Community
Accountancy
PUTTING ACCOUNTANCY TO WORK FOR ALL OF SOCIETY

VALUE CHAIN

FOR DISCUSSION ONLY

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The Tr-Ac-Net Organization

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VALUE CHAIN

Value chain analysis
Value chain analysis shows who are the winners and losers. The result of value chain analysis can be very powerful ... but because of this it is not always easy to get the data that are needed.

Community Accountancy sets the stage for having much more data on the record that are useful ... and though the data will not be good enough to satisfy legal criteria for criminal guilt ... the data will be good enough to make it quite clear what is going on.

Value chain analysis for profit maximization
It can be argued that the most powerful tool that MBA training has given to their students is the spreadsheet mathematics to take the inherent costs, prices and values of the value chain and optimize the value chain to maximize profit for organization. These experts know how to move value from various pieces of the value chain and move it into the optimizing organization.

This is a very powerful concept and has facilitated a very rapid and efficient concentration of wealth into large organizations and entities with a minimum of investment.

Value chain for maximum social benefit
The accounting used for corporate profit maximization does not include social costs nor social benefits. These are both important and are brought into account with Community Accountancy. The costing is not obvious ... but it is pretty clear that some cost needs to be attributed to the consumption or destruction of social value.

Replacement cost of fossil fuel resources
In the energy industry the fossil fuels that are being extracted originated millions of years ago ... the replacement cost of these resources is unimaginable ... so it gets ignored! This is easy and convenient ... but not a good approach.

We know a lot ab
Cost and price determine profit.
Price for the seller becomes cost for the buyer. This next buyer sells for a new price, and profit is again the difference between cost and price.
Where are the big profits? Where are the losses?
How do valuable raw materials create profit with little benefit to the community of origin?
Value chain analysis shows who are the winners ... those that have small cost and high price. But costs are usually based on simple GAAP concepts and not on Community Accountancy analysis.
When cost is based on the consumption of Community Accountancy value rather than the consumption of GAAP cost and value adding and value destruction instead of profit, there are different results.
**Value chain and the market economy**

Value chains flow through markets ... but the market is more a fiction than a reality, which is part of why they are so valuable in value chain manipulation and also so dangerous. It is not easy to tell when a market transaction is driven by supply and demand for physical goods, or whether the market is being driven by speculation about future market values, or whether the driver is legitimate hedging against future price movements.

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Price data
There is a considerable body of data about prices going back a very long time ... but rather less about what these prices mean.

Learning about prices
When I became the CFO of Continental Seafoods I needed to get an understanding of the dynamic of the industry ... I needed this to be a deep understanding that was likely to be right ... and I needed to get this quickly. I asked a lot of questions and did my best to mine the knowledge of everyone in the company ... and friends of the company, and that was a good start.

I also plotted shrimp prices in the US market month by month from 1946 to 1974. The data were available in a government produced market report ... but taking the data out of a table and plotting it on graph paper told a story. Four weeks into my new job, I knew more than most about shrimp prices ... and this gave me a good insight into the potential for the company as we went forward.

This time series plot told me a lot about the long term trends ... and it told me about price behavior month by month during the year, and how different industry conditions impacted this behavior.

We know a lot about some prices, and rather little about other prices. Some prices seem to be hidden from public view ... and one has to wonder why?

What prices should be
It is relatively easy to make a judgment about what something should be priced at. From this it is reasonably easy to judge that a transaction reflects a fair price ... and is probably an honest transaction. But that presupposes that it is possible to see the price of a transaction ... and this is usually not the case.

A colleague had a job in one country (around 1988) where he had to review big contract pricing to help reduce corruption and kick backs ... and he did his work very conscientiously. He refused to OK one big contract because the pricing was way too high ... only to have the contract resubmitted again some months later with the price even higher. The explanation turned out to be that now it was going to take even more bribery to get the contract approved!

These are big numbers and the temptation is huge. With very weak accounting and no accountability it is not at all surprising that corruption is endemic and financial control a shambles.
And even where there is publicity about prices, it is not always clear what the information really means ... price disinformation is as common as price information.

**Example**

Government data about prices is often obtained using a crude system of telephone questioning ... while it gets the information reasonably right it is not perfect by a long shot. It certainly does not have accounting precision.

I was not told about this until after I left the company ... but it turned out that whenever we had a large stock of a specific item we advised the price surveyors that this particular product was selling at a particularly high price ... and when we had low stocks, we reported that the market price was low. In the real world we were then able to discount the one item below market and move the product and overprice the product we did not have, and not be embarrassed by the lack of inventory.

