Talking Economics Monthly

AN ASSOCIATIVE PERSPECTIVE ON ECONOMIC LIFE

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Associative Economics is based on the idea that economic life is the shared responsibility of every human being.

Talking Economics makes this responsibility conscious and gives it practical effect.

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A TO Z OF ECONOMICS

Each month in this section a specific topic is chosen as part of a project to build a glossary about economic life from an associative point of view.

K : Kinetic Capital

When capital is lent the potential of the borrower comes into movement. He can take hold of his initiative because he has the wherewithal to finance its expression. In a healthy economy, potential capital becomes kinetic capital, which then, as profits arise, becomes manifest capital. But kinetic capital entails risk. It is thus the essential form of capital but the hardest to comprehend. Kinetic capital is active capital. It disappears into the means of production that it was used to finance. As such it is now in the hands, not of a lender, but of an entrepreneur, who uses it to bring into being values (ideas or goods) that did not exist before, but which become the economic ground of tomorrow. What lives in human beings as potential cannot enter economic life unless it passes through kinetic capital. Therefore, if we wish to avoid giving to capital only a material or class meaning we need to grasp the significance of kinetic capital and find ways to give it technical expression.

Asset-based Finance – a Capital Idea

Chris Cook

Chris Cook argues for 'Open Capital', which he describes as "partnership finance through the sharing of risk and reward; the risk is shared through a guarantee society or clearing union, where trade credit between buyers and sellers is subject to a mutual guarantee; the reward, in the form of revenues, are shared through co-ownership of a productive asset by the investors and investees." He shows how 'Open Capital' can find expression within the structure of a Limited Liability Partnership, thereby offering a hybrid form of community-enterprise financing, which brings the stakeholders into one partnership, their interests aligned. Such an arrangement allows for a real balance of roles among the partners, in which operational freedom, social responsibility and fairness of rewards can be realised. Moreover this can be regarded as a form of uncollateralised investment, in as much as the collateral for the investment is understood to be the future profitability of the venture (in which all partners have a stake) rather than the market value of an asset.

The world's markets in financial capital are built upon the 'Twin Peaks' of 'equity' and 'debt' – often also characterised as 'Investment' and 'Credit'. 'Asset-based' finance, by which I mean investment in an asset-owning legal entity, is fundamentally different from the familiar 'deficit-based' finance, meaning credit or 'time to pay' which arises in the context of a transaction between buyer and seller with delayed payment (ie 'trade credit'); or a loan created by a 'credit institution' such as a bank or building society. Where credit is secured by a claim over assets such as a mortgage, I refer to it as 'deficit-based' but 'asset-backed'. At this point it is worthy of note that 97% of the money in circulation in the UK consists of such credit which has been 'monetised', two thirds of which is based upon mortgage loans. That is, the UK monetary system is 'deficit-based', but for the most part 'asset (property)-backed'.

The pre-eminent mechanism for asset-based finance is the 'joint stock limited liability company' where investors in shares issued by the company have an absolute and permanent legal claim over the assets and revenues contained within its 'legal wrapper'. The flaws of this structure have been well documented and are essentially twofold. Firstly, a conflict of interest between the shareholders and all other stakeholders may arise, often described as the 'externalisation of costs'. We are all familiar with the rhetoric of 'shareholder value', 'cost-cutting' and of course 'corporate social responsibility' that flows from this. Secondly, there is the 'principal/agency' problem concerning the relationship between shareholder-owners and their agents, the directors and other managers who are often prone to favour their own interests at shareholders' expense.

In recent years we have seen the development of another type of legal 'wrapper' for assets based upon the law of 'trusts'. This body of law is not based upon statute but has developed over hundreds of years through decisions by judges. Essentially a 'trustee' owns the relevant assets and the revenues flowing from them on behalf of a 'beneficiary'. Through the concept of the 'unit trust' and the 'investment trust' investors have been able to invest in assets – typically bundles of investments in companies. More recently, we may observe in Canada – principally due to the existence of a favourable tax regime – the emergence of 'income trusts' or 'royalty trusts' typically invested in oil and gas utilities and providing a stream of revenues based upon oil and gas production. These income trusts are hugely successful, particularly as an asset class for long-term investment by pension funds. We also see in the hugely successful business model of the Australian Macquarie Bank the advantages of acquiring assets using deficit-based financing and then refinancing them using asset-based financing through investment trusts. Like companies, trusts also have flaws, being costly and complex to set up and to amend and also complex in terms of taxation. However, the principal problems are the management issues arising out of the restrictions of the trustee/beneficiary relationship and the conflicts of interest inherent in the use of external managers/advisers.

