dollar value of those sales.

Q. Do you mean that it is more the relationship to cost than an attempt to value inventory?—A. That is true.

Q. Then, has the accountant's view of the meaning of f.i.f.o. also changed over the years?—A. Of f.i.f.o.?

Q. Yes?—A. Well, insofar as we have gone in our thinking, to address our thinking more to the proper flow of cost factors rather than the particular movement of goods, that is true.

Q. That is what I had in mind. You had said in your evidence that "Our concept today is that f.i.f.o. determines flow of costs and not physical flow of goods"?—A. That is right.

Q. And I understand from your evidence that that is the concept today but taking that as being the concept today I suggest that was not the concept some years ago?—A. As a matter of fact, the physical identity concept, as I indicated earlier in my testimony, came out of a simpler day when that would be more applicable than in the complex industry of this day.

Q. And until the present concept of applying f.i.f.o. to determine flow of costs, it was applied as an assumption of physical flow?—A. At some time in the past—yes.

Q. And down until the growth of this present view of l.i.f.o. and its later adoption in the United States?—A. Well, the thinking that was done in the decade after World War I was—I mean the thought of industry and the profession was directed to this problem by reason of the vital effect of fluctuation in prices which, as shown by Mr. Peloubet's chart, assumed much greater proportion—the fluctuations beginning with and after World War I—than in the prior period; in other words, in the earlier period, the first decade of the century, it would not make very much difference between one industry and another what sort of basis you were on because the prices were tending to travel an even path. The difference came about when you had these fluctuations and your year's inventory would close at some period where you may have either a peak or valley, as the case may be, instead of a plateau or even level.

Q. Then, the concept of f.i.f.o. has, over the years, in your opinion changed to a concept of flow of costs?—A. Flow of cost factors, yes.

Q. And with it has not there also been a change in the concept that the expression lower of cost or market has, in your opinion, undergone a similar change?—

A. To this extent, that in the case of a l.i.f.o. invetory an adjustment to market that might be required for the purpose of the balance sheet because otherwise the inventory might be stated therein in excess of the present market value—any adjustment needed for the balance sheet purpose must not be permitted to affect the earnings, the profits or the income. Any adjustment of that type would be made out of the accumulated profits of the past but not to affect the earnings of the period.

Q. But, as you still retain the alternative of market under your l.i.f.o. principle, then the taxpayer would still have the opportunity to adopt market if lower than cost if determined on l.i.f.o. Is that your concept?—A. Not from the income point of view, no, sir.

Q. Well, what would he do?—A. Well, I say that in the United States we talk about this accumulation of past earnings as surplus; over here I think it is accumulated profits of the past—

His Lordship: Undistributed income.—A. Well, by whatever term designated, since the whole thing is traced from the l.i.f.o. point of view to the balance sheet, this question of reckoning with a market decline, any such adjustment finds expression in the accounts through an undistributed income or past earnings or surplus but not as an element of the year's income or profits.

Mr. Pickup: Then, may I put it this way, that under l.i.f.o. you depart from market entirely?—A. As to income, yes. As to the balance sheet no, as I have just explained. It still means that there is a need of not having the inventories on the balance sheet stated at an amount which may be in excess of the market price of the day. To that extent we still carry forward that concept of market.

Q. In the balance sheet but not in the income?—A. Yes, but not in the income account.

Q. Then am I misunderstanding one of the conditions in the United States law that the return for tax purposes under l.i.f.o. must be the same as your return in your books and your accounts in your books and that that would include the balance sheet—A. Except specifically as to adjustments on the balance sheet to market which is recognized in the regulations as permissive where needed without being a departure from the method itself. As long as that market adjustment does not find place in the determination of profits or income for the year, it does not deny the validity of adhering to the method.

Q. And those things, I suppose, are determined in the United States by the Statute?—A. The Statute and the regulations.

His LORDSHIP: And, I suppose, the powers of the Commissioner?—A. Yes, the powers of the Commissioner. May I add there that this particular point, as you may imagine, was one very specifically covered in our deliberations in 1938 and 1939.

Mr. PICKUP: Now, I think you referred to l.i.f.o. as being a rigid system based on flow of costs. I wanted to ask you what you mean by a "rigid system"?—A. Well, I frankly do not quite see how I used that word in the context there.

His LORDSHIP: Not that it was a "rigid system" but a system that was "rigidly adopted" or something of that sort.

Mr. PICKUP: I took down the words "rigid system" but I am often a little behind the witness in quoting.—A. I do not remember the exact context of that word, if I used it in that way.

Q. Maybe I can put it another way to you. Was there something about the l.i.f.o. system that you regarded as rigid?—A. Well, in this respect, that where a company has very definitely these characteristics of relationship between market value of the material and the price and has these other characteristics, where a company has those characteristics I would be inclined to use the word "rigid" because I think a failure to use that method may produce a very erroneous impression.

However, there are other companies where there is somewhat of a lag involved and the inventories are not so important where I would not regard the situation as of the same character as in the case of companies that were definitely in the front rank of companies that should be using that method.

In our later deliberations, which began in the Accounting Procedure Committee prior to the issuance of Bulletin 29, we recognized there, from this questionnaire which we had at that time, that there would be industries in the debatable area where the l.i.f.o. joins the average cost or where the average cost joined f.i.f.o. and there would be companies where there might be room for doubt as to which basis they should be on but presumably in those areas the difference between one method or another might not be too great because of the industrial factors involved.

However, where you have a pronounced situation as in the case of oil, as in the case of copper, my view is inclined to be a rigid one as to the propriety of the determination of earnings according to that method.

Q. Is it really this, that after all it is a matter of opinion as to which companies should and which companies should not use l.i.f.o.?—A. Within certain limitations. I would say that there are such things as very poorly formulated opinions which are opinions nevertheless but I would say that opinions should fully be founded on the weighing of these important factors—not to loosely-gained opinions.

Edward A. Kracke (Appellant)
Cross-examination by Mr. Pickup (Cont.)

I think the determination of the proper place of an industry as to one or another of these three groupings should be a matter of perhaps—may I put it this way—perhaps not one man's opinion but the opinion of a number of people so that some real concensus may be held.

There might be situations where one man might say of a certain company "I think its proper method is f.i.f.o." and another might say: "Well, I think we more nearly conform to average cost" and there might be room for that diversion in viewpoint and there again a concensus of opinions, well informed might be desirable in order to get the right solution.

Q. I was thinking more of this, that assume one has a favourable opinion and one has not. I think it would be difficult to say it was wrong if one Chartered Accountant, for instance, should say: "In this industry I think l.i.f.o should not be used and in this other industry I think f.i.f.o. should not be used". It would be difficult to say he was wrong, wouldn't it?—A. I think Mr. Richardson covered that case well in his testimony when he said that among Chartered Accountants but in a diminishing degree and definitely in a diminishing degree, that is, among the Certified Public Accountants the critical viewpoint with regard to l.i.f.o. is still there, though, as I know, it is decreasing.

Q. But there is still a difference of opinion?—A. But it is decidedly minor in the United States.

Q. I want you to consider with me for a moment the situation in the United States under the earlier Statute (I think you said the one in 1938) and you described it as one that did not work out and changes had to be provided for which were worked out in 1939. Now, was that system of l.i.f.o. as formulated in 1937 the same as was then used by the American Brass Company and the same as is now being contended for by the appellant? I want your comparison of the system that was approved in 1937.—A. You mean in 1938?

Q. In 1938, yes.—A. You are talking of the 1938 Act?

Q. Yes, the 1938 Act.—A. As against the 1939 Act?

Q. Not the 1939 Act. The 1939 Act worked it out in some different detail but in the 1938 Act were there any differences between l.i.f.o. as suggested by the Anaconda American Brass Company Limited here and l.i.f.o. as it was then brought into effect in the United States?—A. If there were any resemblance I would have to ferret it out. I do know this, that the staff, as it wrote the related sections for the 1938 Act, did not follow the outline that Mr. Peloubet had discussed before the House and Senate Committees. I would say that the wording, if I may be permitted the word, sounded to me in the 1938 Act almost like gibberish. It just did not lend itself to application in the accounting business. Manifestly, the wording was put in by someone that did not understand the accounting procedure involved. It was admitted by the Treasury—

Q. You mean it was just a matter of wording?—A. Well, whatever the words said, nobody could, in the parlance of the vernacular, make head or tail out of it. It just could not be put to work and the Treasury admitted that in bringing we three consultants to approach that question and make a new start and get wording that could be worked in practice.

Q. But was the principle or plan of it the same?—A. The principle or plan was all right but its expression in the law was most unfortunate.

His LORDSHIP: In other words, so far as you were concerned, the principle that you contended for was not carried into effect in a practical way in the legislation of 1938 but was carried into effect in a practical way in 1939 but that there was no difference in your concept of l.i.f.o.?

Mr. PICKUP: I did not suggest that. I was rather suggesting that the concept of l.i.f.o. itself, even if it may have been the same, required some restrictions or conditions to be applied to it to make it practicably workable for tax purposes?

His LORDSHIP: Well, it is only proper in certain circumstances, according to what the witnesses have said.

Mr. PICKUP: Then I am confining my question to the instances in which they say it is applicable. The witness has not answered me yet.—A. Would you clarify it?

Q. That is, take a case in which you think the l.i.f.o. principle should be applicable. It has to have some conditions or restrictions prescribing it and surrounding it in order to make it practicably workable doesn't it, from a tax standpoint?—A. Well—practicably workable from a tax standpoint—you mean specific statements as to how it should be manually kept in the accounts?

Q. No, I mean in the first place that if it is introduced at all it should be rigid in this sense, that you cannot change it without the consent of the Revenue. That is one thing that should be tied to it if it is going to be workable?—A. That is true.

His LORDSHIP: Is it true if the conditions of the industry should change?—A. Oh no, but the Commissioner has the power at the request of the taxpayer subsequently to change the method.

Q. Well, he has in the United States?—A. In the United States and that would be true where conditions radically change.

Mr. PICKUP: But in the United States, the taxpayer, having gone on l.i.f.o. no matter what the changes in conditions were could not depart from it without the consent of the Revenue?—A. That is true.

His Lordship: That is in the United States?—A. In the United States. May I clarify that, that that was one of the things that I had something to do with as indicative of the bona fides of the taxpayer who elected to take the method, that he should not try it for a year or two and then, after the third or fourth year, the advantage might be the other way and that he would switch; in other words, he elected to take that method because it best reflected the operating conditions under which he worked and that he should stick by that method through fair weather and foul so long as the conditions remained the same.

Q. So long as it fairly reflected his true position but if his method of doing business did not reflect his position correctly and changed, then he should change?—A. That is true.

Mr. Pickup: But he could not change without the consent of the Revenue People?—A. That is true.

Q. Then, about this slow turnover. What do you mean by a slow turnover?—A. Well, all things are relative. I would say that a fairly fast turnover would be the Department Stores who may have something like seven or eight times a year. There are turnovers even faster than that. A very slow turnover would be one and a half or two times a year. Four times a year would be a slow turnover—definitely.

Q. Do you know the turnover of the General Motors Corporation?—A. It is quite fast for a very specific reason and that is, the method of marketing by putting the finished product immediately over to the dealers and the dealers buy it forthwith. It is not a question, as in other industries, of having a large inventory for the sake of the company's operations and there the financing of that is assisted through the financing organization.

Q. Well, knowing it is fairly fast, you probably know what it is; it is four times a year.—A. I think you will find it is faster than that. I have not checked it recently but I believe it was faster than that. This was perhaps five or six years ago that I had occasion to make a test of it and at that time it was in connection with the functioning of dealer organizations and the financing which permitted the dealer organization to take the product immediately over and I remember that the turnover appeared to me to be a fairly rapid one for an industry of that size.

If it has gone down to anything like four (and you may be right. I don't know if you have checked it up) then it would certainly be due to some sort of change in the operating conditions.

Q. Anyhow, I may say this, that the turnover was four times a year and yet considered fast?—A. Well, all things are relative. You might deem it fast; I would not. Others might.

Q. I think that is all, thank you Mr. Kracke.

His LORDSHIP: Any re-examination, Mr. Pattillo?

Mr. PATTILLO: Just one thing, my Lord.

My Lord, before I ask the one or two questions I would like to ask in re-examination, I did not like to interrupt my learned friend's cross-examination but at one point in the earlier part of the cross-examination of Mr. Kracke, Mr. Pickup was using f.i.f.o. or Mr. Kracke was using f.i.f.o. for part of his answer when it was obvious he was talking about l.i.f.o. The latter was going on when he was talking about the condition of cost or market and he was talking about the market reflection in the balance sheet. In the beginning he was using the word "f.i.f.o.". He later made it quite clear in answer to another question that he was talking about l.i.f.o. but I just thought that I should make that explanation so that we can get the record straight. It is very difficult to follow sometimes as between f.i.f.o. and l.i.f.o.

Mr. PICKUP: I think the record, when it comes out, will make that quite clear. I was asking about l.i.f.o. in connection with his having departed from the market under the l.i.f.o. principle and if there is a slip in the word "f.i.f.o." or "l.i.f.o." I think the transcript as a whole will make it perfectly apparent to your Lordship.

Re-Examination by Mr. Pattillo

Q. Now, Mr. Kracke, just one question I would like to ask you. If a company, from the manner in which it carried on business, was, in your opinion, a company to which l.i.f.o. should be applied for the purpose of arriving at its most accurate income periodically, would it be good accounting practice to change from l.i.f.o. to any other method such as f.i.f.o. unless there had been a change in the method of carrying on business?—A. It would not be good accounting to make that change. Consistency is a virtue in accounting, as we preach it.

His LORDSHIP: Providing conditions remained the same?—A. Providing conditions remained the same.

Mr. PATTILLO: Thank you, Mr. Kracke.

His LORDSHIP: Is that the Appellant's Case?

Mr. PATTILLO: That is the Appellant's case, my Lord.

Mr. PICKUP: My Lord, I have a slightly different suggestion to make to the court. I have been a bit concerned since I asked Professor Butters to come back on Monday morning and I have another suggestion to the court which I think I might make and which I do not think will disturb our time-factor a bit and that is, suppose we were to adjourn now until three o'clock and then I will see to it that I am ready to cross-examine Professor Butters at three o'clock and let him get home.

His LORDSHIP: It would be very nice if you could do that.

Mr. PICKUP: I still think I can then get my first witness in and out today between then and five o'clock.

His LORDSHIP: Then, you suggest that we adjourn now?

Mr. PICKUP: Yes, until three o'clock. I will try to get ready in the meantime.

Mr. PATTILLO: I must say, my Lord, that we appreciate very much my learned friend's efforts.

His LORDSHIP: Yes, I was hoping a way could be found to do that. Then, your case is closed except for the cross-examination of Professor Butters?

Mr. PATTILLO: Yes and any re-examination I may wish to have.

His LORDSHIP: Then, we will adjourn until three o'clock.

(Court adjourned for lunch from 12.15 p.m. until 3 p.m.)

(At 3 p.m. court resumed)

AFTERNOON SESSION

PROFESSOR J. KEITH BUTTERS, recalled

Cross-Examined by Mr. Pickup

Q. May I first say to the court, my Lord, that my reading of the book has not been as complete as one might have expected of counsel.

His LORDSHIP: There cannot be a lot of doubt about what is in it.

Mr. PICKUP: What I propose to do in cross-examination of the witness, my Lord, is to refer him to a number of passages which are already in evidence and, with regard to some of them, I may have to ask questions but a few others I do not need to ask questions about but it will serve also to bring to the attention of the court much of the material I have found it advisable should be brought to the attention of the court.

Now, Professor Butters, I think you might perhaps wait until I address a question to you unless you feel, in reference to anything in the book, there is anything you want to add or interject.

The first reference, my lord, that I want to bring to the attention of the court is on Page 2 and following, the second paragraph:

> "Historically, the most common procedure has been to assume that inventory goods are sold (or used up in manufacture) approximately in the order in which they were acquired. Under this assumption (usually designated as

J. Keith Butters (Appellant)
Cross-examination by Mr. Pickup (Cont.)

first-in first-out or "Fifo") the cost of the earliest inventory goods acquired is charged against sales and the ending inventory is deemed to be composed of the most recent goods purchased."

Then, page 4, towards the bottom of the page is the following:

"As compared with Fifo, Lifo will ordinarily show a smaller profit when prices are rising and a larger profit when prices are falling. If inventory quantities remain constant, the difference in profits will be approximately equal to the amount of inventory profits or losses included in income under the Fifo procedure. Fluctuations in inventory quantities, however, destroy this relationship, especially if they involve large liquidations of Lifo inventories. Under the strict Lifo method, liquidated inventories are costed at their book values which often bear little relationship to current price levels. Hence, unless a reserve is set up out of income for the replacement of liquidated inventories, Lifo does not fully achieve the goal of matching current revenues with current costs. But even when inventory quantities vary it does tend to bring reported profits more nearly in line with disposable profits, since inventory liquidations (unless temporary in character) do free cash for other uses".

And at the bottom of page 6:

"In contrast, since 1939 few management decisions on Lifo have been made without reference to their tax effects. Decisions as to whether to use Lifo how to apply it, and even as to the industries in which the method constitutes acceptable accounting practice, have been dominated by tax considerations."

And on page 8, the last paragraph:

"In general, the opportunities for tax savings from the use of Lifo depend on the combined effects of the following factors: (1) the course of future price movements, (2) fluctuations in tax rates and changes in the tax structure, (3) variations in the amounts and kinds of physical inventories held at the end of each taxable year, (4) the relative stability of income from sources other than inventory profits and losses, and (5) the existence in the tax law of averaging devices such as loss carry-backs and carry-overs."

Then, page 10:

"If any meaningful summary statement can be made, it is that in economic terms the case for including or excluding inventory profits from income rests on the effects of these policies on (1) business and inventory expectations and (2) the cash position of business. The inclusion of inventory profits and losses in income tends to produce excesses of business optimism in times of rising prices and unwarranted business pessimism in times of falling prices. On the other hand, the fact that taxes must be paid on inventory profits if they are included in income tends to put business in a tighter cash position in times of rising prices as compared with the situation if inventory profits are excluded from income. Similarly, if inventory losses are allowed as deductions in the determination of taxable income, business will have smaller tax liabilities and be in a freer cash position in years of falling prices".

Then, page 12, the second sentence of the first new paragraph:

"Our general conclusion is that for the broad purposes of financial reporting the disposable-cash and current-cost criteria applied to inventory accounting have great merit in industries where a large and continuing investment in inventories must be maintained to support effective operations.

Essentially the same conclusion is reached in the discussion of taxable income. To the extent that inventories considered as a unit represent a necessary continuing investment to a firm, changes in the value placed on a constant physical volume of inventories can be likened to unrealized capital gains on fixed assets and appropriately be excluded from taxable income until the inventories are liquidated. The Lifo method in essence accomplishes this exclusion.

Similarly, it is essential to the proper measurement of national income that inventories on hand at the beginning and end of the year be valued at the same price level. Otherwise the objective of national income accounting, namely, the measurement of the volume of goods and services produced in a given year, would be obscured by the element of price inflation or deflation which would be introduced by valuing beginning and ending inventories at differing price levels."

Then, I pass over, my Lord, to page 49 where the witness is quoting William Blackie and I take it that in this page you are adopting the quotation?—A. I would want to read it over before I gave an answer to that.

Q. Well, I will read it over first. The passage reads:

"As William Blackie has remarked:

'(Lifo values) are—comprised of a heterogeneous collection of first-in costs as of a variety of earlier dates which, since it represents neither recent original cost nor replacement market—nor any other acceptable criterion of valuation—has no interpretable significance. In so far as it destroys the homogeneity of the underlying computations, the device, therefore, seriously impairs, even if it does not wholly destroy, the purposes of making a determination of the financial position.' ".—A. Now, did you want me to answer your question, sir?

Q. If you have any comment on it. What I was reading was that in so taking that as your text says that "as William Blackie has remarked" and then you quote him, that you must have meant to pass on the quotation in your book?—A. I think my judgment on l.i.f.o. is similar to Mr. Blackies' in many respects. His company, on his initiative largely, was put on l.i.f.o. for book purposes even though it decided not to go on it for tax purposes and Mr. Blackie in general is highly sympathetic to l.i.f.o. which in general I am. I think both of us realized that for balance sheet purposes the significance of the l.i.f.o. with reference to the current value of the inventory is much less on l.i.f.o. than on f.i.f.o. as is frequently stated by people commenting on l.i.f.o.

Q. He may have only had the balance sheet in mind there?—A. That is all he had in mind, I am sure.

Q. Then, at page 71, the last paragraph on the page:

> "If prices remain unchanged or show only minor variations, income will be reported in approximately equal amounts under the Lifo and Fifo methods of inventory valuation. With substantial price fluctuations, however, large differences in income will result under the two methods. If physical inventories remain relatively constant, price variations will cause a much greater fluctuation in income when Fifo is employed. Income, and therefore tax liabilities, will be greater under Fifo, as compared with Lifo, when prices are rising; and it will be smaller in years of falling prices. If prices eventually return to their beginning levels, however, profits under the two methods over a period of years will be approximately equal—still on the assumption that physical inventories have remained relatively constant throughout the period. The greater profits shown under Fifo in years of rising prices will be approximately offset under these conditions by the smaller profits (or larger losses) reported in years of falling prices."

Then, at the bottom of page 73:

> "A word of caution should be inserted at this point to keep the preceding discussion in proper perspective. No implication is intended that ultimate tax savings are overwhelmingly probable whenever Lifo is adopted in a year of price increases. If prices are believed to be at or near their peak at the end of such a year, it would obviously be shortsighted to shift to Lifo solely to capitalize on the opportunity for immediate tax savings".

Then, page 79, the first new paragraph at the top of the page:

> "The lesson for the future to be derived from this discussion is that the costs of liquidating Lifo inventories must be borne in mind in appraising the desirability of the method. If both tax rates and prices are expected to rise, the immediate benefit of holding inventories on Lifo at a fixed value may be more than offset by the additional income, and hence taxes, resulting from a subsequent liquidation of any substantial part of Lifo inventories."

Then, I go to page 97, the first paragraph of the Conclusion:

> "The opportunity to reduce tax liabilities has been by far the most powerful motivation leading to the widespread adoption of Lifo during the past decade". —A. Could I interrupt for a moment there?

Q. Yes.—A. That statement is inconsistent with the statement which you read on page 6 when I said "since 1939". Now, my real position there which is not clearly stated in the use of the word "decade" in the sentence you read would be in or following 1941 when it was evident that the War's upward price movement was clear, that is, in companies that adopted l.i.f.o. before 1941 when prices were stable and might have been presumed to continue stable.

Q. This would not obviously apply to before 1941?—A. No.

Q. Well, I thought that was what you said?——A. Well, that technically might have been read "ten years before the book was published" back to 1939 and that was the impression I was intending to clear up there.

His Lordship: Lifo was adopted by this Company in 1936.

Mr. Pickup: Yes. Well, I took the "past decade" to mean ten years prior to the date of the book which was 1949. Am I right or wrong?—A. I had in mind there most companies who had adopted the method since the war's upward movement was evident. The statement, literally read, would read 1939. That would not express my real opinion—expressed as 1939.

His Lordship: It starts at 1941?

Mr. Pattillo: Would you read the last paragraph on that page, Mr. Pickup?

Mr. Pickup: I have not finished reading this one yet. The next sentence was:

> "The combination of sharply rising prices and high excess profits taxes gave managements in many industries a strong tax incentive to shift to Lifo during the war years."——A. The point there was that in 1939 there were neither high excess profits taxes nor rising prices so I was using the word "decade" in a very loose sense.

Q. Well, I think we understand you. Then, the next sentence:

> "The large price increases of 1946 and 1947 caused some companies to make the shift as late as these years, though the risk of ultimate tax penalties was then greater because of the height to which price levels had already risen."

I suppose, in that connection, using 1946 rising prices, you had, of course, particularly in mind United States and not Canada?—A. Yes, I am not familiar with the specific movements here. We had large price rises in both 1946, 1947 and in 1948.

His Lordship: After your controls went off?—A. Yes, ours were taken off much sooner than yours.

Mr. PATTILLO: Would you read that last paragraph on page 97?

Mr. PICKUP: My friend asked me if I would read to the court at this point the last paragraph on page 97:

> "While tax incentives have been the controlling motivation in the decision of the majority of managements that have adopted Lifo, numerous other considerations have been involved. A few companies used Lifo or related methods such as base-stock for many years before the tax law recognized Lifo. Their decisions were motivated mainly by the belief that such methods would give a more meaningful statement of income for management and stockholder purposes".

Is that what you wanted?

Mr. PATTILLO: Yes, that is right.

Mr. PICKUP: Now then, page 138, at the bottom of the page and carrying over to 139 where the witness is dealing with the concept of profits and under the heading of "Taxable Income"—

> "The standards which must be applied in deciding how to value inventories in determining taxable income are different from those applicable to a business profits concept. For the latter purpose, to repeat, the essential criterion is the usefulness of a given profits concept to management and to the public. In particular, the dangers of ill-considered management decisions or public policies based on misinterpreted corporate reports should be minimized. To this end, a strong case can be made for excluding from annual profits various nonrecurring gains and losses on the ground that their inclusion would distort current operating profits and hence not furnish the best guide for policy decisions. The exclusion of inventory profits from business income can be defended on this basis.
>
> For tax purposes, on the other hand, these considerations are relevant only to the extent that tax requirements modify business accounting practices. Since tax returns are confidential, the problem of public misinterpretation simply does not arise, except as national income and aggregate corporate profits estimates are based on unadjusted tax data. Also business profits as computed for management and stockholder purposes may and do vary from taxable income, especially on such matters as the treatment of nonrecurring gains and losses not associated with usual operations.
>
> From the tax viewpoint, different criteria, such as consistent treatment of different taxpayers and different sources of income, are much more important. To satisfy these criteria, the tax treatment of inventory profits should be consistent with the general concept of taxable income."

Then, at page 161, two-thirds of the way down the page beginning of the paragraph:

> "Monetary metals have been valued at selling values less costs of disposition in some cases. The Committee on Accounting Procedure has approved this policy for gold, silver, and copper inventories. The primary justification for the use of market valuations in these cases is apparently the high probability of realization."

