Case No. D14/88

Appeals – accounts of taxpayer – to what extent a taxpayer can challenge its own accounts on appeal.

Assessment – 'error or omission' – accounts properly prepared but with hindsight shown to be inaccurate – whether assessment based on those accounts could be corrected – s 70A of the Inland Revenue Ordinance.

Profits tax – meaning of 'accrued' – s 15 of the Inland Revenue Ordinance.

Profits tax – interest derived by taxpayer – interest not payable in relevant tax year – whether interest accrued for tax purposes on day by day basis - s 15(1)(f) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Lester Kwok Chi-hang and Lau Wah-sum.

Dates of hearing: 6 and 7 January 1988.
Date of decision: 1 June 1988.

The taxpayer company made a loan to an associated company. The loan agreement provided that interest would accrue on a day by day basis with yearly rests, but that no interest was payable unless the borrower's directors so resolved. No such resolution was ever made.

The taxpayer included the accrued interest in its profit and loss account, and offered such interest for assessment to profits tax for the 1981 and 1982 tax years. Due to the borrower's financial position, it subsequently appeared that the interest would never be paid. The taxpayer decided to write back the interest in the 1983 and subsequent accounts. This gave rise to losses in the 1983 and subsequent accounts, against which no profits were available for setting off. The taxpayer therefore wished to establish that the interest had been improperly taxed in the 1981 and 1982 years and that adjustments to the assessments for those years ought to be made.

With respect to these years, the taxpayer claimed that the interest had not 'accrued' within the meaning of s 15(1)(f) of the Inland Revenue Ordinance for tax purposes because the borrower had no liability to pay any interest, no resolution as required having been passed. However, it was conceded that the interest had accrued for accounting purposes, and that the accounting treatment had been proper.

The taxpayer claimed that there had been an ‘error or omission’ within the meaning of s 70A with respect to the 1981 and 1982 years, thereby entitling the assessments to be corrected. The Commissioner refused to apply s 70A. The taxpayer appealed.

Held:

The interest was assessable.

(a) Accounts are not definitive, but they are important because they indicate what view was taken by the relevant parties at the relevant time.

(b) Although it was open to a taxpayer to claim that it had offered the interest to tax in error, the onus of proof upon it was a heavy one.

(c) Where accounts have been properly maintained according to sound commercial accounting principles, tax should be assessed on the profits shown in such accounts.

(d) It was permissible to rewrite accounts where they had been prepared otherwise than in accordance with sound commercial accounting principles. However, it was not permissible to rewrite accounts which had been properly drawn up at the relevant time merely because, with the benefit of hindsight, it was possible to say that particular items had turned out to be inaccurate, or should have been the subject of a provision, or should have been included in a suspense account. Where items are in doubt, their proper accounting treatment should be determined at the time the accounts are prepared by taking into account the facts known at that time.

(e) The accounts having been properly prepared, there was no ‘error or omission’ within the meaning of s 70A.

(f) Whether interest ‘accrues’ within the meaning of s 15(1)(f) depends in each case upon the facts. Profits which are merely anticipated cannot be taxed. Likewise, where no date had been fixed for payment of interest, it would not be unreasonable to carry the interest forward in a suspense account. In some cases, there might be an option whether interest should be treated as accrued for tax purposes in a particular year. In this case, however, the interest had accrued in the 1981 and 1982 tax years.

Appeal dismissed.

Cases referred to:

Dailuaine-Talisker Distilleries Ltd v CIR (1930) 15 TC 613

CIR v Gardner Mountain & D'Ambrumenil Ltd (1947) 29 TC 69
Lo and Lo v CIR (1984) 2 HKTC 34
Odeon Associated Theatres Ltd v Jones (1971) 48 TC 257
Symons v Lord Llewelyn-Davies' Personal Representative (1982) 56 TC 630
Wigmore v Thomas Summerson and Sons Ltd (1925) 9 TC 577
Willindale v International Commercial Bank Ltd (1978) 52 TC 242

Denis O'Dwyer for the Commissioner of Inland Revenue.
David Flux of Peat Marwick for the taxpayer.

