Caledonian Trust PLC

Directors' report and financial statements
for the year ended 30 June 2010

Company Number 1040126

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Company information

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CHAIRMAN'S STATEMENT

YEAR ENDED 30 JUNE 2010

Introduction

The Group made a pre-tax loss of £294,000 in the year to 30 June 2010 compared with a profit of £1,346,000 last year. Excluding investment property revaluations the Group made a trading loss of £539,000 compared with a loss of £71,000 last year. The loss per share was 2.47p and the NAV per share was 165.4p compared with 167.8p last year.

Income from rent, service charges and dilapidations was £697,000 compared with £731,000 last year. Rental income was in line with last year but dilapidations were reduced by £32,000. Gains from the sales of properties were £71,000 compared with £560,000 last year. Other operating income was £81,000 compared with £254,000 last year which included the final settlement of £222,000 at St. Magnus House, Aberdeen. Administrative expenses were £889,000 compared with £880,000 last year. Net interest payable was £194,000, which was £263,000 less than last year due to lower interest rates. The weighted average base rate for the year was 0.5% compared with 2.49% last year.

Review of Activities

The Group has continued to concentrate on enhancing the value of its development properties by working toward or gaining valuable planning consents.

The Group's New Town investment portfolio continues to be realised when development opportunities are achieved or the investment value has been optimised. In Young Street, adjacent to Charlotte Square, the lease of number 17 determined in August 2008, and, after agreeing a dilapidations payment the property was sold to an owner occupier in July 2009 for £407,500, at the valuation, and the transaction completed in December 2009. In North Castle Street number 57 was vacated by the City of Edinburgh Council in March 2008 and a dilapidations claim was settled by Expert determination with costs against the tenants. Subsequently planning and listed building consents were granted to divide the property into two residential units, a ground and first floor townhouse and a basement flat. The town house was sold in September 2009 for £540,000, considerably above the June 2008 valuation and has since been converted to a townhouse by the purchasers for their own occupation. The conversion of the basement into a two bedroom flat has just been very satisfactorily completed and will be marketed in the New Year.

The basement of 61 North Castle Street is contiguous with 57 North Castle Street and has benefited from the extensive works to the ground and first floor house above which we sold last year. Plans have been lodged for its re-conversion to the more valuable residential use. The Group's other New Town property, 9 South Charlotte Street, between Charlotte Square and Princes Street, is let to La Tasca for a further sixteen years. The rent is due to be reviewed in 2011.

St Margaret's House, London Road, is our largest property in Edinburgh where we are pursuing differing short and long-term objectives. The building has been wholly let at very modest rents to charitable causes for several years. From 1 November 2010 it has been let to one charity, Art's Complex, who reconfigure and sub-let space to over 250 "artists" and "artisans" and "galleries". Almost all the parking spaces are let to our neighbours, the Registers of Scotland, on a short-term lease. Thus in the short term we hold the building with almost no outgoings and with gross rents which should rise to over £100,000 in a few years while the considerable development potential is realised.

We have made considerable but very slow progress towards our long-term objective for a large scale redevelopment. In June 2007 our Architects produced an "Urban Analysis Report" and in July 2007 Draft Development Proposals from which the City of Edinburgh Council suggested that a Development Brief be prepared covering St Margaret's, the adjacent 125,000ft^2 Meadowbank House, owned and occupied by the Registers of Scotland, and all the smaller varied properties lying between the A1 and "Smokey Brae". The preparation of the "Brief" involved considerable time and preparation including six community consultations over three months! The development brief was adopted by the

City of Edinburgh Council in August 2009, so providing a "Master Plan" for the whole area. In July 2009 we lodged an application for Outline Planning Consent for a 231,000ft^2 mixed use development of residential and/or student accommodation, an hotel, and offices and other commercial space. This proposal was submitted to City of Edinburgh Council in July 2009 and was approved in November subject to a Section 75 agreement which we expect to sign shortly. The consented proposal allows for a street frontage to London Road (A1) and direct vehicular access from it together with an "at grade" pedestrian plaza, a transformation from the current bland appearance.

We have considered several proposals for our large development site at Waterloo, London SE1. Previously we had attempted to negotiate with Lambeth Council to purchase the contiguous garage owned by them or to enter into an agreement with them to our mutual benefit by realising the considerable marriage value. Agreement was not reached but the opportunity remains. Meanwhile we are negotiating a sale of our own site for residential use, unqualified as to planning, but with a delayed settlement subject to a small overage, if the adjacent site is developed.

The M74 extension to the Kingston Bridge over the Clyde in Glasgow is due to be completed in 2011 after considerable delays caused by the extensive planning process and a judicial review. We have two properties in Tradeston just east of the Kingston Bridge to which access will be greatly improved as a result of the road extension and which are benefiting from an extensive development programme, including the demolition or conversion of several Victorian industrial buildings and warehouses and the opening of the pedestrian bridge across the Clyde to the Broomielaw, Glasgow's modern financial district. All these changes will improve our small secondary shopping parade there at 1-7 Scotland Street. More importantly they will greatly improve the access to and attractiveness of our investment property at 100 West Street, a bespoke car showroom let to the Eastern Western Group until 2026 subject to a fixed minimum rental uplift of 16% in May 2011. We have recently agreed to the tenant's proposal to extend the showroom space.

We have three development sites in or near Edinburgh on which we decided in 2007 to delay development because of the worsening economic conditions. In Belford Road, Edinburgh, a quiet cul-de-sac, less than 500m from Charlotte Square and the West End of Princes Street we have a long-standing office consent for 22,500ft^2 and fourteen cars which has been technically "commenced". We are currently promoting the site for an unusual type of office use for which an interest had been expressed. We also have a separate residential consent for 20,000ft^2 and twenty cars. This residential scheme is being redesigned to reduce construction costs by reducing the extent and type of excavation, by eliminating an expensive "weight transfer plinth" and by changing the proposed structural elements. In this revised scheme the parking will extend to two floors with the loss of the least valuable residential floor, but further space may be achievable on the upper floors. The existing residential planning consent has just been extended for a further five years.

In August 2006, five years after the original application, consent was granted for eight detached houses at a site in Wallyford, Musselburgh which is within 400 yards of the East Coast mainline station near the A1/A720 City Bypass junctions and contiguous to a recently completed development of 250 houses by two national house builders. In Wallyford we consider that the market for smaller houses has improved relative to larger houses and we have lodged an application to replace the two largest detached houses with a terrace of four providing ten houses altogether with a larger saleable area of 12,469ft^2. This change is acceptable to the planning department, subject to two minor conditions.

In East Edinburgh at Brunstane Farm, adjacent to Brunstane railway station, we hold a consent to reconstruct an existing cottage attached to the farm steading and to convert the steading into nine houses of various sizes totalling 14,000ft^2 altogether. Beyond the steading lies another detached stone building on which consent was granted in May 2009 for conversion to a detached house extending to 3,500ft^2 on open ground with views to the Forth estuary. We have also gained consent to install French windows in the existing five two-storey farm cottages to improve their southern aspect. Brunstane is in the Green Belt from which we made three separate unsuccessful applications for its abstraction. However, once the redevelopment is complete and the large area to the south recently abstracted from the Green Belt and included in the City of Edinburgh Local Plan for two hundred homes is developed, a reassessment of the existing Green Belt boundaries, including the two-and-a-half acres of scrubland which we own contiguous with Brunstane steading, is likely. Any abstractions from the Green Belt, particularly one within the City Boundary, would be very valuable.

The Company owns fifteen separate rural development opportunities, nine in Perthshire, three in Fife, two in Argyll & Bute and one in East Dunbartonshire, all set in areas of high amenity. Unsurprisingly, proposals for any change there meet local opposition, frequently vocal and often well co-ordinated. The new requirement to be outside the 1 in 200 year flood plan (i.e. less than 0.05% chance of flooding in any one year) can eliminate sites that pass all other tests. As small sites are less financially rewarding to local authorities and less important in achieving their housing targets, the support and priority given to them from planning authorities is often "patchy". The elected members of the planning committee now gain their seats on the council by proportional representation and are much more influenced by the concerns of individual constituents than they were previously. Thus the process of gaining planning consent for small well-located developments has become increasingly more tortuous and in some cases the scale of development has been restricted beyond what in many cases originally seemed appropriate and reasonable. Paradoxically, the more complex the process becomes, the more restricted the permissions are, the more the overall supply is reduced and the more valuable these restricted consents become.

In spite of all these difficulties I am pleased to report that considerable success continues to be achieved with our planning applications. I report first on some of our rural developments in Perthshire. At Tomperran, a smallholding in Comrie on the river Earn, where we submitted an application for twelve houses over 19,047ft^2 in November 2007, we were required to change the proposed layout again, having previously adjusted it to accommodate a cycle path requested by the Council, and resubmitted an application in November 2007 which was approved in July 2009 for 19,206ft^2. The smallholding includes two acres zoned for industrial use and 34 acres adjacent to the settlement, a proportion of which is being promoted for a housing allocation in the emerging Local Plan. At Chance Inn steading, where we had previously applied for seventeen houses plus four affordable houses, in April 2009 we applied for a revised scheme containing ten private houses over 21,836ft^2 which was approved in September 2009. Separately, near Chance Inn farmhouse, an application for two detached houses totalling 3,366ft^2 was approved in June 2010. Recently approval has been gained to convert the integral garage at Chance Inn farmhouse into a semi self-contained "guest suite", and to upgrade the house, including adding an en-suite bathroom, and this work has started. The upgraded house and the two plots will be marketed next year. At Balnaguard, where we originally applied for nine houses over 15,719ft^2, we reapplied for a different configuration of 16,254ft^2 which was approved in July 2009. At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we lodged an application in September 2007 for eight houses totalling 12,410ft^2 on the steading adjacent to the attractive listed farmhouse, which was refused and lodged an appeal in October 2010. At Strathtay we had a proposal for four large detached houses and an alternative proposal for three large detached houses refused. A subsequent proposal for two houses 6,040ft^2 was subsequently approved in May 2010. Proposals for the remainder of the site in the village envelope are being formulated. At Camghouran, in northern Perthshire on Loch Rannoch next to the Allt Camghouran stream, we have lodged an application for three houses over 2,751ft^2. At Carnbo, where our proposal for four houses in the large garden of the former farmhouse was refused and the appeal was refused on the grounds that the housing allocation had already been met, we are now promoting the scheme through the emerging Local Plan. Carnbo farmhouse was sold for £320,000 on 1 March 2010 after some remedial work, the price reflecting the loss of part of the garden.

Planning work has started on two attractive rural sites near St Andrews in Fife. At Larennie, Peat Inn, five miles from St Andrews an application previously made has been withdrawn and a new application was registered in June 2010 for nine houses, five conversions of stone buildings and four "new build". At Frithfield, six miles from St Andrews, an application is being prepared for twelve units.

The potential for planning gain differs between the specific sites already discussed and the large land holdings at Gartshore near Kirkintilloch and Ardpatrick on West Loch Tarbert, Argyll, and these in turn differ between each other, although both offer very considerable opportunities in the medium term.

Gartshore comprises the nucleus of the large estate, owned until recently by the Whitelaw family, and includes 120 acres of agricultural land, with parks surrounded by mature trees and 80 acres of policies, designed landscape and gardens including a magnificent Georgian stone pigeonnier and a huge walled garden. The ornate 15,000ft^2 Victorian stable block is indicative of the breadth of the original design. The exceptional quality of the design is complemented by a quite unexpectedly favourable location. Gartshore is only seven miles from central Glasgow, two miles from the M73/M80 junction, seven miles from the M8 (via the M73) and three miles from two Glasgow/Edinburgh mainline stations (Croy and Lenzie) and Cumbernauld commuter station. We are promoting Gartshore, a site at the very centre of Scotland, with excellent communications, as having enclosed landscaped parks with a designed landscape with mature trees suitable for high quality offices and an hotel together with a destination leisure centre created from the restoration of paths, avenues, walled gardens, and built landscape features. Gartshore offers an immediately available site in a mature setting requiring no remediation and not suffering any of the sometimes difficult and long-delayed procedures associated with brownfield sites. These advantages will allow East Dunbartonshire, which benefits from a highly skilled workforce, to compete strongly with other areas for incoming investment.

Ardpatrick, like Gartshore, has very considerable medium-term development potential but for high quality residential property, compatible with the environment, a destination venue enhanced by restoration and appropriate leisure activities. Restoration provides a key to uncover the attractions of Ardpatrick, mostly masked by neglect. Such restoration also provides a framework within which development can be created which is designed to attract a limited number of purchasers who appreciate Ardpatrick's natural beauty and are anxious to sustain and enhance it. Such purchasers will add to the quality, variety and vibrancy of the community. The ongoing restoration represents a huge commitment in money, time and skill and some particularly difficult tasks remain. Much of the residential property has now been restored including two houses within the house curtilage and four outlying cottages which have been sold. The restoration of the South Lodge is now almost complete and an access to allow restoration of the Keeper's Cottage has been laid. Consents have been granted to divide the house in four, to build one new house, to convert the stone garden shed to a house, to make the existing coach house and flat into two dwellings and to undertake certain residential extensions. Recently consent was also given to build a further house which complements and completes the existing design of houses within the curtilage. Extensive restoration is also taking place in the built and designed landscape of the Estate whose original design and execution appear enlightened, the more so as it is revealed. Thus roads, ditches, walls, fences, gates and fields require attention to exhibit the created and proportionate order within a natural randomness.

Within Ardpatrick there were areas designated as "Rural Development Opportunities" in the Local Plan. The Reporter at the Local Plan Inquiry recommended that these areas should be professionally reviewed to determine the landscape "capacity". The survey covering Ardpatrick, the North and South Kintyre Landscape Capacity Study, was published in early 2010 and concludes that, although much of Ardpatrick landscape is of exceptional quality, most of the development opportunities relate to areas where intrusion is minimal and landscape considerations should not materially affect the high quality developments which we propose. Thus the attractions of staying at Ardpatrick will be made available to a wider public.

Economic Prospects

"Credit is a present remedy against poverty &, like the best medicines in Physick works strongly & has a poisonous quality". So Sir Isaac Newton, Master of the Mint, (1699-1727) succinctly observed. Almost certainly he would have adduced that the "poisonous quality" of credit is both long lasting and contagious. In the current economic crisis both such qualities are widely manifest.