Now, I have one question to ask you there, Professor Butters, as to that. Where you say that "The primary justification for the use of market valuations in these cases is apparently the high probability of realization" would it not be almost more so if, at the end of the year you found that a company had already sold or contracted to sell the major part of its copper inventory at the higher market price that then prevailed?—A. Depending on the nature of the party with whom the contract was made I would suppose so.

Q. I assume that the contract was made with a person who was quite able to—A. Almost more so—there is substantially no doubt at all in the cases which are cited here. I think it probably also should be pointed out that this use of market is a highly specialized exception to any general accounting practice and is mentioned as a quirk essentially rather than as representing any main body of acceptable accounting practice, that is to say, that is widely used in various areas of industry.

Q. Then, page 170, the opening sentence in this chapter:

> "This chapter continues the detailed discussion of specific inventory procedures by taking up the l.i.f.o. method. In contrast to the lower-of-cost-or-market method, procedures used by most companies in applying Lifo for both tax and business purposes have been dominated by the tax requirements for its use. The bulk of this chapter, therefore, analyzes these requirements."—A. I would be glad to explain what I mean if you would like me to there.

Q. Well, if the explanation is anything different from what the text reads.—A. It is not different but it might make it more clear to someone who is not familiar with the background I had in mind.

Q. If there is something you think you should add to make it more clear than it is, then you are entitled to do it?—A. What I had in mind there is that the Treasury in the United States in most areas of inventory valuation has simply taken over accounting practice without any detailed regulation or details as to how the method should be applied. In contrast the Treasury has laid down fairly specific definitions as to how l.i.f.o should be applied, how the average cost, for instance, of the opening l.i.f.o. year should be determined and by and large business practice has coincided with Treasury practice to that degree so that corporate practice has reflected tax requirements with respect to l.i.f.o. whereas it has tended to be the reverse situation to a greater degree with respect to other methods.

Q. Does that mean this, that in taking over or adopting l.i.f.o. you are suggesting it should be adopted on a basis whereby certain procedures are established?—A. It has been adopted in the United States on that basis and the Treasury laid down rules which by and large reasonably and clearly reflected income and business has taken over substantially those same rules.

His LORDSHIP: Business has taken over those rules because the Tax Department laid them down?—A. Yes, both for its own yearly reports as certified by public accountants and, of course, for tax purposes.

Mr. PICKUP: My question was maybe not clearly put. It was intended now to get your own opinion on the point as to whether you were thinking and it is your opinion that if in adopting l.i.f.o. it could be done under some procedure such as is adopted in the United States?—A. There are so very many differences in the way the method is applied in certain respects in the United States that I would not want to give the impression that there is only one method of using it.

Q. Is there some procedure that would effectively control in some way the application of the method?—A. Yes, I think that is correct.

His LORDSHIP: That is, if the conditions were the same—the methods of doing business were the same?—A. Yes, that is really what I had in mind in my statement that the way the method is applied for Department Stores, for example, is grossly different to the way it is applied to the metals industry in the United States.

Mr. PICKUP: This is a statement you made on page 172 the first paragraph of your own chosen quotation:

> "The widespread extension of l.i.f.o. since 1940 to industries not meeting these criteria (that is certain criteria you have discussed just ahead of this) is indicative of the power of tax considerations to modify business practice, not to mention generally accepted accounting practice."—A. Yes, that relates to exactly the same distinction I was trying to make before, that where I am talking about l.i.f.o. being adopted largely for tax reasons, I am talking almost entirely about those companies that have adopted l.i.f.o. since 1940.

Q. "The extension of l.i.f.o. is indicative of the power of tax considerations to modify business practice as well as to modify generally accepted accounting practice"?—A. Yes, I think that is correct. As Mr. Peloubet has written, for example, it would have been inconceivable that l.i.f.o. could have been used by Department Stores before it was authorized for tax purposes. It was not then used.

Q. Then, I have marked 173, the first whole paragraph:

"Inventory goods on l.i.f.o. must be valued on a cost basis regardless of current market values. This rule is designed to protect the Treasury against undue revenue loss and to avoid an unfair discrimination in favour of taxpayers on l.i.f.o. and against those using traditional methods. If the lower-of-cost-or-market convention could be used in conjunction with l.i.f.o., taxpayers on l.i.f.o. would be protected from the taxation of inventory profits in times of rising prices, but nevertheless would be allowed to reduce their taxable income when market prices fell below l.i.f.o. inventory values. Should this option be granted to l.i.f.o. taxpayers, a wholesale shift to the method could be anticipated; many taxpayers have refrained from electing l.i.f.o. mainly because of their fear that the market prices of inventory goods would fall below their l.i.f.o. costs."

and on page 175, the first complete paragraph:

"Another effect of the strict l.i.f.o. procedure is that it leaves management more flexibility in determining the amount of profits and taxable income reported in a given year. If prices have risen steadily during a year, for instance, profits can be reduced by building up inventory increments as of the year end. Such year-end purchases will be charged into cost of goods sold at their actual costs, but the inventory increments resulting from the purchases will be carried in the ending inventory at the costs of the first goods purchased during the year. Profits will be reduced by the excess of the costs of the year-end purchases over the costs of corresponding goods purchased at the beginning of each year. With this in mind, some managements deliberately built up inventories as of the end of 1945 to reduce their taxable income in the last year of excess profits taxation.

In years of falling prices the same device could be employed to increase the income of a given year. This procedure, however, would less frequently be advantageous for tax purposes; for business purposes its potentialities would be limited by the usual practice of showing l.i.f.o. inventories in published reports at the lower of cost or market rather than on a straight cost basis.

While the ability to manipulate income in this way has obvious tax advantages to managements, the social justification for the procedure is more dubious."

A. May I point out there that this discussion is directed not to a comparison of l.i.f.o. and f.i.f.o. but to a comparison of three alternative methods of valuing increments to l.i.f.o. inventories that are allowed in the United States practice and strictly limited to that comparison. If you build up your inventory beyond your base year inventory and you regard the increment as being the earliest year operation without the year-end accretion or average or the latest goods purchased—all three of those alternatives are allowed the taxpayer; that is, he may choose between them and adopt one method and follow that method consistently in the United States. The point I am wanting to make now is that in this last section which was read, the discussion is limited strictly to a comparison of those three alternatives of increment rather than to the l.i.f.o. and f.i.f.o. methods.

Q. I thought it was a little bit of a criticism of the l.i.f.o. method and not a comparison at all?—A. I meant it to be raising the question as to the desirability of using option (*b*), I believe it is, in the United States Code. The section is 22(*b*) for increments to inventories. Section 22(*b*) is what I have referred to as the strict procedure in this quotation and the quotation refers clearly then to increments in l.i.f.o. inventories.

I am raising a question as to whether it would not be more desirable to use Alternative (*a*) rather than (b) in applying the l.i.f.o. inventory method. I am not discussing whether l.i.f.o. itself would be desirable or not in the section you have read.

Q. But you are calling attention, are you not, to the fact that a manufacturer using l.i.f.o. could do the very things that you say on page 175 which he could do and thereby increase or decrease his taxable profits for the year?—A. I think this should be regarded as a very specialized and technical point of not very widespread significance but I agree with your statement.

Q. Then, I think just one more on page 194, the second sentence. Maybe I should read the first one too:

> "Among the many detailed requirements for the use of l.i.f.o. for tax purposes two stand out as of major importance.
>
> The first is that l.i.f.o. inventories must be carried strictly on a cost basis; no writedowns to market prices are permitted if market falls below the book value at which l.i.f.o. inventories are carried. This requirement has been a major deterrent to the tax use of l.i.f.o. If it were removed, the difficult problem of balancing the potential tax gains and losses from the election of l.i.f.o. would be greatly simplified. The risk of incurring increased tax liabilities by electing l.i.f.o. would then be restricted to the rather unlikely probability that special combinations of price movements, physical inventory fluctuations and changes in tax rates would occur simultaneously.
>
> The second major problem affecting the use of l.i.f.o. has been that of defining the types of inventory categories or pools into which l.i.f.o. inventories could be grouped."

A. I, of course, recognized Mr. Kracke's qualification on writedowns to market for published balance sheets and could not cover it in as brisk a summary as this.

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Q. And page 210, the second complete paragraph:

"The typical method of handling seasonal dips in inventory is to create out of income a reserve for the replacement of seasonally liquidated inventories. The size of the reserve is usually determined by the difference between current replacement costs and the l.i.f.o. base price of the liquidated units, multiplied by the number of units liquidated."

A. I believe my discussion here is referring simply to interim published reports, not to annual statements either published or taxable income.

Q. Why should not the same apply to annual statements as well as interim ones?—A. The problem is something that happens within the twelve-month period and does not arise in an annual statement.

Q. Well, if it is a good thing to do in interim statements, would it not be a good thing to do apart from seasonal statements?—A. What I would have in mind as a seasonal problem is when a Department Store builds up its inventory at Easter or Christmas or a manufacturing company at the peak of its year's operations and the issue just does not arise when you are talking of a time period longer than a year. A seasonal problem is a problem within a year.

Q. But does not the same principle apply if you are facing the danger of a rise or fall in prices after the year end?—A. My seasonal problem discussed here refers to fluctuations in inventory quantities. Price changes are not involved at all in that section if I am judging its location at all rightly here.

Q. I think that is all, thank you, Professor Butters.

Re-examination by Mr. DeRoche:

Q. There are just one or two very minor points. May I draw your attention to page 161 of the transcript of your book, the paragraph stating "Monetary metals have been valued at selling values less costs of disposition in some cases." I perhaps should point out to you, Professor Butters that we are dealing here with a brass mill. You use the word "copper" there. Were you directing your attention to copper inventories of brass mills?

Mr. PICKUP: He has said "copper inventories". He did not qualify it.

Mr. DEROCHE: I would have thought it was obvious.—A. I think not. This is one area of accounting with which I am not very familiar in detail and I am not sure of my answer to that question. I was quoting essentially, as I recall, accounting discussions—I notice I have a foot note to the Accounting Research Bulletin 29 and I think a reference to that would make clear what I had in mind.

Q. That is an exhibit here. I will read it to you.

His LORDSHIP: Well, it is all there.

Mr. DeRoche: Copper is not mentioned in the Bulletin, Professor Butters. Let us go on to page 175. I think you did make this explanation here, but you referred to (*b*) which was on 175 and to (*c*) and I thought perhaps (*c*) might be mentioned more than just as (*c*). What is Item (*c*) in the regulations?—A. Item (*c*) provides that increments in l.i.f.o. inventories under Item (*c*) if Item (*c*) is elected may be valued at the average cost of the purchases—I believe it is average unit cost applied to the average cost of units purchased throughout the year divided by the number of units against the costs of the earliest or latest number of units purchased up to the amount of the increment.

Q. Just to clear your own mind, that is the evidence in this case. In the summary on page 194 I think the context makes it clear but are you dealing there with l.i.f.o. as a method or l.i.f.o. as defined in the Tax Act?—A. Well—"Among the many detailed requirements for the use of l.i.f.o."—the requirements I have in mind are those of the Internal Revenue Act and the Treasury Regulations, of course.

Mr. Pickup: I take it I may proceed, my Lord, with the evidence on behalf of the Minister. First, my Lord, I want to put in as an Exhibit the letters patent incorporating the Appellant Company.

Exhibit A: Filed by Mr. Pickup	Letters patent incorporating the Anaconda American Brass Limited.

Mr. Pickup: Then, I will call Mr. Williams.

Mr. William Frederick Williams, Called, Sworn:

Examined by Mr. Pickup:

Q. Now, Mr. Williams, what is your position in the Department of National Revenue at Ottawa?—A. I am the Director General of the Corporation Assessments Branch.

Q. How long have you held that position?—A. Just over three years.

Q. And prior to that what were you doing?—A. During the War from 1940 to 1947 I was with the Department of Munitions and Supply.

Q. By profession what are you?—A. A Chartered Accountant.

Q. And you have not, I understand, been in private practice as a Chartered Accountant for some little while?—A. Not since 1940 when I went to Ottawa.

Q. Will you tell me whether you have continued to be in touch with accounting problems?—A. Very definitely, practically constantly both with the Department of Munitions & Supply and my present position with the Taxation Division.

Q. Then, do not hesitate if there are any papers that you have not got before you in connection with anything I might ask. One of your assistants here will provide you with them. But first I want you to take the Assessments with the income tax returns for the years 1946 and 1947 and explain to the court the basis upon which those assessments were made in this particular case?—A. In 1946 the income for the year 1946 was adjusted downward from the amount that the Company had reported by an amount of $32,469.75.

Q. Would you speak a little louder please, Mr. Williams?—A. The income reported by the Company was adjusted downward for taxation purposes to the extent of $32,469.75. This resulted from what is referred to as an "Inventory Adjustment" and resulted, I believe, in a refund of some $12,000 odd to the Company.

Q. Will you tell me just how that reduction came about or the basis of it?—A. It arose because the Department, the Minister, did not agree with the valuation which the Company had placed on its closing inventories.

Q. You mean closing inventories for the year 1946?—A. 1946—that is correct.

Q. And what did the Minister do about it?—A. He adjusted it so that the cost of sales would be increased resulting in a smaller profit to the extent of the $32,469.75 about which I referred.

Q. And will you explain to us what the adjustment in cost of sales was? You were starting to tell us just of the change made by you in the assessment in the return for 1946 as compared with the return made.—A. It arose out of a difference in the valuation of the closing inventory in 1945 which became the opening inventory in 1946 and the closing inventory at the end of 1946. At the end of 1945 the inventory, as valued by the Company, was shown at $1,481,760.76.

His Lordship: As valued by the Company in their books?—A. In their financial statement, yes sir.

Q. And was there a quotation that it was valued on the l.i.f.o. basis?—A. "Inventories as determined and certified by the management and valued as set out in the attached report".

Q. Then, it would be on the back page of the Report, I suppose?—A. Yes, "That inventory quantities were determined as follows: Metals—raw, scrap, finished and in process—as shown by book records which had been adjusted as at 20th October 1946 to agree with a physical inventory correctly and properly taken under their direct supervision at that date.

Supplies—as shown by perpetual inventory records, quantities having been verified by physical count throughout the year.

2. That the inventories were priced on the same basis as in the previous year which is as follows—Raw copper and zinc and copper and zinc content of goods finished and in process, at cost computed on a 'last-in, first-out' basis.

Other metals, at laid-down cost." . . .

Mr. Pickup: Now then, having that return, just tell us what the Department did, Mr. Williams, please?—A. The value placed on the inventory by the Department at December 31, 1945 was $1,750,592.25. That was an excess of the Department over the Company to the extent of $268,861.49. That had to do with the closing inventory in the year 1945 which became the opening inventory in 1946. Now, the inventory at the end of 1946, was valued by the Company at $1,955,325.84.

His Lordship: Also on the l.i.f.o. basis?—A. Yes sir. I am afraid I read from the return for the year 1946 previously, my Lord. Yes, and was referred to in the Report.

Mr. Pickup: You were now going to speak about the closing inventory of 1946?—A. Valued by the Company on its books at $1,955,325.84 and by the Department at $2,191,717.58.

Q. Now then, it has been suggested here that the difference in 1946 arose not out of any difference between the f.i.f.o. method or l.i.f.o. method but out of some credit that the Department was giving in respect of scrap. What have you to say to that?—A. Well, I cannot see that in the Report here. It is purely an adjustment, taking the difference of the opening inventory and the closing inventory, deducting that and allowing that as a charge to costs of sales.

His Lordship: Are you able to say whether the difference was due to some consideration relating to scrap?—A. There is nothing on my file to indicate that. I was going to say that the excess at the end of the year amounts to $236,391.74. Then, deducting that from the excess at the beginning of the year, we arrive at this figure of $32,469.75 which I referred to as the adjustment made.

Mr. Pickup: Now then, I will come back later to the basis upon which the valuations were made but may we just take in 1947 and give me the same information as to what the Department did in respect of the return for the year 1947?—A. In this case, the method is the same but the amount is substantially different. It amounts to—

His Lordship: You might say what you did with regard to the opening inventory which would, of course, be the same as the closing inventory of 1946.—A. And I start by saying that at the end of 1946, the opening date of 1947, it was $236,391.74 difference. At the end of the year 1947 the inventory, as shown by the statement and the books of the Company, was $1,848,497.89. The Department valued the inventories at the end of the year 1947 at an amount of $3,696,646.06.

Q. A difference of what?—A. A difference of $1,848,148.17. Then, by deducting that $236,391.74 at the beginning of the year from that last figure, we get $1,611,756.43 which is the amount of the invetory adjustment.

Q. And that was added to the assessment?—A. That was added to the taxable income.

Mr. Pickup: Then, Mr. Williams, will you tell us the basis upon which the Department valued the inventory at the end of 1946 and at the end of 1947? I assume first, the basis was the same in both years?—A. Well, at the end of 1946 the price of copper and zinc, I believe, was still pegged.

His Lordship: At 11½c.?—A. Yes, so that the Department valued the copper at 11½c and valued the zinc at 5·75c. Now, those prices are the bare prices at the mine. They did not include transportation charges and premiums for shapes and so on. In 1947 we used a price of 21½c for copper, 11c for zinc, 14·25c for lead and 81·5c for tin. Here again these are the bare mining prices.

Mr. Pickup: Now, will you tell us why the Department used those prices?—A. Well, the Department's view is that—

His Lordship: Were those the market prices at the end of the year?—A. Yes, sir. The Department's view was that the goods most recently purchased were the goods that would be on hand at the end of the year and they, therefore, adopted the traditional practice of pricing them at cost or market and the market was these prices which I have quoted. On that basis we priced the inventory remaining and adjusted the cost of sales accordingly.

Q. Was it cost or market whichever was the lower?—A. The lower of cost or market would be the basis.

Q. Wasn't 21·50c a high price obtaining in that year?—A. That is right.

Mr. Pattillo: Would you speak up a little? We are having great difficulty in hearing you.

The Witness: 21·5c, I believe, was the price obtaining for several months.

His Lordship: As a matter of fact from June 10, 1947?—A. Yes, sir.

Q. But then it had been somewhat lower than that in an earlier part of the year? You assumed that all of that had been used up?—A. Yes, sir.

Q. That is, according to the process and the price which was in effect at the beginning of the year and the price that went into effect on the 22nd January—you assumed that all the goods purchased at that time had been physically used up and had gone into process?—A. That is correct and that, I may say my Lord, is the method that had been adopted for years with this Company.

Mr. Pickup: Then maybe you might explain to us, Mr. Williams, what is the function of the inventory in arriving at profits for any given year?—A. Well, in arriving at the net profit or gain, the inventory is probably the most significant and important item—the value that is placed upon it.

His Lordship: On the basis of its value?—A. Yes, sir.

Q. On the assumption that it could be turned into that much money?—A. That is right, sir.

Mr. Pickup: Or on the other assumption that it cost that much money out of the year's profit to obtain it?

His Lordship: That might have no bearing on its value.

Mr. Pickup: Oh, no.

His Lordship: Value might be different.

Mr. Pickup: Well then, we have heard a good deal here about the l.i.f.o. principle, Mr. Williams. Now, will you tell us why the Department has not permitted the use of l.i.f.o. in this case?

His Lordship: Why it has not "permitted" the use of l.i.f.o.?

Mr. Pickup: Yes.

His Lordship: You are going to give the reasons for it, are you not?

The Witness: In our view, l.i.f.o. in effect perhaps indirectly creates a reserve and an averaging of profits over a period.

Q. It is a reserve and an averaging of profits over a period?—A. In other words, it does what one or two witnesses have already testified, it levels off the hills and valleys. The Department does not agree with that in that the Act calls for the annual net profit or gain to be subject to tax.

Q. That is the net annual profit or gain received?—A. Yes, sir.

Mr. Pickup: Anything further to add to that, Mr. Williams?—A. No, I think that substantially covers it.

Q. How does it in effect set up a reserve?—A. Well, in our view it does not value the inventory at the traditional lower of cost or market.

Q. Anything further that you want to add as to that?—A. I don't think so, sir.

Q. Now, there are two or three returns I want you to refer to—

His Lordship: Has it been an invariable practice of the Department to refuse the use of l.i.f.o.?—A. So far as I am aware, your Lordship, there is an internal directive which was issued to all Income Tax Inspectors many years ago, prior to my time with the Department, and it very definitely states that we will not consider the use of l.i.f.o. for the reasons I have given—that it tends to average the profit over a period rather than to tax each year's profits as and when they are earned or received.

Mr. PICKUP: I had intended at one stage to put that in but I have not done it.

His LORDSHIP: Which was that?

Mr. PICKUP: That directive. Would your Lordship agree to have it?

His LORDSHIP: I did express some doubt as to it.

Mr. PICKUP: I felt I should not put it in unless I brought it home or brought it to the attention of the Appellant and I did not do that and, therefore, I have not tendered the directive in evidence.

His LORDSHIP: I do not know that the directive would have any additional value over Mr. Williams' statement as to the practice of the Department.

Mr. PICKUP: No, my Lord. Then, Mr. Williams, I had asked you to bring here (and Mr. Fykes can get it for you if necessary) the returns of this Company for 1930, 1931 and 1933. I want you to explain to the court just what was done in those years.

His LORDSHIP: Is there any particular reason for picking those years out?

Mr. PICKUP: Just to show, my Lord—and this is all they will show—that when the cycle was the other way and we came into a depression, the Company—

His LORDSHIP: But they did not go on the l.i.f.o. principle until 1936.

Mr. PICKUP: But they were on the f.i.f.o. principle in 1930, 1931 and 1933.

His LORDSHIP: They went onto l.i.f.o. in practice in 1936.

Mr. PICKUP: My only purpose in introducing it was to show that in the earlier years when operating under f.i.f.o., the Company had claimed deductions where the market was less and got the advantage of it on a falling market. Now, that is the sole purpose of it.

His LORDSHIP: I won't restrict you, Mr. Pickup, if you think it has any bearing.

Mr. PICKUP: I had asked one of the witnesses for the Appellant something about that and he rather negatived any such idea although he was not sure about it and I thought I would put it on the record unless your Lordship thinks it is of no assistance to you.

His LORDSHIP: Well, I am not going to restrict you, Mr. Pickup.

Mr. PICKUP: Well, then, will you produce the three of them? Shall I put them in as separate exhibits or as one exhibit?

His Lordship: You can put them in as one exhibit if you wish. Then, are you going to put something in covering the period when in actual fact they kept their books of account on the l.i.f.o. principle and made adjustments for income tax purposes?

Mr. Pickup: I do not think I need to because that has been so fully explained by witnesses for the Appellant. I had nothing to add and I thought it might be encumbering the record.

Now, Mr. Williams, you know what I have in mind. You might refer to it and tell me what each exhibit shows.

Exhibit B: Filed by Mr. Pickup — Income Tax Returns from Anaconda American Brass Limited for years 1930, 1931 and 1933.

The Witness: The first one is the year 1930 Return in which the Company has claimed a loss on raw materials of $318,505.70.

His Lordship: It was then on the same basis you thought it ought to be on?—A. That is right but they were writing down to market, the market having become lower than cost.

Mr. Pickup: Just before you leave it was a deduction as claimed allowed?—A. The amount claimed on the return was $318,505.70. The Company had reported a loss that year of $302,567.52 from which we had deducted in the normal way the amount of income tax which had been included therein so that that would be on the previous year and the net loss was shown as $258,131.81 but, as there was an inventory loss of $318,505.70 allowed after that, if that had not been allowed it would have resulted in a profit of $60,000 approximately.

His Lordship: The allowance for the loss resulted in no tax being exigible?—A. That is correct.

Mr. Pickup: That is 1930. Then, 1931?—A. In 1931 the Company reported a profit of $1,546.36 against which there was an inventory loss allowed of $53,122.15.

His Lordship: Again resulting in no tax?—A. That is right, sir.

Mr. Pickup: In 1933?—A. I made a mistake there, sir. The figure of the net inventory loss would be $149,618.94 instead of $53,122.15.

Q. It would still have the effect of creating a profit into a loss?—A. Yes, writing off the dropping value of the inventory.

Q. Now, 1933?—A. In this case there is a difference of $30,659.52.

His Lordship: Of loss?—A. Of loss but the Company are non-taxable in any event.

Mr. Pickup: But there is a claim made for loss of inventory and the claim was allowed, the effect being merely to increase the loss from a red figure to a greater loss figure?—A. That is right.

Cross-examination by Mr. Pattillo:

Q. Dealing with these tax returns, Mr. Williams, for the years 1930, 1931 and 1933, these losses of raw materials that were allowed by the Department in those years are losses that are always allowed to a company which is reporting its return on a f.i.f.o. basis—is that not correct?—A. That is correct.

Q. And, so far as the Tax Department is concerned, and up to the present time of its thinking as to the method on which the Company must file its tax return, namely f.i.f.o., if there was a loss of raw material tomorrow, you would allow it again?—A. If the market dropped and they wrote down to market.

Q. So it merely gets down to the question of the method of arriving at cost as to whether or not you allow a loss in raw materials as you did in 1930, 1931 and 1933—isn't that so?—A. I do not know; I would not say so.

His Lordship: You dispute the definition of cost?—A. Yes, sir.

Q. The debate will turn on what is meant by "cost" and what portion of an expenditure is properly applicable as cost of certain sales?—A. That is correct.

Mr. Pattillo: Now, coming back to the returns for the years 1945, 1946 and 1947—

His Lordship: The return for 1945 is not in. There is only one point raised in it and that is the closing inventory of 1945.

Mr. Pattillo: Yes. Now, am I correct that for the closing inventory of 1945 which corresponds to the opening inventory for 1946, the Department valued copper at 11.5c per pound and zinc at 5.7c per pound?—A. 5.75c. That is the value that I have for 1946.

Q. The opening market in 1946?—A. That is correct—11.5c for copper and 5.75c for zinc.

Q. And the Department, in valuing the closing inventory for 1946 which would be the same as the opening inventory for 1947 used the same prices in valuing copper and in valuing zinc. Am I not correct?—A. That is correct.

His Lordship: There had been no change in the prices during 1946?—A. That is correct.

Mr. Pattillo: Well, if that is so, how do you then explain these differences in the valuations of your opening and closing inventories that you have been giving here in evidence unless it would be on a scrap adjustment such as we claim?—A. Oh, there are differences in the inventories between the Company and the Department going back further than that. I have seen nothing to indicate that there is a scrap difference.

His LORDSHIP: There may have been but you have not seen anything to indicate that?—A. No.