'Co-ownership' through 'Corporate Partnership' constitutes a new form of asset-based finance. It is based upon the utilisation of a new type of legal 'wrapper' based upon partnership principles.

CONTINUES OVERLEAF

EDITORIAL

Drawing attention to the significance of **uncollateralised investment** for new enterprise may not resonate with popular appeal, but , as the items in this month's issue show, it constitutes more than just a positive attitude to initiative; it is fundamentally distinctive as an approach, drawing out new qualities that belong to the future, much as asset-debt invokes the stagnancy of the past.

How is one to capitalise one's initiative without debt encumbrance, without asset collateral and without giving one's idea away? Chris Cook has a radical yet highly practical approach, which he describes as 'Open Capital', his article 'Asset-based Finance – a Capital Idea', gives some indication as to why this might constitute a paradigm-shift of Copernican proportion, opening the door to a future based on productive initiatives with social outcomes.

'The Uplifting Future' is the title of Christopher Houghton Budd's column, in which he explores why, far from being a mere technical detail, the capitalisation of initiative (rather than lending against assets) is key to creating an economic dynamic in which the alchemy of relationships works to the good.

Is it more productive to give or to invest? That depends, as Caroline Williams shows in 'Venturing Capital - The Line Between Philanthropy And Investment.' While in 'Individual Stockholder, R.I.P.', John Bogle outlines the consequences of handing on shareholding responsibility to financial agents.

The prospect of a common world language may be nearer than we think, that is if the process of creating universal accounting standards continues. Christopher Houghton Budd reports on the 2nd Annual Sir Thomas Gresham Docklands Lecture entitled 'The Future of International Financial Reporting' and D'Arcy MacKenzie uses Accountant's Corner to muse on the themes of complexity and simplicity.

CONTINUED FROM OVERLEAF

The first example of an 'Open Corporate' or 'Corporate Partnership' is the new UK Limited Liability Partnership (LLP) introduced on 6 April 2001. Despite the name an LLP (see end note) is not legally a partnership but like a company is in fact a corporate body with continuing legal existence independent of its members. Also like a limited company, an LLP has the benefit of limitation of liability, so that members cannot lose more than they invest. In taxation terms, an LLP is 'tax transparent" – in other words it is not taxed in its own right, but revenues pass straight through it to the members who are then taxed individually. Crucially, in an LLP it is possible for other stakeholders beyond the investors to be members. This quality of openness combined with infinite flexibility (since the LLP member agreement is not prescribed and need not even be in writing) may mean that an LLP is an optimal vehicle for investment allowing the problems of existing legal vehicles to be transcended.

This is acheived – notwithstanding Treasury-inspired restrictions upon 'Investment LLP's' generally and 'Property Investment LLP's' in particular – through a 'capital partnership' which has three or four members: a 'Trustee' member who owns the asset essentially as a custodian in accordance with Aims and Objectives expressed in the LLP agreement; an 'Investor' or 'Capital Provider' member who invests money or money's worth in assets into the partnership; an 'Occupier' or 'Capital User' member; and a 'Manager' member (optional).

The Capital User pays a 'capital rental' to the Investor and/or Manager consisting of a share in the revenues produced by the assets in question. This rental is not paid for a defined term but is paid for as long as the capital is used. Any rentals paid before the due date automatically become investment. The outcome of a 'Capital Partnership' is 'co-ownership' between the investor and the user of the investment. The asset itself need never be sold again – remaining in Trust – although the Investors, Investment Users and Managers (if any) may change in accordance with the LLP agreement. This essentially comprises an entirely new property right, since the property relationship between an investor and an asset is being encapsulated in a radically simple new way without the conflicts in existing property law between the absolute rights of an 'owner' and the temporary rights of a property user.