Decision:

This appeal is brought by the Taxpayer which is a corporation against an assessment for the year 1982/83 which assessed certain interest to Profits Tax and also against the refusal by the Commissioner to re-open two previous Profits Tax assessments for the years 1980/81 and 1981/82 which likewise had assessed certain interest and which the Taxpayer had sought to re-open under section 70A of the Inland Revenue Ordinance.

As the relevant facts of this case are all important, it is appropriate to set them out as follows:

1. The Taxpayer was a joint venture company formed by two separate parties. The purpose for forming this joint venture company was to participate in a real estate venture in Hong Kong which involved a number of other third parties. To carry out the real estate venture, the Taxpayer together with the other third parties formed a joint venture company which we refer to as 'X Ltd'.

2. The real estate venture comprised acquiring and developing a piece of land by the construction of a large commercial building to be sold or leased upon completion.

3. It was agreed by the shareholders of X Ltd that, to save capital duty, to make it simpler to repay the moneys to the shareholders, and for other reasons, the share capital of X Ltd would be small and that the funds required for the real estate project which could not be commercially borrowed from third parties would be provided by the shareholders of X Ltd pro rata to the number of shares which each of them held in X Ltd.

4. A joint venture agreement dated 13 October 1980 was entered into between all of the various shareholders of X Ltd, which included the Taxpayer, and the relevant part of the clause of that joint venture agreement relating to finance read as follows:

'10. Finance and Bank Accounts

(a) All funds required by [X Ltd] for the purposes of payment of the purchase price for the Land and the development of the Land shall in the first instance be obtained from banking and/or other financial institutions in accordance with a mandate to be given to [ABC] a copy of which is attached hereto marked "A" or from other banks and financial institutions and should such funds be not available or inadequate all funds so required shall be contributed from time to time by each of the parties hereto in proportion to their respective shareholders in [X Ltd] and all or any surplus funds in the hands of [X Ltd] shall, save as otherwise provided herein, be refunded to the parties hereto in the same proportions.

(b) The amount of each contribution shall be determined by the directors of [X Ltd] from time to time and the amount so determined shall be advanced by each of the parties hereto to [X Ltd] within seven (7) days after the directors of [X Ltd] have passed a resolution to that effect unless the directors of [X Ltd] resolve otherwise.

(c) Unless otherwise determined by the directors of [X Ltd] and subject at all times to the obligations of [X Ltd] (if any) under any loan agreement or other contractual arrangement with third parties, each contribution shall be made by way of a loan to [X Ltd] at a rate or rates of interest as may be determined by the directors of [X Ltd] from time to time. Such loans and interest thereon shall not be repayable or paid by [X Ltd] and no demand for payment shall be effective unless approved by a resolution of the directors of [X Ltd].'

5. Pursuant to the joint venture agreement, the parties thereto entered into a loan agreement with X Ltd in the form of a letter to X Ltd which was stated to be made as of the same date namely 13 October 1980. The two relevant terms of that loan agreement read as follows:

' 2. Repayment:

Subject to the Subordination Agreement dated 13 October 1980, all amounts will be repayable by [X Ltd] upon the passing of an unanimous resolution by your board of directors.

3. Other Terms:

The loans shall bear interest at the rate of 5% per annum or such other rates as may be agreed from time to time in accordance with the terms of the shareholders' agreement. Such interest shall accrue from day to day with yearly rests and be payable on repayment of the loans in full. There will be no other interest, commitment, commission or other fees or expenses payable in relation to the loans and no security is to be given in relation to the loans.'

6. The directors of X Ltd passed the following resolutions dated 2 October 1980:

'That for the purpose of payment of [land premium and finance charges] shareholders' loans for the said amount be called from shareholders in proportion to their respective shareholdings …'

'That the interest for all shareholders' loans be fixed at 5% per annum.'