In September 2009 the UK completed six quarters of economic contraction totalling 6.1%, including a swingeing fall of 2.4% in Q1 2009. The recession ended when growth restarted hesitantly, at 0.4% in Q4 last year and the economy has continued to grow since then, including an anomalous 1.1% spurt in Q2 2010, but it has only just returned to the same level of output as at the end of 2008. Thus the recession, as formally defined, is now over although the economy remains "depressed", currently operating at 3.6% below its pre-recession peak in March 2008.

Forecasts of UK growth discussed later vary between 1.0% (Deloitte) and 2.4% (Bank of England central forecast) for 2011 and between 1.5% (Deloitte) and 2.8% (Bank of England) in 2012. If growth should average 1.8% each year, then GNP will regain the March 2008 peak in December 2012, nineteen quarters later, or just under five years, a period exceeding even the 1930-34 depression which lasted less than four years. While the current UK depression is likely to last longer than in the 1930s, it is less severe than in the 1930s when output fell by 7.5%, recovered to 6% before falling again to 7.5% six months later - a "double dip recession" - before making a rapid recovery. The current depression is likely to be longer than any in the last 80 years and has been deeper than any since the 1930s.

The crisis leading to the current "Second Great Contraction" was presaged on 9 August 2007 by a withdrawal of funding for collateralised mortgage securities - a black cloud in an otherwise clear blue sky. I Kings 18 recounts how the prophet Elijah sent his servant seven times to look at the seas. "It came to pass on the seventh time that he said 'Behold there ariseth a cloud out of the sea, as small as a man's hand'. So Elijah the prophet said to King Ahab 'make ready and get thee down that the rain stop thee not'. The heavens grew black and there was a great rain". Losses in the US, predicted at $20-30bn in September 2007, rose within two months to $600-800bn. Surely a very great rain!

The Bank of England and its servants saw no such cloud on or before August 2007. Indeed, because of predicted higher inflation, interest rates had just been raised to 5.75% and growth was predicted at 2.5% to 3.0% per year. But the storm came, catching unprepared virtually all the authorities, who certainly had not made "ready and get thee down" after a long period of clear blue skies, including 63 successive quarters of economic growth, a golden age of exceptional stability with the economy moving steadily in perfect Goldilocks fashion, neither too hot nor too cold, inflation within the target range for more than fourteen years and an economic policy based almost solely on the monetary policy determined by an independent MPC which had eliminated "boom and bust". HM the Queen disingenuously enquired of the Director of the London School of Economics, Professor Luis Garciano: "if these things were so large, how come everyone missed them?" Indeed part of the answer is that everyone who mattered was not looking for them. Specifically the MPC is constrained by its remit to target inflation at a low level on a specific narrow definition. Wider broader objectives favoured by some commentators and considered more likely by them to provide enhanced economic stability and growth are normally excluded from consideration. However, targeting CPI inflation, like all single targets – money supply, the gold standard, the balance of payments, the £/$ rate and the shadowing of the D-Mark – may be necessary, but it is certainly not sufficient.

In the UK, recessions have occurred roughly every decade since WWI – apart from the recent period of golden stability and in the US fifteen times since 1926. The recessions lack common cause but normally follow one or more of wars, external shocks, particularly oil price rises and defaults, inflation and asset booms in finance and/or property. The current depression originates from an asset boom, or bubble. Asset bubbles can usefully be differentiated between the delightfully termed "pure irrational exuberance bubble" and the "credit boom bubble". "Irrational" bubbles involve little credit and on bursting cause little collateral damage. The pricking of the irrational bubble in the high tech stocks in the late 1990s caused little collateral damage and, notably, did not materially affect bank balance sheets. Similarly, when the stock market boom of the late 1980s, which was not primarily sustained by credit, collapsed in 1987, the financial system was not stressed, so allowing the economy to recover quickly. Equity based "irrational" booms on collapse cause little collateral damage as the equity, the paper profits for instance of the dot.com companies, is the principal loss. Credit boom bubbles, or the "cycle of leveraging against higher asset values", as Professor Fredrick Martin, a former governor of the Fed, categorises them, are much more dangerous, causing the finance sector widespread damage on bursting. Such a bubble was categorised by Hyman P Minsky in 1992 as a Financial Instability Hypothesis, or "Minsky" cycle which he describes thus: "capitalist economies exhibit inflations and debt difficulties which seem to have the potential to spin out of control ………… the economic system's reaction to a movement of the economy amplifies the movement – inflation feeds on inflation and debt deflation feeds on deflation": a vicious spiral operates on both inflation and debt deflation, the stage now being experienced.

The advanced economies are experiencing a very severe Minsky cycle described by Carmen M and Vincent R Reinhart ("Reinhart") in the paper "After the Fall" as a synchronous global contraction, following the 2007 US sub-prime collapse, with virtually every country of the 182 recorded reporting significantly lower exports in 2008 and half of the 182 countries reporting outright declines in real GDP in 2009. Similar global contractions have occurred in the Great Contraction after the 1929 stock market crash and following the 1973 oil shock. He comments that the events of the past three years are not without precedent, but the precedents are distributed across countries and over time, and the current global contraction is notable both for the synchronous decline in output and for the "damage" to financial intermediaries which impaired financial markets and abruptly curtailed new lending.

Reinhart's study examines the three synchronous global contractions and the fifteen severe post WWII financial crises in both advanced and emerging economies to determine the behaviour of real GDP (both levels and growth rates), unemployment, inflation, bank credit and real estate prices in a twenty-one year window – i.e. ten years "before" the year, t, and ten years "after" – surrounding economic disruptions. The analysis of the current crisis "after" extends necessarily only to three years.

The effects of these adverse shocks persist long after their immediate and evident costs. In the decade following synchronous world-wide shocks and severe financial crises the median post crisis growth in GNP declined about 1 percentage point each year. Total output declines sharply in synchronous global contractions, particularly so in the Great Depression, but much less so in the 1973 oil shock. In half the advanced economies studied real GNP remained below the 1929 pre-crisis level until 1939 – an ominous precedent. In the current crisis median real per capita GDP is 2% lower than it was in 2007, comparable with the fall in GDP three years after the fifteen severe post WWII crises. Currently 82% of observations are at or below 2007 levels as opposed to 60% at a similar post-crisis interval. Thus individual countries' recessions are proving deeper, and more persistent and widespread.

Employment levels deteriorated considerably in the ten years following severe financial crises, particularly for the five advanced economies studied (Spain 1977, Norway 1987, Finland 1991, Sweden 1991 and Japan 1992) where the median unemployment rate at "t" + 10 is about 5% points higher. In ten countries (the five above plus the five emerging economies in the 1997 Asia crisis) out of the fifteen studied (10 plus four South American plus Turkey) unemployment has never fallen back to its pre-crisis level in the decade that followed or subsequently (30 years for Spain; 18 years for Japan!)
Real housing prices also proved to be significantly affected ten years after Severe Financial Crisis in the ten episodes for which housing data was available. Reinhart used a reference point as one year before (t-1) the financial crisis, as the crisis itself in year "t" affected real prices. In advanced economies' crises at t +10 years (10 years plus 1 year) the median price level was 83.0% of the pre-crisis level, the lowest Finland, 58.9%, and the highest Spain, 123.2%. The inclusion of five emerging with the five advanced economies (i.e. 10 altogether) for which house price data was available (Columbia, Indonesia, Korea, Malaysia and the Philippines) produced similar results: the median price was 82.4%, the lowest Philippines 44.7% and the maximum Spain (as above) 123.2%. Reinhart notes that, while equivalent real estate data was not available in the Great Depression, the Annual Report of the League of Nations of the 1930s, especially 1938-40, devoted several chapters to documenting the collapses in construction (and thus houses and house prices) as key determinants of the abysmal performance of output and employment then.

House prices are probably linked to employment levels and in the Reinharts' study both had long cycle times. In Professor Rogoff of Harvard's study (This Time is Different: Eight Centuries of Financial Folly) following banking crises real house prices declined on average for six years with none less than three years and in Japan, the only country longer than seven years, an amazing eighteen years of decline (not yet recovered), but even excluding Japan the average decline was over five years. Unemployment downturn durations are similar to housing, but less severe. On average unemployment rises for almost five years, with an increase in unemployment rate of about 7 percentage points. In the Great Depression US unemployment rose 20 percentage points, but emerging countries normally experienced less than a 7 percentage point rise, possibly due to greater downward wage flexibility and less advantageous welfare provisions. In contrast Equity declines following banking crises are much shorter than housing declines, averaging 3.4 years, but much more severe, averaging a 55.9% fall.

GDP declines following banking crises occur over a markedly shorter time than asset declines, ie equities and house prices, and employment falls and average only 1.9 years (for non banking crises typically less than a year). The average GDP fall of 9.3% is similar to the percentage point increase in unemployment but significantly less than the 35% and 55.9% falls in house prices and equity values respectively. Two factors contribute to the wide difference between the extent of GDP and asset falls. The actual GDP fall understates the gap between the potential GDP and the actual fall, the "output gap". For instance, with an inherent growth rate of, say, 2.5% potential output two years later would be 5.06% higher and a fall of 9.3% in actual (as above) gives a fall from potential output of 13.7%. The second factor is that GDP and, to a large extent, employment reflect the condition of the economy as a whole, but asset prices reflect an amalgam of the margin of the economy, the residual earnings capacity of enterprises and the marginal demand for assets. Credit availability, or rationing, and credit price are major determinants of such asset demand.

Reinhart has shown that in the fifteen severe post WWII financial crises that, during the ten years before the crises, credit as a proportion of GDP rose significantly, the median being 38.4 percentage points. In Spain, for example, the minimum ratio before the 1977 crisis was 65.6% but at the time of the crisis it was 102.5%, a rise of 36.8 percentage points. However, over that period the Spanish economy has expanded by 3.1% p.a or by 35.7%. Thus the earlier credit to GDP ratio, 65.6%, had grown to 102.5% of 135.7 or 139.1%. Over the ten years following the crisis the median deleveraging between the maximum credit ratio before the crisis and the minimum within ten years was 37.7 percentage points. The median figures encompass a wide range. Surges of 70 percentage points or more occurred in Japan (1992), the maximum in the advanced economies, in Chile (1981) and in Thailand (1997). This ratio often continued to increase after the crisis primarily because GDP decreased, notably in Japan where the ratio peaked in 1996, four years after the crisis. Reinhart concludes:- "The median duration (in years) of these credit booms, is about ten years. The unwinding or deleveraging following a crisis is of comparable magnitude. Indeed, the median decline in credit/GDP is also about 38 percent. This unwinding also stretches over many years – often a full decade (and even longer). We cannot discriminate from this analysis whether the retrenchment in credit arises primarily from financial institutions' inability or unwillingness to lend after the crisis or from weak demand for loans associated with slower economic growth and greater resource slack. The surge in credit does appear to fuel growth in the pre-crisis decade, while its contraction following the crisis no doubt contributes to the sub-par performance in the macro-economic aggregates and in real estate prices in the decade that follows".

The accuracy of any analysis of the possible outcome of the 2007 crisis by reference to the fifteen post-WWII crises studied is prejudiced because, like the 1930s Great Depression and the 1973 oil shock, it is a synchronous global contraction, and because only three years have yet elapsed. An analysis of changes in house prices and debt in the ten years to 2007 shows a similar pattern to that of the fifteen post-WWII severe financial crises. In the ten years to 2007 average real house prices rose by 68.0% (median 79.7%) and the domestic credit GDP ratio rose on average 54.4 percentage points (median 46.9%). The precedent of the outcome of the fifteen post war crises is most unfavourable: after ten years in the five advanced economies the median house prices had fallen 17% and in the [210-18] worst case, in Finland, by 41.1%. De-leveraging expressed as bank credit as a proportion of GDP fell by about 38 percentage points, having risen by about the same figure and this de-leveraging took place over seven years on average. If the fifteen post-WWII crises are a reliable precedent, the re-adjustment as reported by Reinhart in August 2010 is still in its earlier stages. Real house prices have fallen only by an average of 8.0%, but in the five "worst" economies as defined by Reinhart, - US, Spain, UK, Ireland and Iceland - the fall is an un-weighted 24.2% in real terms. In the ten years before the 2007 crisis the median credit/GDP rise was about 59 percentage points, well above the 38 percentage points in the fifteen post-WWII crises but no general adjustment to the credit/GDP ratio has yet taken place except in the US and Iceland where the crisis unfolded earlier.

The extent of the likely further adjustment, how it is effected and how the damage to the economy is mitigated are greatly influenced by policy decisions. Reinhart opines that a "ubiquitous pattern in policy pitfalls has been to assume negative shocks are temporary when these were, in fact, subsequently revealed to be permanent or, at least, very persistent". Reinhart observes associations - he does not posit causation – on the long-term effects of severe economic dislocations. Growth falls and unemployment remains high; additionally real asset values fall and credit in relation to GDP falls; deflation follows except where the dislocation was caused by the exogenous inflationary spike as in the oil price crisis of 1973.

The causes of the associations are varied and complex. Policymakers could provide insufficient stimulus after a major crisis; credit supply may be reduced by the collapse of financial intermediaries or by changes in their criteria, preferences or statutory obligations; or slow recovery might reinforce slow recovery, a self-reinforcing feedback. Such reinforcement occurs if either perceived poor growth prospects resulted in below trend investment and hence lower productivity, or if unemployment, increased in the recession, remained high as a result of the increasing "unemployability" of the long-term unemployed.

Policy decisions taken in adverse economic circumstances may be self-reinforcing and reduce output further. Past inhibiting interventions have included trade, working practice, union and credit restrictions. Thus the output effect of crises may have the "remedy" as the cause. Alternatively perceived poor output after a crisis may represent reality, the higher level prior to the crises being unreal. Technical innovations, including financial innovations and liberalisation, provide increased prospective productivity in anticipation of which investment is increased. Such over-investment has taken place since the introduction of the diving-bell, the steam engine, the railways, the instalment credit industry, the deregulation of aspects of the finance industry and, latterly, aspects of the dot.com industry. Investment created on hope contracts steeply and then recovers to the appropriate level. Prior to the current crisis, from 1997, the period of "great moderation", several countries including the UK, Ireland, Iceland and Spain grew at rates significantly higher than in the previous 46 years. There is no evidence that the period of "great moderation" prior to the 2007 crisis is "normal". Indeed, it is possible that the earlier 46 years were "normal" and the subsequent uplift resulted from the influence of some "abnormal" factors. The prime suspect is the surplus capital or savings of export surplus countries such as China providing a one-off but long-lasting boom in the consuming economies of the West.