Mr. PATTILLO: Do you know anything about this scrap allowance?—A. No, sir.

Q. Did you ever hear about it before you came here to the court?—A. No, sir.

His LORDSHIP: If there had been such an allowance, Mr. Williams, would not you know about it?—A. It may have come to my attention or it may not, my Lord. I do not recall this file coming to me particularly at the time the assessment was made.

Q. But there is nothing in your records to indicate that?—A. No, the question that did come before me was the question of the valuation of the inventory. I can recall that very clearly.

Q. It might be then that the difference is the result of a scrap allowance? —A. It is possible.

Mr. PATTILLO: What I want to get clear, Mr. Williams—knowing, as you do as a Chartered Accountant, how l.i.f.o. and f.i.f.o. work and how they are applied, can you explain how you would get this difference between the opening and closing inventories in 1946 between the two methods if you started the year with the same prices as you closed the year—the same unit prices?—A. You are referring only to copper and zinc. That was not the total inventory.

His LORDSHIP: Were there differences in lead and tin?

Mr. PATTILLO: The remainder of the inventory was on a f.i.f.o. basis both by the Department and the Company, was it not?—A. I would think so.

Q. So you would not get any difference there?

His LORDSHIP: You mean in respect of the lead and tin?—A. In 1946—yes.

Mr. PATTILLO: So there cannot be any difference between you there except some matter of one or the other making a slight clerical error?—A. I am afraid I cannot tell you that, Mr. Pattillo.

Q. Will you agree with me that, having regard to what I have said, that the opening and closing prices would be the same, that the difference you would come up with could only be explained by something such as this scrap allowance?—A. I cannot agree with that.

His LORDSHIP: It is something, as far as Mr. Williams is concerned, which is unexplained.

Mr. PATTILLO: And something extraneous to the l.i.f.o. or f.i.f.o. methods?—A. I would not know.

Q. That is fair enough. Now the Department, so long as you have been associated with it, has recognized f.i.f.o. as a method for calculating cost. Is that correct?—A. It has recognized several methods.

Q. Well, I want to just come first to f.i.f.o. It has recognized f.i.f.o.?—A. Yes.

His LORDSHIP: As a matter of calculating cost?—A. As a method of determining costs in certain circumstances.

Mr. PATTILLO: And it has also recognized average in certain circumstances, hasn't it?—A. I do not of my own knowledge know that but I am told that that is the case.

Q. But since you have been with the Department it has continually refused to recognize l.i.f.o.?—A. That is correct.

Q. Would it be fair, Mr. Williams, to say from your experience in the Tax Department since you have been a member of it, that in your opinion if it were not for the refusal of the Tax Department to accept l.i.f.o. there would be many more companies in Canada on it than there are now?—A. My opinion would be yes, there would be.

Q. Now, I notice that you said that it was the view of the Tax Department that l.i.f.o. in effect creates a reserve. Is that your personal view?—A. It is.

Q. And what do you mean by the use of these words—"in effect"?—A. Indirectly.

Q. You agree that a reserve, as you know the word from your experience as an accountant, is not created by the use of l.i.f.o.—is that so?—A. No, I do not agree. I said "in effect".

Q. Have you finished, Mr. Williams, or do you want to go on?—A. Go ahead.

Q. I know you used the words "in effect" and I intend to come to that. I am asking you first, from your experience as a Chartered Accountant, do you agree that the use of l.i.f.o. does not create a reserve as the word is used and understood by accountants in Canada?—A. I think we are just talking about words.

His LORDSHIP: We are talking about words. He is using "reserve" in the question he is putting to you in the common way that it is commonly interpreted by accountants.—A. I would have to qualify that by saying that accountants know of several types of reserve. There are such things as secret reserves which do not appear on the books. I cannot say that l.i.f.o. has or has not done that.

Q. There might be nothing absolute in the term "reserve"?—A. That is right.

Q. There may be variations in the word "reserve"?—A. Yes. Any time that one under-values an asset, you are in effect again creating a reserve.

Mr. PATTILLO: And is that what you mean by saying that "in effect l.i.f.o. creates a reserve" or would you like to elaborate what you mean by the statement that "l.i.f.o. in effect creates a reserve"?—A. Yes. Can I put it this way? There are a great number of companies in Canada who normally set up a reserve against their inventories to protect themselves against the falling prices. Now, that they may do in a number of ways. They may charge surplus and set up a reserve right on the books and it can be seen over on the right hand side of the balance sheet among the liabilities or deducted from the inventory account itself or they may simply do it by arriving at the valuation of the inventory and deducting the amount which they consider is reasonable under the circumstances. The net figure is then carried into the financial statement. Now, that is setting up a reserve too—sometimes referred to as a "secret reserve" if you like but l.i.f.o., in effect, does the same thing.

Q. That is insofar as the balance sheet is concerned?—A. I think insofar as the accounts are concerned. I have a very simple little statement which I worked out last night. I do not know if your Lordship would care to look at it.

His LORDSHIP: Well, if you think it adds to the case?—A. I think it shows where the reserve is.

Q. Well, I would like you to explain what you mean by saying that l.i.f.o. in effect creates a reserve and if you have any statement that assists in showing that, we would be glad to have it.

Mr. PICKUP: Perhaps as he is my witness perhaps he would now put in as an exhibit the statement he now wishes to produce and perhaps explain it?—A. This is a very simple statement—

His LORDSHIP: "Simplified example of the effect of profits".

EXHIBIT C: Filed by Mr. Pickup { Statement entitled "Simplified example of the effect of profits".

The WITNESS: Now, I tried to keep this right down to the fundamentals. What I have done here, my Lord, is that on the assumption that I have $100 in cash and I buy 100 units at $1 each for cash and I sell 100 units at $2.00 each for cash—now I may have stopped there and said: "That is the middle of the year" but we will go on. It is a matter of no moment. The purchasing market that I have to buy from goes up from $1.00 to $2.00 and I buy 100 units at $2.00 each for cash and the year ends.

Now, the point I am getting at here is what is the profit which we feel is the annual profit or gain and also how does a reserve come into the picture.

The opening balance sheet, which would be the same under every method would show that I would have had on hand $100 in cash and my capital would be

$100. Now the closing balance sheet under the l.i.f.o. method as I understand it from hearing it here this past week, I would have an inventory of $100 that being the inventory that I had on hand at the beginning and a capital of $100 so I would be in exactly the same position at the end as the beginning of the year.

Now, that would arise because under the assumption of l.i.f.o. the costs were not the costs that I had already expended but the costs that I paid at the higher price and, therefore, the sales at $2.00 per unit produced $200.00 in cash and the cost of sales on the l.i.f.o. basis were $200.00 and there was no profit.

Q. You are now confining yourself exactly to the invetory and to the sales of finished goods?—A. No, I am trying to show where, in my view, there is a reserve against that inventory.

The closing balance sheet under f.i.f.o. would show an inventory of $200.00. On the other hand, I would have had a profit of $100.00 and I would still have my $100.00 capital.

Now then, assuming that I want to provide for future losses against this inventory that I bought at higher prices, I would set up a reserve for $100.00. That would wash out the profit because it would be charged against the profit and would be deducted from the inventory and I would arrive back at the same figure as I would in the closing balance sheet in the l.i.f.o. method.

Actually, in my view, what has happened is that they have made a profit of $100.00 which, together with their original capital, has been reinvested in another inventory at a higher price.

Mr. Pattillo: Well, Mr. Williams, taking your Exhibit C for the moment, that is, the example you have just given us—

His Lordship: Your opinion is that they have made a profit and reinvested in additional goods?—A. That is right, sir.

Mr. Pattillo: First of all, in the example the person started out the year without any inventory on hand at all—that is correct?—A. He had $100 in cash—that is right.

Q. He had no inventory on hand at all. Then, he completely sold off the whole of his inventory before he repurchased and bought further supplies—is that correct? —A. He may or he may not.

Q. Well, this is the example that you have here. I am taking your example. You say: "I buy 100 units at $1.00 each for cash. The next step is I sell 100 units at $2.00 each for cash. Then the market goes up from $1.00 to $2.00 and the next step is I buy 100 units at $2.00 each for cash". So, as I understand your illustration, you had no inventory at the commencement of the year, you bought 100 units and then you completely sold all of your inventory before you made any further purchases or before the market went up. Now, is that correct—just as this Company did with some of its scrap?—A. Yes.

Q. Let us get along on this example then. Do you agree that I am stating the thing properly?—A. That is correct.

Q. Then he goes out at the last of the year and he buys a new 100 units at $2.00 each costing $200.00?

Mr. PICKUP: Why do you say "at the last of the year"?

Mr. PATTILLO: That is the way he has got it.

His LORDSHIP: You buy 100 units at $2.00 each for cash and the year ends. He might have bought it on the 1st or 2nd of July.

Mr. PATTILLO: Yes, but he did not dispose of any of it, as I see it. Is that correct?—A. It was not intended that way but I do not disagree with it.

Q. Now, first of all, when you costed your sales here on the l.i.f.o. method—you have heard that the evidence in this case is that the Company costs its sales on the average cost prevailing during the year, by taking the number of units it purchases and dividing that into the dollars that it costs and getting the unit price in that way. You have heard that that is the evidence in this Anaconda Case?—A. That is right.

Q. That is not the method you have employed here, is it, in arriving at this cost?—A. Not necessarily—no. I was not using the Anaconda method.

Q. But if you used the Anaconda method in your example dealing with l.i.f.o., you would have come up with a profit, wouldn't you?—A. No.

Q. You would have had sales of 100 units at $2.00 which would have given you $200.00 sales and when you came to cost all sales, your unit cost figure would have been less than $2.00 because you had bought 100 units at $1.00 and you bought 100 units at $2.00 so that if you took the average of that, you would get a unit price something less than $2.00?—A. That is not the way Anaconda did it.

His LORDSHIP: Surely that is not the way Anaconda did it?

That is not on the l.i.f.o.—the illustration you are putting. The illustration you are putting—is that an illustration of l.i.f.o.?

Mr. PATTILLO: When you come to the end of the year, you find out your dollars that have come in and units that have been disposed of and by making that calculation you arrive at what is your unit price or unit cost price for all of the goods during the year. Then, when you value your increment, if you have any for the year, that is the unit price figure that you take. That, I think my lord, is the evidence very clearly as to what is done.

Mr. PICKUP: I thought what you did, you just simply took your last in and treated it as having been disposed of and that you had left what you started with apart from adjustment of amounts of inventory.

Mr. PATTILLO: But you will remember, my Lord, when Professor Butters was giving evidence this afternoon he said that there were two or three ways of valuing your increments in the year. One was to take the unit price that was prevailing at the commencement of the year. Another method was to average the purchases throughout the year and arrive at your unit price in that way for the whole year and you applied that unit price to your increment.

Now, what Mr. Williams has done in his example is to apply a unit price based on the last purchases here when he is trying to arrive at his profit and I am suggesting to him that if he had done, in his example, what Anaconda did, he would not have got the result that he shows here. Now, that is correct, isn't it?—A. No, I cannot understand it that way.

Q. Now, you have been here throughout the whole of the evidence, haven't you?—A. Most of it—not all of it.

Q. You certainly heard about Exhibit 7?—A. I didn't see it.

Q. We gave copies to you. I am sorry it was not passed on to you.

Mr. PICKUP: You gave us one copy and I had that.

Mr. PATTILLO: We will look at it now. Now, looking at Exhibit No. 7 which shows the inventory as at January 1, 1947 broken down between the starting quantity and then the various strata of the yearly increments following thereafter, you heard Mr. Gordon explain yesterday how these yearly increments came into being, how that during the period between 1939 and 1945 they had to dip back into the increments when he was able to do so in the earlier years because their sales during those years of products contained more copper content than they had been able to buy. You heard that didn't you?—A. Yes.

Q. And you heard Mr. Gordon explain that these prices that are shown here of 09466 for the year 1936 and so on—how those prices were arrived at, didn't you?—A. Well now, we are talking about the closing inventory of 1947? Is that what we are talking about?

Q. I am talking about the closing inventory for 1946 which is the same as the opening inventory for 1947. That is correct, isn't it?—A. Well, as I understood him to say, it was that they valued it as of 802,697 lbs. and it then gave $75,983.30 and that was going back to the furthest period—to 1936.

Q. But he explained, didn't he, Mr. Williams, how he got the unit price which gave him that total amount for that number of pounds?—A. But that figure, as I understood him to say, was the same for the last several years.

Q. Quite, but it was an original cost figure, wasn't it, which was arrived at on the average cost of all purchases during the year?—A. Well, is not that the same thing? This is the original cost I am talking about—the $100.

Q. Now, Mr. Williams, you say in your example that you bought 200 units during the year?—A. Yes.

Q. 100 units cost you $100?—A. Yes.

Q. Another 100 units cost you $200. What would be the average price of a unit that you bought during that year?—A. $1.50.

Q. Of course.—A. Well, what has that got to do with this?

Q. Now then, when we get down here to arrive at our sales on l.i.f.o., you want to arrive at your cost of sales. You have sold 100 units at $2 so that your sales revenue is $200, isn't it?—A. That is correct by every method.

Q. Your opening inventory was nil?—A. I had an inventory of 100 units.

Q. No, you did not. You had no inventory at all for the beginning of the year in this example. You had $100 in cash. Do you want to agree with that now?—A. I won't disagree with you.

Q. So, you had nothing to start with. Now then, what do you next do? What do you add to nothing?—A. I have $100. I have cash to start with.

Q. I am trying to arrive at the cost of goods and you know how to do it. You take the opening inventory and you add to it what?—A. There is no opening inventory. You take the cost of the first 100 units you buy. That is your cost of goods.

Q. Now, for the year, when you are arriving at costs of sales, you have heard all the accountants who have been giving evidence say that you take your opening inventory, you add to it your cost of purchases and you deduct therefrom the value of your closing inventory. Now, do you agree or disagree?—A. In this case, no. We do not have an opening inventory and you said so yourself.

Q. But don't you still go through the process? If you have no opening inventory you, therefore, take your cost of purchases and you deduct from it your value of your closing inventory and the result you get is your cost for the year?—A. Yes.

Q. All right—let us do that here.—A. Well, it is done, isn't it?

Q. I do not agree. I say it has not been. Now, you bought 100 units at $1, so that is $100 and you bought another 100 units at $2 which—A. Just a minute—I have sold the 100 units at $2.

Q. I do not care what you have done. You are taking the sales revenue in. I am trying to arrive at cost of sales. You bought 100 units at $1 which is $100 and another 100 units at $2 which is $200 and the total cost of purchases for the year is $300?—A. That is correct.

Q. Now then, we come to what value we are going to place on our closing inventory that we are going to carry over. Now, I suggest to you that where you have 100 units that you are going to carry over, you say that on l.i.f.o. averaged throughout the year the unit price would be $1.50?—A. I did not say that. I did not say that the average price on l.i.f.o. was $1.50. I believe that the average price in the example you quoted, having no relation whatever to l.i.f.o., was $1.50.

Q. Well, let us put it this way, then. On the evidence which has been given in this case as to the manner in which Anaconda arrived at the valuation of its inventory and valued its yearly increment, would you agree that, in your example, the unit price of your closing inventory should be not $2 as you have it but $1.50? —A. No.

Q. You won't agree?—A. No.

Q. You will admit it should not be $2?—A. No.

Q. On the basis used by Anaconda? I am not talking about anything else.—A. I have not gone into that statement. You put it in front of me just now. I would not make any such admission just now.

His LORDSHIP: Why not take Mr. Williams' statement as contained in Exhibit C and translate it into a result that would be shown on the l.i.f.o. method?

Mr. PATTILLO: I was going to do that but I thought perhaps it might be better if I got him to do it, my Lord, but he does not apparently want to.—A. I do not understand this involved method, I am afraid.

His LORDSHIP: I am not suggesting that you do it now.

Mr. PATTILLO: I will carry on, my Lord, and come back to that later. Now that illustration that you have given us in the form of Exhibit C is, you say, your reason for saying that l.i.f.o. in effect creates a reserve?—A. I am showing that as an example of how it could do it.

Q. But you will agree with me that that is not a reserve that has been transferred from one account to another or a reserve set up in the books of the Company? —A. It has not been so designated in the books of the Company perhaps.

His LORDSHIP: That is why you used the words "in effect"?—A. That is correct, my Lord.

Mr. PATTILLO: Now, I understood you to say that l.i.f.o. averages profits over a period—is that correct?—A. That is correct.

William Frederick Williams (Respondent)
Cross-examination by Mr. Pattillo (Cont.)

His LORDSHIP: It might?—A. I think one or two witnesses, my Lord, have already suggested it.

Q. But it might not?—A. That is possible. It levels off the hills.

Q. Well, if there were no dips, there would be nothing to level?—A. If there were none. But over a period there are always hills and dales in profits.

Mr. PATTILLO: Now, Mr. Williams, from your experience as a practising accountant would you say that this secret reserve that you have talked about—not set up in the books but hidden secretly by one of the illustrations you used, by valuing the inventory and then arbitrarily taking off so many dollars and then using the net figure in the books—is that good accounting practice?—A. It has been done. For taxation purposes I would say it would be disallowed completely.

Q. Is it acceptable?—A. It has been accepted. I do not say it is the best accounting practice. If I may say so, my Lord, in the Dominion Bureau of Statistics Report that you filed as an exhibit this morning, it was stated in there that practically 50 per cent of the reporting firms used reserves against inventory.

Mr. PATTILLO: They are set up in the books?—A. Some of them are and some of them are not. That is exactly the way it is stated in the report.

Q. I am talking about the ones that are not set up.—A. So am I.

Q. They are arrived at, as you illustrated, by valuing the inventory and then arbitrarily taking so much money off and when you came to make up your balance sheet using a net figure you get. Is that good acceptable accounting practice in Canada?—A. I am trying to find an answer to satisfy Mr. Pattillo.

His LORDSHIP: You are being asked your opinion.—A. Well, I have to form my opinion from this D.B.S. Report in this case because I have not been practising for ten years, my Lord.

Mr. PATTILLO: Well, there is some mention about reserves on page 4 which so far has not been put in evidence.—A. That is the paragraph to which I had reference.

Q. The one on page 4?—A. That is it.

Q. That has not been put in evidence up until now. You wish to refer to that, do you?—A. Well, you merely asked me if it was good practice, if I, as a Chartered Accountant, considered that firms are doing it. I can only reply that I have not been in practice for ten years. I do not know what the current practice is but I have respect for the Dominion Bureau of Statistics and the manner in which they have secured this information.

Q. And are you suggesting that the language used in this paragraph as to reserve policy on page 4 of the D.B.S. Reference Papers, 1949, Exhibit 33, is a reserve that was deliberately set up by valuing your inventory and then arbitrarily taking a figure off and only disclosing the net?—A. I do not say that at all.

Q. No, of course, you would not. They are talking about reserves there that are set up in accordance with the principles of acceptable accounting practice, aren't they?—A. I assume so.

Q. Where the auditors of the Companies are making a proper and full disclosure as to the reserves?

Mr. PICKUP: It says "the reserve was not shown separately . . .

Mr. PATTILLO: They do not have to be shown separately. They can be carried in reserve without being earmarked but you are not suggesting they would be anything but reserves that would be properly set up—transferred from one account to another for the purposes of good accounting practice?—A. No, I am not suggesting it but I am suggesting that you get actually the same result by the use of l.i.f.o.

Q. Now, Mr. Williams, I have had Mr. Richardson make this calculation for me and I would like you to follow this through, looking also at your Exhibit C which you have prepared. You will see he has shown the opening inventory as "Nil"—purchases 100 units at $1.00 equals $100.00; 100 units at $2.00 equals $200.00; total purchases 200 units total cost $300.00 Do you agree with them?—A. Yes. Are we talking about the whole year now?

Q. Yes.—A. We did not stop in the middle as you suggest that I do here.

Q. You came up with a profit for the whole year with your system, didn't you?—A. Yes, I still would.

Q. Quantity sold 100 units and there has been an increase in the inventory of 100 units. Now, you agree that at the beginning of the year you have no inventory. At the end of the year you have 100 units?—A. Yes.

Q. So that would be, with the increase in actual value of the closing inventory on l.i.f.o. as applied by Anaconda, 100 units at an average cost of $1.50 per unit or $150.00. Do you agree with all except this "as applied by Anaconda"?—A. On the average cost, that is correct.

Q. Will you accept Mr. Richardson's statement when he writes it down there?—A. I will accept it—yes.

Q. Now then, we come to our profit and loss. Our sales were 100 units at $2.00 or $200.00 in sales revenue. That is correct?—A. That is correct.

Q. Now, our cost of sales is $150.00?—A. Yes.

Q. And you come up with a profit of $50.00?—A. Yes. Now, how does that apply to l.i.f.o.?

Q. That is all worked on the l.i.f.o. method.—A. Now, did not somebody testify here that the valuation to be placed on cost of sales would be the value at which the most recently purchased goods went into inventory?

His LORDSHIP: That would be in respect of the most recent sales?—A. No, I take it that in valuing the inventory at the end of the year they would first of all take the cost of the materials that went into the cost of sales.

Q. They are more concerned with valuing the cost, to see that it is properly attributable to the sales.—A. I think, my Lord, that is where we differ in viewpoint.

Mr. PATTILLO: You understood, did you not, in following the evidence and from your experience as a Chartered Accountant that under l.i.f.o. you start and end the year with the same inventory excepting for the increments or the decreases?

His LORDSHIP: Of previous years.

Mr. PATTILLO: Yes, except for an increment that you may have in the year of purchases over sales or except for a decrease you may have in any year. You followed that, didn't you?—A. I heard it.

Q. And you understand that?—A. I do not agree with it.

Q. That has nothing to do with it. You understood it and this example that I have just given you, worked out by Mr. Richardson, is done exactly that same way.—A. I do not think that is l.i.f.o.—not as I understand it. That is the way I have heard it explained here this week.

Q. You do not think that is l.i.f.o. at all?—A. No.

His LORDSHIP: Do you wish to put this in?

Mr. PATTILLO: I think I have read it into the record.

His LORDSHIP: It is an indirect way of getting evidence from Mr. Richardson.

Mr. PATTILLO: You have heard, Mr. Williams, the evidence that has been given here during this week as to the manner in which this Company, Anaconda American Brass Limited, has been carrying on business. Is that correct?—A. Right.

Q. You heard that it is the policy of the Company to avoid making profits or losses on metals or raw materials as far as possible. You have heard that?—A. I have heard it.

Q. And you accept that evidence, do you not?—A. I have no reason to doubt it.

Q. You have heard that the inventory turnover of the Company is four times a year. You accept that, don't you?—A. So I have heard.

Q. And you accept it, don't you?—A. I have no reason to doubt it; I have not checked it.

Q. And you have heard that it has been the policy of the Company to endeavour to match its sales and purchases both as to quantity and as to cost. You have heard that have you?—A. Yes.

Q. And you accept that, don't you?—A. I have heard the evidence—yes.

His LORDSHIP: And that it has a large inventory?

Mr. PATTILLO: And that it has a large inventory and that of that large inventory two-thirds of it is in process at all times. You have heard that?—A. That is correct.

Q. Now, Mr. Williams, as a Chartered Accountant you will agree with me, won't you, that the manner in which a company is carrying on business is a factor in determining what method to apply in arriving at its true annual periodic profit? —A. So far as its corporate purposes are concerned, yes.

Q. You will agree that the accounting profession in Canada considers the manner in which a company is carrying on business as evidenced by the fact, is a factor that must be taken into consideration in determining whether or not the method employed in arriving at profit is a right one or a wrong one. Isn't that so? —A. Are you referring to the manner in which they determine their annual income —not income or gain for taxation purposes?

Q. I have not mentioned taxation purposes at all. I am asking you as a Chartered Accountant.

His LORDSHIP: The way they do their business?—A. Yes, I would think so.

Mr. PATTILLO: Now, you will agree, Mr. Williams, will you, that the accountants who have given evidence in this case who are Chartered Accountants practising in Canada, that is, Mr. Richardson, Mr. McDonald and Mr. Jephcott are all highly regarded members of their profession throughout the country?—A. They are indeed. I know them all.

Q. And that their opinions are held in high regard by the profession as a whole? —A. I believe so.

Q. And you have heard all of these gentlemen say that in their opinion on the facts of this case as brought out in evidence that the l.i.f.o. method gives a result which brings about a more accurate income for the annual period than any other of the known methods. You have heard them say that?—A. I have.

Q. You disagree with that, do you?—A. I do in this particular case.

Q. You disagree that in this particular case this method as disclosed here by the facts and circumstances, that l.i.f.o. is applicable. You say it is not?—A. I say it is not appropriate here. Let me correct myself there. I am thinking of the manner in which we arrive at the Company's income.

Q. I am not talking about tax purposes at all at the moment. I am trying to arrive at your opinion as a Chartered Accountant.—A. Well, let me say this, Mr. Pattillo, that I do not agree with the assumption, in the first place, of l.i.f.o. so you would not expect me to agree with their opinion on it.

His LORDSHIP: You do not agree with the experts as to that being a method that most nearly reflects their true income position?—A. That is correct, my Lord.

Q. You do not agree with that?—A. No, my Lord.

Mr. PATTILLO: And is your reason for not agreeing with them the fact that you pay a good deal of attention to physical flow?—A. Not necessarily—no. What we tried to arrive at was the actual facts of the case. Now, we have an assumption on l.i.f.o. which says one thing. There is, true enough, as Mr. Richardson was careful to point out, an assumption under f.i.f.o., but the one which more nearly approaches the facts of this case, talking of the Anaconda American Brass Limited, is the f.i.f.o.

His LORDSHIP: Why? Isn't that because it more nearly reflects the flow of the goods?—A. No, sir, what I have in mind is this: that, in arriving at the value of the inventory, at the close of these periods we take the basis that the goods most recently purchased were most likely to be then on hand. We did not care about goods bought some months ago which by the perpetual inventory should have been all cleared up. Those are the ones that should have been charged against inventory and not the ones purchased at the latter part of the year. The inventory actually did not show the goods that were most recently purchased and, therefore, that is the price that should be used for that.

Q. Are not you really, in so doing, hanging onto the concept of physical flow of goods?—A. Possibly. I believe we are trying to get at the facts. If it could be established that in fact they did leave this old .06 cent inventory there or it was there—in this case I think it has satisfied me anyway that they could have identified this inventory without any difficulty up to the point where it is in process. Once it moves into process I think it is a reasonable presumption that it will be out in the next six weeks or eight weeks so will no longer be on the date line; some other material will have come along and forced it out. So it seemed to me that two-thirds of the material was processed material and had moved out and on that basis we made our assessment.