It did not distort the price statistics that much ... but it certainly was a clever little ruse to help keep product moving!

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**Transfer prices**

Prices are critical to corporate profit ... which in turn has a disproportionate impact on value as measured by capital markets.

But price is transient ... and just a part of the data needed to understand and record an economic transaction. It does not matter much if one barrel of crude oil sells for $200 a barrel ... but it matters very much if 100 million barrels of crude oil sell for this price.

In value chain analysis, the transfer price determines how the value adding is shared between the entities in the chain it is very important. Because of its importance very little information is available about transfer prices. The idea that the “market” determines the price assumes a high degree of information and this is rarely the case. Transfer pricing serves those that have the control.

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Profiting from the value chain

One of the ways in which profits are maximized is by using the value chain to get profits domiciled where they most benefit the company.

Outsourcing from a high cost location to a low cost location results (rather obviously) in lower costs and therefore higher profit.

Example

In a practical situation, however, lower costs may be offset by some inefficiencies and other issues. In the 1970s, I pulled back production that had been outsourced to South Korea from the USA. Production cost savings were offset by the costs associated with unmanageable supply chain logistics and rapidly changing consumer tastes.

Value chain can be used to move profits from one legal entity to another ... this may have tax or other financial advantages.

Tea auction – Malawi (as of 1989)

If you are a tea grower in Malawi, your product is sold for export through the Tea Auction. The idea is that this auction price is a market determined price that will maximize the amount paid to the tea industry in Malawi. Up to a point, this is right ... but there is a substantial part of the Malawi production that originates from estates owned by international tea companies. These companies have to sell at the auction ... but they also want to have tea for their international business. As tea distributors they want low prices ... and if low prices mean that the estates get less profit it does not matter much ... in fact it helps because they get less problem with local taxes and with the repatriation of profits.
Value chain can be used to make profit performance look good but not mean much

### $200 Sneakers (as of 2002)

It costs about $2 to make a pair of sneakers in China and a number of other low wage countries. Manufacturers make a good profit by selling a lot of them at (say) $4.

But the profit made by manufacturing is tiny compared to the profit made by the marketing organization and the wholesale and retail system in North America or Europe. Retailers have a very comfortable markup ... and so do the wholesalers and the marketers. They have expenses to keep their “brand” popular ... like sponsoring high profile stars ... but everything in this part of the value chain is about perception and not about the essential substance.

The added value substance happens at the manufacturing stage ... only value perception gets added subsequently. Over time perception loses its value and at the limit there is not much left.

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### Substantial wealth versus perceived wealth

It used to be said that the UK was a nation of shopkeepers ... a sort of back handed compliment meaning that everything could be found somewhere in the shops in Britain. But in fact, it was manufacturing and trade that made the nation's wealth ... and a very aggressive spirit of enterprise and willingness to make investments.

Much of Britain's wealth was generated from end to end value chains that added up to deliver profit ... and a growing pool of capital to invest. The value chains were global, even though, compared to today, the technologies of transport and communications were primitive.

The industrial revolution also created wealth in United States ... in some ways bigger than in Europe ... but the country was still relatively small. Certainly bigger than say, the UK, but not bigger than the British Empire. The pound sterling was a much bigger international influence than the US dollar.

Modern macro-economic measures do not differentiate adequately between the GDP at the manufacturing level and GDP at the pre- and post manufacturing stages. With the prevailing system of metrics the sneaker contributes more to the global economy while it is sitting on a ship, or on trucks or in warehouses and retail stock-rooms than during the manufacturing process. This is patently absurd.
Value Chain – Oil and Gas

Land
Mineral rights
Establishing a legal framework
Geological data
Exploration concession auction
Exploration

Production concession auction
Test drilling
Production drilling
Pipelines
Storage
Royalties
Flares
Air pollution (flares, gases)
Water and ground pollution (oil)
Oil field supplies
Drill casing
Drill mud
Drill pipe
Drill bits
Pumps
Derricks
People
People services – hotels / entertainment
People services – food / water / clothing
Oil storage
Oil export terminals
Crude oil transport – tankers
Crude oil transport - pipelines
Oil import terminals
Oil storage
Pollution
Refining
Refined product storage
Refined product transport – pipeline
Refined product transport – tanker truck
Refined product transport – tanker ship
## Value Chain – Oil and Gas