In terms of financial capital, we see a new 'open' form of 'capital' which is neither equity nor debt, as we know them, but something new and arguably optimal. Proportional shares ('n'ths') in such asset-owning LLP's constitute an entirely new asset class not dissimilar to units in a unit trust, but simpler, tax transparent, and arguably optimal in the way that stakeholders' interests are aligned. The possibilities of 'asset-based finance' as a technique are not limited to the private sector. There is no reason why public assets – such as new schools and hospitals – should not be financed by pension investors interested in a secure index-linked revenue stream using this technique. In fact, it brings in to question the 'Public Sector Borrowing Requirement' since demonstrably borrowing is not involved. In addition to pension funding, the asset class may also attract the huge amounts of petrodollars in the Middle East looking for Islamically-sound investment opportunities. In the housing sector we see the possibility of a new 'Fifth Option' – 'Co-ownership' by tenants in affordable/social housing financed by pension investment in property on land retained in trust for the community.

Note on Limited Liability Partnerships:

The 'Capital Partnership' – based upon a curious hybrid of a commercial company and a partnership, known as a Limited Liability Partnership (LLP), is fast emerging as a potential revolutionary new corporate vehicle. The LLP has two key attributes: firstly it is an 'open' corporate body (not legally a partnership as one would expect from the name) in which any stakeholder, whether or not he is an investor may become a member, thereby aligning his interests with other members. Secondly, the LLP makes it possible for those who invest money in an enterprise or in capital assets such as land to be members of a 'Capital Partnership' alongside the users of the capital, thereby replacing the usual adversarial contracts between those who finance an enterprise or asset and those who utilise it. In essence, all these stakeholders are brought inside the partnership, so their interests are aligned; it's quite a change from traditional structures, which pit stakeholders in competition against each other. The LLP delivers an ideal combination of the collective and the individual; it's flexible and easy to establish while its partnership characteristics are robust enough to make it attractive to the private sector.

Another interesting consequence of this model is of a new form of tenure – ie a right to occupy the property indefinitely for as long as one pays the 'rental'. Once within a 'Community Land Partnership', there is no need ever to sell the land again although the 'owner'/ financier may change, and the occupier/capital user may change.

*The View from Rare Albion**

A column by Christopher Houghton Budd

The Uplifting Future

It is an older understanding of economic life that always seeks to collateralise lending, to lend money against an asset that can be acquired if the money itself does not come back. This form of lending means the money does not go 'into' the activity of the borrower, but sits alongside it. It also means the lender does not trust to the initiative, skills or talents of the borrower. Nor does he, the lender, take a risk. Such lending is understandable if the lender simply cannot afford to lose his money but is nevertheless willing to let someone else use it. But in its effects it can be stultifying. By the alchemy of relationships it can lame the borrower and it can deny the moment of chaos that risk entails, the moment when the past relinquishes itself in favour of the future so that something new can come into being.

In contrast, uncollateralized investment – lending to an individual on account of the new values (the 'income stream') he will engender – can have quite the opposite effect. The borrower is able to stand within the domain of risk, there to perceive the new idea or product that will become tomorrow's capital. The investment goes into the activity to lose itself in what is coming from the future. We need to think less in terms of preserving capital and more in terms of passing it on. Less about hoarding it, more about consciously participating in its circulation. To let go collateral it is necessary to understand and to embrace the circulation of capital. Then to seek ways to give this technical expression.

Overcoming our reliance on collateralised lending need not face us with an impossible challenge. Every time money is put in a bank, for example, it is lent without collateral. We rely not on the bank's physical assets but on the circulation of money in the economy and the advancement of credit. We talk as if money is lent, retained in a drawer, then returned intact to the lender. While this may approximate the world of entitlements, it does not represent economic reality. Money lent is put to use and is in fact used up, becoming, for example, a tractor or building. By using these means of production entrepreneurs create fresh capital out of which entitlements to lenders are honoured. But never does the original capital return whence it came.

Modern finance and the process of credit creation are self-supporting phenomena. Only we do not see this so we do not believe in it, even though we all the time behave as if we did! To move from hoarding to circulation, therefore, we need to recognise that all economic life is born of the unfolding human being, of what we bring to bear on life, not on what we already find there. In its essence, we uplift our economic life making of it a buoyant affair that derives from what we do tomorrow; not a burdensome matter based on our past actions.

