

## The Global Financial Crisis Result of an Accounting Perversion?

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*Commercial banks create the nation's money supply by double-entry bookkeeping out of nothing. A nothing fails the accounting test for an asset and may not be recognized, measured and reported. The nation's circulating medium, write John Maynard Keynes and Irving Fisher, ought to be more concrete. The Bank of England Act of 1844 mandated that money must be legal tender or high-powered central bank money. The English banks circumvented the mandate by inventing the chequing system to perfection. The author offers a solution supported by Fisher's 100% Money model to keep banks liquid at all times and, in the course of the conversion, pay off the twelve trillion dollar national debt.*

The liquidity crisis of 2007 that grew into the global financial crisis may well be the result of an accounting perversion that crept into generally accepted accounting standards in order to circumvent the Bank Charter Act of 1844<sup>1</sup>, sanctifying the accounting construct that allows banks to create deposits out of nothing by simply debiting customers' loans or notes receivable, and crediting customers' demand deposits.

The Bank Charter Act prohibited any bank other than the Bank of England to create its own notes to circulate as money. The proper principles of currency issue are two – “first, that the function of note issue should be entirely separated from banking; and second, that the ‘amount issued on government securities should be maintained at a fixed sum within the limit of the smallest amount which experience has proved to be necessary for the monetary transactions of the country, and that any further amount of notes should be issued on coin or [gold] bullion.”<sup>2</sup> “In England, of course, bankers immediately set themselves to recover the economy and elasticity which the Act of 1844 banished from the English system by other means; and with the development of the cheque [or payment clearing – Author] system to its present state of perfection they magnificently succeeded.”<sup>3</sup>

The creation of money by banks is sanctified by §305-10-20 of the Financial Accounting Standards Board's “Accounting Standards Codification” – *Cash and Cash Equivalents* – that became effective July 1, 2009:

### Cash

Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, **a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.** [Emphasis added]

The Federal Reserve's reports prove the point that more than eighty percent of the United States' money supply is created by banks – out of nothing!

The Federal Reserve Board reports *Assets and Liabilities of Commercial Banks in the United States - H.8* monthly, eg, for October 2, 2009 – excerpt condensed:<sup>4</sup>

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<sup>1</sup> BANK CHARTER ACT 1844. (7 & 8 Vict. c. 32).

<sup>2</sup> Keynes, J. M. (1913). “Indian Currency and Finance.” *Paper Currency*. London: Macmillan, p. 39 Fn. 1 quotef from the Secretary of State's despatch (Sir Charles Wood, March 26, 1860).

<sup>3</sup> Keynes, *supra*, p. 39

<sup>4</sup> At <http://www.federalreserve.gov/releases/h8/current/default.htm>

<u>Assets</u>	US\$ billion	<u>Liabilities</u>	US\$ billion
Cash assets	318		
<b>Loans and leases in bank credit</b>	<b>6,974</b>	<b>Deposits</b>	<b>6,915</b>
Securities in bank credit	2,041	Borrowings	2,266
Interbank loans and 'other assets' <sup>5</sup>	1,727	Trading and other liabilities	1,030
		Residual	1,122
<b>Total Assets</b>	<b>11,059</b>	<b>Total Liabilities</b>	<b>11,059</b>

The Federal Reserve's August 2009 report of the nation's money supply<sup>6</sup> – excerpt analysis in US\$ billions:

	M1	M2
	Mainly currency in circulation plus demand deposits at commercial banks and thrifts	M1 plus mainly savings & time deposits & money funds
Currency in circulation	<b>858</b>	<b>858</b>
Demand deposits commercial & thrifts	789	789
Savings & time deposits & money funds	<u>0</u>	<u>6,644</u>
Bank book money, estimated	<b>789</b>	<b>7,433</b>
Money supply reported <sup>7</sup>	<b>1,647</b>	<b>8,291</b>

The statistical difference in the analysis of \$518 billion or 7% does not take away from the finding that between 83% and 90% of the U.S. money supply is bank created book money and not legal tender. Bank book money is an accounting construct. The bookkeeping entrees are debits to customer loans receivable, and credits to customer deposits, eg, demand deposits that eventually after changing hands become savings deposits that may also be checkable.