Mr. PATTILLO: Mr. Williams, as a Chartered Accountant, do you agree with me that there is no known acceptable method for calculating costs on the basis of physical flow?—A. I would agree—yes.

William Frederick Williams (Respondent)
Cross-examination by Mr. Pattillo (Cont.)

Q. Now, you say that you would not use l.i.f.o. under the circumstances of this particular case?—A. I did not say I would not use them if I were in the same position the Company was in. I said I would not accept it as a tax official.

His Lordship: But, why do you draw a distinction. What difference does it make from the point of view of the Tax Department? Why should that make a difference?—A. Well, my Lord, what I am trying to say is this, that as a Tax Official I must assess the income annually and look on that one year by itself solely and what I have suggested is that the use of l.i.f.o. tends to average the period of a year.

Now, my understanding of the administration I am charged with is that we will allow a man to average but he must do it under the terms of the Act and that is the averaging that is allowed by the statute. Now, my contention is that where it is possible to determine the actual cost of the goods that went into process, that is the manner in which the cost should be determined.

Q. This is all a dispute about actual cost. "Cost" is the term that is in dispute?—A. That is right, but my contention is that it is unrealistic, if you like. They talk about unrealistic profits. By the use of the l.i.f.o. method it is certainly wrong to value the inventory you have just bought at 21 cents at 6 cents.

Q. But you are not trading in your inventory. You make your money out of the processing. This Company makes its money in processing.—A. But it also buys stocks.

Q. And it seeks not to make any profit or loss on the inventory. It seeks to let the buyer either pay the increased cost or get the benefit of the reduced cost.—A. Well, I contend that they do make something.

Q. That is how they operate and have operated for a number of years.—A. But not entirely, my Lord. You will recall that in the evidence—

Q. It is never possible to operate entirely on it.—A. Maybe I am wrong in the amount but I understood someone to say between 25 per cent and 30 per cent was manufactured for stock which they hoped to sell.

Mr. Pattillo: 20 per cent.

His Lordship: You think they make money on it?—A. I think they must have been trading in that if they hope to sell it.

Q. And there is no known method that absolutely accurately reflects— —A. There is a possibility that in some of the heavy industries where they are making huge engines in a shop, for example, I think you could possibly identify that but I quite agree you have got to work on some assumptions either way.

William Frederick Williams (Respondent)
Cross-examination by Mr. Pattillo (Cont.)

Mr. Pattillo: And the assumption is one as to the flow of costs. You agree with that?—A. As to the flow of goods and the cost of the goods. The costs of the materials actually used—not just the costs that someone arbitrarily assigns to them. I do not agree with that.

Q. Now, you have told us that you do not know of any acceptable method for calculating costs on the basis of physical flow?—A. Subject to that one possible exception that I mentioned—yes.

His Lordship: Well, that is back to your identification system.

Mr. Pattillo: You agree we are not dealing with identification here? It does not have anything to do with this case at all ? It is out the window? You agree with that, don't you?—A. That is right.

Q. Well, I am putting it to you that what we are trying to arrive at here is a flow of cost factors. Isn't that so?—A. Of what cost factors?

Q. Well, first, let us find out if you agree that it is the flow of cost factors that we are seeking?—A. I agree that it is the cost of certain factors gone into process.

Q. Now then, you want to link that cost factor up with physical flow, don't you?—A. Insofar as it is possible to do it.

Q. Now, do you know of any such acceptable accounting practice in Canada that follows such a method?—A. Certainly.

His Lordship: Which one?—A. F.i.f.o.

Q. The physical flow?—A. No, on that assumption it is more nearly correct.

Mr. Pattillo: Now, let me put this to you. Supposing that you had two manufacturers who had each a manufacturing plant and they were on opposite sides of the river, they were very close, and they said: "We will do everything identically and in the same manner. We will operate our plants exactly the same".

They both needed coal for their processing. One of them brought in his coal so that it fell into a chute from the top and was taken out at the bottom, the other one brought his coal in and piled it up in big piles and when he wanted it he took it off the top. That was the only difference in their methods of operation.

Do you want to say, Mr. Williams, as a Chartered Accountant that in one case you would use f.i.f.o. because that would be akin to the physical flow of the coal and in the other case you would use l.i.f.o. because that would be akin to the physical flow of the coal?—A. No.

Q. No, of course, not.

His Lordship: You are not hoping, Mr. Pattillo, that you are going to convert Mr. Williams to your theory because if you think there is any chance of doing so I will stay. It will save me writing a judgment but I am inclined to think that you won't be able to convert him.

This is largely a matter of argument as a matter of fact, isn't it? It is quite clear that the Department has a different attitude in the matter from that which your experts have put forward?

Mr. PATTILLO: Yes.

His LORDSHIP: Well, that is that. I wonder if there is any object in pursuing that much further?

Mr. PATTILLO: I do not think there is, my Lord. If you will excuse me for one moment, I will look at my notes. Now, would you say l.i.f.o. is a close thing to the physical flow of goods?—A. The Department has not allowed the use of l.i.f.o.

His LORDSHIP: Has not permitted the use of l.i.f.o. in any case?—A. Not that I am aware of.

Mr. PATTILLO: Now, even though you could show that the physical flow of goods was most akin to that?—A. I do not know of any case where it has been officially.

Q. Now, you agree, Mr. Williams, that the Accounting Research Bulletin issued by the Committee on Accounting Procedure of the American Institute of Accountants in the United States carries weight in Canada, don't you?—A. I believe it is very highly regarded.

His LORDSHIP: But it does not carry any weight in your Department?—A. In some respects, my Lord. We are not serviced with these Bulletins. I have only seen this one through the kindness of Mr. Peloubet some minutes ago. We do not usually get them and I think I am correct in saying that I do not believe they are distributed to the members of our profession in Canada as such.

Mr. RICHARDSON: Not by the Dominion Association.

Mr. PATTILLO: You agree with me also that l.i.f.o. is a generally acceptable method of calculating costs and is so recognized by the profession in Canada?—A. In certain cases, I believe it is. When you say "generally recognized" I am not so sure in Canada that it is generally recognized. As a matter of fact, I know it is a permissible method in the Bureau of Internal Revenue but I have seen very few returns with financial statements prepared on the l.i.f.o. method in Canada.

His LORDSHIP: You have not seen them because why would they make them to your Department? They would just be turned down.—A. But, my Lord, they might have filed a financial statement in the same manner as this Company referring to the fact that it was l.i.f.o. and making necessary adjustments.

Mr. PATTILLO: But the cost in dollars involved in keeping two sets of books like that is not one to be treated lightly by any corporation?—A. I do not think it involves any great cost. It might but I doubt it.

Q. Now, you have seen the recommendations in relation to Bill 454 which were submitted by the Dominion Association of Chartered Accountants to the Minister of Finance of March 25th, 1948?—A. I did see it some time ago.

Mr. PICKUP: I wonder if we are concerned with that at all. They are representations that somebody made.

His LORDSHIP: Well, a lot of people have made representations. We have already had the opinions of accountants at first hand as to the propriety and accuracy of the method and naturally there would be recommendations made.

Mr. PATTILLO: The only reason, my Lord, I was going to call Mr. Williams' attention to this recommendation for was because of the answer that he gave me to my last question where he was not prepared to say it was generally acceptable in Canada—this method of l.i.f.o. I want to call his attention—

Mr. PICKUP: To something that somebody said to the Minister.

His LORDSHIP: If it is a recommendation from a Dominion body—

Mr. PATTILLO: Yes.

His LORDSHIP: It would have more or less the same effect and weight as the references to the American Committee on Accounting Procedure.

Mr. PICKUP: Of course, I am still objecting to it, my Lord. This is factual—not opinion. This is an effort to prove that some Dominion Bureau of Statistics or whatever bureau it is is of some such opinion and I do not think a submission of any one delegation to the Minister proves it. I am not objecting to the form of proof because I have told my friend that he can use this if he was merely proposing to save the time of somebody coming from Ottawa.

His LORDSHIP: To prove that representations were made?

Mr. PICKUP: Yes. These representations were made to the Minister of Finance but whether the Minister accepted them at face value, I do not know. He certainly did not adopt them.

His LORDSHIP: But whether they were the considered opinion of the Association is another matter.

Mr. PICKUP: Yes. I don't know.

Mr. PATTILLO: I wish to read to you the introduction which reads as follows:

> "The following comments and recommendations in respect of Bill 454 (the proposed Income Tax Act) are the result of a detailed study of the Bill by Committees of each provincial Institute of Chartered Accountants in Canada and by the Legislative Committee of this Association. As a result, this submission may be considered as reflecting the view of Chartered Accountants throughout Canada".

Mr. PICKUP: My point is that somebody going down to the Minister and telling him that does not prove it.

Mr. PATTILLO: You are a member of this Organization, aren't you?

His LORDSHIP: What organization?

Mr. PATTILLO: Mr. Williams, are you a member of the Dominion Association of Chartered Accountants?—A. I think I am—yes.

Q. And, as I understand it— —A. Perhaps Mr. Richardson made that clear, that the Dominion Association is a coordinated body of all the Provincial Institutes. I am a member of the Ontario Institute which, I believe, is a member of the Dominion Association. There is that distinction.

Q. And I see that at the time these recommendations were made by this Legislative Committee that it consisted of Mr. F. E. H. Gates. He would be with P. S. Ross & Co.?—A. Yes.

Q. And E. H. Ambrose. He, at that time was a partner in Clarkson, Gordon & Company?—A. So I understand.

Q. A. E. Beauvois?—A. He is a well-known French Chartered Accountant in Montreal, President of the Quebec Institute at that time.

Q. Mr. D. M. Farrish?—A. He does not practice. He is the Treasurer and Vice President of Northern Electric Company.

Q. Mr. E. V. Herrington, Price Waterhouse & Company, partner in Toronto. C. W. Leach. Do you know him?—A. No, I cannot recall him.

Q. And A. V. Sheppard of Thorne, Mulholland & Company. C. D. Smith, Gunn, Roberts & Company and Mr. Glassco of Clarkson, Gordon & Company. Now, that would be a pretty representative Committee, wouldn't it?—A. I would think so.

Q. Now, reading from a part of this Report and dealing with their comments on Section 14 relating to inventories:

> "The regulations should recognize that it is desirable that taxpayers be permitted to change the basis of valuation from that presently in use to one of the accepted bases when the new basis will more clearly reflect the income of the taxpayer in accordance with generally accepted accounting practices applicable to that business."

Do you remember having seen that statement appearing in this brief?—A. I do.

Q. Continuing to read:

> " 'The lower of cost or market' value is the most widely accepted basis of pricing inventory".

Mr. PICKUP: Is my friend going to be entitled to read from this?

His LORDSHIP: He is putting questions to him based on this.

Mr. PICKUP: Well, the effect of that is to read into the record what I have objected to.

His LORDSHIP: I will allow his questions. I will note your objection but will allow the question.

Mr. PATTILLO: May I repeat that paragraph, my Lord:

> " 'The lower of cost or market' value is the most widely accepted basis of pricing inventory."

His LORDSHIP: What I am getting at is this, that this should all be done by calling these persons individually. In that way this is the easier and quicker way of bringing the views of these people before us.

Mr. PATTILLO: Continuing—

> ". . . but under Accounting concepts cost may be determined on any one of a number of bases such as first-in, first-out, average or last-in first-out".

Now, from that last statement that I have read, beginning with the "lower of cost or market" down to the words "last-in first-out", do you agree with that, Mr. Williams?—A. I agree that the statement was made.

Q. First, you agree that the statement was made and do you agree that that statement was contained in the submission?—A. Yes.

Q. And now I am asking you whether you agree with the statement itself—just that part of it that I have read. Do you wish to examine it carefully?—A. Well, it puts me in a rather embarrassing spot. I was active in advising the Minister and now you are asking me do I agree with a statement that was eventually turned down.

Q. No, I am asking you about that sentence which was a statement of fact. —A. What is meant by "accounting concepts"? You will have to explain that to me.

His LORDSHIP: Well, that will bother you.

Mr. RICHARDSON: That is a difficult one.—A. I know that if you are talking about certain assumptions I do not agree with it nor do I agree that this Committee is speaking for me personally.

Mr. PATTILLO: All right, I will not ask you that. I am merely asking you if you agree with that sentence.—A. I do not know what you mean by "accounting concepts" and I do not understand the sentence.

Q. Well, I cannot speculate about it because I did not write the sentence and anything I said would be pure speculation.—A. I do not understand it. I did not say I did not agree or disagree.

Q. Well, I will continue to read:

"At present the first two of these methods (that is f.i.f.o. or average) are generally accepted for taxation purposes".

Q. Do you agree with that statement?—A. I do not disagree.

Q. "The last-in, first-out (l.i.f.o.) method most clearly reflects the annual income of taxpayers in certain industries and should be recognized in those cases where it is applicable".

Q. Do you disagree entirely with that statement?—A. Yes.

His LORDSHIP: There you are. You won't get any farther.

Mr. PATTILLO: Do you think, Mr. Williams, is there any case, in your opinion, under any set of circumstances where l.i.f.o. most clearly reflects the annual income of a taxpayer in any industry?—A. There may be.

His LORDSHIP: What kind?—A. I do not know at the moment, my Lord. I would not say there is not.

Mr. PATTILLO: You say there might be but you know of none?—A. Not at the moment.

Q. In the whole economy of Canada as you know it?—A. I do not know the whole economy of Canada.

His LORDSHIP: In the whole economy of Canada as you do know it?—A. No, sir.

Mr. PATTILLO: That is all, sir.

Mr. PICKUP: No questions in re-examination.

Now, my Lord, there is one other witness for the Respondent and I am assuming we may call him on Monday morning.

His LORDSHIP: I do not think we should meet as early as I thought. So we will adjourn until 10.30 on Monday.

(Court is adjourned at 5.40 p.m. until 10.30 on Monday, 26 June 1950).

Toronto, Ontario
26th June, 1950.

MORNING SESSION

Mr. PICKUP: I call Mr. James C. Thompson.

MR.. JAMES C. THOMPSON, called, sworn:
Examined by Mr. Pickup

Q. Mr. Thompson, I understand you are the senior partner of the firm of Chartered Accountants in Montreal named Peat, Marwick, Mitchell & Company?—A. Yes, sir, the senior partner in Canada.

Q. Then you might give me your professional qualifications, please?—A. I qualified as a Chartered Accountant in Alberta in May 1920. I am a member of the Alberta, Quebec, New Brunswick, Prince Edward Island and Newfoundland Institutes of Chartered Accountants. I am a Fellow of the Alberta Institute of Chartered Accountants. I was elected to that office in 1936. I am also an International Associate of the American Institute of Accountants.

Q. Then, would you give me the record of your employment heretofore?—A. Starting with 1919 I was a student in the office of Harvey, Richardson, Cole & Robertson in Calgary and Edmonton, Alta.

Q. Were they Chartered Accountants?—A. Yes. In 1922 I left Alberta for New York City. I was there a year with the firm of Touche, Nivan & Company, Certified Public Accountants. Late in 1923 I was offered and accepted the appointment of Provincial Auditor of the Province of Alberta and I held that appointment until I resigned some twelve and a half years later, in 1936.

From 1936 to 1941 I was associated with Clarkson, Gordon & Company in Montreal. During the first part of that period I was Manager of their Montreal Office and latterly a partner. In 1941 I formed my own firm and practised under the name of James C. Thompson & Company with offices at Montreal and Calgary.

Early in 1944 I joined my present firm, Peat, Marwick, Mitchell & Company as a partner and I was appointed senior partner of the firm in Canada on July 1st, 1946.

Q. Then, will you give me some of your experience as a consulting accountant?—A. I have acted as a consulting accountant to numerous public bodies, particularly the Manitoba Government in the survey of their telephone system and power commission in 1940, the New Brunswick Electric Power Commission in 1942, 1947 and 1948. I act practically as a permanent consultant to the Board of Commissioners of Public Utilities of the Province of New Brunswick and in that connection have carried out numerous engagements over the last five years.

I acted for the City of Montreal in the Montreal Tramways Case. Over the last three and a half to four years I have attended on behalf of the Railway Association of Canada and the Canadian Pacific Railways various sessions before the Board of Transport Commissioners in Ottawa in connection with freight rates. I acted as a witness for the minority shareholders in the Beauharnois Light & Power Company before the Board of Arbitration in 1949. I recently completed an engagement for the City of St. John which concerned an examination of their water rate structure.

Q. Then, will you give me some of your public appointments or engagements?—A. Yes, from 1919 to 1922 I was Secretary of the Alberta Municipal Financing Commission and in that connection made an examination of the financial affairs of numerous Alberta municipalities. I was a member of the Alberta Taxation Inquiry Board which held sittings throughout the Province of Alberta throughout the year 1935 and submitted a report to the Government on provincial and municipal taxation.

I was Director of the Public Accounts Inquiry for the Royal Commission on Dominion-Provincial Relations—

His LORDSHIP: The Rowell-Sirois Commission?—A. Yes, over a period beginning in 1938 and running through 1941. I acted as a consulting accountant with the Department of Finance in Ottawa on various occasions, particularly in regard to the Dominion-Provincial Conference in 1941, the Dominion-Provincial Tax Suspension Agreement in 1942, the Dominion-Provincial Liquor Agreement in 1943 and the Dominion-Provincial Conference in 1945 and for that Conference I prepared several reference books which are known as green books which dealt with corporate taxation, duties and so on.

I acted as consulting accountant to the Government of Quebec to determine the financial position of the Province in 1940. I made a survey of the tax system of the Province of New Brunswick in 1939. I acted as consulting accountant for the Carroll Commission which was appointed in 1944 to inquire into the closing down of the Trenton Steel Works in New Glasgow, N.S.

I attended sittings and gave evidence before the Royal Commission on Co-Operatives and the taxation of co-operatives in 1945, the Royal Commission on the Taxation of Annuities and Family Corporations, the same year, and the Royal Commission on Transportation, 1950.

I was financial adviser to the Newfoundland Delegation which was appointed to negotiate the terms of union with Canada in 1948. I am now acting as Financial Adviser to the Province of Newfoundland and have been since it became a Province of Canada.

Then, during the period 1941 to 1949 I prepared numerous briefs covering practically every field of accounting practice for submission to the Board of Referees under the Excess Profits Tax Act—I would say probably from 75 to 100 briefs over a period.

Mr. PICKUP: Now, Mr. Thompson, I want to first direct your attention to Exhibit 29, this Accounting Research Bulletin of July 1947 and to the first four statements contained in that exhibit and we have had the evidence of certain accountants here as to those four statements and expressing their agreement with them.

Now, my question to you is whether or not you agree with these four statements. You have them, I think, in front of you?—A. Yes, I have the exhibit here. I agree with Statements 1 to 3 inclusive but I find myself unable to agree with Statement No. 4 to the extent that it states: "Costs for inventory purposes may be determined under the assumption of l.i.f.o.".

Q. Why?—A. Well, in my view, Statement No. 4 conflicts with Statement No. 3. The price basis of the inventory for l.i.f.o. purposes does not, in most instances, represent and I quote from Statement 3 ". . . the price paid or consideration given to acquire an asset". Those are the words—". . . the price paid or consideration given to acquire an asset"—an exact quote from No. 3.

However, in my opinion, the profit reflected on the l.i.f.o. basis, is not the periodic profit but the periodic profit after exclusion of so-called inventory profits which, in my opinion, are nonetheless real although invested in stock at a higher price.

Q. Anything else?

His Lordship: Might I ask why you call them "so-called" inventory profits? —A. That is the term, my Lord, which has been used by the witnesses. They say "so-called inventory profits".

Q. You do not use that?—A. I did not use that. I used it simply to describe what other people have said. I consider these profits real—not so-called.

Mr. Pickup: Anything further on that?—A. In my opinion, the application of l.i.f.o. results in the creation of an inventory reserve in a period of rising prices. While an inventory reserve during such a period may be highly desirable, in my opinion it should be disclosed and a transfer for the purpose made from surplus account.

Q. Now, have you anything further to add with regard to this Statement 4 which we have been discussing?—A. Yes, in my view, in order to be consistent in matching replacement costs against sales, it will be necessary to deal similarly with depreciation costs on replacement values.

Now, this latter procedure is not advocated by the accounting profession and, in my opinion, the failure to adopt depreciation on replacement values is inconsistent with the adoption of l.i.f.o. for inventory purposes. I consider both are wrong.

His Lordship: I do not quite understand. Why would you deal with depreciation costs on replacement values in respect of raw materials—copper?—A. Well, in the case of raw material—copper, the advocates of l.i.f.o. attempt to match the replacement value of the copper against the sale.

Q. But what depreciation is there in copper?—A. I do not say there is depreciation in copper. I say that there is a common school of thought in accounting which states that for income accounting depreciation should be calculated on replacement values—not on historical costs.

Q. But I do not quite understand the relevancy of that to this particular case?—A. Well, in my view, the relevancy is this, that in the income statement an attempt is made to calculate all the items of profit or loss and in calculating depreciation, which is an item of loss, it is a case of the transfer of the costs of an asset to the loss statement, the income statement, the proportionate amount of loss for the year.

Now, if that is calculated as it should be calculated, and which accountants accept generally, on the basis of historical cost, then I claim that for inventory purposes l.i.f.o. should not apply to the valuation of inventories because l.i.f.o. is matching replacement values against the goods which are sold and not the historical cost and I think there is some relation between the two principles. In other words, if accountants say: "We have certain assets which have replacement costs. If we depreciate them on replacement cost, we arrive at a higher amount of depreciation, that will affect the income statement". Instead of that they do not say "replacement cost"; they say "historical cost".

Mr. Pickup: I take it it is an inconsistency you are pointing out?—A. Yes.

Q. Dealing with one on the historical cost and the other on a replacement basis?—A. That is my view—yes.

Q. Anything further?—A. Yes, I cannot recognize l.i.f.o. as a procedure if market prices are dropping. In such case, in my opinion, the lower-of-cost-or-market would be applicable.

Q. Now, I want to refer you to two statements made by Mr. Richardson and ask you whether you agree with them. One was—he said—and I may not quote it exactly:

> "The determination (and he was dealing with how much of the incurred costs should be carried forward to the new year) does not involve a determination of inventory in the sense of arriving at value"

and he also said:

> "The significance of the inventory value when determined is primarily its importance as a complement to determining cost of sales".

Now, my question to you is whether you agree with these statements of Mr. Richardson or either of them?—A. No, I do not agree with his first statement.

Q. Why?—A. Well, take the first point. I direct attention to Exhibit 29, Statement No. 3 which states in part:

> ". . . the primary basis of accounting for inventories is cost . . .".

That is the first sentence in that Statement. In other words, in my opinion, the amount of money invested in the inventory.

His Lordship: You think "cost" means the amount of money invested in the inventory?—A. Yes, sir.

Mr. Pickup: Now, with regard to the second point?—A. With regard to the second point, I consider that the valuation is equally important in regard to the asset valuation placed on the inventory for balance sheet purposes as well as for determining the cost of sales.

Q. Then, Mr. Richardson also said that there are three methods in general use based on assumptions as to the flow of cost and he gave f.i.f.o. which he said was one. He gave average cost and then, as a third he mentioned last-in, first-out, frequently referred to as l.i.f.o. He further said that none of these methods are based on any assumption as to any actual physical movement. My question to you is whether you agree with that statement?—A. No, because under f.i.f.o. or average cost, the underlying principle is based on an assumption of fact, namely, that the flow of cost will parallel the physical flow of goods. This is a natural assumption although there may be exceptions.

Q. Now then, Mr. Richardson gave the following criticisms of f.i.f.o. and I am reading it as I have it and I think correctly:

> "(*a*) That when the rate of inventory turnover was slow the method resulted in including in the figure of net profit so-called 'inventory profits' or losses. By the term 'inventory profits' is meant the amount which would be included in income under this method arising out of the sale at higher price levels of inventory acquired presumably many months ago at substantially lower price levels. The criticism was particularly strong when current sales were being made based on prices having no relationship to the inventory prices. It was argued that when there had been a substantial rise in price, there was little justification for claiming credit for the profit to the extent that the existence of the profit was due to pricing identical quantities of goods at a price higher than the price of which the same kind and quantity of goods was priced in the opening inventory. To this extent it was argued that the profits are fictional."

Now, I am quoting what Mr. Richardson has said and I am asking you as to what are your views?—A. In my opinion such profits are not fictional. They are real. The profit under such conditions has been invested in identical goods at a higher price. As I see it the term "inventory profits" would only arise if an original investment in an item of a closing inventory had been written up at the end of the year to a higher value. Under those conditions, that would be a fictional paper profit.

I have in mind this. Suppose at the end of one year 20 or 30 pounds of copper were placed in a long box and it was known exactly what that copper cost and the box was not opened. At the end of the year one could say that even though the price had gone up in the interim, that copper could be priced at the end of the year at the same price as at the beginning of the year because it could be physically identified.

His LORDSHIP: You say that where it can be physically identified, then there is no real profit?—A. If it can be physically identified and the cost is known, then I would take the actual known cost at the beginning of the year.

Q. As its value at the end of the year?—A. Yes.

Q. Why would you do that? You could sell it for a higher price if you wanted?—A. Yes, but I believe the presumption is this—it is the lower of cost or market—What did that copper cost you?

Q. We are not speaking of cost; we are speaking of value.—A. Well, I would say "cost".

Q. We are speaking now about value.—A. Well, let us take value at the end of the year—

Q. Because cost and value are not the same thing.—A. No, I know that. I would pay at the end of the year maybe .20 cents. The known cost was .10 cents. Under those conditions, if the copper had not moved in any way whatsoever, I would price it at the end of the year at cost.

Q. Price it—but if you were asked to value it why would not there be an increase in value of that copper over what it had cost you?—A. If one was valuing it, I would certainly say—

Q. Well, aren't you going to base your figures on value of inventory at the end of the year?—A. No, I base it on cost or market whichever is the lower—the incurred cost.

Q. Or market, whichever is the lower?—A. Yes, in that case the incurred cost would be the lower so I would take it in at incurred cost—at known cost.