Islamic economics knows the 'secret' of uncollateralised lending because there the investor participates in profits paid after they have been made and after they can be released as cash from the business; not interest paid before profits have arisen and thus oftentimes instead of their creation. The investor also takes the risk, not the entrepreneur. Share capital is a 'western' equivalent provided the investment is not always seeking to extricate itself, wanting to become liquid at a moment's notice. Whereas, under Islamic economics, this practice is required by shari'a law, the challenge to the West is to achieve the same result out of our own free will. But the reason is the same: to take to oneself values that belong to humanity as a whole is both anti-social and anti-economic. It results in the return to capital taking precedence over all else, so that the costs of economic life press unfairly down on labour and the environment, but not on capital.

* The column takes its name from a book by the same name in which the human being learns to take the point of view of humanity as a whole: *Rare Albion – The Further Adventures of a Wizard from Oz, A Monetary Allegory*. Christopher Houghton Budd, New Economy Publications, Canterbury, 2005, available from cfae.biz/publications.

SIGNS OF THE TIMES

6 October, Chatham House, London, home of the Royal Institute of International Affairs, was the venue for deliberations on **the future of the corporation**. Attended by a wide spectrum of participants from the deeply corporate to the overtly anti-capitalist, the gathering amounted to an impressive combination of expertise, experience and professionalism. Whether from government, academia, business, unions or the NGO community, all speakers contributed to a rigorous debate that provided an in-depth survey of the state of the art concerning corporate responsibility.

Looking into the future and the past, the discussion gave the question of the future of the corporation a refreshingly insightful rather than wearyingly polemical context. Various models were considered in relation to six principles of corporate redesign being proposed by an American activist group aiming to give companies a sustainable social purpose. The principles included concerns such as: harnessing private interests in service to the public interest; meeting the needs of the present generation without compromising the ability of future generations to meet theirs; and being governed in a manner that is transparent, ethical, and accountable.

Particularly instructive were the comments of a London think-tank representative – whose subtler interpretation of the corporation contrasted markedly with the strident attitude of the director of a major American transnational. The meeting culminated in a significant question: Because it has one legislative area, rather than a conglomeration as in Europe or 50 states as in the US, is the effective lead in transforming the corporation likely to come more from Britain than Continental Europe or the USA? The language used here is telling, of course. As to the answer, the jury will be out for some time.

FEATURE

Venturing Capital - the Line between Philanthropy and Investment

Caroline Williams

There is increasing talk of a blurring of the boundary between the non-profit and for-profit sectors, of a continuum from philanthropy to investment and of a middle ground where trade-offs are readily made between financial return and social benefit. However, that has not been the historic norm. There have been, and remain, some major dividing lines. Philanthropy can be characterized as the process of distributing excess income through contributions to charitable causes. The question is whether the investment function and the charitable functions need to be kept separate. Alternatively, should the investor, individual or foundation, consider some investments that may have lower targeted financial returns, but significant social benefit or charitable purposes?

The usual model is to keep the investment and charitable contribution functions separate on the premise that the better the financial return on the investment portfolio, the more excess income there will be for distribution to charitable purposes. I would argue that other models are acceptable under certain circumstances. However, it is not a simple blending of the functions. Rather, it requires an understanding and respect for several interrelated factors: fiduciary responsibility, regulation and tax considerations.

Venture Capital vs. Venture Philanthropy

Venture philanthropy is generally considered the application of businesslike approaches to making contributions to non-profit organizations. It borrows its vocabulary from venture capital and some of the analogies are valid. The growth of any initiative or enterprise, for-profit or non-profit, usually depends on financial capital raised from outsiders. Venture, an undertaking that involves chance, risk or danger, can apply to either sector; we know from experience that most new businesses and non-profits struggle and many ultimately fail.

Venture capitalists are financial investors who are in it for the money. They take big risks in exchange for the prospect of big financial returns. Because the success rates for new businesses are low, venture capitalists usually invest in several companies in order to diversify their risk. If problems arise, the venture capitalist may take an active (occasionally ruthless) role in management. Investments that don't work are sold or liquidated. After the successes are offset by the failures, the venture capitalist might expect to earn an average of 25-40% or more.

