BETWEEN:

ANACONDA AMERICAN BRASS LIMITED ..... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

1950
June 19-23, 26, 27
1952
June 7

Revenue—Excess profits tax—Excess Profits Tax Act, 1940, S.C. 1940, c. 32 ss. 2(1) (c), 2(1) (i), 2(1) (f), 3—Net taxable income—Income War Tax Act, R.S.C. 1927, c. 97—Determination of income through matching appropriate costs against revenues—Cost of sales—Value of closing inventory—Last-in first-out or Lifo method of inventory accounting.

The appellant operated a primary mill and produced copper and copper alloys in the form of sheets, rods and tubes. It sought to make its profits by processing its metals into its finished products and did not trade or speculate in its raw materials. It maintained a policy of having the sales price of its finished products closely reflect the replacement cost of their metal content and it matched its metal purchases to its sales so that the inward flow of metals matched the outward flow of the metal content of its finished products. Its business required a large inventory and the rate of turnover of its inventory was slow. It made no attempt to use its raw materials in the order of their purchase or in any particular order. The appellant had used the last-in first-out or Lifo method of inventory accounting for its own corporate purposes ever since 1936 but first used it in computing its income tax and excess profits tax in its returns for 1946 and extended its use in its returns for 1947. The Minister refused to recognize the method and on his assessment for 1947 added a large amount to the amount of taxable income reported by it. From this assessment the appellant appealed.

Held: That the proper determination of income through matching appropriate costs against revenues is a major objective of accounting.

2. That there is no single inventory method that is applicable in all circumstances and the method that ought to be selected for any company is the one that is in accord with its genius of profit making and most nearly accurately reflects its income position according to the manner in which it carries on its business.

3. That the Lifo method of inventory accounting and ascertaining the materials cost of sales is a recognized and acceptable method in the circumstances that are appropriate to it.

4. 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 Lifo method of inventory accounting and ascertaining the materials cost of its sales for the year is the method that most nearly accurately reflects its

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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.

5. That the Lifo method of inventory accounting was appropriate in the circumstances of the appellant's business.

APPEALS under the Excess Profits Tax Act, 1940.

The appeals were heard before the President at Toronto.

A. S. Pattillo Q.C., W. C. De Roche and *A. J. MacIntosh* for appellant.

J. W. Pickup Q.C. and *F. J. Cross* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

THE PRESIDENT now (June 7, 1952) delivered the following judgment:

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.

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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 semi-finished. 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 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

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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 their 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.

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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. Crowley, 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 Lifo method.

The Lifo 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 Lifo 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 Lifo 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 Lifo 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

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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 Lifo 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 Lifo method. On this basis the closing inventory was carried at the same price as the opening one. Indeed, this was implicit in the Lifo 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 Lifo 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 Lifo 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 value 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. Beltfort, 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. Beltfort, 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. Beltfort also testified from his own knowledge that the Lifo 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 Lifo 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

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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 Lifo basis on which they had been kept to the Fifo 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 Lifo basis or adjusted its accounts to the Fifo 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 Lifo 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 Lifo 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 Fifo basis. He admitted freely that while it did not matter prior to 1947 whether the tax returns were on a Fifo or Lifo 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 Lifo basis

in order to avoid the heavy tax to which it would be subject if the Fifo 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 Lifo 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 Lifo 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 Lifo 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 Selves. In addition, several Canadian accountants were called for their expression of opinion as to the acceptability of the Lifo 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

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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

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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.

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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 Fifo, 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 Fifo 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 Lifo. 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 Lifo 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 for the 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.

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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 Lifo 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 Fifo basis because of the requirements of the tax authorities but it also kept unofficial operating records on substantially what is now called the Lifo 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 fluctuation 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 Lifo 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 Lifo 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 Lifo method effective. The legislation was defectively drafted and

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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 Lifo 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 Lifo 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 Fifo 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 Fifo 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 Fifo method the total approximated closely to what is now determined under the Lifo 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

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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 Lifo 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 Lifo 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, Fifo, average cost, and Lifo.

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 accounts 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 Fifo 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 Fifo method will probably give the best reflection of income according to the actual course of trading. And, as Mr. Kracke pointed out, Fifo 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 Fifo 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.

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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 Fifo 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 Fifo 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 Fifo 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 Lifo 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 Fifo method. It is the related cost of sales that ought to be ascertained. The Lifo 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 Lifo 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 Lifo 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

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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 Lifo 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 Lifo 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 Lifo method resulted in an averaging of profits that was not authorized by law. So far as the Lifo 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

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sustains the same loss whether prices go up or down and the Lifo 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 Lifo method as compared with those of the Fifo 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 Lifo 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 Lifo 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 Lifo 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 Lifo 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 Lifo method in 1947. And I have already referred to Mr. Beltfort's statement that the Lifo 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 Lifo 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 Lifo 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 Lifo 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, Waterhousse and Company did not like the Lifo method because the inventory figure in the balance sheet was relatively meaningless but he

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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 Lifo 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 Lifo basis of valuing their inventories.

The experts for the respondent were against the Lifo 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 Lifo 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 Lifo 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 Lifo 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 Lifo 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 Lifo 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 Lifo method to a primary producing brass mill such as the appellant's was probably the clearest, simplest and most easily operated application of Lifo 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 Lifo 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 Lifo 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 Lifo was preferable to either Fifo 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 Lifo 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 Lifo method was appropriate.

Under the circumstances, I find that the Lifo 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

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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 Lifo method, is appropriate. The Minister used the Fifo 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 Fifo 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 Lifo method its standard profits were computed on the Fifo 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 Lifo 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.