Q. You say in that case there would be no profit?—A. No, no profit.

Q. No profit in that valuation of the inventory although the owner of the inventory could sell it at a higher price if he wanted to?—A. If he sold it, then he would realize his profit—yes.

Q. But the fact that he has not sold it, he has kept it intact and that there has not been any profit realized under such conditions—

Mr. PICKUP: And that if a profit comes, it would have to come at a later time?—A. Yes.

Q. And to mark that up to the higher price would be what you would call an inventory profit?—A. Yes.

Q. Because the copper is still there. It has gone up in value but it has not been realized. Is that correct?—A. That is correct.

Q. Then, Mr. Richardson said in his evidence a further criticism of f.i.f.o.

> "That in an industry in which a continuous and substantial investment in inventories is required, inventory profits shown by the first-in-, first-out method are actually unrealized and cannot be realized without liquidating the business."

I ask you as to whether or not you agree or disagree with that statement?—A. I would disagree.

Q. Why?—A. Under such conditions, in my view, there is an investment in identical goods at a higher price. It does not mean liquidation; it means more money is required to finance the inventory if it is desired to maintain the same quantities on hand at the end of the year as were on hand at the beginning of the year.

His LORDSHIP: It is realized profit, in your view, to invest in identical goods at a higher price?—A. Yes, my Lord.

Mr. PICKUP: Then, Mr. Richardson, in his evidence, also said, and I am quoting:

> "The fictional character of the so-called inventory profits was further alleged from the fact that on a subsequent fall in the market price, the inventory profit disappears, being offset by inventory losses which are equally fictional".

What are your views?—A. Well, I disagree that the profits or losses are fictional.

His LORDSHIP: You would say there had been a loss on the investment?—A. If it went down, yes.

Q. A loss on the investment?—A. Yes.

Q. You have realized your cost on the way up?—A. Yes.

Q. And reinvested that in identical goods at a higher price and then, if the price of those goods falls, you have suffered a loss on your investment?—A. That is correct, my Lord. I would like to add this, that under f.i.f.o. with a reduction to the lower of cost or market it is insured that as far as reasonably can be anticipated the so-called inventory profit will be realized. That is one of the reasons why, when prices fall, businesses generally show an improved cash position. They liquidate their inventories.

Mr. PICKUP: Then, Mr. Richardson states in his evidence:

> "It will be seen from this that the l.i.f.o. method is based not on any assumption as to physical flow but upon the objective of charging against the sales of any period the costs which are related to the sales."

Do you agree?—A. Well, my concept of it is this: that the l.i.f.o. method is an attempt to match replacement costs and not incurred costs against sales. Now, by "incurred costs" I mean the actual cost in dollars of the goods being sold.

His LORDSHIP: And not the value of the goods that were used in course of the finished product?—A. No, I mean the actual cost in dollars of the goods being sold.

Q. Well, does it not really amount to this—that your concept of "cost" is a different concept from the concept that the other witnesses have put forward as to cost?—A. That is correct, my Lord.

Q. It really comes down to that. Your concept is that "cost" means what was paid for an article in dollars?—A. That is correct.

Q. It does not mean anything else?—A. Not in my opinion.

Q. Now the concept of "cost" which other witnesses have put forward is not that same "cost"?—A. It is an entirely different cost and I disagree with their view.

Q. You disagree with their concept of "cost"?—A. Yes, my Lord.

Q. Does not the whole controversy boil down to this difference in concept of "cost"?—A. It is the principal point at issue.

Mr. PICKUP: Now then, I want to refer you to three criticisms of l.i.f.o. which Mr. Richardson in his evidence mentioned and then to ask you whether or not those criticisms are in accord or not in accord with your views. Now, those criticisms were three—(1) that it does not reflect physical realities, since only in the most exceptional circumstances is the physical flow of goods in last-in, first-out order. Do you agree with that criticism?—A. Yes.

Q. Now, the second one was that what was claimed by the advocates of l.i.f.o. to be an unrealized profit was in fact a realized profit which has been reinvested in the business—in this case in the form of a higher priced inventory. It was contended that such a profit is no less realized than a profit which has been realized and reinvested in additions to a company's plant. You have already said that that is your view?—A. That is my view.

Q. The third Mr. Richardson referred to as being a criticism of l.i.f.o. was that it results in a valuation of inventory which is meaningless from the point of view of the balance sheet, which is not related to current prices and whose value is dependent partly upon the date when the method was adopted and partly on the timing of the increases in inventory. It would appear from what you have already said that you also agree with that criticism?—A. Most decidedly, yes.

Q. Then, Mr. Richardson states in his evidence that:

"Consequently, the accounting profession has agreed that when there is conflict between a method which would lead to a more correct determination of income as compared with the method which might be preferable from the balance sheet point of view, the balance sheet must give way to the income account".

Do you agree with that?—A. No, I do not. One complements the other.

Q. When you say one complements the other you mean the balance sheet and the income statement?—A. Yes, sir. If there is an error of principle in allocating cost from the asset accounts in the balance sheet to the income statement, then both statements must be in error. I cannot see how one can be correct and the other incorrect.

Q. Then, will you give us your opinion as to whether or not the l.i.f.o. principle as used by the Appellant in this case results in the correct determination of annual profits?—A. In my opinion the l.i.f.o. method as used by the Appellant in this case does not result in the correct determination of annual profits and I say this because the method excludes profits earned which have been reinvested in similar or identical commodities at a higher price.

Q. Maybe you might just illustrate that over a period and the result?—A. Yes, I have in mind that during a period of rising prices the method has the effect of carrying over from year to year profits which have been earned.

By way of illustration I would like to take 1 million units acquired at .10 cents each which, in spite of purchases and sales, remained constant in quantity over a period of twenty years during which a steady price rise has taken place. At the end of the twentieth year the 1 million units were sold at $1.00 per unit on account of the increase in prices.

Under l.i.f.o. there would be a profit of $900,000 and that would appear in the accounts of the last fiscal year of that period whereas, in my opinion, the profit had actually been earned in each year of the twenty and should have been so reported.

His Lordship: May I ask, Mr. Thompson, are there any circumstances in which the l.i.f.o. method could properly reflect a company's income?—A. Not in my view. I look upon l.i.f.o. as having to do with a price-selling policy.

Q. Then, do I take it that there are no circumstances under which the l.i.f.o. principle would be properly applicable as reflecting the income of any person?—A. Well, in my view, l.i.f.o. results in a fallacious conception of income and, therefore, I am opposed to it.

Q. I am not asking you whether you are opposed to it. I wonder whether you would give me an answer to the question which I put to you. Am I to understand that there are no circumstances under which l.i.f.o. could be properly applied to reflect a company's income?—A. I can answer this way. I do not know of any circumstances where it could be used to reflect a company's income.

Q. You do not know of any circumstances where it could be used to reflect a company's income?—A. That is correct.

Cross-examination by Mr. Pattillo

Q. Mr. Thompson, I would gather from what you said in giving your qualifications that the greater part of your experience in accounting since your association with the Alberta Government, has been in the realm of Government and I am using that term broadly to include municipal government, provincial government and federal government activities and accounts and in the public utilities field. Is that a fair summary of the greater part of your experience?—A. I can answer that in this way. I have spent a great deal of time in those fields but in addition to that, as part of my duties in connection with my present position I review every balance sheet and every statement of profit and loss that is issued by my firm by any office in Canada. There is a constant flow of information passing across my desk as to accounting methods, accounting principles and the presentation of information setting forth financial facts.

Q. Now, you have just anticipated me a bit. I wanted to come to your firm. As I understand it, your firm is an international firm. It is also in England and it is in the United States. Is that correct?—A. We have offices throughout the world.

Q. And—I do not want to inquire into the tie-up as between the various countries—but are some of the United States and English partners of the firm also partners in the Canadian firm?—A. Yes, that is correct. We run what we call interconnecting partnerships.

Q. Now, is Mr. Broad of the United States firm a Canadian partner?—A. He is a partner of the Canadian firm.

Q. And since you have been a member of this firm, have you had occasion to advise any of your clients as to the desirability of them using l.i.f.o. or not?—A. Yes.

Q. You have—and have you recommended against it?—A. In my view, since I joined this firm we have been in a period of rising prices and I recommended against it.

His LORDSHIP: You recommended against the adoption of l.i.f.o.?—A. Yes, my Lord.

Mr. PATTILLO: When was the first occasion when you were consulted as to whether or not l.i.f.o. should be brought in by one of your clients?—A. As far as I recall I think it was either towards the end of last year—in 1949, or early in 1950.

Q. Now, are any clients of the firm in Canada employing l.i.f.o.?—A. Not so far as I know.

Q. Not to your knowledge?—A. Not to my knowledge.

Q. So then would it be fair to say that except for the study you have given the subject, you have had no practical experience with the workings of it?—A. I suppose that is a fair statement—yes.

His LORDSHIP: Well, what difference does that make?

Mr. PATTILLO: It may not make any, my Lord. I just wanted to find out.

His LORDSHIP: Am I to understand that you have never advised anybody to use l.i.f.o.?—A. That is correct, sir. I have advised clients not to use l.i.f.o.

Q. You have advised clients not to use l.i.f.o.?—A. Yes, my Lord.

Q. Am I to take it that you have never advised any client to use l.i.f.o.?—A. That is correct, my Lord.

Mr. PATTILLO: And, as I understand it, the first time that you gave that advice, to the best of your recollection (I am not pinning you down to the exact time) was sometime in the year 1949?—A. Yes, that is about right.

Q. Now, you have been in court throughout the whole of this trial, haven't you?—A. Yes.

Q. And you heard the following facts brought out, that the sales prices of the products of Anaconda American Brass Limited closely follow the prices of the raw material content of the products. Do you agree that that fact was brought out in evidence?—A. Yes, I have heard that in evidence.

Q. And that the Company has a large inventory which is more or less constant? —A. Yes, I heard that.

Q. With a slow turnover and that its goods are of a homogeneous nature and that they do not deteriorate and that they are incapable of identification after they have once got into process. You have heard all those things brought out?—A. Yes, I heard the statements made.

Q. Now, do you agree with the evidence given by Mr. Richardson, Mr. Carter, Mr. McDonald and Mr. Jephcott that l.i.f.o. is recognized in Canada as being an acceptable method for calculating costs of sales?—A. I find it very hard to agree.

His LORDSHIP: But is it a fact—not whether you agree or whether you regard it as acceptable but these persons have said that l.i.f.o. is recognized in Canada as an acceptable method. You may disagree but is it a fact that it is recognized?—A. My Lord, to answer that question I would have to talk to every Chartered Accountant in Canada.

Q. No, you would not. You would know whether there is any appreciable body of Chartered Accountants who regard l.i.f.o. as an acceptable principle. Whether you agree with it or not as being a proper principle is a totally different matter but that is not the question that is being put to you.—A. Then, to answer the question as put I do not agree with these witnesses.

Q. You say that it is not recognized as an acceptable method?—A. That is my view.

Mr. PATTILLO: Mr. Thompson, were you aware of the representations made by the Dominion Association of Chartered Accountants to the Minister of Finance in the year 1948 in connection with Bill 454?—A. Yes, I read them.

Q. And you have studied those recommendations? Had you studied them prior to their being made?—A. No, I read them after they were issued.

Q. And do you take issue with this statement that is contained in the opening paragraph:

"As a result, this submission may be considered as reflecting the view of Chartered Accountants throughout Canada"?

A. Yes, I take exception to that.

Q. I wish to read to you from another part of the submission:

"'The lower-of-cost-or-market' value is the most widely accepted basis of pricing inventories".

Do you agree with the statement so far as I have read?—A. Yes.

Q. "But in accounting concepts cost may be determined on any one of a number of bases such as first-in, first-out, average or last-in, first-out".

Q. Do you agree with that statement?—A. I agree with part of it; in other words—

His LORDSHIP: You agree with all of it except that relating to l.i.f.o.?—A. Yes, my Lord.

Q. You agree with the first and second but not with the third?—A. That is correct, my Lord.

Mr. PATTILLO: You say it is not an accounting concept that cost may be determined on the basis known as last-in, first-out?—A. Not in my opinion.

Q. I am not talking of your opinion but whether or not this is an accounting concept. You have made it very clear that you do not accept it.

His LORDSHIP: He says no it is not recognized as such. Did I understand you to say that?—A. That is correct, my Lord.

Q. Some people may have the concept but it is not recognized by the profession as a concept?—A. That is correct, my Lord.

Mr. PATTILLO: Reading on, Mr. Thompson:

"At present the first two of these methods (that is first-in, first-out and average) are generally accepted for taxation purposes".

You will agree with that statement?—A. Definitely.

Q. "The last-in, first-out method (l.i.f.o.) most clearly reflects the annual income of taxpayers in certain industries and should be recognized in those cases where it is applicable".

You disagree, I understand, entirely with that statement?—A. I do.

Q. Now, I want to read to you the names of this Dominion Legislative Committee which was responsible for preparing this summary. Mr. F. C. H. Gates. Do you know Mr. Gates?—A. Quite well.

Q. And he is a member of what firm?—A. P. S. Ross & Sons.

Q. Practising in Montreal?—A. Yes.

Q. Mr. E. H. Ambrose. Do you know Mr. Ambrose?—A. Yes.

Q. And he at that time was with Clarkson, Gordon & Company?—A. That is correct.

Q. Do you know him well?—A. Reasonably well, yes.

Q. Mr. A. E. Beauvois?—A. Yes, I know him too.

Q. And he is with what firm in Montreal—a large firm, is he not?—A. One of the large French firms. I admit your point freely, yes.

Q. Mr. D. M. Farrish?—A. No, I don't know him.

Q. Mr. H. P. Harrington of Price, Waterhouse?—A. I have met him.

Q. And you know he is a partner of Price, Waterhouse & Company resident in Toronto?—A. Yes.

Q. Mr. C. W. Leach. Do you know him?—A. Yes.

Q. And what firm is he with?—A. P. S. Ross.

Q. In Montreal?—A. In Montreal.

Q. Mr. A. B. Sheppard of the firm of Thorne, Mulholland & Company in Toronto?—A. I have met him.

Q. Mr. L. J. Smith of Gunn, Roberts in Toronto?—A. I cannot recall having met him.

Q. Mr. J. Grant Glassco of Clarkson, Gordon & Co?—A. Yes.

Q. And Mr. C. L. King, Secretary. Do you know Mr. King?—A. Yes.

Q. Now, isn't it fair to say that those men are representative men in the accounting profession throughout Canada?—A. Well, they are certainly representative of Eastern Canada. I would not say throughout Canada. It is quite a lot of territory.

Q. Well, their firms practice throughout Canada so far as Clarkson, Gordon are concerned and P. S. Ross & Sons and Price, Waterhouse & Co.?—A. That is correct, yes.

Q. And all of their firms are highly thought of by the profession as a whole?—A. All highly regarded, yes.

Q. Now, as I understand it, Mr. Samuel J. Broad of the United States firm of Peat, Marwick, Mitchell & Co., is a member of the Canadian partnership?—A. That is correct.

Q. Have you ever read Mr. Broad's article "Thoughts on Inventory Valuation" which was part of an address given by him before the New York Chapter of the Public Certified Accountants in 1940?—A. I think I have it here but I will make sure. Mr. Broad has written quite a number of articles.

Q. Mr. Broad is a great proponent of l.i.f.o., isn't he?—A. Yes, definitely, but let me say this that Mr. Broad, in any of his public addresses or as a member of any committee of any association including the American Institute of Accountants of which he is the former President, speaks personally. He speaks for himself. He does not speak for the firm and the firm is not committed in any way by Mr. Broad's views.

Q. Quite—I am not suggesting that it would be, Mr. Thompson. In the same way, the views that you have been expressing here today are solely your personal views?—A. That is correct.

Q. You do not purport to speak for your firm or for the Chartered Accountants in Canada?—A. No.

Q. Now, I would like to read to you this statement which Mr. Broad makes here. I will read it slowly:

> "The point I would like to make, and I think it is fundamental, is that the policies—"

His Lordship: What are you reading from?

Mr. Pattillo: This article which is headed "Thoughts on Inventory Valuation" of Mr. Broad's which appeared in a book called "Control and Valuation of Inventories" issued by the National Association of Cost Accountants in the United States and this is part of a speech that Mr. Broad gave before the New York Society of Public Certified Accountants. Reading again, Mr. Thompson, and I am starting at the beginning:—

> "The point I would like to make, and I think it is fundamental, is that the polices, methods and conditions under which a business is operated have an important bearing in determining what method of computing cost should be adopted in a particular case".

Do you agree with that statement made by Mr. Broad?—A. Yes, as far as it goes.

Q. I will read another statement to you:

"Again I will come back to the proposition that any method of pricing should be applied only under conditions to which it is suited and in which it reflects methods and conditions of doing business".

Do you agree with that statement?—A. As far as it goes. Of course, the trouble with picking out sentences here and there is that I think they should be read in conjunction with the context and I do not know what Mr. Broad said before he made that statement or after he made that statement but, as far as that statement goes, I would not disagree with it.

Q. Then he says:—

"The last-in, first-out or similar inventory methods would appear to be appropriate when (1) the inventory is of relatively greater importance than in other industries as evidenced by the large ratio to other assets and by the fact that it consists of basic or homogeneous goods which form a substantial part of the cost of the product sold: (2) Inventory turnover is slow either because of length of process or conditions of merchandising: (3) Raw material prices and finished goods prices tend to run parallel: (4) The cost of raw material is such an important factor in the conduct of the business that fluctuations in raw material prices cannot be absorbed in the ordinary operations of business making it necessary so far as possible to match purchases and sales (or sales and purchases) in a manner similar to that in which hedging operations in an available futures market may be used".

Now, have you read that article where Mr. Broad outlines those four conditions which, if found, make l.i.f.o. the appropriate method?—A. I have that book and I may have read that article some time ago—not recently—but I know that those are Mr. Broad's views and I disagree with them.

Q. Now, from your reading, would you admit that these conditions set out by Mr. Broad are very similar to the conditions that are expressed by the text writers and proponents of l.i.f.o. as being the conditions that make l.i.f.o. appropriate?—A. Yes, I would think so.

Q. And would you agree that from your reading that in the United States there is no question that l.i.f.o. is an acceptable method of calculating costs of sales?—A. As far as I know.

Q. And after reading Bulletin No. 29 to which you were referred you would agree, would you not, that the Accounting Procedure Committee of the American Association of Accountants accept l.i.f.o. as being an acceptable method when they issued their Bulletin in July 1947?—A. On that basis, yes.

Q. And you agree from your knowledge of accounting practice in the United States that the Accounting Procedure Committee Bulletins reflect the concepts of the Accountants in the United States?—A. I would think so, yes.

Q. And that their bulletins have considerable weight in Canada—that is correct?—A. That is correct, yes.

Q. Now, do you agree that f.i.f.o. is a method which is based on assumption as to flow of costs?

His LORDSHIP: Did you say f.i.f.o.?

Mr. PATTILLO: Yes, f.i.f.o., my Lord.

A. Yes, I think I said my evidence is based on the assumption that the flow of costs parallels the flow of goods.

Q. Now, you have made that statement in your evidence. You have read in many texts both in Canada and in the United States the bald statement that it is an assumption as to the flow of costs and that is the end of it, haven't you—nothing whatever about flow of goods?—A. Well, my conception of it is—

Q. I just want you to answer my question, please Mr. Thompson, as of what you have read in accounting journals issued in Canada and the United States, that they have made the statement that f.i.f.o. is a method based on the assumption as to flow of costs and there is no mention whatever as to flow of goods?—A. Yes, that is correct.

Q. And then, when we come to average, average also is a method which is spoken of by the text writers and leading accountants as being a method based on an assumption as to flow of cost. Is that correct?—A. That is correct—yes.

Q. And of the leading text writers and authorities on accounting matters who are writing on these conditions today you do not find any of them linking up this flow of goods to these methods which are based on an assumption as to flow of costs, do you?—A. Well, I think one parallels the other.

Q. That may be your opinion but I am trying to find out as to whether any of the authorities who are writing on this thing today are doing what you are doing and trying to link the two together.

His LORDSHIP: Will you just direct your attention to the question specifically asked, Mr. Thompson please? It is being asked whether there are any writers who associate these methods as to flow of costs with physical flow of goods?—A. I think that is correct.

Mr. PATTILLO: You agree?

His LORDSHIP: You mean that there are no writers that do so?—A. As far as I know.

Mr. PATTILLO: Now, as I understood your evidence, your view is that l.i.f.o. is not acceptable under any circumstances whatever?—A. In my view.

Q. You will agree, however, that the textbook writers and authorities on these conditions speak of l.i.f.o. also being a method which is based on an assumption as to flow of costs and that it is so recognized?—A. On those conditions?

Q. Yes.—A. Well, of course, most of the writers are in the United States.

Q. That is true but there have been Canadian writings on the matter, haven't there?—A. There have been some—very few.

Q. You have read the recent article that has been published in the "Canadian Chartered Accountant" by Mr. R. M. Parkinson which appeared in the May 1950 issue of the Canadian Chartered Accountant?—A. Yes, I read that.

His LORDSHIP: Who is Mr. Parkinson?

Mr. PATTILLO: Mr. Parkinson is a Montreal partner of Clarkson, Gordon & Company?—A. I didn't say.

His LORDSHIP: Do you know him?—A. I know him, yes.

Q. Is he a Montreal partner of Clarkson, Gordon and Company?—A. That is correct, my Lord, as far as I know.

Mr. PATTILLO: And you know that according to the footnote that appears in the article that this was an address which he delivered before the Canadian Electrical Association in Montreal on October 12th of last year?—A. I do not recall the footnote but I will accept the statement.

Q. From your reading of the writing, you would agree that Mr. Parkinson treats the l.i.f.o. as being a method which is based on an assumption as to flow of costs?—A. Yes, I think that is correct.

Mr. PICKUP: Mr. Parkinson said "flow of cost factors" whatever that means.

Mr. PATTILLO: Now, will you agree with me, Mr. Thompson, that from your readings of the writers and authorities that it is generally accepted by them that under certain circumstances f.i.f.o. is the best method to employ in calculating costs of sales, that under other circumstances average is the best method to employ and that under other circumstances l.i.f.o. is the best method to employ?—A. I have read that, yes.

Q. And that is the general opinion of all the writers today who are writing on these subjects—isn't that so?—A. Not all the writers—no. There are some opponents, I think, still of l.i.f.o.

Q. Well, we know that you are here as one.—A. There are quite a few others.

Q. But "some" is a relative term?—A. Well "all" is a relative term, I would suggest.

Q. Let us put it like this. From your reading today would you say that the great majority of the writers are putting it as I have just put it to you, that f.i.f.o. is the best method to use in certain circumstances, that average is the best method to use in other certain circumstances and that l.i.f.o. is the best method to use in other circumstances?—A. That is true, I would say, of the majority of writers today.

Q. And would you agree with me that from your readings and the facts that you have heard brought out in this case, the writers say that such facts are the facts indicative of the application of l.i.f.o.?—A. Yes, I think I would agree with that.

Q. You would also agree, would you not, with the statement that Mr. Williams made the other day in answer to a question that I addressed to him, that he knew of no known method for calculating costs on the basis of physical flow?—A. Well, I do not entirely agree with Mr. Williams on that because I feel this, that the flow of costs parallels the flow of goods and I think I have said that.

Q. But you agree that that is not always so?—A. It may not always be so—no.

Q. Taking the illustration that I put to Mr. Williams the other day about the coal pile—A. Two coal piles, wasn't it?

Q. I am just going to take one at the moment where the manufacturer was processing coal and it came in and was dumped in a big pile and he was taking it off the top and using it so that it would be quite clear that the physical flow would be the "last-in, first-out".

Now, on your theory of physical flow paralleling the flow of cost would you then advocate the use of l.i.f.o.?—A. No, I would use average costs under those conditions.

His Lordship: Notwithstanding the fact that it is always the last added to the pile that goes into the goods?—A. Well, I think it would be extremely difficult to identify the coal.

Q. But you started off with the assumption that you take it off the top?—A. Then I would use average cost.

Q. Although it would not be related to the flow of goods?—A. Not in that particular case.

Mr. Pattillo: Now, do you agree with me that when an accountant is trying to ascertain the costs of sales for any period of time, that his great problem is to search for the costs that are applicable to the sales dollars which have come in and that he is not concerned as to flow of goods?—A. Well, I think in arriving at the cost of sales, he has to proceed along certain definite assumptions. I do not think he could help but establish with a homogeneous product, some reasonable assumption as to how the goods are flowing into the process and to the purchaser.

His LORDSHIP: We are back again to the concept of estimating your costs according to the physical flow of goods?—A. That is correct, sir.

Mr. PATTILLO: And if you restrict yourself to that, then am I correct in thinking that you would entirely disregard this statement of Mr. Broad's which you admitted a moment ago you agreed with and I will read it again to you—

> "The point I would like to make, and I think it is fundamental, is that the policies, methods and conditions under which a business is operated have an important bearing in determining what method of computing cost should be adopted in a particular case".

Now, if you direct your attention solely to physical flow of goods, would not you be entirely disregarding that statement of Mr. Broad's which you say you agree with?—A. No, I do not think so because my conception is this, that in valuing an inventory, you first try and identify specifically the articles which are in that inventory. That is the first method.

Now, where you have a homogeneous product you are probably unable to do that and, therefore, you must adopt some other method.

Q. You must make an assumption?—A. You must make some kind of an assumption. Now, as I see the picture, you take your opening inventory, you add to that your purchases, then from the sum of the two you must deduct the closing inventory and when it comes to a question of pricing the closing inventory, you are forced to make certain assumptions and the usual assumption is under f.i.f.o., that the last goods which you received during that fiscal period are the ones which are then in that closing inventory. On that assumption, and pricing the inventory on that basis, you deduct the cost of that inventory from the sum of the opening inventory and the purchases and you arrive at your cost of sales. To my mind you are getting down to the closest practical approach under those circumstances.

Q. Well, I suggest to you that when you do it that way, when you calculate cost of sales as you have said and valued the closing inventory—and I assume you have valued the opening inventory in the same way?—A. Oh yes.

Q. Then, having done that, I suggest to you that in arriving at cost of sales in the manner you have outlined, you have paid no attention whatever in a case such as the Anaconda American Brass Limited to the "policies, methods and conditions under which the business was being operated"?—A. I disagree. I think I have.