Whatever the cause or causes of the present crisis, the Second Great Contraction, the outcome is dependent on economic management. The Great Depression represents the economic downturn closest to the current crisis: it was a synchronous global contraction emanating from the heart of the western capitalist society. In the US the recession began in 1929, apparently a similar recession to that of December 1919-1921, as economic growth flattened before a steep collapse coincided with the rapid failure of banks in 1931. A sustained recovery did not take place until March 1933 accompanied by the New Deal measures taken after the end of the "Banking Holiday". The index of Industrial Production fell from 114 in July 1929 to 54 in March 1933 when unemployment peaked at 24.9%. The cause and "cure" of the Great Depression may provide guidance for economic management now.

Many explanations have been put forward as to the cause or causes of the Great Depression. Recessions were not an uncommon feature of the US economy, the early 1920s commencing with three recessions: December 1919 - July 1921, May 1923 - July 1924 and October 1926 - November 1927. The latter two were mild, lasting just over a year, but the earliest one was judged severe as real GNP fell 15% from a post-WWI peak in 1919. This post-war recession followed the high inflationary period of the War and during the course of the recession the Fed tightened monetary policy, described by Milton Friedman as "the first real trial of the new system of monetary control introduced by the Federal Reserve Act". The Fed's tightening occurred as the economy recovered and it was argued contributed to the economic recovery: Friedman notes "in retrospect we can see that this was a major step towards the assumption by government of explicit continuous responsibility for economic stability. During the 1920s the system took – and perhaps more correctly was given – credit for the generally stable conditions that prevailed, and high hopes were placed in the potency of monetary policy as then administered". Indeed the roaring twenties were a great economic success achieving a real growth rate of 4.6% per annum from 1920-1929. One cannot escape the hint of an ominous parallel with the esteem felt for the present regulatory and monetary system and its era of "great moderation".

The Fed tightened monetary policy in the 1919-1921 recession during a period of substantial deflation and the economy subsequently recovered: this association indicated that the economy could be deflated or liquidated without paying a severe penalty in terms of reduced output. However this misguided conclusion or premise was based on a misjudgement then of both the supply and the demand sides of the economy: the tragedy is that it was a premise that conditioned the initial response to the Great Depression. The supply position in early 1920s was the mirror image of the oil shock of 1973. There was a wide range of increases in supply following the Great War, particularly in the production of agricultural goods and in imported primary commodities which led to a drop in the wholesale price index of 46% between 1920 and 1921. Changes in domestic demand were offset by a huge growth in exports especially to the European countries devastated by war whose economies were not being constrained by monetary policy. If the earlier estimates of a 15% decline in output are adjusted for changes in real prices, the contraction is only 3%, an economic outcome in spite of, but not because of, the Fed's monetary policy.

The Fed's strategy, seemingly so successful over the 1920s, was carried into the beginning of the recession and was summarised by Hamilton "Overview of the Great Depression":- "in short in terms of magnitudes consciously contributed by the Fed, it would be difficult to design a more contradictory policy……". Milton Freidman's "A Monetary History of the United States", considers that the Fed made three major policy errors. First, in order to protect the dollar and prevent the loss of gold reserves the Fed raised interest rates; second, although for a short time in 1932 the Fed eased monetary policy by making "open market" purchases of US debt - so releasing money into the system, this was reversed within six months as a result of Congressional pressure; third, the Fed took no steps to ameliorate the liquidity problems faced by the banks of which 40% of those trading in 1929 had failed by 1932. The Fed was not alone in its view: Treasury Secretary Andrew Mellon said in 1929 "I see nothing in the present situation that is either menacing or warrants pessimism". Friedman's explanation, the Monetary Hypothesis, of the great contraction when the supply of money fell 35% and prices dropped by 33% was that the relationship between the decline in aggregate output and the failure of the banks was causal. He contended that the failure of the banks caused the general economic contraction and not vice versa. Bank failures were transmitted to the economy by reducing the wealth of bank shareholders and presumably depositors, but much more importantly by leading to a rapid fall in the supply of money.
Bernanke in his thesis "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression" contended that the thesis proposed by Freidman was an incomplete explanation. He found that the monetary effects of the financial crisis were of themselves quantitatively insufficient to explain the subsequent falls in output; separately he argues that as money, according to monetarism, influences prices and not output, i.e. the "neutrality of money", the money supply restrictions do not explain the fall in output. He found instead that in such a deep recession the effectiveness of financial inter-mediation decreased, leading to reductions in credit supply and increases in its cost. He argued that as contracts between lenders and borrowers require detailed specific individual information on data that is subject to rapid and random change, sufficiently reliable information became increasingly difficult and expensive to obtain. Bernanke states "as the real cost of intermediation increased some borrowers especially householders, farmers and small firms (SMEs) found credit to be expensive and difficult to obtain. The effects of this credit squeeze on aggregate demand helped convert the severe but not unprecedented downturn of 1929-30 into a protracted depression".
Bernanke coined the phrase "Cost of Credit Intermediation", "CCI", a cost which bore particularly on "small idiosyncratic borrowers whose liabilities are too few to be publicly traded". He describes this cost as that of distinguishing between "good" and "bad" borrowers. Good borrowers desire loans to undertake individual specific investment projects which generate a return from a wide range of possible outcomes whose mean always exceeds the total costs, including the CCI and opportunity (i.e. best other option) costs. Bad borrowers try to look like good borrowers but in fact they have no "project". They are assumed to squander any loan received in profligate consumption, then to default! Banks differentiate between these two classes of borrowers and in a competitive banking system the CCI is this cost of transmitting funds from savers to borrowers and includes all associated costs including losses by loss-making loans within the "good" category. The Banks' skill lies in evaluating potential borrowers, establishing long-term relationships and offering loan conditions that encourage potential borrowers to "self-select" in a favourable way. For instance it has been shown that borrowers with a high probability of default choose a contract with a higher interest rate and with lower collateral than borrowers with a low probability of default. Thus good borrowers offer both better collateral i.e. a lower loss on default and a lower risk of needing such collateral.

The banking crisis altered the CCI. Liquidity preferences for the banks and the failure of others banks moved a proportion of borrowers to other credit channels with a higher CCI. Defaults also increased the CCI and the progressive erosion of borrowers' collateral relative to debt burdens increased the cost and the probability of default. A normal response to a CCI increase would be to increase margins, but the more usual response is for banks just not to make loans to some people they might have lent to in better times. This pattern was reported in the 1930s, and precluded many borrowers, even with good projects, from getting funds while lenders rushed to compete for existing high grade assets. It was put at the time: "We see money accumulating at the centers (sic) with difficulty in finding safe investment for it; interest rates dropping down lower than ever before; money available in great plenty for things that are obviously safe, but not available at all for things that are in fact safe, and which under normal circumstances would be entirely safe (and there are a great many such), but which are viewed with suspicion by lenders" (Frederiksen D.M 1931 p139).

Bernanke contends that money was available for a few safe borrowers but difficult for everyone else. A proxy for this shift is the margin for Baa corporate bonds over treasury bonds. Baa represents the "same" given risk over Treasury, the Baa rating being constant, currently classified as Moody's lower medium and in turn being proxy for borrowers having limited access to capital markets. In 1930 the margin was 2.67 percentage points over Treasury but this widened to 7.93 percentage points in mid 1932. In contrast in the 1919-22 recession the differential never exceeded 3.5 percentage points.

The rise in the Baa-Treasury yield gap coincided with both the maximum rate of deposits loss in failed banks and in the sharpest reduction in loans granted as a proportion of personal income, a net reduction of 31%. It was reported at the time by the National Industrial Conference Board survey that "During 1930 the shrinkage of commercial loans no more than reflected business recession. During 1931 and 1932 it unquestionably represented pressure by banks on customers for repayment of loans and refusal by banks to grant new loans." The classes of borrowers most affected were households, farmers, unincorporated business and small corporations. The Great Depression exacted a heavy price on normally creditworthy business as the choice of assets in banks' portfolios was skewed in a non-perfect market where actions were determined according to different criteria.

A study of the Canadian economy in the Great Depression illustrates an economy with a similar debt crisis to the US but no banking crisis. Debt problems in Canadian agriculture and mortgage markets were as severe as the US, and major industries, notably pulp and paper, experienced many disruptions. In consequence, although these were no serious bank runs, bankers shifted from loans to safer assets. The following was reported in the America Banker (6 Dec 1932):- "The chief criticism of our present system appears to be that in good times credit is expanded to great extremes …………. but, when the pinch of hard times is first being felt, credit is suddenly and drastically restricted by the banks. At the present time loans are only being made where the banks have a very wide margin of security and every effort is being made to collect outstanding loans. All our banks are reaching out in an endeavour to liquefy their assets …………..". Thus good borrowers find it more difficult to obtain credit when there is extensive insolvency: debt crisis should be added to the credit crisis as a source of disruption to the credit system.

The "credit view", as Bernanke's hypothesis has became known, reinforced Friedman's monetary view and provided a basis for explaining the depth of the Great Depression. It also offered an explanation for its persistence which in the US was for ten years, or until 1939.

The second Great Contraction's recovery cycle will be very much shorter than that of the Great Depression, although, as argued above, the period will be considerably longer than the non-banking recessions. However, there are several significant points of difference between the depressions and between the countries experiencing the depression. The second Great Contraction is modest compared to the Great Depression, primarily because of the massive early and appropriate intervention of the authorities' fiscal and monetary policies, the consequences of which are the source of some subsequent sovereign crises and give rise to policy options specific to the individual economies. The success of the interventions was noted earlier by The Economist as "Deft Policy saw off Calamity". Importantly, the economies affected by the banking crisis, while they were predominantly also those affected by the Great Depression, now contribute a very much smaller percentage of the world aggregate demand, and are therefore more easily able to expand exports into the rest of the world, whose economy is estimated to grow 3.5% in 2010.
In July 2008 the FT surveyed the European economies and only one, Austria, was classified "sunny" i.e. "economic growth accelerating unemployment falling", and none were classified as "serious lasting disruption". By September 2010, six countries had become "sunny", but three, Greece, Iceland and Ireland had been reclassified as "serious disruption". In Western Europe, i.e. leaving aside former CIS members, no non-Eurozone EU member was classified "as serious disruption" nor were any non EU members except Iceland, an exceptional and anomalous case. The focus of difficulties lies in four Eurozone countries the "PIGS" in all of which the uniform Eurozone monetary policies have facilitated a higher cost structure. Such uncompetitiveness can be remedied by one or more of: a step up in productivity, a lowering of real wages or a devaluation of the currency, but all these options present grave difficulties. Productivity increases have historically varied only within a narrow range,

labour cost reductions are only achievable by maintaining wages below inflationary rises, an achievement accomplished by Germany in recent years, but one requiring unusual cultural norms, and such norms are not normally ascribed to the nations currently in need of them; the devaluation of the currency is precluded by membership of the Euro.

The "Anglo-Saxon" economies, principally the US and the UK, being not tied either to an external monetary system or to a fixed exchange system, are inherently more flexible in their economic policies. The US, has two unique advantages: the mandate for the Fed and its Chairman. The Fed has a dual mandate, to foster maximum employment and price stability, a wider mandate than the MPC. The Chairman is Ben S Bernanke, the author of Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression (1983 American Economic Review), extensively discussed above, surely a serendipitous appointment.

The US economy, while at the epicentre of the storm, contracted only 5.4% in the Second Great Contraction, appreciably less than other high income countries, all much less than the historic average of 9.3% in the fifteen major banking crises studied by Rogoff and significantly below the catastrophe of the Great Depression. Qualitatively the US response has been "textbook": support for the financial system through "TARP" financial guarantees to "banking" institutions; fiscal stimulus; and action by the Fed to sustain the flow of credit. The TARP has been remarkably effective and likely to cost only ½% of GDP while financial guarantees sustained the financial institutions. True to his analysis of the Great Depression the Fed under Ben Bernanke has reduced interest rates to such an extent that this aspect of monetary policy is no longer effective, the so called "liquidity trap", where cash is preferred over bonds which are likely to fall in value as interest rates rise. Fiscal stimulus, outside the Fed's remit, has been relatively limited, currently estimated at 6% of GDP representing under a fifth of the cumulative expected deficits of 2009, 2010 and 2011 and, although growth in the third quarter was 0.5%, it is less than the 1.2% in Q4 2009 and, due to a surge in productivity, unemployment has risen. Further fiscal measures would stimulate demand but until very recently seemed politically precluded. Martin Wolf polemizes such an attitude: an ambulance crew renders desperate resuscitation measures to a patient who has suffered a cardiac arrest; timely measures (the Economists "Deft Policy") save him and he makes a protracted and partial recovery in hospital; after two years, but not fully recovered, he sues his saviours alleging that, but for their interference, he would be as good as new; as for the arrest, it was a minor event and he would have been better off if left alone!
Fortunately the patient is not in sole charge of treatment, given the diagnosis is that the recovery from the cardiac arrest is only partial and the arrest had been induced by continuing external factors whose elimination is required to pre-empt a relapse. "Dr" Bernanke had prescribed further monetary expansion in the controversial form of the delightfully termed "Quantitative Easing" which, while not a panacea, should contribute to the treatment of several separate but inter-connected ailments. QE "treats" long-term interest rates, as opposed to the short-term rates modulated by the Fed "rate", but given the patient's many-faceted illnesses incorporates important therapies to treat two others: the threat of deflation and the growing overhang of external dollar balances.

Severe deflation constituted a major self-reinforcing factor in the Great Depression. Each time prices fell asset values fell, LTVs increased and some debtors became insolvent, so forcing further sales and then further asset writedowns. Such deflation increased the real value of debt and of interest costs. The Japanese experience in the 1990s is a contemporary example of a deflationary spiral when price changes fell from a "high" of plus 3% in 1990, to plus 1% in 1993 to 0% in the late 1990s and to minus 1.5% now. Between 2007 and 2010 the US prices changes have fallen comparably from nearly plus 3% to plus 1%: the graphs are shockingly similar. Low inflation is undesirable and deflation potentially calamitous as the Japanese experience shows and as its pernicious reinforcing effect on the Great Depression confirms.