The point that turns the issue:

Is bank book money created out of nothing an asset that may be recognized, measured and reported in the banks' financial statement? Or is it a perversion? And if the money so created is a perversion, are the resulting deposits a nullity that ought to be replaced by something more concrete such as high-powered federal funds?

### Definition of an asset

The FASB's Conceptual Framework Board concludes:

<sup>5</sup> All other amounts. See H.8 Fn. 17 ... Includes other real estate owned, premises and fixed assets, investments in unconsolidated subsidiaries, intangible assets (including goodwill), direct and indirect investments in real estate ventures, accounts receivable, and other assets.

<sup>6</sup> Federal Reserve H.6 Statistical Release "Money Stock Measures" released October 1, 2009

<sup>7</sup> Adjusted for statistical differences

“An asset is a present resource to which, through an enforceable right or other means, the entity has access or can limit the access of others.”<sup>8</sup>

The key amplifying text states, among others:

“An economic resource is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources.

The concept visualizes the process of production or commerce rather than financial intermediation. The father of accounting, Luca Pacioli (1445-1517), in presenting his double-entry bookkeeping system<sup>9</sup> made no distinction between commercial, industrial or any other entity. At this point in time, the FASB and the IASB do not appear to make a distinction, either, unless one is construed later.

A debit to the customer’s loans receivable and a simultaneous credit to the customer’s deposit account is not “production” resulting from production except self-construction, in which case it still could not be recognized because it has no cost basis, unless the FASB and the IASB construed such one, which would be most interesting to observe.

On the question of “scarcity” double-entry bookkeeping would hardly qualify, because it can be performed by modern computers at the speed of Gigabytes per second for virtually infinite numbers of transaction. For example, a bank with a data bank of all Social Security Numbers could credit each of the tax accounts at the Internal Revenue Service with loan amount proceeds in seconds. The time to set up and process the documentation is another question but does not make the money creation through double entry bookkeeping scarce.

The joint IASB/FASB Conceptual Framework project reports:

“An asset is a present economic resource to which the entity has a present right or other privileged access.”<sup>10</sup>

The key word appears to be “economic resource” which is further delineated to “include contractual promises... including those to pay cash, deliver goods, or render services ...

The definition is further reduced to the requirement:

“As long as there is some capability of producing net cash inflows or reducing net cash outflows, there is an economic resource.”

According APB Statement No. 4:

“Assets are economic resources of an enterprise that are recognized and measured in conformity with

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<sup>8</sup> FASB Conceptual Framework Board, Minutes of the meeting, October 22, 2007 at [http://www.fasb.org/board\\_meeting\\_minutes/10-22-07\\_cf.pdf](http://www.fasb.org/board_meeting_minutes/10-22-07_cf.pdf) visited 2009-10-05

<sup>9</sup> Pacioli, L. (1494) “Summa de arithmetica, geometria, proportioni et proportionalita.” Venice

<sup>10</sup> (a) An *economic resource* is something that has a net positive economic value because it is capable of being used (either alone or together with other economic resources) for carrying out activities such as production and exchange and, thus, producing net cash inflows or reducing net cash outflows (either directly or indirectly) without imposing a corresponding claim against the entity. Economic resources include contractual promises (other than those that are conditional) from others to the entity. Such promises include those to pay cash, deliver goods, or render services (rendering services includes standing-ready to perform and refraining from undertaking an activity that the promisor could otherwise undertake). As long as there is some capability of producing net cash inflows or reducing net cash outflows, there is an economic resource.

(b) A *right or other privileged access* enables the entity to use the economic resource (either directly or indirectly) and to deny or limit use of it by others. *Rights* are a type of privileged access that comprise contractual rights and other rights that are legally enforceable or enforceable by equivalent means (such as by a professional association). Other privileged access is access that is neither legally enforceable nor enforceable by equivalent means.