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<thead>
<tr>
<th>Item</th>
<th>Community</th>
<th>National Interests</th>
<th>Local Investors</th>
<th>External investors</th>
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<tbody>
<tr>
<td>Land</td>
<td>Traditionally an assets of the community and the people ... now the basis of a culture of property rights based on new laws</td>
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<td>Mineral rights</td>
<td>Under modern law are deemed to belong to the nation</td>
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<td>Establishing a legal framework</td>
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<td>Geological data</td>
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<td>This is the key to getting results from investment in exploration and drilling.</td>
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<td>Exploration concession auction</td>
<td>This is the key to getting wealth flows accruing to national interests. How is this received? How is this accounted for?</td>
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<td>A necessary investment. How is this paid?</td>
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<td>Pipelines</td>
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<td>Storage tanks</td>
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<td>A necessary investment</td>
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<td>Royalties</td>
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<td>How is this received and accounted for?</td>
<td>How is this calculated? How is this paid?</td>
<td>Cheapest way of handling gas that cannot be processed</td>
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<td>Flares – air pollution</td>
<td>Pollutes the local area</td>
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<td>Water and ground pollution (oil)</td>
<td>Pollutes the land, pollutes the water, Kills the fish, Destroys livelihood.</td>
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<td>Oil field supplies</td>
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<td>Opportunity for others to be suppliers</td>
<td>Need to be purchased and used all the time</td>
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<td>Drill casing</td>
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<td>Pumps</td>
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<td>Derricks</td>
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<tr>
<td>People</td>
<td>Few local people have training and experience needed for the available work</td>
<td>Some employment generated in the services and support businesses</td>
<td>Most critical staff are international and very well paid</td>
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<td>People services – hotels / entertainment</td>
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<td>Opportunities for local business to provide services</td>
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<td>People services – food / water / clothing</td>
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<td>Oil storage</td>
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<td>Oil export terminals</td>
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<td>A necessary investment</td>
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<td>Export taxes, fees</td>
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<td>How is this received?</td>
<td>How is this paid?</td>
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<td>Crude oil transport – tankers</td>
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<td>A necessary investment</td>
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<tr>
<td>Pollution</td>
<td>Local pollution a matter of course ... nobody cares</td>
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<td>Expensive ... very low public tolerance of pollution in any</td>
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<td>Distribution depots</td>
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<td>Gas stations</td>
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**Monopoly control**

Everyone has heard of the story of John D. Rockefeller and Standard Oil. It is amazing how much money can be made when an organization gets monopoly control of the value chain. And amazing also, that so little has been learned from that experience.

One of the lessons is that monopoly is powerful ... and laws do not work very well unless they are very careful crafted. Most statutory laws are notable not for what they control, but what they allow ... whether this is because of sloppy lawmaking or because the lawmakers know exactly what they are doing is a matter of opinion.

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**1970s – new oil and old oil**

The oil shock of 1973 was a wake up call ... and not surprisingly Washington went to work to legislate a solution. Part of the solution was going to be the profit incentive and removal of price controls over domestic production of oil and gas.

Oil from oil wells that were already producing was to keep the old price. Oil from new wells could be sold at the (then much higher) prevailing market price.

Not surprisingly production of old oil declined and production of new oil increased ... never mind the timeline for creation of new wells was months and years, but the change took place in days. Did the legislators know this was going to happen and give great profit to (their friends) the oil industry? Clearly this was good popular legislation because the old price controls were kept in place, and high price incentive was only allowed for incremental new production that was needed ... or was this just a sham?

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**1970s – Foreign Corrupt Practices Act**

In the aftermath of the 1970s oil shocks, a new era of international profit opportunities emerged. For the first time in history there were many governments that had previously unimaginable wealth ... the oil exporting countries ... and the world's entrepreneurs wanted to tap into this market.

Bribery, kickbacks, etc. emerged as the marketing modality of the era ... but it was found offensive by much of the public when the media started to tell stories. Stories about Lockheed were everywhere ... but not much about Boeing. The American press has all sorts of stories ... but not so much in the European press.

Washington had to do something ... and this something was the Foreign Corrupt Practices Act. I am not a lawyer but I get the impression that this law, like so many others is big on PR, but rather irrelevant in terms of addressing the underlying core problem ... and it is relatively easy to step around.