The Fed's motive for preventing deflation, or indeed for promoting "normal" inflation, may be reflected in recent remarks by William Dudley, President of the Reserve Bank of New York: "Very low interest rates can help smooth the adjustment process by supporting asset valuations, including making housing more affordable and by allowing some borrowers to reduce debt interest payments …. monetary policy 'can cut off the tail' of the distribution of potential economic outcomes ……. it can help encourage the households and businesses with money to spend to do so". The US money supply is almost static and there is considerable excess capacity so any increase in supply, unless trapped in the financial system as excess reserves i.e. not lent, should increase output.

Rising US inflation diverts capital movements and modifies trade balances. Capital will move into more stable economies such as Switzerland or to economies offering higher returns such as emerging economies. In 2010 and 2011 as much as $800bn was diverted according to the Washington based Institute for International Finance. The recipients of these inflows will experience exchange rate appreciation, although its appreciation may be offset by Capital controls, taxes or intervention by those recipients wishing to avoid such revaluation. The US has huge $ creditor balances, an extra $6,800bn being accrued since 2000, this massive inflow being a major source of the credit flood preceding and contributing to the "Second Great Contraction". This huge balance can be paid off in two ways: at one extreme the US economy deflates reducing $ prices and causing a major slump or, at the other extreme, the US inflates reducing $ prices by devaluing the $ and increasing the value of external currencies (read China). The imposition of a deflation is exactly what the Eurozone creditor countries led by Germany are imposing on Greece and now Ireland. Fortunately the extent of the damage to their economies and to their banks can be contained by the "surplus" Eurozone creditor countries. If the $ creditor nations, such as China, have mercantilist intentions to maintain trade surpluses and to resist their currency revaluation then the corollary is that the US deflates, an outcome that would cause a world slump. Such intentions could be interpreted as trying to impose a "German" solution on the US economy.

The Fed's actions indicate that the US prefers, with which the world should concur, the alternative policy. Unlike small Eurozone nations which have fixed exchange rates, no independent currency and no central banks, the US has a very wide discretion. To put it at its simplest form: there is no limit to the dollars the Federal Reserve can create. Earlier, on such a topic, President Nixon's Secretary to the Treasury John Connolly said the dollar "is our currency, but your problem". In a similar vein Martin Wolf said of the G20 negotiations over the dollar balances "if the G20 don't hang together, the Fed is about to hang them separately".

Bernanke demonstrated that amongst the major causes of the Great Depression were the cost of credit and its rationing, or non-availability on the current market credit terms, including credit withdrawal and its non-renewal. In corroboration Reinhart found that the median of private debt to GDP rises by 38 percentage points in the10 years before a financial crisis and falls by an equal amount in the 10 years following the crisis. He concluded that deleveraging, repaying credit, is a powerful drag on recovery. The pattern of credit "freezing" described by Bernanke for the Great Depression is evident in the Second Great Contraction. As an illustration Alan Greenspan, formerly Chairman of the Fed, notes that "the instinctive reaction of businessmen and householders (and bankers!) to uncertainty is to disengage from these activities that require confident predictions of how the future will unfold". This is evidenced by the rise in non-reinvested liquid resources by non-financial organisations to 21% the highest proportion since records began 58 years ago. These liquid assets have recently risen by $1,800bn, the highest share of total assets for nearly 50 years. The banks hold a trillion dollars of "excess reserves" i.e. lendable reserves remaining parked in Federal Reserve banks yielding 25 basis points and as Greenspan notes "little evidence of banks seeking higher returns through increased lending". QE may alleviate credit shortages as well as counter deflation and unemployment but five years of extensive QE by Japan in the early 2000s affected no apparent changes, although the outcome without it is unknown. Its use in the US has been widely criticised in part because money is "created" to which Martin Wolf replies: "the essence of the contemporary monetary system is the creation of money by private banks' often foolish lending. Why is such privatisation of a public function right and proper but action by the central bank to meet pressing public need inappropriate, especially when the broad money supply is barely growing and the banks will not lend?"

Bank lending in the US was 10% lower in Q3 2010 than a year earlier having dipped to 14% lower in Q1 2010 and in 2009 was about 10% lower than in 2008. The credit contraction does not indicate a strong recovery for the US where unemployment and spare capacity remain high and growth in 2010 is expected to be only 2.8% before slowing in 2011. Fortunately further fiscal loosening seems likely after a political deal between President Obama and the congressional Republicans to extend all the Bush era tax cuts together with a $120bn payroll tax holiday. If enacted the US economy would grow in 2011 by 3.5% according to JP Morgan, by an extra 0.7%, up to 4.1%, according to Deutsche Bank and by 4.0% according to the Economist. The proposal would raise the US fiscal deficit to 9-10% of GDP in 2011. The US would then be the only large industrial nation not to tighten fiscal policy in 2011. The Economist says "America is injecting itself with another dose of stimulus steroids just when Europe is checking into rehab and enduring cold turkey". The lessons of the Great Depression seem to have been well learned across the pond. Reinhart author of "This Time is Different – Eight Centuries of Financial Folly" estimates that economies grow 1.5% points slower in the decade that follows a financial crisis: for the US, this time might indeed be "different". One hopes so.

For the UK the economic impact of external influences is favourable but domestic influences conflict. The continuing growth in World GDP estimated to be 22% over five years, including the resurgence of the US and the projected rapid expansion of developing countries will be beneficial. The significant devaluation of Sterling by 25% on a trade weighted basis since 2007 and by 16% and 19% against the $ and the € respectively will provide a major stimulus to the economy. The availability of devaluation is a continuing reminder of one of the advantages of an independent currency.

The UK emerged from the recession with 0.4% growth in Q4 of 2009, later than other major economies, reflecting the disproportionate importance to the UK's over-extended financial sector, which was repeated in Q1 2010, before achieving strong rises of 1.1% and 0.7% respectively in the subsequent two quarters. In the current three months NIESR suggest a reduction in growth to 0.6%, a respectable 2.4%pa annualised. However the economy is still 4% below the pre-recession output in March 2008 and probably 10% below its potential capacity.

The UK economic downturn started in the spring of 2008, but as late as August 2008 when the Bank identified escalating inflation as the "key risk", economic output was projected to be "flat" and interest rates were still 5%. By November 2008, the Bank's greater concern was deflation and it then forecast a peak to trough decline in GDP of about 1.9% (actually 6.5%). The Governor removed his previously stated opposition to a fiscal stimulus, saying the "transmission mechanism" of monetary policy had become impaired through the banking crisis. Subsequently interest rates were cut very rapidly to the still current 0.5% in March 2009. Patently further cuts are possible but little additional economic stimulus occurs due to the phenomenon quaintly described as the "liquidity trap". Monetary policy, as defined by interest rates, has been at its most accommodating practical level for over 21 months.

The Bank initiated a further monetary boost to the economy with its unprecedented programme of the delightfully styled "quantitative easing" and by February 2010 had purchased its self-imposed limit of £200bn of assets, providing liquidity to the vendors and reducing medium and long-term interest rates. Further asset purchases in 2011 are predicted by the EIU and the Bank reports that a survey by Reuters showed that 50% of respondents expected further asset purchases. Tellingly, the Bank, which in its November 2009 Inflation Report reported interest rate expectations of 3½% and of 4% at the end of 2011 and 2012 respectively now reports these at 0.75% and 1.25% respectively. Fortunately most forecasters agree that monetary policy will be expansionary for up to three years.

The expected continuing expansionary monetary policy contrasts with the fiscal contraction outlined in the CSR on 20 October 2010. The Chancellor, Mr Osbourne, prefaced his proposals: "we are going to ensure, like every solvent household in the country: that what we buy we can afford; that the bills we incur, we have the income to meet; and that we do not saddle our children with the interest on the interest on the interest (sic!) of the debts we were not ourselves prepared to pay". Cynics aver that politicians rarely say what they mean and even less frequently mean what they say. Possibly this colourful couthy rhetoric was an enjoinder to the whole community to brace themselves for "cuts" and possibly the extreme nature of the proposals that followed was a "worst case" scenario from which he could jubilantly retreat or indeed it could allow "slippage" in its implementation so reducing the "cuts".

At face value the Government's proposals exhibit a strict pre-Keynesian ideology and, although the circumstances are far far removed from those of the Great Depression, there appears through the mists of time a shadowy spectre of the authorities' early reaction to that financial crisis. Then the US Fed mistakenly believed that the balancing of the budget was a correct response. The proposed costs are equivalent to a structural fiscal tightening of 1.6% per annum of GNP over the parliamentary term, the most sustained in living memory. The Chancellor's description of borrowing draws images of Thatcherism and the classic literary allusions of Micawber and Hamlet's Polonius. But economic management is not morality nor an abhorrence of fecklessness, but a balancing of returns and costs, where borrowing can be beneficial. In reality, as Samuel Brittan says, "the Deficit should be a policy variable rather than targeted to meet a dim accountant's idea of balance". Moreover it has been one

used in the past: the current debt is 70% of national income but the average over the last 322 years is 112% with long periods above 100%.
The UK's fiscal stance is in marked contrast to that of the US although both countries have the same post bubble economic adjustments. The effects may not be exactly the same – the UK had a larger fall in output 6.4% compared to 4.0% but a smaller rise in unemployment 2.5% compared to 5.0% and higher "core" inflation 2.9% compared to 0.8%, due largely to the impact of the UK's devaluation, but the similarities outweigh the differences and they share precipitating factors. Most importantly they both must now choose between the immediate risks of fiscal retrenchment on recovery and the longer-term risks of fiscal deficits on creditworthiness and both rely on continuing expansionary monetary policies, the UK particularly so because of its choice of extreme fiscal tightening.

The IMF has recently shown that a 1% fiscal consolidation reduces real domestic demand by 1% and GDP by 4% over two years, provided at the same time monetary policy becomes more accommodating, an option not realistically available in the UK. The IMF also concludes, helpfully for the UK, that a depreciating currency cushions the impact of a fiscal retrenchment and that spending cuts, 73% of the UK adjustment, are less damaging than tax increases. Finally reduced debt, i.e. following fiscal consolidation, is beneficial for itself but also because it lowers overall real interest rates, but with real interest rates close to 1% such an effect is currently muted. It is concluded that the proposed UK fiscal consolidation would contract GDP at a rate of 1% to 2% per year.

There are additional adverse factors affecting economic recovery. Further monetary stimulus is restricted to Quantitative Easing which affects the already low long-term interest rates and in any case as many long term borrowers are flush with cash low rates will not induce further investment. A further major hindrance to the expansion of the economy is the rationing of credit by the banks, as now confirmed by the Bank, where unwillingness to lend is independent of price. As Martin Wolf observes "the UK has launched a remarkable policy experiment. The contrast with the US should at least be instructive. We will never know whether disaster was indeed imminent, but the British are going to learn much and so will the rest of the world". Elsewhere he concludes: "The Chancellor and the Treasury are confident and persuasive. They can also point to the array of official organisations that support them. Having written on the UK economy for 23 years, I know it was ever thus. Yet, in retrospect the government was wrong perhaps half of the time. Economics is an art, not a science". Perhaps like the Fed in the Great Depression there will be changes – after all Mervyn King said "of all the ways of organising banking, the worst is the one we have today".
On present indications UK economic growth will fall below long-term trend historic levels and the 10% gap between actual and projected output will not easily close with a risk that capacity is being lost by the atrophy of the supply side. Growth is forecast at less than 2% pa until 2014 by Capital Economics and at 1.5% or lower by the EIU: these figures are more likely than higher figures produced by official sources. I conclude as I did last year, and I suspect I may do next year, quoting Alfred Marshall, the eminent Cambridge economist: "The commercial storm leaves a path strewn with ruin; when it is over there is calm, but a dull heavy calm".

PROPERTY PROSPECTS
In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001 and fell steadily to a trough of 4.8% in May 2007 before rising in this cycle to a peak of 7.8% in February 2009, a yield surpassed only twice since 1970. A higher yield occurred over six quarters in 1974/75, the time of the secondary banking crisis, but then "Bank Rate" averaged about 11%, and in one quarter in 1991, just before Sterling left the ERM in 1992, when "Bank Rate" was again over 10%. In contrast in February 2009 Base Rate was 1.0%. Yields fell rapidly from the 7.8% peak in February 2009 and by February 2010 were 6.4% before falling only another 0.1% point in May 2010 to 6.3%, the present yield. The yield drop since last year is 0.9% points, equivalent to a rise in capital values of 14.3%.

The 7.8% peak yield in February 2009 was 4.6 percentage points higher than the ten year Gilt Yield, the highest "Yield Gap" since records began in 1972, and 1.4 percentage points higher than the previous record in February 1999. From the 1970s until the late 1990s, except for one year, the 1993/94 downturn, the position was reversed the - "Reverse Yield Gap"- and the Gilt yield exceeded the property yield. The "Yield Gap" of Property exceeding Gilts, was re-established in 1997 and has persisted since then until very briefly, at the recent 2007 property peak only. The current "Yield Gap" is 3.3 percentage points, much higher than the average over twenty years partly because of the current low gilt yields.

The All Property Rent Index which, apart from a brief fall in 2003, had risen consistently since 1994, fell 0.1% in the quarter to August 2008 and then fell substantially in each of the following four quarters, giving an annual rental loss of 12.3%. Since August 2009 the Index has risen slightly each quarter and at August 2010 was a small 0.9% higher. The growth in the rental index is due to a rise of 6.9% in office rents, with other sectors static or still falling. The most notable change was the rise in office rents in London where the City rents increased by 12.2%, Mid Town by 14.0% and the West End by 8.5%. In all rental categories there were widespread rental falls in most English northern Regions.

The recent returns to property investment, as measured by the IPD All Property Index, have been high, primarily because of the yield drop of 0.8% points between Q3 2009 and Q4 2009. In the year to 31 October 2010 the All Property return was 20.4%, compared with minus 14.0% in the year to 31 October 2009 and minus 22.5% in the year ended 31 December 2008 a month that produced a record fall of 5.3%. As the IPD total return figures include about (plus) 7 percentage points of return from income, the total figures disguise a larger capital loss. The Bank shows that Commercial Property prices are currently 35% below the mid 2007 peak having recovered from the maximum fall of about 44% in late 2008. The total returns to all property for the year to October 2010 were 20.6% slightly better than equities, 17.5%, but well in excess of bonds, 8.9%. Interestingly, property equities returned only 8.8%. Since October the investment market has continued to improve slightly and the Jones Lang LaSalle prime yield has dropped from 5.74% to 5.62% in December due to small changes in most sectors excluding retail.