The directors of X Ltd passed the following resolution dated 1 December 1980:

'That the interest rate for all shareholders' loans be fixed at 7/8% per annum over the prime rate quoted by the Hongkong and Shanghai Banking Corporation from time to time to replace and supersede the rate of 5% per annum as previously resolved on 2 October 1980.'

7. By circular letter to shareholders dated 8 May 1981, X Ltd informed the Taxpayer as follows:

'We have prepared a revised Cash Flow Statement and the related Estimates for the captioned project and enclose herewith photocopy of same for your reference. In the meantime, we would like to advise that, according to the provisions of the letter of 13 October 1980, accrued interest on shareholders' loans will be compounded with yearly rests, and we have now fixed the date to be the first day of October for calculation purposes.

If your have any queries on the above matters, please do not hesitate to contact us.'

8. For some considerable period of time which has not been specified, the shareholders and directors of X Ltd and of the Taxpayer believed that the real estate project which was the reason for incorporating X Ltd would be a financial success. However, as a result of adverse market conditions which arose subsequently, there was doubt as to whether or not the real estate project would be financially successful and it was decided that further interest on the loans which had been made would be waived with effect from 1 January 1984 and no further interest would thereafter arise.

9. Subsequently, it transpired that the real estate project would not be financially successful and it was decided to write off and write back the interest which has been credited and provided in the accounts of the Taxpayer.

10. The Taxpayer's accounts were audited each year by a leading international firm of auditors and tax returns were filed with the Commissioner in which the Taxpayer offered for assessment the interest earned on the loans which it had made to X Ltd. The audited accounts of the Taxpayer showed that the major income for the Taxpayer was the interest earned on the money lent to X Ltd and the major expense of the Taxpayer was interest payable. The interest earned less the interest payable was brought to account in the books of the Taxpayer as profit. The audited profit and loss account appearing in the audited accounts for the year ended 31 December 1982 appeared as follows:

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 1982

(Expressed in Hong Kong Dollars)

	1982	1981
INCOME		
Interest	$38,5487,443	$31,333,019
Service fee	10,000	10,000
Turnover	$38,557,443	$31,343,019
EXPENSES		
Interest on borrowings repayable within five years	$33,416,807	$29,625,938
Salaries	30,000	30,000
Auditors' remuneration	10,000	12,000
Professional fees	2,870	10,570
Miscellaneous	245	375
	$33,459,922	$29,678,883
PROFIT BEFORE TAXATION	$ 5,097,521	$ 1,664,136
TAXATION (note 2 (a))	840,673	273,746
PROFIT AFTER TAXATION	$ 4,256,848	$ 1,391,390
RETAINED PROFITS AT 1 JANUARY 1982	1,768,167	376,777

RETAINED PROFITS AT 31 DECEMBER 1982	$ 6,025,015	$ 1,768,167

The auditor's certificate for the audited accounts for the year ended 31 December 1982 was unqualified.

11. The interest earned by the Taxpayer was not received by the Taxpayer and, after it had become apparent that X Ltd would be unable to pay either the interest or all of the principal due to its shareholders, it was decided to write back the interest in full and to write off part of the loan. This was done in the financial years ended 31 December 1983 to 31 December 1986. The audited profit and loss account for the financial year ended 31 December 1983 appeared as follows:

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 1983

(Expressed in Hong Kong Dollars)

	NOTE	1983	1982
INCOME			
Interest		$47,600,674	$38,547,443
Service fee		10,000	10,000
Turnover		$47,610,674	$38,557,443
EXPENSES			
Interest on borrowings repayable within five years		$51,393,685	$33,416,807
Salaries		30,000	30,000
Auditors' remuneration		12,000	10,000
Professional fees		40,850	2,870
Miscellaneous		375	245
		$51,476,915	$33,459,922
(LOSS)/PROFIT BEFORE TAXATION AND EXTRAORDINARY ITEM		$(3,866,241)	$5,097,521
TAXATION		-	840,673
		$(3,866,241)	$4,256,848