Getting control of a value chain is enormously valuable ... this is true with the oil value chain ... it is true with any market where there are a limited number of competing entities.
Value Chain – Coffee

**Production**
Land
Prepare land
Plant coffee
Tend growing trees
Harvest coffee

**Post harvest activities**
Transport coffee
Wash coffee beans
Dry coffee
Transport coffee
Store coffee
Process coffee
Grade coffee
Store coffee
Taste coffee
Store coffee
Auction coffee – physical auction
Auction coffee – futures
Transport coffee
Export coffee
Insure coffee
Ship coffee
Coffee market futures
Store coffee
Roast coffee
Grind coffee
Package coffee
Wholesale coffee
Transport and distribution
Retail coffee – coffee shop
Retail coffee – store
Consume coffee
Value Chain ... Fair Trade Coffee

The Fair Trade movement has become popular ... but is it a value adding initiative of something that merely adds to the complexity, adds to the cost and really does not do very much good.

The Fair Trade Value Chain

I watched a TV documentary about Fair Trade (probably in 2005) which followed some foreign buyers as they toured through Central America on a Fair Trade buying trip. The narrator pointed out that this was very important to the villages being visited, because if their quality was acceptable to the buyers they would get the higher Fair Trade prices.

So far so good ... but the narrator did not answer the question about what price the village would get if the quality was not good enough! The data included in the documentary seemed to suggest that Fair Trade was mainly marketing PR and hardly relevant for farmers.

Production
Land
Prepare land
Plant coffee
Tend growing trees
Harvest coffee

Post harvest activities
Transport coffee
Wash coffee beans
Dry coffee
Transport coffee
Store coffee
Process coffee
Grade coffee
Store coffee
Taste coffee
Store coffee
Auction coffee – physical auction
Auction coffee – futures
Transport coffee

Fair Trade ... how much of the post harvest value chain is Fair Trade?

Export coffee
Insure coffee
Ship coffee
Coffee market futures
Store coffee
Roast coffee
Grind coffee
Package coffee

Fair Trade ... Fair Trade certification fees ... who gets this money and what is it used for?

Wholesale coffee
Transport and distribution

Retail coffee – coffee shop
Fair Trade ... higher prices
Retail coffee – store

Consume coffee
Value Chain – The Housing Business

Land
Land acquisition for development
Planning approval
Development permits
Impact studies
Utilities – electricity
Utilities – water
Utilities – sewage
Utilities – solid waste disposal
Infrastructure – roads
Infrastructure – drainage
Services to properties
Services to people – education
Services to people – health
Services to people – transport
Services to people – unemployment insurance
Services to people – retirement insurance
Land as lots
Building permits
Build house
Finance house building
Buy house
Finance house purchase / ownership
Legal work around real estate transactions
Title search
Title insurance
Attorney for the bank
Attorney for the developer
Attorney for the owner
Certificate of occupancy
Inspections
Sales of mortgage to another financial institution
Bundling of mortgages into another financial instrument
Bond rating agency
Bond insurance
Resale of mortgage bundle to another financial institution

Default on mortgage payments
Cash flow from mortgage payments drops
Value of mortgage paper drops
Contact between mortgage owner and borrower / homeowner
Attorney contact
Courts
Foreclosure
Move out
Property empty
Auction ... sheriff sale
Owner in new place
FUND FLOW PROBLEMS

Phantom Aid
The amount of money being raised for international relief and development assistance is huge.
Fund raising in the aftermath of natural disaster is impressive, and shows how supportive many people are of development initiatives.
But sadly the relief and development industry is less than candid about how the resources are used and what is being accomplished.
In 2003 a well know UK based NGO named this Phantom Aid. Some years before the phenomenon had been described as “Black Hole Development” implying that no matter how much fund flow there was, the results would still be the same!

Value destruction
The amount of money that gets spent and the amount of good that gets done seems to be more and more unrelated. Five decades or more of teaching MBA students about ways to maximize profit without teaching much about society has created a very large community of experts in profit maximization and hardly anyone that has a deep understanding of the social costs and value destruction associated with this economic paradigm. The problem, however, is worse, because the relief and development industry has many people well trained in various other disciplines, but with rather little training in this dimension of economics ... and even less trained in accountancy.

Focus on disbursement ... on activity
Metrics ought to serve the needs of society ... but the easy metric that has been important in the Breton Woods institutions and their development clones has been disbursement. While there are cases where disbursement is a useful proxy for results, this is not so when it is used to the exclusion of almost anything else. Disbursement serves as a fairly good proxy for activity ... but neither can stand in for result other than in a very controlled and stable environment. Development, when it is successful, is not stable, but progressing ... and the only metric worth having is a measure of the results.