Venture capital and venture philanthropy are, in fact, very different. There may be similarities in analytic approach, but the objectives are different. Wealthy individuals who have made significant money through venture capital may well be interested in turning their attention to philanthropy. However, that is not a basis for assuming that they will change their investment objectives and start to blend the two activities into one.

Socially Responsible Investing

Socially responsible investing can be categorized across a spectrum from full commercial return to little, if any, commercial return. At one end is the practice of screening socially negative investments out of an investment portfolio. This segment has been growing rapidly as investors have realized competitive returns.

At the other end of the spectrum is the practice of making investments where financial return is not a primary purpose, but rather social benefit is. Fiduciary responsibility prohibits professional investment managers, i.e., managers of mutual funds, endowments, pension funds, etc. from even considering this type of investment. Individuals can make these types of investments, but tax consideration will usually argue against their doing so. An intermediate category would be investments that are structured to offer a combination of financial (internal) rate of return (IRR) plus social (external) rate of return (ERR). Some socially responsible investments may offer a full IRR while others may offer a somewhat lower, but still reasonable, IRR. The first may be hard to find, but are easy to evaluate; full IRR plus some ERR equals more than just IRR. Those that involve some trade-off, a somewhat lower IRR but clear ERR, may be easier to find in the venture capital market, but are harder to evaluate.

Making venture capital investments that are not expected to generate a full financial return is mostly the arena of individual investors. When doing so they are often called angel investors because they 'save the day' for struggling young companies and entrepreneurs. This type of trade-off investing can be treacherous ground for foundations, though, because such investments do not fall cleanly within either the investment or program areas. However, properly managed, they represent an attractive opportunity for the investment of excess income, particularly as foundations are under pressure to increase their payout ratios.

For the individual investor as philanthropist the two functions, investment and contributions, need not be separate. Presumably, the individual investor has already made the determination that he has, or expects to have, excess income that he will use for charitable purposes. This excess income is above some base level of income the individual retains for his own use. If this excess income is to be donated for charitable purpose, in theory it makes no difference to the individual investor whether he actually receives the excess income and then redistributes it or provides the charitable support directly through a lower IRR from a socially responsible investment. The individual's resulting net investment income seems to be the same.

There are two problems here. First, this requires some implicit calculation of the trade-off between IRR and ERR. However, it is difficult to factor cleaner air, better schools and a lower poverty rate into the calculus of risk and return. Secondly, in this so-called middle ground of trade-off between financial and social benefit there is a very definite dividing line: the tax deduction.

An investment that produces little or no financial return is no longer a good investment; it's a bad deal. Only if the company is

liquidated or sold for next to nothing will the investor will be able to write-off the full investment. The resulting tax deduction will be a capital loss, which generally will not be as valuable as a deduction against ordinary income. However, bad deals often remain among the living deal, surviving, but with little or no return and no ability for the investor to take a tax deduction. Charitable donors, including venture philanthropists, like to think they are 'investing' in good causes, but their expectations are very different from those of financial investors. They do have an important financial expectation, not of an investment return, but of a tax deduction, and one against ordinary income. Used appropriately, the tax deduction can yield very favourable financial results.

Trade-Off Investments

Investments that involve some trade-off between IRR and ERR should be acceptable under fiduciary responsibility considerations if the trade-off is not substantial. For these types of investments, though, the issues may be regulatory and operational. Generally speaking, foundations in the US are required to make annual charitable distributions in an amount equal to 5% or more of the investment portfolio. This has significant implications when considering trade-off investments. If the foundation's investment income available for grants is normally at the 5% level, it would be penalized for accepting a somewhat lower IRR from investing in a project that has a significant ERR.