EXTRAORDINARY ITEM		
Provision against interest in associated company	(222,672,134)	-
(LOSS)/PROFIT AFTER TAXATION AND EXTRAORDINARY ITEM	$(226,538,375)	$4,256,848
RETAINED PROFITS AT 1 JANUARY	6,025,015	1,768,167
(LOSS)/RETAINED PROFITS AT 31 DECEMBER	$(220,513,360)	$6,025,015

A note to the audited balance sheet as at 31 December 1983 included the following statement:

> 'Repayment of the unsecured loan and interest will depend upon future rental income and property sales by [X Ltd].'

The audited profit and loss account for the financial year ended 31 December 1986 appeared as follows:

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 1986

INCORPORATING RESULTS OF ASSOCIATED COMPANY

(Expressed in Hong Kong Dollars)

	NOTE	1986	1985
TURNOVER – interest income and service fee		$ 52,413	$ 53,631
OPERATING (LOSS)/PROFIT		$(282,810,865)	$ 1,083
After charging: Auditors' remuneration		$ 22,000	$ 11,000

Provision against interest in associated company	$282,807,091	-
SHARE OF PROFIT OF ASSOCIATED COMPANY	$ 4,798,403	$ 4,578,562
(LOSS)/PROFIT BEFORE TAXATION	$(278,012,462)	$ 4,579,645
TAXATION	-	-
(LOSS)/PROFIT FOR THE YEAR	$(278,012,462)	$ 4,579,645
ADVERSE BALANCES BROUGHT FORWARD DEALT WITH BY		
Company	$(219,830,845)	($219,831,928)
Associated company	(10,374,789)	(14,953,351)
	$(230,205,634)	$(234,785,279)
ADVERSE BALANCES CARRIED FORWARD	$(508,218,096)	$(230,205,634)
ADVERSE BALANCES CARRIED FORWARD ARE DEALT WITH AS FOLLOWS:		
Company	$(502,641,710)	$(219,830,845)
Associated company	(5,576,386)	(10,374,789)
	$(508,218,096)	$(230,205,634)

Taxpayer's submission

At the hearing of the appeal, Mr David Flux appeared on behalf of the Taxpayer and one witness was called to give evidence for the Taxpayer. The witness was a director of the Taxpayer but not at the material times and his evidence can be said to have been of little assistance one way or the other. He said that it had been the intention that X Ltd would pay interest but it had not done so because it did not have the financial ability so to do. He said that X Ltd had been financed by way of shareholders' loans to avoid capital duties (stated to be stamp duty), so that the money could be returned to the shareholders more easily, and for other reasons. He confirmed that in his opinion, and in the opinion of the shareholder of the Taxpayer which he represented, the accounts as audited were true and correct and properly represented the affairs of the Taxpayer at the material times and at the present date.

Mr Flux submitted that no interest had accrued due within the meaning of the relevant provisions of the Inland Revenue Ordinance because there was a vital factor missing. Unless and until a resolution of X Ltd was passed to pay the interest, such interest did not accrue for tax purposes. Mr Flux openly admitted and accepted that interest had accrued for accounting purposes and maintained that the accounts of the Taxpayer had been properly prepared and presented because interest earned should be accrued due even though it might never become payable.

When asked to explain why the Taxpayer had filed tax returns offering for taxation the interest as it accrued due in the accounts if it had not accrued due for taxation purposes, Mr Flux explained that the reason was that the matter had previously been handled by the Taxpayer's auditors and not by its tax advisers.

The onus of proof in a case where a taxpayer, acting on advice of professional advisers, has offered interest for assessment to and has paid tax thereon and then submits that it has done in error is heavy. However, that does not mean that it is insuperable, but it does mean that the facts and the interpretation of the facts must be unequivocably in favour of the Taxpayer's case.