Sovereignty ... anything goes
The idea of sovereignty that embraces the independence of a people from a foreign power is good ... but the use of the idea of sovereignty to allow a regime of “anything goes” is not. People are being treated abominably by governments and elite leaderships ... and external interference is constrained by the idea of sovereignty. At what point does doing right become the driver of meaningful action?

Weak financial controls
Weak financial controls has been endemic and as a result all sorts of resources have gone missing ... stolen money ... stolen inventory ... over invoicing ... under delivering. Embezzlement of all sorts ... petty corruption and grand corruption.
Price has an important role in the matter of economic incentive ... and the question of sustainability. The value chain works and is efficient when the transfer pricing through the value chain provides a reasonable rate of return on capital employed within each piece of the value chain. If any of the links in the chain become unprofitable, the value chain becomes dysfunctional.
HOW PRICE IMPACTS COMMUNITY

Price is a key variable in the performance of society. It is not as important as cost, but the way price is used in society determines the way value is shared between the various economic actors. The following graphic shows how an economic transaction that has costs and value is shared between the enterprise and the client depending on the price being applied to the transaction.

For society as a whole the value adding is the difference between the value and the cost. For the client the value adding is what is left of value adding after the enterprise has taken out its profit. In the profit maximizing enterprise the goal is to have profit as much as possible, and the amount left in the hands of the client is of little consequence.

<table>
<thead>
<tr>
<th>Base Case</th>
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<tbody>
<tr>
<td><strong>Cost, Price and Value</strong></td>
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<tr>
<td><strong>The Business View</strong></td>
</tr>
<tr>
<td>ENTERPRISE</td>
</tr>
<tr>
<td>COST</td>
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<tr>
<td><strong>Cost, Price and Value</strong></td>
</tr>
<tr>
<td><strong>The Community View</strong></td>
</tr>
<tr>
<td>COMMUNITY</td>
</tr>
<tr>
<td>COST</td>
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</tbody>
</table>

In a lower cost case the enterprise profit increases at the same price point ... and the amount of value derived by the client stays the same.

<table>
<thead>
<tr>
<th>Lower Cost Case</th>
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<tbody>
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<td><strong>Cost, Price and Value</strong></td>
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</table>

If the client and the enterprise are in the same community it does not matter so much whether the client or the enterprise has what share of the value added ... but where the enterprise is from outside the community it matters a lot. In the case where the enterprise is external ... the case of Foreign Direct
Investment (FDI) for example ... the value adding for the community is small because the profit leaves the community. If the costs are incurred in the community there is some multiplier effect ... but typically local disbursements are small and most of the costs, as for example in mining are equipment, fuel, expatriate payroll ... with rather little value for the community.
**Value chain**

The value chain is very well understood in the corporate sector, and there has been very effective profit improvement for the corporate sector by taking advantage of all sorts of cost improvement opportunities in manufacturing to improve the profit bottom line.

But the deep knowledge of the corporate value chain is not matched by anything like the same amount of understanding of the value chain as it impacts social value and the impact of corporate activities on society.

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**Example**

The relocation of manufacturing from the United States to China has been very profitable ... but what are the costs to society that do not figure in the corporate accountancy. Nobody has been doing Community Accountancy and nobody knows. We do know corporate profits increased as more and more manufacturing was outsourced to low cost areas. We do know something of the job creation in these low cost areas and we do know something of the job losses in the places where manufacturing plants were closed ... but what we know is far less than what we need to know. We do not really know very much at all about the impact on the communities --- this is not part of a system of metrics, and only part of what we need to know is on the record.

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**Value Chain**

Al Gore on July 17th, 2008

"We're borrowing money from China to buy oil from the Persian Gulf to burn it in ways that destroy the planet," he said. "Every bit of that has to change."

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**Example**

Over the past 30 years the USA has taken apart most of the regulatory framework around banking and the capital markets, with very good results reported by the institutions in the sector over this period of time. The good results do not, however, take into account the costs of the periodic failures of big institutions in the sector (Continental Illinois) and whole segments of the sector (Savings and Loan). But worse they do not take into account the wealth that is merely removed from one segment of society to become profit in the banking and finance sector. The sub-prime mortgage crisis is just the latest in a series of moves over the years by the banking and capital market industry to concentrate wealth in their sector at the expense of society as a whole.