While this may sound like an argument for foundations forgetting about pursuing investment opportunities that may have significant social benefit, it is not. Rather, it is meant to make the case for making socially beneficial, trade-off investments outside the normal investment evaluation process, for making them in the same manner as Programme Related Investments (PRIs). This would mean removing the funds for trade-off investments from the investment pool and moving them to program. Technically, they will then need to meet PRI criteria. This may require some pushing the envelope on PRI practices, but some of the lawyers with particular expertise in this area believe there is significant room to do so. Within the foundation a transition period may be needed. It will take time to gear up this new program investment activity. In addition, changes may be needed in compensation formulae for the investment staff so as not to penalize them for a reduced amount of investment funds under their oversight or, if they remain involved in the investment decision process for these trade-off funds, planned lower returns.

Conclusion

With the increasing talk of venture philanthropy and socially responsible investing some are assuming that there may be a merging of investing and philanthropy, a so-called middle ground. In this new calculus investors might value social benefit as well as financial return and be willing to accept a blended return on investments comprised of a low financial return (IRR) and a significant social benefit (ERR).

The implications of this for arts and culture organizations, actually all non-profit organizations, would be substantial. Many organizations are now looking to create earned income ventures. Such enterprises may generate substantial earned income for the sponsoring non-profit organizations, but insufficient financial returns to attract commercial investors. If less expensive capital from PRIs and trade-off investments could be attracted to such ventures, the result would be increased financial resources and, therefore, increased financial stability for the sponsoring not-for-profit organizations.

The working assumption has been that the source of such middle ground capital will be wealthy individuals. While there undoubtedly will be instances of such middle ground investment, it is unlikely to become a major factor. What has been ignored is the importance of the tax deduction, a very real consideration for wealthy individuals as they make investment and philanthropic decisions. This is likely to remain a major dividing line between their investment and philanthropy.

Increased use of PRIs and trade-off investments by foundations would increase the capital available to enterprises that may be created by cultural and other non-profit organizations. It would also increase capital efficiency within the non-profit sector. Unlike grants, investment instruments that are repaid, and possibly with an investment return, are available for reinvestment.

To IRR is human, to ERR divine...

...according to Investors Circle, a US network of early-stage private equity investors who seek financial, social and environmental returns on their investments. In distinguishing between IRR (an Internal or Financial Rate of Return) and ERR (an External or Socio-Environmental Rate of Return, which is normally treated as a bottom line cost), they seek to 'to galvanize the flow of capital to entrepreneurial companies that enhance bioregional, cultural and economic health and diversity' and acknowledge that responsibility as investors does not end with maximizing return and minimizing risk. Their byline, *patient capital for a sustainable future*, would seem to encapsulate this approach. Indeed since 1992, they have facilitated the flow of over $100 million into 163 companies and small funds. Their network is comprised of angel investors, professional venture capitalists, foundations, family offices and others who are using private capital to promote the transition to a sustainable economy.

If this sounds encouraging, the entrepreneur should remember that, whether from an angel or an angler, this is still venture capital. The criteria that IC publish indicate they do not see small as beautiful; 'we do not consider individuals or technologies, only fully formed companies. Companies that do not expect to generate revenues of at least $5 million within the next 5 years will not be accepted. We will consider a submission from a company that sells organic coffee to retailers across the country but not from a company that is launching a single, local, organic coffee shop.' Even where one might feel most hopeful of finding it, the idea of providing uncollateralised capital for embryonic individual initiative is still hardly seen as a fundamental aim.

- Ed.

COMMENT

Individual Stockholder, R.I.P.

John C. Bogle

Is the shift in ownership from individual to financial institutions an abdication of responsibility, if those agents, by failing to exercise the responsibilities of corporate citizenship, have proved unfit for their purpose? Must an enforced public policy put the beneficiaries in the driver's seat?

The amazing disappearance of the individual stockholder as the backbone of the U.S. stock market has been one of the least recognized but most profound trends of the last half-century. Direct ownership of stocks by American households has declined from 91% in 1950 to just 32% today. In the same time, financial institutions have increased their stake from 9% to 68%. Of course, individual investors remain major participants in the stock market, but now do so largely through mutual funds and public and private pension plans. But such participation lacks the traditional attributes of ownership such as selection of individual stocks and engagement in the process of corporate governance. But aren't our financial institutions owners of stocks? Not really. They are owners in name, agents in fact, with a duty to act on behalf of their principals, including our mutual fund owners and beneficiaries of our retirement plans. Today's agency-dominated investment society is overwhelmingly composed of those two groups of underlying owners.