Mr Flux rightly submitted that this appeal depends entirely upon the meaning of the word 'accrued' appearing in section 15(1)(f) of the Inland Revenue Ordinance and this was likewise confirmed by Mr O'Dwyer representing the Commissioner.

Mr Flux argued that, on the authority of <u>Wigmore v Thomas Summerson and Sons Ltd</u> (1925) 9 TC 577, the interest had not accrued due to the Taxpayer from X Ltd because the Taxpayer could have sold the loan together with the interest thereon. The interest had never become payable under the terms of the joint venture agreement because the directors of X Ltd had not resolved to pay it.

Mr Flux said that it was right and proper to include provision for interest as it became due in the accounts of X Ltd even though it was not yet payable and likewise to make provision for interest owing. He said that this was in accordance with the good accountancy practice of being conservative, but the fact that provisions are included in accounts does not mean that the moneys provided are taxable. He referred the Board to

Dailuaine-Talisker Distilleries Ltd v IRC (1930) 15 TC 613 and Willingale v International Commercial Bank Ltd (1978) 52 TC 242.

Mr Flux summarized his client's case by saying that this was an unusual arrangement in which the loans were in effect equity. He said that the interest would not and could not become payable unless and until the Board of X Ltd resolved to make payment. He said that in such circumstances the interest could not accrue for tax purposes even though it was right and proper that the interest should be accrued for accounting purposes. He drew attention to what he considered to be a cardinal principle of taxation that income should never be subject to tax until it was realised and that the mere anticipation of interest in the early accounts did not mean that such interest was liable to tax if it was never received.

Revenue's submissions

Mr O'Dwyer for the Commissioner submitted that it was wrong to say the interest should only be brought to charge for tax purposes in a year when it is received or becomes receivable. He said that the word 'accrue' should be given its normal wide dictionary meaning and that accrue did not mean become payable. He said that normal accounting procedures and practices should be followed for taxation purposes. When something was accrued for accounting purposes, it should likewise accrue for taxation purposes. He drew our attention to the dictionary definition of the shorter Oxford dictionary and Kohler, A Dictionary for Accountants, 4th ed at page 15. He drew our attention to Halsbury's Laws of England 4th ed Vol 32 para 106 which says that the common law rule is that interest accrues from day to day even if it is only payable at intervals. He submitted that this common law rule should apply to taxation.

He also referred us to the Willingale case which drew a distinction between a discount which does not accrue from day to day and interest which does.

He drew to our attention the Hong Kong Society of Accountants' Professional Standards Statement and pointed out that the interest in question had been accrued in the Taxpayer's books and had been shown as accrued in the Taxpayer's audited financial statements. He pointed out that there is no authority to give the word 'accrue' anything other than its wide ordinary meaning and that to accept the submission of Mr Flux would mean that the word 'accrue' could have a wide meaning for general purposes and a narrow meaning for taxation purposes. He submitted that this would be incorrect.

He said that taxation should be assessed on the accounts of a company and that the accounts should be based on sound commercial accounting practices. He pointed out that there was no suggestion that the Taxpayer's accounts were not based on sound accounting principles and he cited to us the case of Odeon Associated Theatres Ltd v Jones (1971) 48 TC 257.

Mr O'Dwyer than referred us to the cases of Symons v Lord Llewelyn-Davies' Personal Representative (1982) 56 TC 630 and Lo and Lo v CIR (1984) 2 HKTC 34.

Mr O'Dwyer said that the existence of a legally enforceable right to payment is not necessary before an amount can be included in chargeable profits and cited the case of CIR v Gardner Mountain and D'Ambrumenil Ltd (1947) 29 TC 69.