Total property returns for 2010 are widely estimated at 13%-15% (Colliers 14.7%, Clutton 14.9%, IPF 13.6%). The return based on derivatives as at 13 December 2010 is 13.85%. These estimates are much higher than those made previously when, for example, on 1 March 2010 the return implied by the property derivatives for 2010 was 10.0%. The implied forecast then for 2011 was 6.5% which has now fallen to 4.1%. Other forecasts have also downgraded the 2011 forecasts during 2010. In February IPF forecast 2011 returns as 6.6% but in November the forecast was 5.2%, the reduction being due primarily to increases in investment yields. Colliers have reduced their 2011 un-weighted average from 12.0% in January 2010 to 7.6% in October 2010, primarily because of much lower figures for the retail sector. In 2012 the return implied by derivative pricing is currently only 3.5% but the IPF forecast 9.2%, Colliers 10.6% and Clutton 8.8%.

The projections for 2011 probably reflect the likely economic conditions resulting from the fiscal squeeze being implemented by the Government. Even in the year to October 2010 retail sales fell 0.1% and further falls seem likely next year. Projections of falls in retail rents and capital values are consistent with reduced growth, but other sectors may not be so adversely affected.

"Is this the end of the house price boom?" – so John Kay wrote in the FT as long ago as 12 October 2004. Among his conclusions were that booms are followed by slumps and that these who make "confident" predictions about the future of house prices are mistaken!" This time last year most commentators predicted a fall in prices in 2010 but a recovery thereafter. Deloitte forecast falls of 10.0% whilst Savills and Jones Lang LaSalle forecast setbacks, in 2010 of 7%. The Nationwide predicted a "period of moderation" in the months ahead. The price of derivatives based on the Halifax Property Index implied a 1% fall in 2010, a remarkably prescient indicator as the Halifax Index shows a 0.7% fall in the twelve months ended November 2010. Two years ago the derivatives based on the Index indicated a 21% drop in 2009 – the index rose 1% - and a drop of 15% in 2010. The Nationwide's prediction of a "period of moderation" is being vindicated by the rise of 1% in the annual rate in November 2010.

The results of two principal mortgage providers are remarkably consistent at present, but even this year the difference between these indices in the annual change in house prices has varied between them by up to 4 percentage points. Both indices are based on surveys for mortgage purposes based on "standardised houses" whose make-up is not disclosed but will comprise a set number of rooms including a bathroom. The Land Registry and LSL/Acadametrics indices are amongst those based on actual sales, i.e. including cash sales but the Land Registry compares current sales prices with the previous sale price of the same property i.e. it excludes new house sales and alone amongst the surveys takes a geometric mean thereby reducing the significance of outlying sales values.

The significance of the mensuration method can be illustrated by the "average" prices shown for June 2010: Halifax, Nationwide and Land Registry between £165,000 and £169,000; Communities and Local government £213,000; and LSL/Acadametrics £221,000. To November 2010 the Nationwide and the Halifax annual indices were within 1% of November 2009 the LSL and Communities and Local Government indices were 6% higher and the Land Registry index (using a geometric mean) 4% higher. Two other indices are based on surveys of or samples from selling agents. Hometrack collects data from 3,500 agents including estimates of price rises or falls. Rightmove has about 35% of all home sales particulars posted on its website and amongst other data it collates asking prices. These two surveys also report prices within 1% of last year's.

What has happened to prices over twelve months depends on which survey is used. The actual prices achieved eliminate considerable uncertainty and the wider the sample the better. Thus the LSL model has many advantages – unfortunately it excludes Scotland! In general terms the 2010 outturn is almost certain to be considerably better than the forecasts quoted last year. There appear fewer predictors than last year, some possibly heeding John Kay's advice about "confident predictions". Last years predictions for 2010 were in the broad range nil to -10% but this year's predictions for 2011 are almost wholly in the nil to 5% range. Capital Economics are the most gloomy at -5.1%, Deutsche Bank -5%, Savills -3%, Hometrack -2%, Cluttons -0.1% and the CML "flat or fall slightly".

The housing market, like all markets, depends on the balance between supply and demand, but with an important distinction between the long and the short term. The supply of houses is relatively inelastic and slow to respond to changes in demand largely due to the long cycle time of acquiring, planning and then constructing. The supply is further constrained by the planning process which determines how many houses shall be built but then, because of the increasing complexities in the planning system, is frequently unable to deliver the programmed number of houses. Within established housing areas supply can be further curtailed by restrictions due to listing, conservation or by the requirements of flood protection. The long-term demand for houses, according to the currently used econometric models, is likely to continue to grow at a rate which is unlikely to be significantly altered, even by a depression as severe as is currently being experienced. Demand also grows with increasing affluence as time, convenience, amenity and quality of location all become of greater value. The fundamental imbalance between the supply and demand will result in higher prices in the long term.

In the short term the market is supplied by new houses and by recycling existing houses. The newly built stock houses have been largely liquidated following the overhang from the earlier boom and new construction is a small proportion of the previous output. Existing house supply is derived from owners exercising their discretion to move house –larger, smaller, smarter, relocation – who buy other houses so effectively completing a cycle, their demand matching the recycled supply. Another supply source, but a "non-discretionary" one is from estates, from household "breakups" and from repossessions. The volume from the first two should be relatively fixed, although the recession may have somewhat reduced "breakups", but the supply from repossessions will vary considerably with interest rates and with economic activity.

Interest rates are likely to remain low, unlike recent depressions, but the effects of the proposed fiscal tightening on economic activity, particularly on unemployment is likely to be severe. Already unemployment has risen 35,000, employment levels are down and the jobless rate up to 7.9% from 7.8%. The OBR, which is forecasting 2.1% growth in 2011, higher than seems likely, expects unemployment to peak at 8.1% but more pessimistic forecasts are for 8.5% to 9.0%. The supply of houses from this source seems likely to rise, a view shared by the Council of Mortgage Lenders.

Short-term demand will be determined primarily by mortgage cost and availability. Fortunately Mortgage costs are likely to remain low but credit for house purchase seems very restricted. The rationing of credit highlighted in the Bank of England Q4 2010 Bulletin is almost certainly a major restricting factor in the future short-term demand for houses.

The housing market is a paradox: demand rationed by credit is the major influence on short-term prices and supply rationed by institutional factors is the major influence on long-term prices. In the short term credit rationing together with deteriorating economic conditions is likely to depress prices.

Credit rationing is also a major contributory factor to the current slowdown and when it eases, probably coincident with stronger economic growth, supply will become limiting. The key determinant of the long-term housing market will continue to be the restrictions of supply by many overlapping and reinforcing controls and conventions producing significantly higher real prices.

Future Progress
We are not at present undertaking any development. During the year we succeeded in gaining planning permission for several of our sites which we have added to our existing portfolio of sites ready for development. However we will not commission development until market conditions improve further. We are completing minor refurbishments in the basement at 57 North Castle Street, and at Chance Inn Farmhouse. These houses will be marketed in the Spring. Foundations have been laid for two houses at Cockburnspath to protect the existing consents and other similar work elsewhere will be undertaken as necessary.

Refurbishment and restoration will continue at Ardpatrick on West Loch Tarbert, Argyll. Previously we have sold six separate properties, including four refurbished cottages, and at least two more properties will be marketed in 2011. The landscape review required by the Local Plan has confirmed a range of long-term development opportunities and may allow one or two further sites to be marketed shortly.

Planning work continues on many of our development sites. This comprises both submissions to the Local Authority for inclusion in future Local Plans and for developments under existing or evolving Local Plans. At Gartshore in East Dunbartonshire, but only seven miles from central Glasgow, discussions continue on the long-term prospects for the restoration of the estate coupled with a high quality "Green Business Park". At St Margaret's House, which now benefits from Outline Planning Permission for 231,000ft^2, we will undertake further planning work to enhance long-term value. At Baylis Road, Waterloo, there have been a number of proposals, one of which we expect to finalise shortly.

We continue to gain valuable consents on several of our fifteen rural development sites. Most of these sites were purchased unconditionally, i.e. without planning permission, for prices not far above their existing use value, and before the 2007 house price peak. The main component of the possible development value lies in the grant of planning permission and in its extent and is relatively independent of even large changes in house values. For development or trading properties no change is made to the Company's balance sheet even when improved development values have been obtained. Naturally, however, the balance sheet will reflect such enhanced value when the properties are developed or sold.

I have commented on the investment property market in these statements over the last few years. The broad conclusion was that over the cycle real returns were at best poor. Consequently we decided to withdraw from that market and reinvest in specialist development opportunities. In the years immediately before the 2007 crash, I reported that investment yields were too low to be sustainable. Fortunately, during that period we declined several very highly-geared investment proposals. We retained investment properties where we expected them to provide value above the then current investment value and some of these have achieved that goal.

Our conservative view of the investment market had been reflected in a conservative financing policy and our long-term relationships with our bankers. Our main funding is a low LTV loan maturing in 2011 which, in spite of the widespread falls in investment values, has always remained within covenant. We are at the advanced stage of negotiating a refinancing on a conservative basis at current market rates. Other facilities are with banks with whom we have had borrowings secured over the same properties since 1990 and 1994 respectively and these relationships are being continued or being offered for continuation.

The mid-market share price on 22 December 2010 was 95p a discount of 43.4% to the NAV of 167.8p. The Board does not recommend a final dividend but intends to restore dividends when profitability and consideration for other opportunities and obligations permits.

Conclusion

Three years ago I concluded: "The UK economy is expected to experience a major deflationary shock resulting from an unprecedented contraction of credit"; two years ago I concluded: "Fortunately the recession will pass, but will not leave its passage unmarked"; and last year I concluded: "This present alleviation (of the recession) comes at a terrible and continuing long-term cost: huge debts; high servicing costs; lower output ….." and presages "a watershed in economic management, in political power and moral sway and in changing world order ….." The scale of the cost in the UK is becoming evident, a continuing process, as the Euro crisis highlights, and the prospective pain of the remedial measures looms, encompassing lower employment, continuing business failure and a fall in the economy's output, now operating up to 10% below capacity. The depression resulting from a financial crisis is the worst since the Great Depression, but, fortunately, severe as it is, the worst consequences of that period appear to have been avoided, largely by improved economic management. However, there will be long-term changes following "The Second Great Contraction" which although discernible, are not yet evident.

The Group has improved the value of its development portfolio over the year and added slightly to the value of its investment portfolio. The short-term residential market is unattractive but the long-term market is becoming increasingly attractive. We expect to continue to realign the Group's assets to support a development programme at the appropriate time.

I D Lowe
Chairman

23 December 2010

The directors present their report and the group financial statements for the year ended 30 June 2010.

Activities

The principal activities of the group are the holding of property for both investment and development purposes.

Results and dividends

The group loss for the year after taxation amounted to £294,000 (*2009 profit £1,346,000).* The directors do not propose a dividend in respect of the current financial year (*2009 Nil*).

Business review

A full review of the group's business results for the year and future prospects is included in the Chairman's Statement within the Review of Activities on pages 2 to 5 and Future Progress on pages 19 to 20. In accordance with legislation the accounts have been prepared in accordance with IFRS as adopted by the EU ("adopted IFRS").

Key performance indicators

The key performance indicators for the group are property valuations, planning progress and the stability of house prices, all of which are discussed in the Chairman's Statement.

Principal risks and uncertainties

There are a number of potential risks and uncertainties, which have been identified within the business which could have a material impact on the group's long-term performance.

Planning and development

The increasing development profile of the group places increased emphasis on the planning stage of each project. The group seeks to minimise this risk with its firmly established risk control strategy, which includes detailed research and planning advice. On obtaining planning consent a decision will be taken on progressing the project on its own or with a joint development partner. At all stages the company seeks professional advice, conducts thorough diligence and continually monitors each development.

Property values

Conditions in the UK property market represent uncertainties in the operating environment rather than risks which can be managed. Nevertheless, many of the investment properties held by the group have development prospects or a development angle which will insulate them against the full effect of any general investment downgrade of commercial property.

Principal risks and uncertainties (continued)

Tenant relationships

All property companies have exposure to the covenant of their tenants as rentals drive capital values as well as providing the necessary cash flow to service debt. The group seeks to minimise exposure to any single sector or tenant across the portfolio and continually monitors payment performance.

Availability of funding

The group is dependent upon bank borrowings for current and future property transactions. Bank facilities are negotiated and tailored to each project in terms of quantum and timing. Any intended borrowings for future projects will be at conservative levels of gearing and should therefore be readily available.

Management of funding risk

The group seeks to ensure that adequate resources are available to meet the short and long term funding requirements of the group at all times and that any funding risks arising from group activities be effectively identified and managed.

Management of interest rate risks

Group borrowings are primarily in relation to and secured by properties, which are held as investments or are being developed. As and when future development projects are undertaken banking facilities will be negotiated and tailored to each project. Interest rate risk is constantly monitored and reviewed. This risk is managed by securing floating rate debt, which can be fixed from time to time by the group or by the use of interest rate swaps or other financial instruments.

Environmental policy

The group recognises the importance of its environmental responsibilities, monitors its impact on the environment and designs and implements policies to reduce any damage that might be caused by the group's activities.

Directors

The directors who held office at the year end and their interests in the company's share capital are set out below:

Beneficial interests - Ordinary shares of 20p each

	Percentage held	**30 June 2010**	30 June 2009
		£	£
ID Lowe	78.5	9,324,582	9,324,582
MJ Baynham	6.1	729,236	729,236
RJ Pearson	-	-	-
AJ Hartley	-	-	-

Beneficial interests - Floating rate loan stock 2012

ID Lowe	100.0	1,900,000	1,700,000

No rights to subscribe for shares or debentures of group companies were granted to any of the directors or their immediate families or exercised by them during the financial year.

Suppliers

It is the company's policy to settle suppliers' invoices within sixty days of their receipt.

Donations

The group made charitable donations of £33,000 *(2009: £27,000)*

Disclosure of information to auditors

The directors who held office at the date of approval of the Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the company auditors are unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the company auditors are aware of that information.

Auditors

In accordance with Section 489 of the Companies Act 2006, a resolution for the re-appointment of KPMG Audit Plc as auditors of the company is to be proposed at the forthcoming Annual General Meeting.