Q. You say you have?—A. Yes.

James C. Thompson (Respondent)
Cross-examination by Mr. Pattillo (Cont.)

Q. Now, you said that l.i.f.o. created an inventory reserve and that this should be disclosed and transferred from surplus. I assume that when you make that statement as to disclosure I assume you mean should be disclosed in the balance sheet?—A. Well, there are two places where it could be primarily disclosed, either at the foot of the income statement or in the surplus account and it would also, of course, in turn be disclosed in the balance sheet.

Q. Now, I would put this to you. You agree that the figures that appear in the opening inventory and in the closing inventory in calculating costs on l.i.f.o. method are cost figures which at some time or another have been paid out by the Company. You do agree with that, don't you?—A. Will you repeat the question?

Q. That in valuing the opening inventory and in valuing the closing inventory when employing the l.i.f.o. method, the figures that appear as the unit costs for your inventory are cost figures that were sometime incurred by the Company. They may not have been recent except to the extent of the increments but they are actually cost figures. You agree, don't you?—A. Yes, presumably so, yes.

Q. Then, when you come to value on a f.i.f.o. basis, the figures that appear for unit prices in the opening and in the closing inventory are also cost figures that were incurred at some time. It is only a matter as to the difference in time. Isn't that so? As between l.i.f.o. and f.i.f.o. they are both cost-incurred figures but there is a difference in time as to when the costs were incurred?—A. Well, there might be twenty years, of course.

Q. All right. Now, that being so, isn't it true that when you have a rising market, you may have a hidden reserve in your f.i.f.o. method?—A. Of course, I would say this—

His LORDSHIP: Well, is it so?

A. I must qualify it to this extent, my Lord.

Mr. PATTILLO: Now, you can answer that question "Yes" or "No".

His LORDSHIP: There either is or is not a hidden reserve.

Mr. PICKUP: If the question cannot be answered categorically—

His LORDSHIP: I quite agree but there are some that cannot be answered categorically.

Mr. PICKUP: If a witness feels he cannot, I think he is entitled to say to this court why not.

The WITNESS: I will answer the question categorically. In my opinion I say there is not a hidden reserve.

Mr. Pattillo: Now, I will put this to you. Supposing that your purchases of your raw materials in the months of October and November in a year equalled the quantities that you have on hand at the end of the year, that you bought them at .10 cents a unit, that you made no purchases in December and on December 20th the market price jumped to .20 cents a unit, do you mean to tell me that when you value your opening and closing inventories using f.i.f.o. that you do not come up with this hidden reserve concept as the difference between the .10 cents and .20 cents a unit?—A. Under those conditions you use—

Q. Answer my question.—A. Now, wait a minute. You use the lower-of-cost-or-market obviously.

Q. And you use incurred cost for f.i.f.o., you use incurred cost for l.i.f.o. and I suggest to you that the same situation may arise. It is just a question of degree when it comes to talking about hidden reserves?—A. I do not agree at all.

His Lordship: You say it is not a question of degree?—A. No.

Q. And that one is totally different from the other?—A. My conception of it, yes, my Lord.

Q. That there is no hidden reserve at all in mind in the application of the f.i.f.o. principle on a rising market?—A. Well, you recall—

Q. Do I understand you to say there is no hidden reserve?—A. I was pinned down to that question before and my view is, as I have repeatedly stated, that the end of the year inventory should be valued on the lower-of-cost-or-market. Now, if that is done there is no hidden reserve and if it is solely f.i.f.o. without the limitation placed on that by the lower-of-cost-or-market, you would create a reserve but I do not advocate that and I have not.

Q. There would be a reserve unless you used the concept of cost or market whichever is lower?—A. Yes, my Lord.

Q. So that apart from the question of cost or market there is no difference in kind between the application of l.i.f.o. and the application of f.i.f.o. There is a hidden reserve in each. Is that what you say—leaving aside the concept of cost or market whichever is lower?—A. I think that would be correct, yes.

Mr. Pattillo: And just so that we will have the record straight, you admit that when you use average the same situation arises?—A. Yes, to my mind average is simply a slight variation from f.i.f.o.

Q. My Lord, I was wondering if I might have a few minutes recess at this moment to go over my notes and perhaps shorten the length of my cross-examination.

His Lordship: Yes—recess for ten minutes.

(A short recess was here taken.)

Mr. PATTILLO: Mr. Thompson, would you agree with me that in ascertaining the costs of sales that if you value your opening inventory on incurred costs and that if you value your closing inventory on incurred costs, after having made the resulting calculation which you describe that the cost of sales would be on incurred costs?—A. Yes, that is correct.

Q. And then you have told us that you admit that the opening inventory and the closing inventory on the l.i.f.o. basis are incurred cost figures although they may have been costs incurred some time ago. That is correct?—A. Yes. They may be very far apart.

Q. Excepting for any increments which you may have had in the particular year with which you are dealing?—A. Yes, that is correct.

Q. But having admitted what you have just admitted in these last two questions, then don't you agree that perhaps you phrased it incorrectly to say in your direct examination that "l.i.f.o. is an attempt to match replacement costs and not incurred costs"?—A. No, I do not change that view at all. I think it is definitely an attempt to match replacement costs.

Q. Notwithstanding the admissions that you have just made?

His LORDSHIP: Well, isn't it an attempt to match replacement costs?

Mr. PATTILLO: Incurred cost, incurred during the year and replacing the goods which have gone out. Isn't that so?

His. LORDSHIP: The incurring takes place afterwards?

Mr. PATTILLO: The incurring takes place afterwards in the matching. It may be made any day afterwards. If Anaconda American Brass Limited came to you tomorrow with its balance sheet and profit and loss statement for the year and the facts that were brought out at this trial were disclosed to you and their accounts were made up on the l.i.f.o. method, would you, as a Chartered Accountant in Canada, sign the certificate?—A. I would qualify the certificate.

Q. You would state that the inventories were valued on the l.i.f.o. method? —A. Yes.

Q. That is done in the documents that are before us. Other than that, would you sign the certificate?—A. I would state the amount by which the profit differed under l.i.f.o. as compared with f.i.f.o. or average cost and I would also state in the balance sheet itself the difference between the value attached to the inventories under f.i.f.o. as compared with l.i.f.o.

Q. By a note on the balance sheet, would you?—A. In the certificate.

Q. And if your firm, Peat, Marwick, Mitchell & Company in Canada was asked to sign and not you personally—you might, as a partner of the firm, insist on that being your firm's policy?—A. I thought I was giving my personal view, not my firm's view. I will answer the question if I have to but I am here giving a personal view—not the firm's view.

His LORDSHIP: The firm is not under examination.

Mr. PATTILLO: Quite right, my Lord. You do know, do you not, Mr. Thompson, that the United States firm of Peat, Marwick, Mitchell & Company has certified many company accounts when they have employed the l.i.f.o. method?—A. Yes, I admit that.

Q. Now, there is just one other matter I would like to direct your attention to. I am correct in thinking that you say that where it is possible to identify the goods, then the identity should be ascertained and that should be the cost that is taken? —A. Yes.

Q. When you cannot identify the goods, then you apply assumptions and, in your judgment, the assumption should relate to the physical flow, first-in, first-out or average cost and you limit it to those two?—A. Yes.

Q. Now, I would like to put this example to you and see what you would do with it. Supposing that you went to a tailor shop today and he had just gone into business and you picked out a particular suit which you wanted to buy and the material he had on hand and that cloth was enough and only enough to make your suit and he priced the suit at $125.00 allowing himself $25.00 profit figuring the cost of the material at $75.00 and the cost of the work at $25.00.

You had no more than gone out of the door and, as you were leaving, you said to the man: "I won't need my suit for another month". Then I came in and it so happened that I picked out the identical cloth that you had picked and I told him that I must have the suit within a week. He then goes to check as to where he can get the cloth and he is advised that the price of the cloth has gone up from $75.00 to $85.00. So he quotes me $135.00 for the suit, still taking his same margin of profit and the same cost of the work and adding on an additional $10.00 for the cost of the material.

I get my suit and I pay $135.00 for it and you get your suit and you pay $125.00. —A. A month later?

Q. A month later. Now, to make my suit he used the cloth that had been shown to you and to make your suit he used the cloth that came in later.

Now, from my example it is quite clear that the tailor thought he was making a $25.00 profit in both cases. Do you say that was incorrect?—A. Yes, I would. He made a $35.00 profit on the suit he sold to you.

Q. And what did he make on the suit he sold to you?—A. At a later date?

Q. The one he sold to you for $125.00.—A. He would make $15.00 because the price of the raw material had gone up in the interim.

Q. So that you say his concept of what he was doing, his profit that he anticipated he was making and everything from his figuring was not at all in accordance with the facts?—A. Yes, he paid $75.00 for his material which he sold to you. He was selling the suit for $135.00 which included the profit margin of $35.00 so I cannot help but think that he made $35.00.

His Lordship: What principle of costing was he applying as related to the physical flow of goods?—A. In that particular case he knew that material cost him $75.00—

Q. Which principle was he applying? What principle would be applicable to the costs?—A. In that case he could actually identify the goods.

Mr. Pattillo: You agree that if you employed the l.i.f.o. method he would have made a profit of $25.00 on each suit which was the profit he thought he was making?—A. I agree up to a point.

Q. Well, let us put it like this. Do you agree that in employing the l.i.f.o. method he would have come up with a profit of $25.00 on each of the two suits?—A. Yes, I would agree to that.

Re-examination by Mr. Pickup:

Q. Just one question, I think Mr. Thompson, I want to put to you and that is in connection with the suggestion or statement that there might be or could be a reserve in the case of f.i.f.o. Now, I just want you to expand that further. Let me put it this way. We are considering f.i.f.o. and we have a rising market and we are considering f.i.f.o. as being an assumption that is factually true and that is that the inventory that first came in had gone out. Now, let us take that under f.i.f.o., that the market is rising and the first goods in were used. Will you explain to me how you could get a reserve in those circumstances on that rising market?—A. Well, actually under those circumstances under f.i.f.o. I do not see how you could create a reserve.

Q. Then let us take a falling market. If the market were falling, then could there be a reserve under f.i.f.o. if there is attached to the f.i.f.o. method the alternative of the lower of cost or market? There, of course, cannot be?—A. No.

Q. That is all, thank you.

That is the evidence for the Respondent, my Lord.

His Lordship: All right; Thank you, Mr. Thompson. Now, are you calling any rebuttal evidence, Mr. Pattillo?

Mr. PATTILLO: I have not any wish to do so, my Lord. I would like to put Mr. Gordon back in the box. He has made a calculation. You will remember there has been some question about that difference in 1946 of that $32,000 and Mr. Gordon has worked it out and I thought it would be advisable to put that in.

MR. DUNCAN LOCKHART GORDON, recalled

Re-Examined by Mr. Deroche

Q. You have been sworn, Mr. Gordon?—A. Yes.

Q. Did you, at our request Mr. Gordon, make a calculation or refinement from your actual working papers of the years in question?

His LORDSHIP: Which years in question?

Mr. DEROCHE: 1946 and 1947, my Lord, as to the comparison of opening and closing inventories after each year calculated alternatively on a l.i.f.o. basis and a f.i.f.o. basis. Did you make that calculation?—A. I did.

Q. These are the pencilled notes you made at the time, are they, Mr. Gordon?—A. They are.

His LORDSHIP: Are you putting this calculation in?

Mr. DEROCHE: Yes, my Lord. Unfortunately we have only the one hand-written copy but we will put that in.

EXHIBIT No. 35: Filed by Mr. DeRoche: Handwritten calculation of opening and closing inventories of Anaconda American Brass Ltd., prepared by witness showing comparison on l.i.f.o. and f.i.f.o. basis.

Q. Now, Mr. Gordon, if I may just take you through this. You have indicated the inventory of January 1st, 1946. That, I take it, is the opening inventory of the year 1946 and you have said "copper and zinc f.i.f.o."?—A. That is correct.

Q. And have shown the figure calculated from the books as the opening inventory on a f.i.f.o. basis?—A. That is correct.

Q. And below that you have shown "copper and zinc l.i.f.o." and given the same thing re-calculated on the other method?—A. That is correct.

Q. And then the next one is the inventory December 31st, 1946. That is the closing inventory?—A. Yes.

Q. And the same calculations—"copper and zinc f.i.f.o."—"copper and zinc l.i.f.o." with the difference shown?—A. Yes, correct.

Q. Now the figures shown for the difference between the two methods in the opening and closing inventories are the same figures?—A. That is correct.

Q. That I think follows from the fact that there was no change in price during the year?—A. That is correct.

His Lordship: That is in 1946?

Mr. DeRoche: Yes, my Lord. Now, below that you have made a tabulation headed "Scrap adjustment, December 31st 1945 $54,000 odd, December 31st, 1946 $87,000 odd and you have carried out the difference—$32,469.75?—A. That is correct.

Q. And that, I believe, is the exact figure of the inventory adjustment figure in the assessment for 1946?—A. It is exactly the same figure.

Q. And did you make these calculations from your working paper records?—A. Yes.

Q. Now, moving on to 1947—I see it says "1937". Should it be "1937" or "1947"?—A. It should be "1947".

Q. And in 1947 we have a similar tabulation—Inventory January 1st, 1947 copper and zinc f.i.f.o., copper and zinc l.i.f.o. and again the difference between the two figures which, of course, is the same figure as the closing inventory of 1946?—A. That is correct.

Q. And December 31st, 1947, the only thing here is the word "f.i.f.o." but I take it that means "copper and zinc f.i.f.o."?—A. Yes.

Q. Perhaps you had better write that in too.—A. Actually all four metals will be in. All we are looking for here is the difference between l.i.f.o. and f.i.f.o. in the two metals and there is no difference at the beginning of the year as far as lead and tin are concerned. There is at the end.

Q. So that at the opening inventory you did not need to distinguish between lead and tin and in your closing inventory you did?—A. That is correct.

Q. "At December 31st, 1947 copper, zinc, lead and tin, f.i.f.o." with a figure, the same metals l.i.f.o. with a figure and the difference between those two figures. Then, I see in the third column another figure. What does that represent?—A. That represents the difference between two differences. There was a difference between the two methods at the beginning of the year and there is a difference between the two methods at the end of the year. By subtraction of one figure from the other we reach this figure you are mentioning.

His Lordship: What figure is that?

Mr. DeRoche: The figure is $1,642,081.38.

His Lordship: Is that the amount of the assessment?

Mr. DeRoche: No, it is not, my Lord. If I understand your explanation, the figure I have just read is the net difference for the year between l.i.f.o. and f.i.f.o.?—A. That is correct.

Q. Then, below that we have "Scrap adjustment December 31st, 1946 $87,386.00, the second figure December 31st, 1947 $117,711 odd and the third figure is what—the difference between those two figures?—A. The increase in scrap adjustment during the year.

Q. I take it that the figure of $30,324.95 is the increase in scrap from 1946 to 1947?—A. That is correct.

Q. Then, I see you subtract that from the l.i.f.o. and f.i.f.o. difference which we mentioned before and end up with a figure of $1,611,756.43?—A. Yes.

Q. And that, I believe, is the exact figure which appears as the inventory adjustment in the assessment?—A. I believe it does.

Q. Now, Mr. Gordon, I understand you have here and can give us, if we wish it, the complete detail of the method of calculating the scrap adjustment in 1946?—A. That is correct.

Q. And the same method, I take it, was followed in 1947?—A. To the best of my knowledge it was.

Q. Unless your Lordship wishes it we do not propose to bother your Lordship with it because the only point we are trying to make is that it is outside the issue in this case and we do not care what happens to it. Mr. Gordon, the scrap adjustment to which we have referred and without wandering about, how is it done—is it in principle a matter which relates to either f.i.f.o. or l.i.f.o.?—A. Yes.

Q. To which does it relate in principle?—A. In principle it could relate to either l.i.f.o. or f.i.f.o.

Q. I think perhaps I stated my question wrongly. It has no special relation to either, then?—A. That is correct.

Q. It is an extraneous matter to either l.i.f.o. or f.i.f.o.?—A. That is right.

Re-cross-examination by Mr. Pickup:

Q. Would you explain to us just what the adjustment was just in a general way—not that we are concerned with the system but what sort of thing was being done?—A. Included in the inventory of the Company on hand in any year is a certain amount of metal which came from scrap. Now, the Company's records, when they purchase scrap for slightly below the raw metal price, when they take it onto their books in one account they take it in at the price of raw metal and they credit an offsetting account. There is a charge to that offsetting account for any processing charge or charge in converting the scrap into raw metal.

At the end of the year those credited accounts show a credit balance; in other words, the difference between the price they paid for scrap and the price of the raw metal was slightly more than the actual cost of converting the scrap into raw metal. At the year-end some of that scrap metal which came from scrap is in the inventory. It has a value in the inventory on a f.i.f.o. basis slightly higher than the raw material price.

Q. May I just interrupt for a moment. You say on the f.i.f.o. basis. Do you need the f.i.f.o. basis? Is the fact not that that scrap had a value higher than the market whether it is on f.i.f.o. or l.i.f.o. or any other way?—A. That scrap had a book figure higher than the figure the Company paid for it. They wrote it up as soon as they bought it and, therefore, at year-end we write it down again. I think I can take a very simple illustration.

Q. All right—do.—A. Supposing they bought a chair and, as soon as they bought it, they put it on their books. They bought it for $25.00 and they put it on their books at $50.00. At the end of the year they come along and say: "We put that on our books at too high a price", so they bring it down on their books from $50.00 to $25.00. That, in essence, is the same type of thing we are doing in the scrap adjustment.

His Lordship: That is, you are bringing the value of the metal down so that it will equal the difference betwen the price at which you bought the scrap and the cost of processing the scrap into the raw metal?—A. That is correct, my Lord.

Mr. Pickup: Then, one other question with regard to Exhibit 35—

His Lordship: In other words, originally you charged too much for processing the scrap into the raw metal and then you made that adjustment at the end of the year?—A. Well, in essence you are right, but it is the other way around. We actually cost it in as raw metal at more and then charge up the cost against the difference.

Mr. Pickup: The question I wanted to ask you was—looking again at Exhibit 35 and the two figures which you show as the opening inventory of January 1st, 1946, one on the l.i.f.o. basis and the other on the f.i.f.o. basis, can you tell me which of those figures was the closing inventory figure at the end of 1945?—A. They both were as far as the Company's books are concerned. The l.i.f.o. figure of $1,280,000 was the closing figure on the Company's books because the Company's books are on l.i.f.o. throughout.

Q. Then you carry forward into the 1st January 1946 the l.i.f.o. figure of inventory?—A. Yes.

Q. But for tax purposes in 1945 that figure was adjusted and tax paid on the other basis—is that correct?—A. As I understand it the Tax Department has carried forward f.i.f.o. opening and closing inventories throughout the period.

Q. I am speaking now of the adjustment which the Company made from the l.i.f.o. figure in the books to agree with the f.i.f.o. figure?—A. I am afraid I do not understand what you mean, Mr. Pickup.

Q. Well, you told me that you carried forward the l.i.f.o. figure from the 31st December 1945 to January 1st, 1946?—A. That is correct.

Q. And that the l.i.f.o. figure was the figure that was on your books at that time as the value of the inventory at the opening and closing period?—A. That is correct.

Q. Then, in your tax return for 1945, that figure was not adopted for tax purposes?—A. I think the answer I can give to that is that the Company's books throughout have been on l.i.f.o. and the Tax Department's figures up to date were on f.i.f.o. and there is no question as at January 1st, 1946 that differences existed between the two sets of figures. It had accumulated over a period going back to 1930.

Q. And in 1945 you were taxed, you say, on the f.i.f.o. figures?—A. As I understand it, that is correct.

Q. And, being taxed on the f.i.f.o. figure, you carried forward to the 1st January 1946 a l.i.f.o. figure as the opening inventory?—A. No, we are dealing here in differences all the way through. If a difference, as shown here, existed at the beginning of the year and a difference existed at the end of the year between the Department and ourselves, it makes no difference whatsoever to what happened during the year. If anything was wrong then it was wrong in prior years.

Q. But, at the moment, I am not dealing with the difference. I am trying to get at whether or not you made a change at the end of the year 1945 so far as carrying forward the inventory figure was concerned so that you would be taxed on one year on one basis and the next year on a different basis?—A. The only thing I can say on that is that throughout the period, the Company has carried forward l.i.f.o. and, therefore, as far as 1946 was concerned in the method the Company filed its tax returns the same difference existed at the beginning of the year as at the end of the year. Therefore, this made no difference whatsoever as to what the Company's taxable income was in 1946.

Q. Thank you, Mr. Gordon.

Mr. PATTILLO: That is all, my Lord.

His LORDSHIP: Does that close the case?

We shall adjourn until this afternoon at 2.30 and you will be ready to go on, Mr. Pattillo?

Mr. PATTILLO: Yes, my Lord.

(At 12.50 p.m. Court adjourned for lunch until 2.30 p.m.)

In the Exchequer Court of Canada

OTTAWA, the 7th day of June A.D. 1952

PRESENT: The Honourable the President

IN THE MATTER OF THE EXCESS PROFITS TAX ACT,

AND

IN THE MATTER OF THE APPEAL OF ANACONDA AMERICAN BRASS LIMITED, of New Toronto, in the Province of Ontario

APPELLANT

AND

THE MINISTER OF NATIONAL REVENUE

RESPONDENT

This appeal having come on for hearing before this Honourable Court at the City of Toronto in the Province of Ontario on the nineteenth, twentieth, twenty-first, twenty-second, twenty-third, twenty-sixth and twenty-seventh days of June, A.D. 1950 in the presence of counsel for the Appellant and for the Respondent, upon hearing read the Pleadings herein, the evidence adduced and the representations by counsel; this Court was pleased to direct that the said appeal should stand over for Judgment and the same coming on this day for Judgment,

1. THIS COURT DOTH ORDER AND ADJUDGE that the appeal of the Appellant herein from its 1946 assessment be and the same is hereby dismissed without costs.

2. AND THIS COURT DOTH FURTHER ORDER AND ADJUDGE that the appeal of the Appellant herein from its 1947 assessment be and the same is hereby allowed and that the said assessment should be varied to provide that the Excess Profits Tax payable by the Appellant for the said year is $65,128.59.

3. AND THIS COURT DOTH FURTHER ORDER AND ADJUDGE that the Appellant is entitled to recover from the said Respondent its costs in respect of the appeal from the assessment for the year 1947.

DATED this 25th day of November, 1952.

RALPH M. SPANKIE,
Deputy Registrar.

In the Exchequer Court of Canada

BETWEEN:

ANACONDA AMERICAN BRASS LIMITED

APPELLANT

AND

THE MINISTER OF NATIONAL REVENUE

RESPONDENT

THORSON P.

The appeals herein were brought against the Appellant's assessments under The Excess Profits Tax Act, 1940, Statutes of Canada, 1940, chap. 32, for the years 1946 and 1947 but at the hearing it developed that the dispute over the assessment for 1946 turned on a question of scrap allowance and it was agreed that the appeal against it should be dismissed without costs. The Court is thus concerned only with the appeal against the assessment for 1947.

The tax in question was imposed by section 3 of The Excess Profits Tax Act, 1940, which read:

> "3. In addition to any other tax or duty payable under any Act, there shall be assessed, levied and paid a tax in accordance with the rate set out in the Second Schedule to this Act upon the excess profits of every corporation or joint stock company residing or ordinarily resident in Canada or carrying on business in Canada:"

And "excess profits" was defined by section 2(c) as:

> "2. (1) (c) "Excess profits" means
>
> (ii) in the case of a corporation or joint stock company that has not filed a consolidated return for the taxation period, the amount by which the profits of the taxpayer exceed one hundred and sixteen and six hundred and sixty-six one thousandths per centum of the standard profits of the taxpayer;"

And "standard profits" was defined by section 2 (i) as:

> "2. (1) (i) "Standard profits" means the average yearly profits of a taxpayer in the standard period in carrying on what was in the opinion of the

Minister the same class of business as the business of the taxpayer in the year of taxation or the standard profits ascertained in accordance with section five of this Act:"

And finally "profits" was defined by section 2(f) as:

"2 (1) (f). "Profits" in the case of a corporation or joint stock company for any taxation period means the amount of net taxable income of the said corporation or joint stock company as determined under the provisions of the *Income War Tax Act* in respect of the same taxation period,"

Thus what falls to be determined is the amount of the appellant's net taxable income in 1947 as determined under the Income War Tax Act, R.S.C. 1927, chapter 97.

The issue in the appeal is whether the appellant in computing its net taxable income for 1947 was entitled to deduct from its gross revenue from the sale of its finished products the cost of their metal content as ascertained by the last-in first-out method of accounting, commonly called the Lifo method. The appellant contends that it was entitled to use this method in ascertaining such cost. The Minister on the other hand, asserts that the appellant's cost of sales for the year must be determined according to the first-in first-out method, commonly called the Fifo method. This would result in a much higher valuation of the appellant's closing inventory for 1947 than under the Lifo method. The Minister asserts that the increase in value of this closing inventory calculated on the basis of cost or market whichever is lower over the value of the opening inventory for 1947 calculated on the same basis must be regarded as inventory profit in 1947 and included as an item of the appellant's taxable income. Under the Lifo method there would be no such addition. The question whether a company such as the appellant may ascertain the materials cost of its sales by the Lifo method is a novel and important one that is not free from difficulty. This is the first case in which the question has arisen for decision in Canada.

Proper understanding of the issue requires knowledge of the nature of the appellant's business and its policy and practice in selling its finished products and purchasing its raw materials, an analysis of the accounting methods in dispute and an examination of the conditions of their respective applicability.

Evidence of the nature of the appellant's business and its business policy and practice was given by Mr. A. H. Quigley, its president, Mr. J. S. Vanderploeg, its general manager, and Mr. U. M. Evans, its works manager.

The appellant was incorporated under the laws of Canada in 1922 and has carried on its business at New Toronto since that date. It operates what is called a primary mill and produces copper and copper alloys in the form of sheets, rods and tubes, which it sells to its customers for further manufacture by them. Its products, although referred to as its finished products, are, strictly speaking, only semifinished. It is a wholly owned subsidiary of its United States parent, the American Brass Company. The parent company operates in the United States through six primary mills similar to the appellant's and considers the appellant as one of its branches in the same way as it does its United States mills. They all operate in the same manner and follow the same business policy and practice.