He drew our attention to the fact that the directors of the Taxpayer in each year had set out the profits of the company in the audited accounts and the accounts had been certified by the auditors to give a true and fair view of the profits of the Taxpayer. He pointed out that, as the interest in question was virtually the only income of the Taxpayer, it could hardly be argued that the accountants and auditors had not given due consideration to the manner in which it had been treated in the accounts. He said that, in the absence of any statutory provisions to the contrary, the profits as shown in the accounts should not be adjusted for taxation purposes and that therefore the Commissioner's assessments were correct.

He pointed out that as a matter of fact the Taxpayer was now seeking to rewrite history and its accounts for the relevant years. He cited the case of Symons v Lord Llewelyn-Davies (above) to support this submission. He said that it would now be wrong to rewrite the accounts of the Taxpayer for taxation purposes.

Conclusion

This appeal depends entirely upon the view which is taken of the relevant facts. The two representatives for the respective parties ably argued their cases so that it is possible to focus on the main issues with precision.

We entirely agree with the proposition that facts are not changed by the accounting treatment of those facts and profits or losses are not created by accounting treatment. This has been clearly established and upheld in many decided cases. However, that does not mean to say that accounts can simply be ignored. Accounts are the method in which companies and businesses record their transactions and audited accounts are particularly important because they indicate the view which was taken by those concerned at the time regarding what had happened. The fact that a profit or a loss appears in accounts or audited statements does not mean that such profit or loss was in fact made or incurred. It does however indicate that those concerned at the time took a particular view with regard to the transaction.

In the present case, there is no allegation that the audited accounts were wrong and indeed no evidence was called before us to suggest that the audited accounts were wrong. The one witness who did appear before us confirmed that the audited accounts were correct. Likewise there was no suggestion that the audited accounts did anything other than correctly reflect the books of account of the Taxpayer and the transactions appearing therein.

The parties referred the Board to the relevant accountancy standards. Whilst figures which appear in accounts are finite and must balance with total precision, accountancy and the manner in which business transactions are reflected in the accounts of a business enterprise are not a matter of science but rather a matter of art. Many decisions are taken which are optional or discretionary. Perhaps the greatest area of optional decision-making is in deciding what profits or losses should be brought to account in any particular year. In this case we are dealing with interest, but the same principles apply to many transactions in diverse types of business. In the cases cited before us there is reference to discounting of bills, contracts for the sale and storage of whisky, fees and progress payments earned by professional partnerships and many others. At the end of any accounting period, the management of a business must sit down and decide what profits and losses should properly be brought to account during the accounting period in question. Indeed this is why professional accountancy bodies throughout the world have published accounting standards. For obvious reasons, business men are often optimistic and auditors tend to be more conservative. The directors of a company must carefully study the business which they conduct and decide what profits or losses should be brought to account in the period in question. Where there is any doubt, it is customary to make provision or to carry items in suspense accounts.

In many cases, courts have upheld the principle that, for taxation purposes, tax should be assessed on the profits of a business as they are reflected in accounts maintained according to sound commercial accounting principles. A good case in point is Simons v Lord Llewelyn-Davies (above). In that case the taxation authorities were seeking to rewrite the accounts of a partnership which had already been closed and agreed by the partners. Much reference is made in that case to 'hindsight'. Expert witnesses were called to give evidence on the accounts. The suggestion that the accounts should be rewritten was rejected. Warner J said at page 680 the following:

> ' Attractive though that argument is, I cannot accept it. Simpson v Jones was a case in which it became necessary to reopen accounts because a mistake had been made in them. A debt had been inadvertently left out. On the general principle that 'where facts are available they are to be preferred to prophecies', Megarry J held that the debt must be taken into the corrected accounts at the figure that subsequent events had proved it to amount to. The whole tenor of his judgement shows that his decision was inapplicable to a case where the accounts had been correctly drawn up in the first place – which, ex hypothesi for the purposes of the present point, Messrs Llewelyn-Davies's accounts were. It cannot, I think, be right that, where accounts of a trading or professional concern have been drawn up in the first place on what Pennycuick VC called 'the correct principles of commercial accountancy', the Inland Revenue should be entitled to treat them as still open for as long as it may take to ascertain whether subsequent events prove or disprove the accuracy of estimated items in them.'