By Order of the Board

MJ Baynham
Secretary

23 December 2010

Statement of Directors’ responsibilities in respect of the directors’ report and financial statements

The directors are responsible for preparing the Directors' Report and the group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare group and parent company financial statements for each financial year. Under that law they are required to prepare the group financial statements in accordance with IFRSs as adopted by the EU and applicable law and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- for the group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group and the parent company will continue in business

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a Directors’ Report that complies with that law and those regulations.

KPMG Audit Plc
Saltire Court
20 Castle Terrace
Edinburgh EH1 2EG
United Kingdom

Independent Auditors' report to the members of Caledonian Trust PLC

We have audited the financial statements of Caledonian Trust Plc for the year ended 30 June 2010 set out on pages 27 to 29.

The financial reporting framework that has been applied in the preparation of the group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 24, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's web-site at www.frc.org.uk/apb/scope/UKNP.

Opinion on financial statements

In our opinion:
- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 30 June 2010 and of the group's loss for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the group financial statements, Article 4 of the IAS Regulation.

Independent Auditors’ report to the members of Caledonian Trust PLC (continued)

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Hugh Harvie (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants

23 December 2010

Group income statement for the year ended 30 June 2010

	Note	2010 £000	2009 £000
Gross rental income		**648**	650
Service charge income		**24**	24
Dilapidation income		**25**	57
Property charges		**(305)**	(265)
Net rental and related income		**392**	466
Proceeds from sale of trading properties		**370**	1,058
Carrying value of trading properties sold		**(347)**	(661)
Profit from disposal of trading properties		**23**	397
Administrative expenses		**(889)**	(880)
Other income		**81**	254
Other expenses		**-**	(14)
Net other income		**81**	240
Net operating (loss)/profit before investment property disposals and valuation movements	5	**(393)**	223
Profit on disposal of investment properties		**48**	163
Valuation gains on investment properties		**450**	1,932
Valuation losses on investment properties		**(205)**	(515)
Net valuation gains on investment properties		**245**	1,417
Operating (loss)/profit		**(100)**	1,803
Financial income	7	**1**	7
Financial expenses	7	**(195)**	(464)
Net financing costs		**(194)**	(457)
(Loss)/profit before taxation		**(294)**	1,346
Income tax	8	**-**	-
(Loss)/profit for the financial period attributable to equity holders of the company		**(294)**	1,346
(Loss)/earnings per share			
Basic (loss)/earnings per share (pence)	9	**(2.47p)**	11.33p
Diluted (loss)/earnings per share (pence)	9	**(2.47p)**	11.33p

The notes on pages 31- 49 form part of these financial statements.

Caledonian Trust PLC

Statement of comprehensive income for the year ended 30 June 2010

	2010	2009
	£000	£000
(Loss)/profit for the period attributable to the equity holders of the parent company	**(294)**	1,346
Change in fair value of equity securities available for sale	**3**	(9)
Total other comprehensive income/(loss)	**3**	(9)
Total comprehensive income for the period	**(291)**	1,337

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Caledonian Trust PLC

Consolidated balance sheet as at 30 June 2010

	Note	2010 £000	2009 £000
Non current assets			
Investment property	10	**16,410**	17,045
Property, plant and equipment	11	**22**	25
Investments	12	**5**	2
Total non-current assets		**16,437**	17,072
Current assets			
Trading properties	13	**10,891**	11,032
Trade and other receivables	14	**134**	207
Cash and cash equivalents	15	**250**	906
Total current assets		**11,275**	12,145
Total assets		**27,712**	29,217
Current liabilities			
Trade and other payables	16	**(485)**	(612)
Interest bearing loans and borrowings	17	**(5,673)**	(1,985)
		(6,158)	(2,597)
Non current liabilities			
Interest bearing loans and borrowings	17	**(1,900)**	(6,675)
Total liabilities		**(8,058)**	(9,272)
Net assets		**19,654**	19,945
Equity			
Issued share capital	21	**2,377**	2,377
Capital redemption reserve	22	**175**	175
Share premium account	22	**2,745**	2,745
Retained earnings	22	**14,357**	14,648
Total equity attributable to equity holders of the parent company		**19,654**	19,945

The financial statements were approved by the board of directors on 23 December 2010 and signed on its behalf by:

ID Lowe
Director

Company registration number 1040126

The notes on pages 31-49 form part of these financial statements.

Caledonian Trust PLC

Consolidated cash flow statement for the year ended 30 June 2010

	2010 £000	2009 £000
Cash flows from operating activities		
(Loss)/profit for the period	**(294)**	1,346
Adjustments for :		
Profit on sale of investment property	**(48)**	(163)
Gains on fair value adjustment of investment property	**(245)**	(1,417)
Depreciation	**12**	10
Net finance expense	**194**	457
Operating cash flows before movements in working capital	**(381)**	233
Decrease in trading properties	**121**	351
Decrease in trade and other receivables	**73**	252
(Decrease)/increase in trade and other payables	**(110)**	129
	(297)	965
Interest paid	**(210)**	(468)
Interest received	**1**	7
Net cash flows from operating activities	**(506)**	504
Investing activities		
Proceeds from sale of investment property	**947**	1,450
Acquisition of property, plant and equipment	**(10)**	(13)
Cash flows from investing activities	**937**	1,437
Financing activities		
Repayments of long term borrowings	**(1,087)**	(1,077)
Cash flows from financing activities	**(1,087)**	(1,077)
Net (decrease)/increase in cash and cash equivalents	**(656)**	864
Cash and cash equivalents at beginning of year	**906**	42
Cash and cash equivalents at end of year	**250**	906

1 Reporting entity

Caledonian Trust PLC is a company domiciled in the United Kingdom. The consolidated financial statements of the company for the year ended 30 June 2010 comprise the company and its subsidiaries as listed in note 5 in the parent company's financial statements (together referred to as "the Group"). The Group's principal activities are the holding of property for both investment and development purposes.

2 Statement of Compliance

The group financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards as adopted by the EU ("Adopted IFRSs"). The Company has elected to prepare its parent company financial statements in accordance with UK GAAP; these are presented on pages 50 to 57.

3 Basis of preparation

The financial statements are prepared on the historical cost basis except for available for sale financial assets and investment properties which are measured at their fair value.

The preparation of the financial statements in conformity with Adopted IFRSs requires the directors to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

These financial statements have been presented in pounds sterling which is the functional currency of all companies within the Group. All financial information has been rounded to the nearest pounds thousand.

Going concern

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Chairman's Statement on pages 2 to 20. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in Note 18.

In addition note 18 to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group and company finance their day to day working capital requirements through a combination of related party loans and three third party debt facilities (see note 17). The main debt draw down, which was £4.0m as at 30 June 2010 expires in February 2011. The loan facility of £1.0m is due for renewal within the next 12 months.

The group is in advanced discussions with a view to refinancing the main loan facility with a new lender. The directors believe that these negotiations will be successfully concluded and expect to sign a new facility in the near future. In addition, the group has received confirmation from the bank concerned that, should it be necessary, the £1.0m facility referred to above, will be renewed when it falls due.

3 Basis of preparation (continued)

There is of course no guarantee that the new facility will be agreed in which case the directors would seek to negotiate an extension to the current main debt facility whilst seeking alternative longer term funding. Should the existing lender not grant such an extension and call in the loan the directors are confident that they would be able to sell sufficient properties within a short timescale, albeit in all likelihood at reduced valuations from those currently shown in the financial statements, to repay the existing facility in full and keep within the other current facilities. In addition the major shareholder has committed to provide further additional funding up to £500,000 should this be necessary.

After making enquiries and considering the circumstances described above, the directors have a reasonable expectation that the group and company will have adequate resources to continue in operational existence for the foreseeable future. For these reasons they continue to adopt the going concern basis in preparing the financial statements.

Areas of estimation uncertainty and critical judgements

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements is contained in the following notes:

- *Valuation of investment properties (note 10)*
  The valuation of properties is subjective and based on similar transactions in the market, rental yields and development potential. The company's directors are experienced in dealing with such properties. Valuations at the balance sheet date are based on independent external valuations.

- *Valuation of trading properties (note 13)*
  Trading properties are carried at lower of cost and net realisable value. The net realisable value of such properties is based on the amount the company is likely to achieve in a sale to a third party which is dependent on availability of planning consent and demand for sites which is influenced by the housing and property markets.

- *Taxation (note 8)*

As noted in note 8, the company has treated a dilapidations payment from a tenant as a capital receipt and accordingly no taxation has been provided in these financial statements. In the event that HMRC do not agree with this treatment the directors will vigorously challenge any such contrary view. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

4 Accounting policies

The accounting policies below have been applied consistently to all periods presented.

Basis of consolidation
The financial statements incorporate the financial statements of the company and all its subsidiaries. Subsidiaries are entities controlled by the group. Control exists when the group has the power to determine the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date it ceases.

Revenue
Rental income from properties leased out under operating leases is recognised in the income statement on a straight line basis over the term of the lease. Costs of obtaining a lease and lease incentives granted are recognised as an integral part of total rental income and spread over the period from commencement of the lease to the earliest termination date on a straight line basis.

Revenue from the sale of trading properties is recognised in the income statement on the date at which the significant risks and rewards of ownership are transferred to the buyer with proceeds and costs shown on a gross basis.

Other income
Other income comprises income from agricultural land and other miscellaneous income

Finance income and expenses
Finance income and expenses comprise interest payable on bank loans and other borrowings. All borrowing costs are recognised in the income statement using the effective interest rate method. Interest income represents income on bank deposits using the effective interest rate method.

Taxation
Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case the charge / credit is recognised in equity. Current tax is the expected tax payable on taxable income for the current year, using tax rates enacted or substantively enacted at the reporting date, adjusted for prior years under and over provisions.
Deferred tax is provided using the balance sheet liability method in respect of all temporary differences between the values at which assets and liabilities are recorded in the financial statements and their cost base for taxation purposes. (Deferred tax includes current tax losses which can be offset against future capital gains.) As the carrying value of the group's investment properties is expected to be recovered through eventual sale rather than rentals, the tax base is calculated as the cost of the asset plus indexation. Indexation is taken into account to reduce any liability but does not create a deferred tax asset. A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

Investment properties

Investment properties are properties owned by the group which are held either for long term rental growth or for capital appreciation or both. Properties transferred from trading properties to investment properties are revalued to fair value at the date on which the properties are transferred. When the Group begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property, which is

4 Accounting policies (continued)

Investment properties (continued)
measured based on fair value model, and is not reclassified as property, plant and equipment during the redevelopment.

The cost of investment property includes the initial purchase price plus associated professional fees. Borrowing costs directly attributable to the acquisition or construction of qualifying assets are capitalised during the period of construction. Subsequent expenditure on investment properties is only capitalised to the extent that future economic benefits will be realised.
Investment property is measured at fair value at each balance sheet date. External independent professional valuations are prepared at least once every three years. The fair values are based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arms length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Any gain or loss arising from a change in fair value is recognised in the income statement.

Purchases and sales of investment properties
Purchases and sales of investment properties are recognised in the financial statements at completion which is the date at which the significant risks and rewards of ownership are transferred to the buyer.

Property, plant and equipment
Property, plant and equipment are stated at cost, less accumulated depreciation and any provision for impairment. Depreciation is provided on all property, plant and equipment at varying rates calculated to write off cost to the expected current residual value by equal annual instalments over their estimated useful economic lives. The principal rates employed are:

Office equipment	-	33.3 per cent
Plant and equipment	-	20.0 per cent
Fixtures and fittings	-	33.3 per cent
Motor vehicles	-	33.3 per cent

Trading properties
Trading properties held for short term sale or with a view to subsequent disposal in the near future are stated at the lower of cost or net realisable value. Cost is calculated by reference to invoice price plus directly attributable professional fees. Net realisable value is based on estimated selling price less estimated cost of disposal

Financial assets

Trade and other receivables
Trade and other receivables are initially recognised at fair value and then stated at amortised cost.

Financial instruments

Available for sale financial assets
The group's investments in equity securities are classified as available for sale financial assets. They are initially recognised at fair value plus any directly attributable transaction costs. Subsequent to initial recognition they are measured at fair value and changes therein, other than

4 Accounting policies (continued)

impairment losses, are recognised directly in equity. The fair value of available for sale investments is their quoted bid price at the balance sheet date. When an investment is disposed of, the cumulative gain or loss in equity is recognised in profit or loss. Dividend income is recognised when the company has the right to receive dividends either when the share becomes ex dividend or the dividend has received shareholder approval.

Cash and cash equivalents

Cash includes cash in hand, deposits held at call (or with a maturity of less than 3 months) with banks, and bank overdrafts. Bank overdrafts that are repayable on demand and which form an integral part of the Group's cash management are shown within current liabilities on the balance sheet and included with cash and cash equivalents for the purpose of the statement of cash flows.

Financial liabilities

Trade payables

Trade payables are non-interest-bearing and are initially measured at fair value and thereafter at amortised cost.

Interest bearing loans and borrowings

Interest-bearing loans and bank overdrafts are initially carried at fair value less allowable transactions costs and then at amortised cost.

IFRS not yet effective

The following IFRS have been adopted by the EU and so will require to be applied in future periods and are expected to affect the entity

IFRS 7 Financial Instruments: Disclosures – Amendments to disclosures will become mandatory for the 2011 Group and Company financial statements. IFRS 7 is amended to add an explicit statement that the interaction between qualitative and quantitative disclosures better enables users to evaluate an entity's exposure to risks arising from financial instruments.

The following new standards, amendments to standards and interpretations are mandatory for the first time for financial periods commencing on 1 January 2009 but are not currently relevant for the Group:

- IAS 23 (amendment) 'Borrowing costs';
- IFRS 2 (amendment) 'Share-based payment';
- IAS 32 (amendment) 'Financial instruments: Presentation';
- IFRIC 16 'Hedges of a net investment in a foreign operation'; and
- IAS 39 (amendment) 'Financial instruments: Recognition and measurement'.

4 Accounting policies (continued)

Changes in accounting policies

The following new standards and amendments to standards are mandatory for financial periods commencing on 1 January 2009 and have therefore been adopted by the Group:

- IAS 1 (revised) 'Presentation of financial statements'.
- IFRS 8 'Operating segments'.