Over 80 per cent of the metal content of the appellant's finished products consists of copper and zinc is its main metal for its alloys. Copper and zinc between them account for about 98 per cent of the metals used by it. Lead, nickel, tin and a little silicum and magnesium make up the remaining 2 per cent. With the exception of tin, which it imports, the appellant purchases all its supplies of metals from Canadian refineries which are independent of it. Indeed, the appellant is dependent on them for its supplies.

It was asserted by the appellant's witnesses that its business is that of a primary producer of copper and copper alloy products, that it does not trade in its raw metals and deliberately avoids speculation in them and that it makes its profit, if any, solely by processing its metals into its finished products. The appellant's objective was said to be achieved by its policies of selling its finished products at sales prices based on the replacement cost of their metal content together with a processing charge covering all the expenses of manufacture, other than such replacement cost, and an allowance for profit, changing the sales price of its products whenever necessary in order to reflect any change in the purchase price of their metal content and matching its purchases of metals as closely as possible to its sales of finished products so that the inflow of metals should equal the outflow of the metal content of the products. By following these policies the appellant was not concerned with the rise or fall in the price of its raw metals since that would be reflected either up or down in the sales price of its finished products, and its profit from processing would remain unaffected thereby, and it incurred no risk through being left with an excessive closing inventory.

Prior to the war the appellant sold its products for delivery within 90 days at a firm price based on the price of copper at the date of acceptance of the order because it could purchase its requirements of copper from the refineries for delivery within 90 days at the price prevailing at the date of the order. Later, however, this became impossible and the appellant followed the practice of making the sales price of its products reflect the purchase price of their metal content and determining its sales price at the date of shipment of the products according to the purchase price of the metals at the date of such shipment. For example, while the price of copper was controlled at 11·5 cents per pound and that of zinc at 5·75 cents the appellant's Base Price List No. 1, dated July 16, 1945, was in effect showing the sales price of its various products. But when the price of copper was permitted to be increased to 16·625 cents per pound on January 22, 1947, and that of zinc to 10·25 cents the appellant immediately issued its Base Price List No. 2, dated January 22, 1947, with its new sales prices. And when the controls on metal prices were lifted on June 10, 1947, and copper rose to 21·5 cents per pound and zinc to 11 cents the appellant immediately issued its Base Price List No. 3, dated June 10, 1947, reflecting the increases in these prices. There was a further Base Price List No. 4, dated September 1, 1947, but this was not related to any change in the prices of metals. There were two exceptions to this general practice. The appellant did a small amount of Government and export business on a firm price basis using the price list in force at the date of the acceptance of the order. The appellant also had some customers who purchased its products on what was called a commodity price based on a special processing charge and the replacement cost of their metal content at the date of shipment. Subject to these exceptions, the appellant's sales price for its products was based on the replacement cost of their metal content and a processing charge to cover all its other expenses of production and provide an allowance for profit. While the factor in the sales price dependent upon the replacement cost of the metals was subject to fluctuation as such cost went up or down there was much less variation in the factor of the processing charge. A change in the replacement cost of the metals would, therefore, not affect its processing charge or the profit from its business.

The close relationship between the terms on which the appellant purchased its supplies of raw copper and those on which it sold its finished products appears from Exhibit 4. During the war years and until April 30, 1946, the appellant purchased its copper at firm prices which were controlled. From May 1, 1946, to November 30, 1946, it purchased at the prices which were in effect on the first day of the month in which the copper was shipped. From December 1, 1946, to June 30, 1947, the prices paid were those that prevailed on the date of shipment. Then from July 1, 1947, the appellant purchased at prices for delivery in the following month. The terms of sale corresponded closely. During the war years and until May 31, 1946, the appellant sold its products at prices from the price list in effect on the date of acceptance of the order if accepted for delivery within 90 days. From June 1, 1946, to February 28, 1947, the sale price was from the price list in effect on the first day of the month in which the shipment was made. And from March 1, 1947, to December 31, 1947, the sale price was from the price list prevailing on the date of shipment. There was thus only a very slight lag on two occasions in the correspondence between the sale price of the finished products and the replacement cost of their metal content. The close correspondence between such sales price and replacement cost and the slight lag in such correspondence was illustrated in graph form by a series of charts, Exhibits 12 to 20, prepared by Mr. D. L. Gordon, the appellant's auditor.

Notwithstanding the lag referred to I find that the appellant's policy of having the sales price of its finished products closely reflect the replacement cost of their metal content was carried out in practice.

The appellant carried out its policy of matching its purchases of metals to its sales of finished products by monthly estimate and orders. During the first nine days of each month it estimated from the orders already received and those that might be expected the amount of the metal content of such orders, calculated the amount of scrap that might be engendered in processing them and estimated the amount of scrap that might be expected from its customers and dealers. It was then able to determine the amount of raw metals required to replace what was taken out of its inventory for processing and its practice was to order for delivery in the following month the amount of metals that would be needed to make the inward flow of metals match the outward flow of the metal content of the finished products. This was a quantity matching with no regard being had to the factor of price. There could not, of course, be an exact matching for there might be delays in the delivery of the incoming metals or in the shipment of the finished products or errors in processing that would engender more scrap than had been calculated or in estimating the amount of scrap that would be brought in by customers or dealers or special circumstances, such as threatened strikes, might dictate the desirability of purchasing metals in advance of actual requirements and there might also be some fluctuations in the amount of the orders that could be filled from stock. But, apart from these factors, the general objective and practice was to maintain the inventory of metals and match the amount of metal coming in with that required for the out-going production subject to plus or minus adjustments according to the rise or fall in the volume of production. There was a natural tendency on the part of workmen to have somewhat more in the inventory than was actually required but this was held within close hands. The purchase price of the metals had nothing to do with the quantity of the purchases.

It was also established that the appellant did not attempt to use its raw materials in the order of their purchase or in any particular order. The raw metals could be identified up to the time they went into process but thereafter their identity was lost. It was impossible to maintain identification of the scrap. And it was not possible to identify the raw materials that had been used in processing a particular order. As the raw metals came in they were stored in the most convenient position and as they were required for use in production they were taken from the most convenient source. The metals did not deteriorate with age and it did not matter when they had come into the plant. One pound was as good as another. The appellant had no policy of using first the metals that had been first purchased or of using first those that had been last purchased. There was no attempt to maintain or follow the physical flow of the materials according to any particular order. Convenience of storage or source of use was the governing consideration.

The rate of turnover of the appellant's inventory was slow. About 80 per cent of its processing was according to its customers' specifications, the balance of its orders being filled from finished stock. The processing according to specifications required exactness and made for slowness of production. There was also a large amount of scrap engendered in the course of processing. This was put at 30 per cent. The evidence indicated that the inventory turned over three or four times a year. This was a slow rate.

It was also shown that the nature of the appellant's business was such that a large inventory of metals had to be kept on hand. About 60 per cent. of every sales dollar represented the cost of the metal content of the finished products. The business was not seasonal but steady. About ten to twelve million pounds of metal were continuously in process, and enough metal had to be kept on hand to maintain production for from two and a half to four months.

On the facts, I find that in 1947 the appellant maintained a policy of having the sales price of its finished products closely reflect the replacement cost of their metal content, that it matched its purchases of metals to the metal content of its finished products, that its business required a large inventory and that the rate of turnover of its inventory was slow.

The manner in which the appellant kept its inventory accounts and ascertained the metals cost of its sales was described and explained by Mr. A. R. McGinn, its controller, and Mr. D. B. Crawley, its assistant controller. Mr. D. L. Gordon, the appellant's auditor, also gave evidence of its accounting methods and annual statements.

The appellant's fiscal year coincided with the calendar year and each year was regarded as a unit. It kept a perpetual inventory account of its metals, in their raw state, in the course of process and in their finished condition. This recorded the amounts of metal received and the amounts taken out. The account was credited with the amounts of the metal content of the finished products only when they were actually shipped out. The accuracy of the perpetual inventory account was verified from time to time by physical check. The appellant also kept a purchase record showing the prices at which the metals had been purchased. With these two accounts the cost of the metals in the inventory at any given time could be determined. At the end of each year the amount and the cost of the inventory was ascertained. The manner in which the appellant ascertained its metals cost of sales for the year can be stated briefly. The opening inventory for the year was carried at the same cost as that of the closing inventory of the previous year. The purchases during the year at the prices paid were added to the opening inventory and from the total of this addition the amount of the closing inventory at the same cost as that of the opening one was deducted. The resultant figure was the metals cost of the sales during the year as ascertained by the l.i.f.o. method.

The l.i.f.o. method was first used by the appellant in 1936 and has been used by it ever since. But this use was only for its own corporate purpose of determining its income position and extended only to copper and zinc. The first time that it filed its income tax and excess profits tax returns on the l.i.f.o. method basis was in its return for 1946. In 1947 it extended the method to the ascertainment of the cost of its lead and tin and in its return for that year the cost of the copper, zinc, lead and tin content of its sales during the year was ascertained by the l.i.f.o. method.

How the amount of the cost of sales was determined, so far as it related to these four metals, was illustrated in detail by Exhibit 7. I shall refer only to the figures for copper. When the appellant began to use the l.i.f.o. method in 1936 it started with an inventory of 6,500,000 pounds of copper which it had purchased at 7·5 cents per pound, making a total cost of $487,500. The exhibit then shows the increments to this inventory in the years 1937, 1938, 1939, 1945, and 1946 in quantities and prices. For example, in 1946 there was an increment of 2,936,468 pounds at 11·5 cents per pound amounting to $337,693.82. At the end of 1946 there was an inventory of 15,021,710 pounds which had cost a total of $1,439,867.78 at prices ranging from 7·5 cents to 11·5 cents per pound. This was the opening inventory for 1947. The total purchases of copper in 1947 amounted to 63,268,555 pounds at an average price of 18·854 cents per pound amounting to $11,928,728.71. The addition of these purchases to the opening inventory made a total of 78,290,265 pounds at the price of $13,368,596.49. From this amount the closing inventory for 1947 amounting to 14,291,007 pounds at the price of $1,355,836.93 was deducted. The resultant figure of 63,999,258 pounds at $12,012,759.56 represented the amount of copper used in the finished products sold in 1947 and its cost as ascertained by the l.i.f.o. method. The exhibit showed that more copper had been used in 1947 than had been purchased in that year to the extent of 730,703 pounds. This amount was regarded as having been withdrawn from the increment in 1946 and was priced at 11·5 cents per pound, that having been the price paid in 1946. The copper cost of sales in 1947 was thus ascertained at $12,012,759.56. The zinc, lead and tin costs of sales were ascertained in a similar manner.

The appellant carried forward its closing inventory of metals into its balance sheet as an asset at $1,848,497.89 with the following notation of its valuation: "Metals—raw, scrap, finished and in process at cost which with minor exceptions is computed on a 'last-in first-out' basis." This was sufficient notification that the appellant kept its accounts by the l.i.f.o. method. On this basis the closing inventory was carried at the same price as the opening one. Indeed, this was implicit in the l.i.f.o. method. Consequently, the closing inventory for 1947 carried forward the opening inventory of 1936, when the method was first used, at the cost of such opening inventory and the cost of the increments in the years since then.

The Department of National Revenue has always refused to recognize the l.i.f.o. method of accounting and when the appellant's returns for 1946 and 1947 came in with the metals cost of sales and the closing inventory computed according to the l.i.f.o. method it proceeded to value the inventory on the traditional basis of cost or market whichever is lower. It put the prices of the metals in the inventory at their most recent prices, its view being that the metals most recently purchased were the ones that would be on hand at the end of the year. The result was that whereas the appellant had computed its closing inventory, as indicated, at $1,848,497.89 the Department valued it at $3,696,646.06, an increase of $1,848,148.17 over the appellant's figures. There was a deduction of $236,391.74 in respect of the previous year which left a difference of $1,611,756.43. On the assessment for 1947 this amount was added to the amount of taxable income reported by the appellant and described in the notice of assessment, dated December 6, 1948, as Inventory Adjustment. This is the assessment against which the present appeal was brought.

There was nothing strange or unusual about the manner in which the appellant carried on business or kept its accounts. Mr. T. E. Veltfort, the manager of the Copper and Brass Research Association in the United States, who had a thorough knowledge of the brass industry, stated that the appellant's mill was a typical brass mill and that it was run in exactly the same way as the brass mills in the United States. It was the standard practice in the brass industry in that country to price the finished products on the basis of the replacement cost of their metal content and to keep the inflow of metals in accordance with the outflow of the metal content of the products. The charts prepared by Mr. Veltfort, Exhibits 5 and 6, show the close relationship between the sales prices of the copper and brass products and the purchase prices of the copper and brass. Mr. Veltfort also testified from his own knowledge that the l.i.f.o. method of accounting for inventory and ascertaining the materials cost of sales was in common use throughout the brass industry in the United States and had been in such common use for income tax purposes since the amendment to the Internal Revenue Code in 1938, regarding which more will be said later.

When the appellant began to use the l.i.f.o. method in 1936 it followed the practice of its parent company in the United States and that of the brass industry generally in that country. I have already mentioned that it did not use the method in filing its tax returns prior to making its returns for 1946. One reason for this was the Department refused to recognize the method and the appellant therefore, in making its tax returns adjusted its inventory account from the l.i.f.o. basis on which they had been kept to the f.i.f.o. basis required by the Department. During the war years, when the prices of metals were controlled, it was a matter of little consequence to the appellant whether it made its returns on the l.i.f.o.

basis or adjusted its accounts to the f.i.f.o. basis to meet the views of the Department. But when the time came for filing the returns for 1946 there was a radical difference in the situation. The war was over and the prices of metals had risen sharply as already stated, first on January 22, 1947, and then on June 10, 1947, when the controls were lifted. It now became important to raise the issue. The decision to employ the l.i.f.o. method in its returns for 1946 and 1947 was made by the appellant on the recommendation of Mr. McGinn and with the approval of Mr. Gordon and after consultation and correspondence with the parent company and its auditor Mr. Peloubet. The return for 1946 was made on June 18, 1947. This was after the price increases referred to and there can be no doubt that these increases greatly influenced the appellant's decision. The reasons for the decision were put in various forms but they were all really the same. Mr. Quigley said that in 1947 it became obvious that the appellant should not pay taxes on an unrealized profit. Mr. Vanderploeg expressed the view that it was a matter of justice to the appellant to have its tax computed by a method of accounting that reflected its way of doing business rather than on increased prices of metals that had not affected the profits from its business. Mr. McGinn, who recommended the filing of the returns on the l.i.f.o. basis, said that early in January, 1947, he could see the distortion that was going to take place in 1947 if the appellant's income should be calculated on the f.i.f.o. basis. He admitted freely that while it did not matter prior to 1947 whether the tax returns were on a f.i.f.o. or l.i.f.o. basis it did make a difference in 1947. The difference is a substantial one and a large amount of tax is involved.

In his cross-examination of the appellant's witnesses counsel for the respondent sought to establish that the appellant had filed its returns for 1947 on the l.i.f.o. basis in order to avoid the heavy tax to which it would be subject if the f.i.f.o. method of accounting were applied and the resulting so-called inventory profits were included in the assessment as an item of taxable income. There can be no doubt that the difference in tax incidence under the two methods, which resulted from the sharp increases in the prices of metals in January and June of 1947, was a major factor in the appellant's decision to make its return on the l.i.f.o. basis, notwithstanding the Department's refusal to recognize the method. It is no answer to the appellant's contention that it did not raise the issue before. If the Department's refusal to recognize the method was wrong it cannot become right merely because the appellant did not dispute it previously. The issue is now squarely before the Court and must be decided on the merits. What falls to be determined in this case is whether the l.i.f.o. method of accounting correctly reflects the appellant's net taxable income in 1947. If it does, then the appeal against the Minister's assessment must be allowed.

I now come to the evidence of the accounting experts explaining the accounting methods in dispute and the reasons that led to the formulation and adoption of the l.i.f.o. method. The experts called for the appellant were Mr. G. Richardson of the Canadian accounting firm of Clarkson, Gordon and Company, Mr. M. Peloubet of the New York accounting firm of Pogson, Peloubet and Company, Professor J. K. Butters, an associate professor of business administration at the Harvard School of Business Administration, and Mr. E. A. Kracke of the New York accounting firm of Haskin and Sells. In addition, several Canadian accountants were called for their expression of opinion as to the acceptability of the l.i.f.o. method and its applicability to the appellant's business. For the respondent, expert evidence was given by Mr. W. F. Williams, the Director General of Corporation Assessments in the Department of National Revenue, and Mr. J. C. Thompson of the International accounting firm of Peat, Marwick, Mitchel and Company.

I was very favourably impressed with the careful and able manner in which counsel for the parties prepared and presented their respective contentions and with the constructive attitude shown by the accounting experts. The Court is indebted to counsel and the experts for their exposition of the pros and cons of a new method of inventory accounting. It was made clear that the accounting profession is not a static one. Its leaders do not consider that the principles of accounting are like the laws of the Medes and Persians. They are not immutable. The profession is naturally and properly conservative in its attitude towards new accounting methods and critical of them. But it does not hesitate to accept and adopt a new method if it stands the tests of criticism and correctly reflects the true position of the business to which it is applied. The fact that a method is new does not condemn it. It is the objective of accountancy to record in figures the true facts of what has happened in the period of business to which the accounting relates. Accountants have freely recognized that methods of accounting that were reasonably adequate to record the truth when business was simple and prices of commodities were stable may not necessarily be sound in a world of complexity and price fluctuation. The result has been that traditional positions have been abandoned and new ones taken up when changing conditions made such shifts necessary in the interests of true accounting. One important difference in concepts of accounting that has developed in recent years was stressed by Mr. Kracke and Mr. Richardson. Accountants are no longer primarily concerned with the annual balance sheet of assets and liabilities. This was originally of prime importance particularly to the banker who was interested in the amount of capital security behind his loans. He was concerned with the amount for which the company could be liquidated for this was the measure of the credit that might safely be extended to it. Now the greater emphasis is put on the annual profit and loss statement. This has become the dominating accounting statement. Accountants now look at a company's position from the point of view of its being a going concern and are more anxious to portray its income position than to set out its liquidation possibilities.

This shift in emphasis from the balance sheet to the profit and loss statement is reflected in a difference of attitude towards inventory accounting. The modern attitude is shown in a bulletin on Inventory Pricing issued by the Committee on Accounting Procedure of the American Institute of Accountants in July, 1947, which will be referred to as Bulletin No. 29. The portion of this bulletin consisting of the introduction, the first four statements and the discussion thereof was put in for the appellant as Exhibit 29. Statement 1 defines the term "inventory" as follows:

> "The term 'inventory' is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in the process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale."

I adopt this definition as applicable to the appellant's stock of goods. Its inventory embraces its finished products in stock, its work in process of production and its raw materials in their various forms, such as the raw metals purchased from the refineries, the scrap engendered in the course of processing and the scrap purchased from customers and dealers. Statement 2 sets out what is now the accepted objective of accounting for inventories in the following terms:

> "A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues."

And Statement 3 sets out that the primary basis of accounting for inventories is cost. It reads as follows:

> "The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or evidently incurred in bringing an article to its existing condition and location."

The net annual income of a company like the appellant is the difference between its gross income and the costs and expenses related thereto. It is the purpose of the annual statement of profit or loss to show this difference. There is no difficulty in ascertaining its gross income. That is the total amount of its sales during the year and whatever other incoming revenue it had. It is in the ascertainment of the related costs and expenses properly chargeable against the gross income from sales that the difficulty arises. Mr. Richardson emphasized that it is always necessary to allocate the costs and expenses incurred during a year as between those properly chargeable against the gross income from sales for the year and those to be charged against the gross income from sales for a future period. In accounting terminology the former portion is styled cost of sales for the year and the balance carried forward is called the closing inventory. This becomes the opening inventory of the following year. Thus each year a company like the appellant starts with its opening inventory and makes purchases of raw materials during the year. The accountant who is concerned with ascertaining the company's income position for the year cannot simply charge all the purchases against the sales regardless of their quantity. He must pay attention to the relationship between the quantity of finished products sold and the inventory and is faced with the problem of ascertaining what portion of the opening inventory and purchases made during the year is properly chargeable against the gross income from sales for the year as part of the cost of such sales and what should be carried forward into the closing inventory to be charged against the sales for a future period. The cost of sales for the year must be ascertained for the purpose of determining the company's income position. It is thus of the utmost importance to ascertain what is the appropriate cost of sales. The balance carried forward as the closing inventory is eliminated from the costs incurred during the year and prior thereto and treated as an asset in the company's balance sheet, although its true nature, if the company is looked upon as a going concern, is that of a residue of unabsorbed costs of sales to be charged against the sales for a future period. Under this concept of accounting the determination of the amount of the closing inventory and the value to be placed on it is a complement of the ascertainment of the cost of sales for the year and the determination of the company's income position. The cost of sales is first to be ascertained and the valuation of the closing inventory follows.

The appropriate cost of sales for the year may be determined, according to the experts, under one of several acceptable methods of accounting for inventories, depending upon the circumstances of the case. There was general agreement that the method to be used is that which will most nearly accurately reflect the true income position. This view, which is now generally taken, was expressed in Statement 4 of Bulletin No. 29 as follows:

> "Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as 'first-in first-out', 'average', and 'last-in first-out'); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income."

In addition to the three methods mentioned in Statement 4, Mr. Richardson described another method which he called the method of specific identification. Under this method the cost of specific items is established by physical identification of them. It is useful in a limited number of cases and necessary in some. It is, as Mr. Kracke pointed out, the proper system to employ in jewellers' shops where special precious stones are sold, or by art or antique dealers, where the cost of sales can be determined by reference to the sum paid for the specific article. But the method is inapplicable in cases where the goods in the inventory have similar characteristics and utility. There, in many cases, physical identification is impossible as, for example, in piles of scrap or coal, or in industries where the raw materials lose their identity in the process of production. In other cases, physical identification would be possible only with a great deal of effort of accounting or handling. Moreover, no useful purpose would be served in such cases by maintaining the identity of the goods. On the contrary, the method lends itself to manipulation or variations in profit depending on which item is selected. The result has been that the method of specific identification has been abandoned except in the cases where it is obviously applicable.

Mr. Richardson explained the differences in the three methods mentioned in Statement 4 but before doing so referred to the view that there is a presumption that the physical movement of goods out of an inventory will occur in the order in which they were received into it on the assumption that a prudent business man will move his oldest stock first. Historically, this was the common assumption and it is sound in certain cases as, for example, where the goods in the inventory are subject to physical deterioration or style changes. But there is no foundation for it in industries where the goods are not so subject. There the physical movement of goods will depend upon factors of convenience rather than the order in which they were received. For example, in a pile of ingots the item first received into stock will not be the item first removed for processing if it is at the bottom of the pile. Nor would a paper mill turn over its wood pile to obtain the logs at the bottom. Nor is there any presumption of a last-in first-out physical movement of goods. Indeed, in the three methods referred to there are no presumptions of physical flow of the goods in any particular order. In their place there are assumptions of a flow of cost factors.

Under the first-in first-out method, known as f.i.f.o., the cost of the items of goods first received into stock is the cost assigned to the items first removed from stock and charged against the gross income from sales as an item of cost of such sales. It follows that the cost of the items in the closing inventory will be the cost of the corresponding quantity of items most recently received into stock. The f.i.f.o. method is not based on any assumption of a physical flow of goods out of stock in the order in which they were received into it, but on an assumption of a flow of cost factors, namely, that the cost of the items of goods first-in will be regarded as the cost of the items first-out. This was illustrated by Exhibit 22. It is not a case of goods first received into stock being necessarily the goods first removed from it. The goods may move in that order or they may not. What is first-in and first-out in the accounting for the inventory and, therefore, in the determination of the cost of sales is an item of cost. Thus the cost chargeable against the gross income from sales for the year is the cost of the earliest corresponding quantity of open items in stock and the cost assigned to the items in the closing inventory is the cost of the corresponding quantity of items most recently received.

Under the second valuation method, called the average cost method, the year is started with the opening inventory showing a quantity of goods at a certain cost. When purchases are made an average is struck between the cost of the goods on hand and that of the purchases either each time a purchase is made or at the end of a defined period. As goods are removed from stock the cost assigned to them is the average cost existing at the time of the removal and this is the cost charged against the sales.

Then there is the last-in first-out method, called l.i.f.o. Under this method the cost of the items last received into stock is the cost assigned to the items first taken out. Here again there is no assumption of physical flow of the goods in any order but only an assumption as to the order in which costs flow from the inventory account into the cost of sales. The effect of the l.i.f.o. method is that the cost of sales for any period reflects substantially the prices at which purchases were made during the same period. Regard must, of course, be had to the relationship of the quantity of goods purchased to the quantity sold. The effect of the method is that quantity for quantity the cost of sales reflects the replacement cost of their materials content. Thus in the case of a company like the appellant if the quantity of raw material purchased during the year corresponds exactly with the quantity used in the sales for the year the raw materials cost of the sales will be exactly the price paid for the raw materials purchased during the year and the closing inventory will be the same in quantity and cost as the opening inventory. If the quantity of raw materials purchased in the year exceeds the quantity used in the sales in the year the raw materials cost of the sales will be the price paid forthe raw materials purchased during the year less the amount of the excess priced at the average price of the purchases during the year and the excess so priced will be carried into the closing inventory as an increment. On the other hand, if the quantity of raw materials purchased during the year is less than the quantity used in the sales for the year the raw materials cost of the sales will be the price paid for all the raw materials purchased during the year plus the amount of the shortage at the price paid for the most recent purchases in the previous year and the shortage so priced will be regarded as having been withdrawn from the opening inventory. The operation was illustrated by Exhibit 23.

It cannot be too strongly stressed that these methods of inventory accounting and determining the materials cost of sales do not depend upon any assumption of the physical flow of the goods in the inventory in any particular order. Nothing could be plainer from the evidence, notwithstanding the vigorous and persistent cross-examination by counsel for the respondent, that the three methods described in Statement 4 are not based on an assumed flow of the goods in any order. The accountants are not concerned with the physical flow of the goods at all. There has been a complete departure, except where the specific identification method is applicable, from the idea of determining costs according to physical identity of the goods. What matters is the flow of cost factors into and out of the inventory account. What is last-in and first-out or first-in and first-out is not an item of goods at all but an item of costs into and out of the inventory account. The objective of accountancy is to charge against the gross income from sales for the year the appropriate cost of the sales. As Statement 2 of Bulletin No. 29 puts it, a major objective of inventory accounting is the proper determination of income through matching appropriate costs against revenues. That is the prime consideration. The physical flow of the goods has nothing to do with the matter.