The Odeon Associated Theatres case likewise upheld the same principle. Pennycuick VC said at page 273 the following:

> ' Mr Watson, who appeared for the Crown, contended that there is a third and distinct requirement, namely that the profit of the trade must be ascertained for the purpose of income tax. It was not clear to me (I do not suppose that is Mr Watson's fault) precisely what standard the Court should adopt, apart from that of the ordinary principles of commercial accountancy, in arriving at the profit of a trade for the purpose of income tax. Mr Watson used the word "logic'. If by that he intended no more than to say that one must apply the correct principles of commercial accountancy, I agree with that, as I will explain in a moment. I think, however, he intended to go beyond that and meant that the Court must ascertain the profit of a trade on some theoretical basis divorced from the principles of commercial accountancy. If that is what is intended, I am unable to accept the contention, which I believe to be entirely novel.
>
> I think that, in deference to the arguments of Mr Watson and also of Mr Medd and to the authorities which were cited, I ought to say a few words by way of explanation of the time-honoured expression "ordinary principles of commercial accountancy". The concern of the Court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the Court applies the correct principles of the prevailing system of commercial accountancy. I use the word "correct" deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the Court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the Court will agree with the accountants, but it will not necessarily do so. Again, there may be a divergency of view between the accountants, or there may be alternative principles, none of which can be said to be incorrect, or, of course, there may be no accountancy evidence at all. The cases illustrate these various points. At the end of the day the Court must determine what is the correct principle of commercial accountancy to be applied. Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation. The expression "ordinary principles of commercial accountancy" is, as I understand it, employed to denote what is involved in this composite process. Properly understood it presents no difficulty, and I would not be at all disposed to attempt any alternative label.'

It is quite clear from those cases and many others that taxable profits are to be decided according to ordinary accounting principles and that, where there is a dispute regarding such principles, it is appropriate for the court to arbitrate or decide. In the present case, there is no suggestion that the Taxpayer did not maintain its accounts according to anything other than sound commercial accounting principles. It brought to account in the financial years 1981 and 1982 substantial sums of interest as shown in its audited accounts (fact 10 above). There can be no doubt whatsoever about this. The accounts were unqualified and no provisions or contingency sums were provided. As at that date and dates prior thereto the Taxpayer had taken the view that it had earned the interest on the moneys which it had lent to its associated company. About this there can also be no doubt. Through the profit and loss account, net profits were calculated and retained profits were ascertained and carried forward. There is no ambiguity about the meaning of those accounts. It was suggested that the accounts might be wrong or that the audited accounts did not truthfully reflect the Taxpayer's own accounts. However, there was no evidence to support this and the one witness who appeared before us confirmed that the audited accounts were correct.

It can be argued that the directors and indeed the auditors of the Taxpayer should have been more cautious and should not have brought to account 100% of the interest earned, but that was a decision for the directors and their auditors at the relevant time with the facts then available to them. Knowing that the interest had not yet become payable they decided that it should nevertheless be brought to account as interest without any provision being made and indeed that tax should be paid thereon. With the benefit of hindsight this may not have been the best decision, but it is not for this Board of Review or indeed the Commissioner or the Taxpayer to attempt to rewrite accounts or change decisions taken in good faith at the time based on sound commercial principles.