IAS 1 (revised) Presentation of financial statements

The Group has applied IAS 1 (revised 2007) 'Presentation of financial statements' in these financial statements. As a result, the Group presents a statement of comprehensive income. All 'non-owner changes in equity' are required to be shown in a performance statement. The Group has elected to present two statements: an income statement and a statement of comprehensive income. Owner changes in equity are shown in a statement of changes in equity.

Comparative information has been re-presented so that it also is in conformity with the revised standard. Since the change in accounting policy only impacts presentation aspects, there is no impact on earnings per share.

Determination and presentation of operating segments

The Group has adopted IFRS 8 'Operating segments' which replaces IAS 14 'Segment reporting'. Therefore, from 1 July 2009 the Group determines and presents operating segments based on the information that is internally provided to the Board of Directors ("The Board"), which is the Group's chief operating decision maker.

The directors review information in relation the group's entire property portfolio, regardless of its type or location and as such are of the opinion that there is only one reportable segment which is represented by the consolidated position presented in the primary statements. There has been no impact on the measurement of the Group's assets and liabilities as a result of the adoption of this standard. Since the change in accounting policy only impacts presentation and disclosure aspects, there is no impact on earnings per share.

5 Operating profit/(loss)

	2010	2009
	£000	£000
The operating (loss)/profit is stated after charging :		
Depreciation	**12**	10
Fees paid to auditors		
- audit of the financial statements	**13**	13
- audit of financial statements of subsidiaries pursuant to legislation	**13**	14
	======	======

6 Employees and employee benefits

	2010	2009
	£000	£000
Employee remuneration		
Wages and salaries	**365**	349
Social security costs	**42**	39
Other pension costs	**58**	64
	465	452

Other pension costs represent contributions to defined contribution plans

The average number of employees during the year was as follows:

	No.	No.
Management	**2**	2
Administration	**2**	2
Other	**4**	3
	8	7

The directors consider that key management personnel are the company's directors. Compensation is shown below:

	2010	2009
Remuneration of directors	**£000**	£000
Directors' emoluments	**256**	251
Company contributions to money purchase pension schemes	**52**	59

Retirement benefits are accruing to 2 *(2009 - 2)* directors under money purchase schemes.

The directors who served during the year and their remuneration for the year are shown below:

Director	Salary Fees	Benefits	Pension Contributions	**2010 Total**	2009 Total
	£000	£000	£000	**£000**	£000
ID Lowe	110	3	28	**141**	144
MJ Baynham	125	2	25	**152**	150
AJ Hartley	8	-	-	**8**	8
RJ Pearson	8	-	-	**8**	8
	251	5	53	**309**	310

Notes to the consolidated financial statements (continued)

7 Finance income and finance costs

	2010 £000	2009 £000
Finance income		
Interest receivable:		
- on bank balances	**1**	7
Finance costs		
Interest payable:		
- Bank loans and overdrafts	**132**	377
- Loan stock repayable within five years	**63**	87
	195	464

8 Income tax

	2010 £000	2009 £000
Recognised in the income statement		
UK corporation tax – current period	**-**	-
	-	-
Deferred tax – effect of change in rate	**-**	-
Deferred tax – current period	**-**	-
Total income tax charged in income statement	**-**	-

Reconciliation of effective tax rate

	2010 £000	2009 £000
(Loss)/profit before tax	**(294)**	1,346
Current tax at 28% (2009 : 28%)	**(82)**	377
Effects of:		
Expenses not deductible for tax purposes	**23**	18
Capital gains tax indexation (restricted)	**(30)**	(345)
Deferred tax asset not recognised	**74**	(53)
Other	**15**	3
Total tax credit	**-**	-

Notes to the consolidated financial statements (continued)

8 Income tax (continued)

In the case of deferred tax in relation to investment property revaluation surpluses, the base cost used is historical book cost and includes allowances or deductions which may be available to reduce the actual tax liability which would crystallise in the event of a disposal of the asset.

The Emergency Budget on 22 June 2010 announced a phased reduction in the main UK corporation tax rate from 28% to 24%, with the first 1% reduction taking effect from 1 April 2011. The first 1% reduction was "substantively enacted" for the purposes of IFRS and UK GAAP (i.e. completed its Commons stages) on 20 July 2010. The remaining 3% reduction is expected to be included on a phased basis in future Finance Acts. There will be no material impact on the accounts as a result of the change in corporation tax rate.

Factors affecting the future tax charge

The group received a dilapidations payment from the former tenants of an investment property amounting to £2,100,000 during the year ended 30 June 2005. The payment was made to fulfil the tenant's obligations under the repairing lease held by them. The directors successfully promoted a development brief for the island site of which the property forms part which was formally adopted by the Planning Authority in August 2009. The directors have been progressing an outline planning consent for the site owned by the group which forms part of this island site which the Planning Authority are now minded to grant subject to completion of a Section 75 Agreement which is currently in solicitors' hands and will be completed shortly. Accordingly the repair work to the property has not been carried out and it is unlikely that it will be undertaken. The receipt was treated as a capital receipt for taxation purposes on which basis no taxation was payable or has been provided. HMRC has queried the tax treatment of this receipt and there is an ongoing dialogue with HMRC local inspector on the matter. The directors continue to be of the opinion that the receipt is a capital receipt and accordingly no taxation has been provided in these financial statements. In the event that HMRC do not agree with this treatment the directors will vigorously challenge any such contrary view. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

9 (Loss)/earnings per share

Basic (loss)/earnings per share is calculated by dividing the (loss)/earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period as follows:

	2010	2009
	£000	£000
(Loss)/profit for financial period	**(294)**	1,346
	========	========
	No.	No.
Weighted average no. of shares: for basic earnings per share and for diluted earnings per share	**11,882,923**	11,882,923
	========	========
Basic (loss)/earnings per share	**(2.47p)**	11.33p
Diluted (loss)/earnings per share	**(2.47p)**	11.33p

The diluted figure per share is the same as the basic figure per share as there are no dilutive shares.

10 Investment properties

	2010	2009
	£000	£000
Valuation		
At 30 June 2009	**17,045**	16,915
Revaluation in year	**245**	1,417
Sold in year	**(900)**	(1,287)
Additions in year	**20**	-
Valuation at 30 June 2010	**16,410**	17,045

The carrying amount of investment property is the fair value at the balance sheet date as determined by external independent valuations at open market value made by Montagu Evans, independent property consultants, at 30 June 2010. The properties have been valued individually in accordance with the definition of market value and good practice guidelines set out in the 6th Edition of the Royal Institution of Chartered Surveyors valuation and appraisal manual. In this regard, market value is defined as "the estimated amount for which a property should exchange between a willing buyer and willing seller in an arm's length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion". The valuers have taken into account rental values and development potential.

Fair values were calculated having regard to recent transactions for similar properties.

Investment properties comprise a number of commercial properties, some of which are leased to third parties with an initial rental period. Subsequent renewals are negotiated with the tenant.

The cumulative amount of interest capitalised in respect of the group's investment properties is £ 684,000 *(2009: £744,502)*.

Certain of the company's investment properties with a carrying value of £13,125,000 *(2009: £13,760,000)* are secured against bank borrowings and as such on disposal of investment properties a proportion of proceeds are remitted to reduce bank borrowings

11 Property, plant and equipment

	Motor Vehicles £000	Fixtures and fittings £000	Other equipment £000	Total £000
Cost				
At 30 June 2008	15	48	33	96
Additions in year	3	-	10	13
At 30 June 2009	**18**	**48**	**43**	**109**
Additions in year	-	4	5	9
At 30 June 2010	**18**	**52**	**48**	**118**
Depreciation				
At 30 June 2008	15	45	14	74
Charge for year	2	-	8	10
At 30 June 2009	**17**	**45**	**22**	**84**
Charge for year	**-**	**4**	**8**	**12**
At 30 June 2010	**17**	**49**	**30**	**96**
Net book value				
At 30 June 2010	1	3	18	22
At 30 June 2009	1	3	21	25

12 Investments

	2010 £000	2009 £000
Available for sale investments		
At the start of the year	**2**	11
Gain/(loss) on investments recognised in equity	**3**	(9)
Available for sale financial assets	**5**	2

13 Trading properties

	2010 £000	2009 £000
At start of year	**11,032**	11,383
Additions	**206**	310
Disposals	**(347)**	(661)
At end of year	**10,891**	11,032

Trading properties with carrying value of £2,546,000 (2009: £2,524,000) are secured against the Group's bank borrowings.

14 Trade and other receivables

	2010	2009
	£000	£000
Amounts falling due within one year		
Other debtors	**52**	97
Prepayments and accrued income	**82**	110
	134	207

The company's exposure to credit risks and impairment losses relating to trade receivables is given in note 18.

15 Cash and cash equivalents

	2010	2009
	£000	£000
Cash	**250**	906

Cash and cash equivalents comprise cash at bank and in hand. Cash deposits are held with UK banks. The carrying amount of cash equivalents approximates to their fair values. The company's exposure to credit risk on cash and cash equivalents is regularly monitored.

16 Trade and other payables

	2010	2009
	£000	£000
Accruals and other creditors	**485**	612

The Group's exposure to currency and liquidity risk relating to trade payables is disclosed in note 18.

17 Other interest bearing loans and borrowings

The Group's interest bearing loans and borrowings are measured at amortised costs. More information about the Group's exposure to interest rate risk and liquidity risk is given in note 18.

Current liabilities

	2010	2009
	£000	£000
Current portion of secured bank loans	**5,673**	1,985

Non current liabilities

	2010	2009
Non-current portion of secured bank loans	**-**	4,975
Floating rate unsecured loan stock	**1,900**	1,700
	1,900	6,675

17 Other interest bearing loans and borrowings (continued)

Terms and debt repayment schedule

Terms and conditions of outstanding loans and loan stock were as follows:

	Currency	Nominal interest rate	**2010 Fair value £000**	**2010 Carrying amount £000**	2009 Fair value £000	2009 Carrying amount £000
Secured bank loans	GBP	LIBOR + 0.95 to 3.00% Base +1.5%	**5,673**	**5,673**	6,960	6,960
Floating rate unsecured loan stock	GBP	Base + 3%	**1,900**	**1,900**	1,700	1,700
			7,573	**7,573**	8,660	8,660

The bank loans are secured by standard securities and charges over the assets of certain subsidiaries and by an unlimited guarantee by Caledonian Trust PLC.

18 Financial instruments

Fair values

Fair values versus carrying amounts

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

	30 June 2010 Fair value £000	**30 June 2010 Carrying amount £000**	30 June 2009 Fair value £000	30 June 2009 Carrying amount £000
Available for sale financial assets	**5**	**5**	2	2
Trade and other receivables	**134**	**134**	207	207
Cash and cash equivalents	**250**	**250**	906	906
	389	**389**	1,115	1,115
Secured bank loans	**(5,673)**	**(5,673)**	(6,960)	(6,960)
Loan from related party	**(1,900)**	**(1,900)**	(1,700)	(1,700)
Trade and other payables	**(485)**	**(485)**	(612)	(612)
	(8,058)	**(8,058)**	(9,272)	(9,272)

18 Financial instruments (continued)

Estimation of fair values

The following methods and assumptions were used to estimate the fair values shown above:

Available for sale financial assets **–** as such assets are listed, the fair value is determined at the market price.

Trade and other receivables/payables – the fair value of receivables and payables with a remaining life of less than one year is deemed to be the same as the book value.

Cash and cash equivalents – the fair value is deemed to be the same as the carrying amount due to the short maturity of these instruments.

Secured bank loans and other loans – the fair value is calculated by discounting the expected future cashflows at prevailing interest rates

Overview of risks from its use of financial instruments

The Group has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk

The Board of Directors has overall responsibility for the establishment and oversight of the company's risk management framework and oversees compliance with the Group's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Group.

The Board's policy is to maintain a strong capital base so as to cover all liabilities and to maintain the business and to sustain its development.

The Board of Directors also monitors the level of dividends to ordinary shareholders.

There were no changes in the Group's approach to capital management during the year.

Neither the company nor any of its subsidiaries are subject to externally imposed capital requirements.

The group's principal financial instruments comprise bank loans, cash and short term deposits. The main purpose of these financial instruments is to finance the group's operations.

As the group operates wholly within the United Kingdom, there is currently no exposure to currency risk.

The main risks arising from the group's financial instruments are interest rate risks and liquidity risks. The board reviews and agrees policies for managing each of these risks, which are summarised below

18 Financial instruments (continued)

Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Group's receivables from customers, cash held at banks and its available for sale financial assets.

Trade receivables

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each tenant. The majority of rental payments are received quarterly in advance which reduces the group's exposure to credit risk on trade receivables.

Other receivables

Other receivables consist of amounts due from a company in which the group holds a minority investment and an amount due from a previous tenant in respect of dilapidations.

The Group reviews the carrying value of trade and other receivables and will establish an impairment provision only if there are indications that the debt is not recoverable.

Available for sale financial assets

The Group does not actively trade in available for sale financial assets. The Group's investments had a fair value of £5,000 at 30 June 2010 *(2009: £2,000)* and so the Group does not have significant exposure to credit risk in relation to these assets.

Bank facilities

At the year end the company had loan facilities of £7.6 million *(2009: £8.7 million)* available.

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	Carrying value	
	2010	2009
	£000	£000
Available for sale investments	**5**	2
Other receivables	**52**	97
Cash and cash equivalents	**250**	906
	307	1,005

A table showing the ageing of receivables at the balance sheet date is not disclosed as the company does not have trade receivables at the year end or previous year end. This position is representative of the position throughout the year.

The company does not have an allowance for impairment on trade receivables as, based on historical experience, management does not consider that such an impairment is required.

Credit risk for trade receivables at the reporting date was all in relation to property tenants in United Kingdom.

The company's exposure is spread across a number of customers.

Notes to the consolidated financial statements (continued)

18 Financial instruments (continued)

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking damage to the Company's reputation.

The group's main banking facility is subject to financial covenants and other conditions which the group monitors regularly. These covenants and conditions are sensitive to changes in rental income, interest rates and the value of properties. Whilst the directors cannot envisage all possible circumstances, the directors believe that, taking account of reasonably foreseeable adverse movements in rental income, interest or property values, the group has sufficient resources available to it, including additional support from the major shareholder if necessary, to ensure continued compliance with these conditions.