(c) *Present* means that the economic resource and the right or other privileged access to it exist on the date of the financial statements.” (International Accounting Standards Board. “Conceptual Framework. Definition of an Asset (Agenda Paper 3). London, 16 November 2006)

generally accepted accounting principles [GAAP]...”

“Assets also include certain deferred charges that are not resources but are recognized and measured in conformity with GAAP.”

IASB Board Member, Jim Leisenring eloquently comments:

“Look at this APB Statement No. 4 from the fifties, I guess. Look at this. This definition has the potential and succeeded in its potential of retarding the development of an entire generation of accountants. Anything is an assets. You could be an asset if you’re a resource. And you could be an asset if you’re not a resource. Virtually anything is an asset under this definition. That pretty well covers the waterfront as long as the standard setter said it was. There is not an ounce of discipline and rigor in this definition. It’s not a definition. It’s just a statement that runs a bunch of words together....”

Ref.: James J. Leisenring (2005). “Conceptual Frameworks.” Introduction by Sir David Tweedie. Video (supporting slides 19 and 20). London: International Accounting Standards Board.

James J. Leisenring’s clarification to the statements in this article is below (dated October 5, 2009):

“It is clear to me the framework would conclude that a loan receivable is an asset. It is a right to collect cash and no one else can access that right to cash if it occurs. I also believe the framework would conclude that a deposit liability is a liability for obvious reasons. How this asset and liability is created is not relevant to the definitions as both meet the definitions. It is also not unusual to simultaneously create an asset and a liability. At the time one pays in advance for a good the same situation occurs. My point on APB ST. 4 is that both resources and nonresources are assets and EVERYTHING in the world is or is not a resource. Nothing else exists!!!”

## Author’s Conclusion

Bank created money or, as Irving Fisher called it, “check-book money”<sup>11</sup>. He wrote “Under our present system, the banks create and destroy check-book money by granting, or calling, loans.” “Thus our national circulating medium is now at the mercy of loan transactions of banks; and our thousands of checking banks are, in effect, so many irresponsible private mints.”

We should remember that during the banking crises of the 1980s and early 1990s three thousand five hundred (3,500) of such mints failed including sub-prime lenders and had to be resolved,<sup>12</sup> many with intact capital positions which proves the misconception that bank capital is a protector of deposits.<sup>13</sup>

## Solution

This article attempts to analyze the shortcomings in the field of accounting that brought us here. A suggested solution is discussed in another article entitled “U.S. Banking Reform 2010” also published on this website outlining the conversion process, paying off the nation’s twelve trillion dollar national debt in the process.<sup>14</sup>

Comments are highly welcome.

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<sup>11</sup> Fisher, I. (1935) “100% Money: Designed to keep checking banks 100% liquid; to prevent inflation and deflation; largely to cure or prevent depressions; and to wipe out much of the national debt”. New Haven: The City Printing Company. Reprinted 1996/7 by Pickering & Chatto (Publishers) Limited, Old Post Road, Bookfield, Vermont 05036 and 21 Bloomsbury Way, London WC1A 2TH. | German translation by Klaus Karwat (2007). “100%-Geld”. Kiel: Gauke GmbH. | Fisher, I. (1936). “100% Money and the Public Debt” at <http://www.iicpa.com/articles/articles.HTML>

<sup>12</sup> The FDIC resolved 1,650 insured banks and 1,320 Savings & Loans. (Schemmann, M. “MBA Handbook 2008.” *The Financial System and Bank Failures*. Thailand: ThaiSunset Publications, p.165).

<sup>13</sup> Schemmann, M. (2007). “Why Banks Keep On Failing.” *Central Asia Business* Volume I, No. 1, 2008. 72 at [www.kimep.kz/files/BCB/VI\\_2\\_Why\\_Banks\\_Keep\\_On\\_Failing.pdf](http://www.kimep.kz/files/BCB/VI_2_Why_Banks_Keep_On_Failing.pdf)

<sup>14</sup> Schemmann, M. (2009). “U.S. Banking Reform 2010.” At <http://www.iicpa.com/articles/articles.HTML>