By way of analogy we would like to refer to the case of a trader. If at the end of one year he sells and delivers an item but does not collect payment he will be left with an account receivable for book-keeping purposes. In such circumstances it would be open for the trader to bring the profit of that transaction into account in the year in which the item is sold and delivered or to carry the transaction in suspense because there is a doubt as to whether or not the moneys due will be paid by the purchaser. If the date for payment has not been fixed, it is a factor to be taken into account but it is not the only factor. In the present case we are dealing with interest but the accounting principles are similar. The Taxpayer has done everything which is required of the Taxpayer to earn the interest. The money has been delivered by way of loan to X Ltd and the interest rate has been determined. Assuming that the capital and interest is duly paid at some future date, the amount of the profit which the Taxpayer will make or has made is capable of precise calculation. In such circumstances, if the Taxpayer has no doubt that the moneys will in due course be paid we consider that it would be in accordance with good and sound commercial accounting practice for the Taxpayer to bring into account the profit in the form of the net interest earned. Alternatively if the Taxpayer were to feel that the interest or indeed repayment of the capital was in any way in jeopardy, then it would be open to the Taxpayer to either carry the interest in suspense or make a provision against it.

The Taxpayer acting either on professional advice or at least with the approval of its professional advisers decided to bring the net interest into account and show it as profit for the years in question. In such circumstances there can be no doubt that the Taxpayer at that date considered it had earned the interest and that the net amount of the interest could be shown as a profit and carried into its retained earnings.

With due respect we cannot agree with the submission made by Mr Flux that the interest was merely accrued in the accounts of the Taxpayer. Indeed the Taxpayer was so confident at that time with regard to the fact that it had earned the interest that it prepared its tax returns on that basis.

Section 70A

Section 70A of the Inland Revenue Ordinance refers to it being established that the tax charged for a previous year is excessive by reason of an error or omission in any return or statement submitted in respect thereof or by reason of any arithmetical error or omission in the calculation of the amount of the assessable income or profits or the amount of the tax charged. In the present appeal we cannot find any error or omission which would come within the meaning of this section. The Taxpayer acting in good faith and in accordance with sound accounting principles brought to account a profit. With the benefit of hindsight it may have been a mistake for the Taxpayer to have so done if the Taxpayer does not have future profits against which to offset future losses. Such a mistake does not fall within the ambit of section 70A.

Meaning of 'accrue'

In the course of the arguments before us much debate took place as to the meaning of the word 'accrue' appearing in section 15(1)(f) of the Ordinance. Having carefully studied the arguments submitted before us, we feel that it would be wrong to decide this case on the basis that the word 'accrue' has any special meaning either narrow or wide. We take the view that the word 'accrue' means interest earned which has been and should have been brought to account in the books of the Taxpayer for commercial reasons as opposed to tax reasons. It would in our opinion be wrong to make a hard and fast rule that all interest must have accrued for tax purposes regardless of whether or not it has been or is likely in the future to be paid. Likewise it would be wrong to adopt the rule that interest never accrues unless and until it is received or a fixed date for payment has been set. Each case must depend upon its own particular facts and the directors acting in conjunction with their professional accounting advisers must decide on the then facts whether or not sound commercial accounting principles permit or require the taking into account in any particular year interest earned. Where the interest has not been received it is appropriate to consider whether it will be received in the future and obviously the then financial ability of the debtor and the question whether or not a fixed date for payment has been set will be material factors. In normal cases, where no date has been fixed for payment, it would not be unreasonable to carry interest forward in suspense but this will depend upon the facts and the judgement of the company's directors and auditors.

Giving the word 'accrue' the meaning which we do is consistent with the same words, namely 'received by or accrued to', which appear in all of the eleven paragraphs of section 15(1).

In reaching our decision we have borne in mind the statement appearing in Simons v Lord Llewelyn-Davies (above) at page 682 as follows:

> ' It is undoubtedly a well-established principle of the law of income tax that neither profits nor losses must be anticipated. A profit and loss account should show only profits earned and ascertained during the accounting year and losses incurred during that year.'

That statement is clearly true and correct law. However, as stated above, there are many occasions when there is an option and the directors of a company can decide whether or not a profit has or has not been earned in any particular year. As we have said, accounting is an art and not a science.

The parties when appearing before us agreed that the three years in question should be decided on the same basis and accordingly we do not draw any distinctions between the two section 70A applications and the third assessment.

For the reasons given this appeal must be dismissed and the determination of the Commissioner upheld.