Institutional investing is now largely the business of giants. America's 100 largest money managers alone now hold 58% of all stocks. Too many of our financial agents have their own interests to serve, often conflicting with the interests of their investor-principals. Corporate pension plans, for example, are controlled by the same executives whose compensation is based on the earnings they report to shareholders. Similarly, mutual fund managers are compensated by separate corporations seeking to maximize the return on their own capital, in direct conflict with their duty to maximize the returns on the capital entrusted to them by their fund shareholders. The excessive advisory fees, expenses, hefty sales loads, and huge commissions on portfolio transactions paid to brokers in return for their sales support consumed something like 45% of the real returns earned on fund portfolios during the past two decades. Unlike their predecessors in the '50s and '60s, financial institutions focus on investment strategies that emphasize short-term speculation in evanescent stock prices, rather than traditional long-term investing based on durable intrinsic corporate values. From 1950 to 1965, equity mutual funds turned over their portfolios at an average rate of 17% per year; in 1990-2005, the turnover rate averaged 91% per year. The old own-a-stock industry could hardly afford to take for granted effective corporate governance in the interest of shareholders; the new rent-a-stock industry has little reason to care.

The problems created by this new and conflicted world of financial intermediation are hardly trivial. Excessive return projections for pension plans have played a major role in creating the current shortfall of $600 billion in private pension plan liabilities relative to plan assets. Individual retirement savings are also at dangerously low levels. With today's agency society arrogating to itself far too large a share of market returns, the outlook for future individual retirement savings is dire. A citizen entering the work force today has an investment horizon of at least 60 years. If the stock market were to earn an average nominal return of 8% per year, $1,000 invested today would then be worth $101,000. But if our financial system consumes 2.5 percentage points annually of that total return (a conservative estimate of today's reality) that $1,000, growing now at 5.5% net, would be worth just $25,000, a minuscule 25% of the accumulation that could have been obtained simply by owning the stock market itself.

The serious shortfalls in retirement reserves that represent the backbone of the nation's savings have arisen importantly because our manager-agents have placed their own interests ahead of the interests of the investor-principals they are duty-bound to serve. Our financial institutions have failed to exercise the rights and responsibilities of corporate citizenship; to adequately fund pension reserves; and to deliver to fund shareholders their fair share of the returns generated by the financial markets themselves. Why? Largely because the radical change from an ownership society dominated by individual investors to an intermediation society dominated by professional money managers and corporations has not been accompanied by the development of an ethical, regulatory and legal environment that requires trustees and fiduciaries, as agents, to act solely and exclusively in the interests of their principals. The overarching need is for a clearly enforced public policy that honours the interests of our citizen-investors and puts them in the driver's seat where they belong.

DIARY

The Metamorphosis of Capitalism
An introductory course in associative economics
Fridays, 2 - 5 pm, booking only
Venue and dates below

3x3x3
An opportunity to study
Rudolf Steiner's *Economics Course*
Come occasionally or sign for the whole course
Fridays, 7.15 - 9.15 pm
Venue and dates below

Rudolf Steiner House, London
14 Oct, 4 Nov, 2 Dec 2005
20 Jan, 17 Feb, 10 Mar 2006
28 Apr, 19 May, 9 Jun 2006

Talking Economics Evenings
Star Anise Arts Café, Stroud, UK (£3.50)
Mon 31 Oct, 7- 9 pm
Competition and Economic Individualism
Mon 21 Nov, 7- 9 pm
Globalisation - Humanity at a Threshold
Mon 12 Dec, 7- 9 pm
Gold and Beyond - What Underpins Money?

For details of all above events:
info@talkingeconomics.com
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Caroline Williams worked for 20 years in investment banking before joining the Nathan Cummings Foundation in USA.
John C.Bogle is founder of the Vanguard Group and author of 'Battle for The Soul of Capitalism.'
D'Arcy MacKenzie works as an accountant in Canada.

REPORT

The Future of International Financial Reporting

Report by CHB of 2nd Annual Sir Thomas Gresham Docklands Lecture organised by Gresham College, London, on 27 September 2005, given by Sir David Tweedie, chairman of International Accounting Standards Board (IASB).