The group's exposure to liquidity risk is given below

30 June 2010	Carrying amount	Contractual cash flows	6 months or less	6-12 months	1-2 years
Secured bank loans	5,673	5,766	771	4,995	
Floating rate unsecured loan stock	1,900	2,034	67	67	1,900
Trade and other payables	485	485	485	-	-

30 June 2009	Carrying amount	Contractual cash flows	6 months or less	6-12 months	1-2 years
Secured bank loans	6,960	7,155	2,059	53	5,043
Floating rate unsecured loan stock	1,700	1,760	30	30	1,700
Trade and other payables	612	612	612	-	-

18 Financial instruments (continued)

Market risk

Market risk is the risk that changes in market prices, such as interest rates, will affect the company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Interest rate risk

The Group borrowings are at floating rates of interest based on LIBOR or Base Rate.

The interest rate profile of the Group's borrowings as at the year end was as follows:

	2010	2009
	£000	£000
Floating rate instruments – financial liabilities	**7,573**	8,660

The weighted average interest rate of the floating rate borrowings was 2.80 % *(2009: 2.61%)*.

A 1% movement in interest rates would be expected to change the Group's annual net interest charge by £75,000 *(2009: £86,000)*.

19 Operating leases

Leases as lessors

The group leases out its investment properties under operating leases. The future minimum receipts under non cancellable operating leases are as follows:

	2010	2009
	£000	£000
Less than one year	**529**	524
Between one and five years	**1,923**	1,982
Greater than five years	**4,093**	5,022
	6,545	7,528

The amounts recognised in income and costs for operating leases are shown on the face of the income statement.

Notes to the consolidated financial statements (continued)

20 Income tax and deferred tax

At 30 June 2010, the group has a potential deferred tax asset of £866,000 (2009: £670,000) of which £351,000 (2009: £261,000) relates to differences between the carrying value of investment properties and the tax base. In addition the group has tax losses which would result in a deferred tax asset of £515,000 (2009: £409,000). This has not been recognised due to the uncertainty over future taxable profits.

Movement in unrecognised deferred tax asset

£'000	Balance 1 July 08 at 28%	Additions	Balance 30 June 09 at 28%	Additions	**Balance 30 Jun 10 at 28%**
	£000	£000	£000	£000	**£000**
Investment properties	265	(4)	261	90	**351**
Tax losses	458	(49)	409	106	**515**
Total	723	(53)	670	196	**866**

21 Issued share capital

	30 June 2010		**30 June 2009**	
	No	**£000**	No.	£000
Authorised				
Ordinary shares of 20p each	**20,000,000**	**4,000**	20,000,000	4,000
Issued and fully paid				
Ordinary shares of 20p each	**11,882,923**	**2,377**	11,882,923	2,377

Holders of ordinary shares are entitled to dividends declared from time to time, to one vote per ordinary share and a share of any distribution of the company's assets.

Notes to the consolidated financial statements (continued)

22 Capital and reserves	Share capital £000	Capital redemption reserve £000	Share premium account £000	Retained earnings £000	Total £000
At 1 July 2009	2,377	175	2,745	14,648	**19,945**
Total recognised income and expense	-	-	-	(291)	**(291)**
At 30 June 2009	2,377	175	2,745	14,357	**19,654**

Capital redemption reserve arose in prior years on redemption of share capital. The reserve is not distributable
The share premium account is used to record the issue of share capital above par value. This reserve is not distributable and can only be reduced with court approval
The retained earnings reserve is distributable with the exception of amounts arising in relation to property revaluations of £875,000 (2009: £1,200,000). Such reserve is only distributable when the revalued assets are sold outside the group.

23 Related parties

Transactions with key management personnel

Transactions with key management personnel consist of compensation for services provided to the company. Details of this are given in note 6.

Other related party transactions

The parent company has a related party relationship with its subsidiaries. The group and company has unsecured floating rate loan stock due to Leafrealm Limited, a company of which ID Lowe is the controlling shareholder. This is on normal commercial terms. Leafrealm received £63,000 *(2009: £87,000)* interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year end was £1,900,000 (2008: £1,700,000).

Company balance sheet at 30 June 2010

	Note	£000	2010 £000	£000	2009 £000
Fixed assets					
Tangible assets					
Investment properties	3		**4,425**		5,435
Equipment and vehicles	4		**22**		25
			4,447		5,460
Investments	5		**11,162**		11,159
			15,609		16,619
Current assets					
Stock of development property	6	**3,003**		3,270	
Debtors	7	**16,470**		16,702	
Cash at bank and in hand		**197**		638	
		19,670		20,610	
Creditors					
Amounts falling due within one year	8	**(15,958)**		(12,358)	
Net current assets			**3,712**		8,252
Total assets less current liabilities			**19,321**		24,871
Creditors					
Amounts falling due after more than one year	8		**(1,900)**		(6,675)
Net assets			**17,421**		18,196
Capital and reserves					
Called up share capital	9		**2,377**		2,377
Share premium account			**2,745**		2,745
Capital redemption reserve			**175**		175
Revaluation reserves:					
Property	10		**1,991**		2,520
Investments	10		**1,305**		1,305
Profit and loss account	10		**8,828**		9,074
Shareholders' funds			**17,421**		18,196

The financial statements were approved by the board of directors on 23 December 2010 and signed on its behalf by:

ID Lowe
Director

The notes on pages 51-57 form part of these financial statements.

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1 Accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the financial statements.

Basis of preparation

The financial statements are prepared under the historical cost convention as modified by the revaluation of investment properties and investments and in accordance with applicable accounting standards. The company has not presented its own profit and loss account in accordance with section 408 of the Companies Act 2006.

The company has taken advantage of the exemption contained within FRS 8 and has not disclosed details of transactions or balances with companies the results of which are included within the consolidated accounts of Caledonian Trust PLC.

Properties

Properties held by the group are classified within fixed assets as investment properties, or current assets if held as trading stock.

Investment properties

In accordance with Statement of Standard Accounting Practice No 19, investment properties are revalued annually at open market value either by the directors or by independent professional advisers. Independent professional valuations are prepared at least once every three years. All surpluses and deficits on valuation are taken directly to revaluation reserve except that any permanent diminution in the value of the investment property is taken to the profit and loss account for the year. No depreciation or amortisation is provided in respect of freehold investment properties.

This treatment may be a departure from the Companies Act requirements concerning the depreciation of fixed assets. However, the properties are not held for consumption but for investment and the directors consider that systematic annual depreciation would be inappropriate. The accounting policy adopted is therefore necessary for the accounts to give a true and fair view. Depreciation or amortisation is only one of the many factors reflected in the annual valuation and the amount which might otherwise have been shown cannot be separately identified or quantified.

1 Accounting policies (continued)

Properties held as stock

Properties held as trading stock are stated at the lower of cost or net realisable value.

For properties previously held as investment properties which are now held for development and reclassified as current assets, cost is considered to be the latest valuation prior to their reclassification. This is not in accordance with the Companies Act 2006, which requires current assets to be included at the lower of cost and net realisable value, and which would therefore require such properties to be restated on the basis of historical cost when they are reclassified. The directors consider that compliance with this requirement would fail to give a true and fair view of the profit and loss to the company on disposal of such properties from current assets, since such profit or loss would be dependent on the classification of the asset immediately prior to sale. The effect of this departure is to increase both the value of properties held for resale and the balance on the revaluation reserve by £nil at 30 June 2010 *(2009 - £nil)*.

Investments

Investments in subsidiary undertakings are included in the balance sheet of the company at valuation representing the net asset value of the undertaking concerned. Surpluses or deficits arising on revaluations are taken to the revaluation reserve except in the case of impairments which are taken to the profit and loss account. The revaluation reserve is not distributable.

Other investments are held at cost unless they are considered to have suffered a permanent impairment. Such impairments are taken to the profit and loss account.

Dividends on shares presented within shareholders' funds

Dividends unpaid at the balance sheet date are only recognised as a liability at that date to the extent that they are appropriately authorised and are no longer at the discretion of the company. Unpaid dividends that do not meet these criteria are disclosed in the notes to the financial statements.

Depreciation

Tangible fixed assets, other than investment properties, are depreciated by equal instalments over their estimated useful lives at the following rates:

Office equipment	-	33.3 per cent
Plant and equipment	-	20.0 per cent
Fixtures and fittings	-	33.3 per cent
Motor vehicles	-	33.3 per cent

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1 Accounting policies (continued)

Taxation

The charge for taxation is based on the profit for the year and takes into account taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes.

Deferred tax is recognised, without discounting, in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by FRS 19.

Post retirement benefits

The group makes payments to defined contribution pension schemes on behalf of certain employees. The amount charged to the profit and loss account represents the contributions payable to the schemes in respect of the accounting period.

2 Profit of parent company

As permitted by Section 230 of the Companies Act 1985, the profit and loss account of the parent company is not presented as part of these financial statements. The parent company's loss for the financial period after taxation was £648,000.

3 Investment properties

Investment properties	**£000**
Valuation	**£000**
At 30 June 2009	5,435
Additions in year	20
Revaluation deficit in year	(130)
Disposals in year	(900)
Valuation at 30 June 2009	4,425

The carrying amount of investment property is the fair value at the balance sheet date as determined by external independent valuations at open market value made by Montagu Evans, independent property consultants, at 30 June 2010.

Fair values were calculated having regard to recent transactions for similar properties.

Investment properties comprise a number of commercial properties, some of which are leased to third parties with an initial rental period. Subsequent renewals are negotiated with the tenant.

	2010	2009
	£000	£000
The historical cost of investment properties included at valuation is:	**2,260**	2,915

The cumulative amount of interest capitalised for the company is £157,000 *(2009 - £218,000).*

4 Tangible fixed assets

	Motor vehicles £000	Office equipment £000	Other equipment £000	Total £000
Cost				
At 30 June 2009	18	48	43	109
Additions in year	-	4	5	9
At 30 June 2010	**18**	**52**	**48**	**118**
Depreciation				
At 30 June 2009	17	45	22	84
Charged in year	-	4	8	12
At 30 June 2010	**17**	**49**	**30**	**96**
Net book value At 30 June 2010	**1**	**3**	**18**	**22**
At 30 June 2009	1	3	21	25

5 Investments

	Shares in subsidiary investments £000	Listed investments £000	Total £000
Cost			
At 30 June 2009	4,933	2	4,935
Revaluation surplus	-	3	3
At 30 June 2010	4,933	5	4,938
Revaluation surplus			
At 30 June 2009 and 2010	6,224	-	6,224
Net book value			
At 30 June 2010	**11,157**	**5**	**11,162**
At 30 June 2009	11,157	2	11,159

Subsidiary undertaking	% of ordinary shares held	Activity
Caledonian Scottish Developments Ltd	100%	Property Development
South Castle Properties Ltd	100%	Property Investment
Caledonian Stoneywood Ltd	100%	Investment Holding Company
Caledonian City Developments Ltd	100%	Property Development
West Castle Properties Ltd	100%	Property Investment
Melville Management Ltd	100%	Property Investment

All the principal subsidiary undertakings are included in the consolidated Group accounts and are registered in Scotland except Caledonian City Developments Limited and Caledonian Stoneywood Ltd, which are registered in England and Wales. A list of the other subsidiary undertakings will be included in the company's next annual return.

The company holds an unlisted investment of 19.9% of the share capital of Bedrocks Limited, a leisure activity operator registered in Scotland.

The market value of the company's listed investments at 30 June 2010 was £5,000 (2009 £2,000)

6 Stock of development property

	2010 £000	2009 £000
Properties held for resale or development	**3,003**	3,270

7 Debtors

	2010 £000	2009 £000
Amounts falling due within one year		
Prepayments and accrued income	**52**	71
Group relief receivable	**54**	225
	106	296
Amounts falling due in more than one year		
Amounts owed by subsidiary undertakings	**16,364**	16,406
	16,470	16,702

8 Creditors

Amounts falling due within one year

	2010	2009
Bank loans	**3,975**	287
Amounts owed to subsidiary undertakings	**11,576**	11,665
Other creditors and accruals	**407**	406
	15,958	12,358

	2010	2009
Amounts falling due after more than one year		
Bank loans	**-**	4,975
Floating rate unsecured loan stock	**1,900**	1,700
	1,900	6,675

Analysis of debt

	2010	2009
Debt can be analysed as falling due:		
In one year or less, or on demand	**3,975**	287
Between one and two years	**1,900**	1,700
Between two and five years	**-**	4,975
	5,875	6,962

The company's bank loans are secured by standard securities and floating charges over the assets of the company and certain subsidiaries and by an unlimited guarantee from Caledonian Trust PLC. Interest charged on these loans is based on margins ranging from 0.94% over the prevailing London Interbank Offer Rate to 1.5% over the Bank of Scotland base rate.

The floating rate unsecured loan stock is repayable in July 2012. Interest is charged at a margin of 3% over the Bank of Scotland base rate.

9 Share capital

	2010 No.	2010 £000	2009 No.	2009 £000
Authorised				
Ordinary shares of 20p each	**20,000,000**	**4,000**	20,000,000	4,000
Allotted, called up and fully paid				
Ordinary shares of 20p each	**11,882,923**	**2,377**	11,882,923	2,377

10 Reserves

	Revaluation reserves Property £000	Revaluation reserves Investments £000	Profit and loss account £000
Balance at 30 June 2009	2,520	1,305	9,074
Property revaluation in year	(130)	-	2
Loss for the financial year			(647)
Transfer to profit and loss	(399)		399
Balance at 30 June 2010	**1,991**	**1,305**	**8,828**

The movement in the valuation of investment properties has been reflected through the revaluation reserve as the directors are of the opinion that such increases are temporary.

11 Reconciliation of movements in shareholders' funds

	2010 £000	2009 £000
Retained loss for the financial year	**(647)**	(502)
Revaluation(deficit)/surplus	**(128)**	132
Net decrease in shareholders' funds	**(775)**	(370)
Opening shareholders' funds	**18,196**	18,566
Closing shareholders' funds	**17,421**	18,196

12 Related party transactions

The group and company have unsecured floating rate loan stock due to Leafrealm Limited, a company of which ID Lowe is the controlling shareholder. This is on normal commercial terms. Leafrealm received £63,000 *(2009: £87,000)* interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year end was £1,900,000 (2009: £1,700,000). Transactions with subsidiary undertakings have not been disclosed as the company has taken advantage of the exemption contained within FRS 8.