The story of the origin of the l.i.f.o. method of inventory accounting and its general acceptance in the United States in certain circumstances was clearly told by Mr. Peloubet and Mr. Kracke. These eminent United States accountants, with whose evidence I was favourably impressed, played an active part in this development. I shall deal with Mr. Peloubet's evidence first. His firm have been the auditors of the appellant's parent company, the American Brass Company, since 1922 and he is familiar with its business operations as well as those of the appellant. In the early 20's the American Brass Company was running on a dual system. It kept its accounts on the f.i.f.o. basis because of the requirements of the tax authorities but it also kept unofficial operating records on substantially what is now called the l.i.f.o. basis for its own operating purposes. About 1924 or 1925 it was clear to the management that the inventory method then in use did not correctly portray the realized business profits of the organization for dividend purposes. This was due to the disturbed condition of prices. Mr. Peloubet filed a chart, Exhibit 28, showing the fluctuations in prices of four principal commodities, namely, cotton, wheat, pig iron and copper, from 1900 to 1929. This shows that prices were fairly stable between 1900 and 1915 but that there were violent price disturbances during and after the first world war. A similar chart, Exhibit 32, shows sharp fluctuations starting in 1946. It took several years before the first price fluctuations forced themselves on the management and made it realize that the accounts did not properly show the true profits. It was disturbed about the amount of apparent inventory profits caused by merely marking up goods which they did not and could not sell and the fact that the accounts showed profits that were not really there. It was not the rise in prices that worried the management but rather their fluctuations and the distortion in the income position that followed from the existing accounting methods. The result was that in 1926 the entire Anaconda group of companies, including the American Brass

Company, adopted for its corporate purposes the base stock method. This eliminated the inventory profits. The base stock method was applicable in an industry which had to carry a large amount of raw material at all times. The amount required was determined by the management and when so determined was carried permanently at a fixed price. The additions to it were carried at current prices. The principal distinction between it and the l.i.f.o. method was that if part of the base stock was sold it was replaced at the same price and a reserve was set up of the difference. It is an old method in England that was allowed there for tax purposes but limited to a few industries such as iron and steel. In 1933 the American Brass Company went on the last-in first-out method that was just coming into use. It was not then called the last-in first-out method but was simply described as a method that charges current cost against current sales and carries forward the opening inventory to the closing one at the same price. It was first referred to as l.i.f.o. in 1937. It was not originally adopted for tax purposes. An attempt was made in 1936 to get legislative recognition of it but this failed. In 1938, however, Mr. Peloubet appeared before the House Ways and Means Committee and the Senate Finance Committee of Congress as a representative of the Copper and Brass Mill Products Association and the Revenue Act amendment of 1938 was enacted to make the l.i.f.o. method effective. The legislation was defectively drafted and proved inoperative. But in the Revenue Act of 1939 as the result of the work of a group of three consultants, of whom Mr. Kracke was one, the l.i.f.o. method was legislatively recognized. Mr. Peloubet was thereafter a member of the Committee on Accounting Procedure of the American Institute of Accountants which issued its findings on Inventory Pricing as Bulletin No. 29 in July, 1947, to which I have already referred. There was no dissent on the part of any member of the Committee from the portion of the bulletin filed as Exhibit No. 29 and it may, in my opinion, be regarded as a generally accepted statement of principles.

I shall now summarize Mr. Kracke's account of the origin and acceptance of the l.i.f.o. method. At the beginning of the century the valuation of a company's inventory on the basis of "cost or market whichever is lower" was predominantly a balance sheet concept. At that time the balance sheet was the company's most important financial statement prepared largely to meet the needs of the banker. Moreover, in the simpler state of industry that then obtained a company's inventory lent itself to specific identification which was then the desired objective. With the coming of the industrial era the income account of the company grew in importance and the complexity in business operations gave rise to other methods of inventory valuation of which f.i.f.o. was the first and average cost the second. During the first decade and a half market fluctuations in certain basic goods were of a minor nature but during the first world war and in the post war period they were substantial and the older methods of valuation bore heavily on industries where the sale prices of the finished products were determined by the replacement costs of their materials content. Some of such industries, for example, textile mills using cotton and cereal mills using grains could protect themselves against price fluctuations, even with the continued use of the f.i.f.o. or average cost methods, by resort to the futures market and the system of hedging. Then when the profit or loss on the futures market was brought into account with the operating result calculated under the f.i.f.o. method the total approximated closely to what is now determined under the l.i.f.o. method. But there were other industries which could not protect themselves against price fluctuations by hedging. They were deeply concerned with the distortion caused by these fluctuations particularly if their inventories were large and the rate of their turnover slow. The earliest effort in these industries to meet this situation, made between 1919 and 1929, was to use the base stock method. This failed to generate much enthusiasm and finally the oil industries evolved the concept of the last-in first-out assumption of the flow of costs as the proper one for their industry. Then in 1933 the American Petroleum Institute requested the American Institute of Accountants to set up a committee to discuss the whole field of inventory valuation with particular reference to the new method of last-in first-out which had been initiated by certain members of the American Petroleum Institute. The American Institute of Accountants then appointed its Inventory Committee with Mr. Kracke as its chairman. This committee collaborated with the American Petroleum Institute and finally in 1936, after deliberations that stretched over more than two years, brought in a unanimous report approving of the last-in first-out method of valuation of inventories in those industries where there was a close relationship between the sale price of the finished product and the replacement cost of the materials content and there was a large inventory and a slow rate of turnover. The petroleum industry adopted the method for the proper determination of its profits and without regard to whether it would be accepted for tax purposes. Mr. Kracke stressed that the committee found that this method was not an attempt to deal with an assumed physical flow of goods. The assumption was one of a flow of costs in the books that were related to the revenue in the books and what was attempted was a true matching of the revenue with the related costs. Mr. Kracke gave an interesting illustration of a case where it was not desirable to attempt to follow physical identity. A refinery might one day derive its crude oil from pipe lines and another day draw it from tanks where it had been stored for a year or two years. Thus there might easily be quite a mixture and there could be quite a range of cost prices. There was also danger of evaporation. Moreover, if a company wanted to favour its earnings it might utilize the cheaper oil in the tanks instead of the more expensive oil in the pipeline and so lead to monopoly earnings. The Committee considered this undesirable and found that a rigid last-in first-out system that based itself on the flow of costs rather than on any attempt to follow through a physical flow of goods was the only method that could make for a real, defensible earning or profit or loss in those industries. Mr. Kracke was one of the consultants to the Treasury Department of the United States in 1938 and 1939. In 1938 the Revenue Act first recognized the l.i.f.o. method but the wording of the 1938 amendment was such that it was unworkable. It did not follow the outline that Mr. Peloubet had discussed before the House and Senate Committees. A committee of consultants, of which Mr. Kracke was a member, was then appointed by the Department to consider the problem. It recognized that the method had found a proper place in business and the question was how to apply it. The Department expressed a desire that the consultants should submit a list of the industries that would be entitled to use this method. The consultants' preference was that the law should recite the specific conditions which had been dealt with in the deliberations with the American Petroleum Institute, namely, quickness of communication of replacement cost of the raw materials to the prevailing sale price of the product, size of inventory and slowness of turnover, of which the price factor was the most important. It was finally agreed that it should be left to the election of the taxpayer to use the method if he considered that it best reflected the operating conditions under which he worked, unless the Commissioner felt that it was improper, in which case he could deny the right. The law was correspondingly amended in 1939 to allow the use of the l.i.f.o. method. Thereafter, Mr. Kracke was a member of the Committee on Accounting Procedure of the American Institute of Accountants and chairman of the Sub-committee on Inventory Valuation. This continued the exploration of inventory problems which eventually led to Bulletin 29 in July, 1947. The work was done through a questionnaire addressed to one hundred of the largest companies in the United States in various industries. This produced a pattern which showed that eventually accountants may safely look for a condition whereby the various industries can be allocated into three groups of methods of valuating inventories and determining costs, namely, f.i.f.o., average cost, and l.i.f.o.

It is generally agreed by accountants, with very few exceptions, that there is no single inventory accounting method that is applicable in all circumstances. Each method, even that of physical identification, has its proper place and the method to be selected is dependent upon the circumstances of the case. It was the objective of the Committee on Accounting Procedure of the American Institute of accountants in its promulgation of the principles stated in Bulletin No. 29, as Mr. Kracke put it, to bring industries into their respective profit determinations where they belonged by reason of the operating characteristics of the industry. To put it in other phraseology, meaning the same thing, the method that ought to be selected is the one that is in accord with the company's genius of profit making and most nearly accurately reflects its income position according to the manner in which it carries on its business.

The f.i.f.o. method was the first method to be adopted at the beginning of the century and was largely predicated on perishable goods. It is also clear that in a business, such as the ordinary retail business, where sales prices are based on the prices paid for stock received and are altered only when the stock purchased at earlier prices has been exhausted, the f.i.f.o. method will probably give the best reflection of income according to the actual course of trading. And, as Mr. Kracke pointed out, f.i.f.o. is well suited to the liquor industry where the sales price of the liquor sold in any year has nothing to do with the price of grain in that year but is related to the price of grain several years previously depending upon the age of the liquor. It is the price of that grain which should be considered in ascertaining the cost of the sales of the liquor.

The average cost method, which is really a variation of the f.i.f.o. one, will take care of a large field of industry where there is a relationship between sales prices and replacement costs but only after varying lapses of time as, for example, in the tobacco industry where it is usual to have two or three years' lapse for the maturing of the tobacco and the matured crops are mixed. There the average cost method is ideal. Likewise, it is the proper one in the case of an investment trust selling securities out of its portfolio.

Where prices are reasonably stable it makes little, if any, difference which of the three methods is used. The cost of sales under each of them will be approximately the same. But when the prices paid for goods received into stock are subject to fluctuations there may be a substantial difference, depending upon the extent of the fluctuations and the size and rapidity of turnover of the inventory. This fact led to criticism of the correctness of the f.i.f.o. method in certain circumstances. While it was recognized that its range of proper use was a wide one, it was felt, as the evidence of Mr. Peloubet and Mr. Kracke shows, that its universal application was not justifiable and that there were circumstances in which its use did not accurately reflect the income position of the business to which it was applied.

The first criticism of the f.i.f.o. method was that when there were price fluctuations and the rate of inventory turnover was slow the method resulted in so-called inventory profits or losses that were fictional. This criticism was particularly strong when sales were made on the basis of prices that had no relationship either to the opening inventory prices or to those obtaining at the time of the sales. In such cases there was no justification for claiming a profit merely because there had been an increase in the price of the goods in the closing inventory over that which obtained at the date of the opening one when there was no difference in the quantity of the goods and their character and utility were the same. A second criticism was that in an industry in which a large inventory must be maintained at all times and the rate of its turnover is slow it was unrealistic and untrue to say that because of a rise in prices there were inventory profits, as would be the case under the f.i.f.o. method, when such so-called profits had not been realized and could not be realized without liquidating the business. In such circumstances, it was inconsistent with the business continuing as a going concern to ascribe inventory profits to it. It was also urged that the fictional character of the so-called inventory profits was shown by the fact that on a subsequent fall in prices the so-called profits disappeared and so-called inventory losses took their place, although the quantity, character and utility of the goods in the inventory remained unchanged.

The l.i.f.o. method was designed to meet these criticisms and produce greater reality in determining the income position. It was formulated by accountants to reflect the opinions of practical business men who considered that when a business is carried on in such a way that sales prices closely reflect replacement costs the correct profit or loss of the business cannot be determined by charging against the gross income from sales the cost of their materials content that obtained several months previously if it was different from the current cost, as would be the result under the f.i.f.o. method. It is the related cost of sales that ought to be ascertained. The l.i.f.o. method, therefore, charged against the gross income from sales the cost of their materials content that was current at the time of the sales and thus matched the appropriate costs against the revenues, thereby accomplishing the major objective of inventory accounting set forth in Statement 2 of Bulletin No. 29.

The evidence of Mr. Peloubet and Mr. Kracke shows that the l.i.f.o. method developed gradually. It was a radical change in accounting practice and naturally provoked discussion and criticisms. The criticisms have died out and now, as Mr. Richardson pointed out, there are very few accountants who oppose its use in the circumstances that are appropriate to it.

According to Mr. Richardson there were three main criticisms of the method. The first was that it does not reflect physical realities, namely, that only in exceptional circumstances would the physical flow of goods be on a last-in first-out basis. There is no substance in this criticism in view of the fact that accountants are now generally in agreement that physical identification of the goods is neither necessary nor desirable in the ascertainment of the appropriate cost to be charged against gross income and the determination of net income.

The second criticism was that the l.i.f.o. method excluded inventory profits from the computation of income and it was urged that although advocates of the method claimed that there were no inventory profits because they had not been realized the fact was that the profits had been realized and re-invested in stock at a higher price. This criticism, like the first one, is based on an assumption of physical flow of the goods on a first-in first-out order and on the assumption that the goods first received into stock had in fact been sold and a profit realized on them which had been re-invested in stock at a higher price which was still on hand. In my opinion, there was no merit in this criticism. It has already been shown that there is no assumption of physical flow of the goods in any particular order in any of the inventory accounting methods under discussion, except that of specific identification. And there is no foundation in fact to establish the criticism in the appellant's case.

The third criticism was that the Lifo method resulted in a valuation of the closing inventory that was meaningless from the point of view of the balance sheet since it was not related to current prices and the valuation was dependent partly upon the date when the method was adopted and partly upon the date of the increments from year to year. This criticism was answered by Mr. Richardson. It is not primarily the purpose of an inventory accounting method to determine the value of the closing inventory. If it were so all inventories would be valued at the market price of the goods. The more important objective is to reflect as nearly accurately as possible the income position according to the manner of carrying on business. Consequently, the accounting profession has agreed that when there is a conflict between a method which would lead to a more correct determination of income and one that might be preferable from the balance sheet point of view the balance sheet must give way to the income account. The ascertainment of the costs properly chargeable against the gross income is the primary objective of the accounting for that determines the net income and the valuation of the closing inventory follows as a complement for balance sheet purposes.

Mr. Williams and Mr. Thompson objected to the l.i.f.o. method on the ground that in a period of rising prices it resulted in the creation of an unauthorized inventory reserve. Mr. Williams explained that, in his opinion, a reserve was created whenever an asset was undervalued and that there was such an undervaluation of the closing inventory under the l.i.f.o. method. The objection is due to a misconception of the true nature of the closing inventory. Earlier in these reasons I referred to Mr. Richardson's discussion of the problem involved in ascertaining what portion of the opening inventory and purchases made during the year is properly chargeable against the gross income from sales for the year as the materials cost of such sales. Once that is ascertained by whatever method is appropriate the balance is carried forward as the closing inventory and included in the balance sheet. I have already referred to the shift in accounting emphasis from the balance sheet to the profit and loss statement. Mr. Richardson also referred to the changed attitude towards the balance sheet itself that has developed in modern accounting practice. Instead of being a statement of assets and liabilities largely based on the concept of liquidating value, cost has come to play a dominant roll as distinct from value and the balance sheet is now not so much a statement of values as a statement of unabsorbed costs and liabilities. Mr. Richardson stated that many illustrations could be given of the changed attitude towards various items in the balance sheet, but it is sufficient to say that within the modern concept of it the closing inventory is not to be regarded as an asset to be liquidated but rather as a residue of unabsorbed costs incurred in the past but applicable to the future to be charged against the gross income of a future period. This view of the closing inventory is the same whatever accounting method is applied. It has thus nothing to do with the determination of the income position.

It was also urged by Mr. Williams and Mr. Thompson that the l.i.f.o. method resulted in an averaging of profits that was not authorized by law. So far as the l.i.f.o. method eliminates so-called inventory profits or losses it may perhaps be said that it levels off the hills and fills up the valleys of profits and losses but that is not the correct way of describing the result. What really happens is that when a company like the appellant follows a deliberate policy of avoiding speculation or trading in its inventory and confines itself to its processing business and follows a policy whereby the sales price of its finished products closely reflects the replacement cost of their materials content and matches its purchases to its sales its income position is not affected by the rise or fall of materials. It makes the same profit or sustains the same loss whether prices go up or down the l.i.f.o. method reflects its actual course of business. The method accomplishes the same result for it as is accomplished in certain industries by hedging and bringing its results into account along with those of the processing operations. Mr. Richardson showed the results of the l.i.f.o. method as compared with those of the f.i.f.o. one both on a falling market and on a rising one by Exhibits 25 and 26.

The problem in this case is the ascertainment of the appellant's materials cost of sales in 1947 that may properly be chargeable against its gross income from sales for 1947. There is no definition of "cost" in the Income War Tax Act. Net taxable income as determined under it means in effect for the appellant its gross income from the sales of its finished products for 1947 and any other revenues it might have in that year less the 1947 costs that are related to such gross income. What costs are properly chargeable against the gross income must depend upon accepted business and accounting principles unless the Act declares otherwise. The Act being silent on the subject it is necessary to seek the aid of the accountant and the business man. The question for decision is whether the l.i.f.o. method properly ascertained the appellant's materials cost of sales in 1947. This depends upon whether the method is an acceptable accounting method and whether it was appropriate in the circumstances of the appellant's business.

There cannot be any doubt that the l.i.f.o. method of inventory accounting and ascertaining the materials cost of sales is now an accepted method in certain circumstances. That fact is beyond dispute in the United States. It is noteworthy that after the American Petroleum Institute in 1933 requested the American Institute of Accountants to set up a committee to discuss inventory valuation and particularly the new l.i.f.o. method which some of its members had initiated the

Inventory Committee of the American Institute of Accountants under the chairmanship of Mr. Kracke unanimously approved the method for use in the circumstances already mentioned. Then there was the adoption of the method by the Treasury Department of the United States leading first to the abortive amendment of 1938 and then the effective legislation of 1939. Here there are two interesting facts to note. In the first place, the 1939 legislation made the method an elective one and gave it a wider scope of application than that which the Inventory Committee had contemplated. There is also Mr. Kracke's statement that, in his opinion, the Commissioner of Internal Revenue could have allowed the method without any legislative action on the part of Congress in view of his broad power to determine what accounting method fairly reflected the taxpayer's income. While it is not a matter for this Court to decide I must say that I was impressed with Mr. Kracke's opinion. Furthermore, we have the statement in Bulletin No. 29 that "cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as "first-in first-out", "average", and "last-in first-out"). There is also Mr. Peloubet's evidence that l.i.f.o. is a generally accepted accounting method in the United States. This was given not as a matter of opinion but as one of personal knowledge. It is a recognized and accepted method in the cases to which it applies. As an illustration of the extent of its use there is Table 29 in Appendix A of Professor Butters' book on Inventory Accounting and Policies, Exhibit 34, showing the number of companies in the non-ferrous metals fields that were on the l.i.f.o. method in 1947. And I have already referred to Mr. Veltfort's statement that the l.i.f.o. method is in common use in the brass industry in the United States. There was also the evidence of Professor Butters regarding the method.

The evidence of the acceptance of the l.i.f.o. method in Canada is almost as convincing. Mr. Richardson stated that criticism of it has largely died out and that there are very few accountants who oppose its use. Mr. Richardson said that l.i.f.o. is now well established as an acceptable method. Then there were the statements of other Canadian accountants of high standing. Mr. K. Carter of the accounting firm of McDonald, Currie and Company said that l.i.f.o. is a generally acceptable accounting method in Canada for determining cost. He agreed with the first four statements in Bulletin No. 29. Mr. L. McDonald of the accounting firm of Price, Waterhouse and Company did not like the l.i.f.o. method because the inventory figure in the balance sheet was relatively meaningless but he admitted that it was a generally accepted method and expressed the view that if the attitude of the Department were to change there would be a greater acceptance of it. And Mr. G. Jephcott of the accounting firm of P. S. Ross and Sons said that l.i.f.o. was a generally acceptable accounting method in Canada. Then there was the Dominion Bureau of Statistics Reference Paper of May, 1949, Exhibit 33, showing the number of companies in Canada that were on the l.i.f.o. basis of valuing their inventories.

The experts for the respondent were against the l.i.f.o. method. Mr. Thompson denied its acceptability and went so far as to say that there were no circumstances in which it should be applied. Mr. Williams did not go so far as this. While he could not as a tax official accept the method for tax purposes he admitted that there might be circumstances in which it would most clearly reflect income.

While I have great respect for the respondent's experts I have no hesitation in finding that the l.i.f.o. method is an acceptable and recognized inventory accounting method in the circumstances that are appropriate to it.

After careful consideration of the opinions of the experts I have come to the conclusion that where a manufacturing company avoids speculation or trading in its materials and makes the sales price of its finished products closely reflect the current replacement cost of their materials content and matches its purchases of materials to its sales of finished products so that the inflow of the materials equals the outflow of the materials content of the finished products and it must continuously maintain a large inventory and the rate of its turnover is slow the l.i.f.o. method of inventory accounting and ascertaining the materials cost of its sales for the year is the method that most nearly accurately reflects its income position according to the manner in which it carries on its business and is the method that ought to be applied in ascertaining the materials cost of its sales and determining its net taxable income.

As to whether the l.i.f.o. method is appropriate in the circumstances of the appellant's business the evidence is overwhelming. I have already found on the facts that the circumstances in which the method is an acceptable one exist in this case. The evidence and opinions of the experts and others support this finding. Mr. McGinn, the appellant's controller, thought that the l.i.f.o. method was the best recognized inventory method to reflect correctly the appellant's method of doing business. Mr. Gordon reviewed the appellant's income tax and excess profits tax returns for 1947 and considered that they fairly reflected its income calculated on the l.i.f.o. method. Then we have the strong, clear cut opinion expressed by Mr. Peloubet who was thoroughly familiar with the appellant's operations. He said that the application of the l.i.f.o. method to a primary producing brass mill such as the appellant's was probably the clearest, simplest and most easily operated application of l.i.f.o. that could be found. In his opinion, it was the proper method to be used for such a business. It more clearly reflected the periodic income of such an enterprise than any other accounting method of which he had knowledge. By "clearly" he meant "fairly" or "accurately" or, to be more precise, "most nearly accurately". Then there was Mr. Kracke's carefully considered view that l.i.f.o. was definitely the proper method to use for the purpose of arriving at the appellant's profits. In his opinion, it was the proper method because it most nearly accurately reflected the Appellant's true profits. I must say that the opinions of such eminent accountants as Mr. Peloubet and Mr. Kracke carried great weight with me. The Court also had the assistance of several well known Canadian accountants. Mr. Carter considered that l.i.f.o. was the best method of arriving at a fair measurement of the appellant's annual net profits. And Mr. McDonald said that under the circumstances of the appellant's case l.i.f.o. was preferable to either f.i.f.o. or average as a method of determining the appellant's profit or loss, because it more clearly reflected periodic income. And Mr. Jephcott considered that l.i.f.o. was the most desirable plan of determining the appellant's cost that could be utilized. For the respondent Mr. Thompson and Mr. Williams refused to agree that the l.i.f.o. method was appropriate.

Under the circumstances, I find that the l.i.f.o. method was appropriate in the circumstances of the appellant's business. This means that it was entitled to use the method in ascertaining the cost of the metal content of its finished products that was properly chargeable against its gross income for sales and that the method correctly reflects its net taxable income in 1947 and I so find. It follows that the appeal from the assessment for 1947 must be allowed.

While I need not say more I also find that the method employed by the Minister in arriving at his assessment was not a proper one. This is not a case in which either of two accounting methods is acceptable. Only the one method, namely, the l.i.f.o. method, is appropriate. The Minister used the f.i.f.o. method in ascertaining the appellant's materials cost of sales which left it with a much larger income than it earned. The result of this method has been to ascribe to it greater profit than could have come to it through its processing charges. The additional profit so ascribed is said to be inventory profit. The criticisms of the f.i.f.o. method mentioned by Mr. Richardson apply here. It seems plain to me that when a company so conducts its business as to avoid the risk of profit or loss through the rise or fall of its raw materials its income position cannot be correctly determined if so-called inventory profits or losses which it has not earned or sustained are brought into its accounts. To do so is to use an accounting system that is not in accord with its business policy and practice and does not fairly reflect its income position.

There is only one other comment to make. Although the appellant filed its 1947 returns with its cost of sales ascertained by the l.i.f.o. method its standard profits were computed on the f.i.f.o. basis. This may make a difference in the amount of excess profits tax. If it does it seems proper that since its net taxable income should be determined under the l.i.f.o. method its standard profits ought to be computed under the same method, particularly since it has kept its corporate accounts by that method ever since 1936.

For the reasons given, I find that the assessment for 1947 is invalid and the appeal against it must be allowed with costs.

Judgment accordingly,

J. T. THORSON
President

Ottawa, June 7, 1952.

Solicitor's Certificate

IN THE SUPREME COURT OF CANADA

IN THE MATTER OF THE EXCESS PROFITS TAX ACT, 1940

BETWEEN:

THE MINISTER OF NATIONAL REVENUE
(Respondent) APPELLANT;

AND

ANACONDA AMERICAN BRASS LIMITED
(Appellant) RESPONDENT.

CERTIFICATE AS TO CASE

I, Frederick James Cross, of the City of Ottawa, in the Province of Ontario, hereby certify that I have personally compared the annexed print of the Case in Appeal to the Supreme Court of Canada with the originals and that the same is a true and correct copy of such originals.

Dated at Ottawa, this day of A.D. 1952.

Solicitor for the Appellant.

Registrar's Certificate

IN THE SUPREME COURT OF CANADA

BETWEEN:

THE MINISTER OF NATIONAL REVENUE

(Respondent) APPELLANT;

AND

ANACONDA AMERICAN BRASS LIMITED

(Appellant) RESPONDENT.

I, the undersigned, Registrar of the Exchequer Court of Canada, do hereby certify that the printed documents from page 9 to page 430 inclusive, together with the Exhibits filed separately in Volumes III and IV, is the case stated by the parties pursuant to Section 68 of the Supreme Court Act and the rules of the Supreme Court of Canada in a Appeal to the said Supreme Court of Canada in this cause.

In witness whereof I have hereunto subscribed my hand and affixed the Seal of the Exchequer Court of Canada this day of , A.D., 1952.

Registrar—Exchequer Court of Canada