With the droll humour and no nonsense delivery of a Scot, Sir David Tweedie outlined the aims and expectations of the work being undertaken to converge different approaches to accounting standards into one worldwide international standard. After many years work, there is now an international standard leading the way, which is in effect the British standard developed and then adopted by the European Union as of 1 January 2005. This is concentrating minds and requiring the next step to be a coalescence between the, essentially British, approach that prefers principles to over-complicated rules and the American preference for a rule-based approach. The former puts a premium on judgement and entails less bureaucracy.

The need for harmonised standards is obvious. To further international trade, to facilitate worldwide investing and the flow of capital by way of a single method for understanding accounts. But it would seem that many have much to lose from the transparency and 'let's call a spade a spade' approach of Sir David and his colleagues. In particular, resistance is coming from those, for example in California, in high tech industries or companies which have substantial unrecorded pensions liabilities, such as General Motors, or those that provide generous share options to their top directors. For such companies, a 'tidying up' of current accounting practices would entail a substantial marking down of their share value, because many things lost onto balance sheets, such as leases, would come onto the profit and loss statement. For Sir David, a payment represents either an expense or an asset, but there can be no 'whatsits'. As his slide put it: Dr = Asset or Expense.

The framework for accounting standards included five main considerations: quality reporting, clear definitions of assets and liabilities, especially that a liability is an obligation one cannot escape. And clear recognition of the true nature of transactions, their measurement and the manner of their presentation.

Streamlining the world's accounting systems into one would also require a greater distinction between short and long-term economics. Not, for example, 'marking to market' an asset that is part of a long-term pension provision. Clearer accounting entails clearer representation of economic reality, a welcome salutary effect, but one that would cut across inflated or false valuations. The convenience of a discrepancy between the two is less and less possible, if for no other reason than the globalisation of trade and finance requires it.

A measured timetable has been established within which the IASB set of standards, a core of 17, and the US standards will be brought into mutual alignment. Some changes will be agreed in order to simply to get on with the job; other things will be changed because they are clearly not working or realistic. Inter alia, the range of changes embraces business combinations, consolidations, financial statements, fair value measurement, revenue recognition, liability definitions, performance reporting and the treatment of pension funds, nearly all of them great opportunities for 'creative' accounting.

Quite apart from the need to create a level playing field and to root out corruption, a main effect of the standardisation of accounting will be the improvement to management that will result, in that such things as pension funds will have to be properly taken into account.

From an associative point of view, the adoption of a universal set of accounting standards is equivalent to devising a worldwide language. This can only be a good thing. But it will take time because by implication businesses or organisations that do not account for themselves in accordance with the economic realities in which they operate will have to adjust their behaviour. As will the investors and other stakeholders whose interests such institutions represent! This will not be an easy journey because much of modern economic life, especially in its financial aspect, is heavily reliant on the kind of accounting 'creativity' that one worldwide set of accounting standards would render impossible.

ACCOUNTANT'S CORNER

Accounting seems simple enough, as the phrase 'Debit = asset or expense'" indicates. Debits can be thought of as ***use*** of cash – we buy something and call it an asset if there is ongoing value (a building) or an expense if it is used up at once (lunch). Conversely, 'Credit = liability or revenue.' Credits are a ***source*** of cash – we borrow money and call it a liability or we receive money for service and call it revenue.

Accounting uses a concept of matching in determining the categorization of an item. A school treats tuition received as a liability until it delivers the service – the teaching – whereupon it becomes revenue. The revenue is matched with the service provided.

More complicatedly, the calculation of a pension liability, which does not arise out of current cash transactions but out of a promise to make future payments, involves both agreement on standards (methods and assumptions) and actuarial expertise. Consider also stock options whereby company executives are given the right to buy shares at below market prices. They benefit from a discount, but where is the corresponding cost to the company? There is no ***use*** of cash, and for a long time, no expense recorded, such as salary or bonus. However there is a cost to existing shareholders as their share of company profits is diminished by the exercise of such options.

These examples show how accounting, though simple in essence, becomes complex and thereby calls for clear and agreed standards.

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AIR MAIL

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