Accounting and the saudi stock crash in 2006

Finance

In the article, the compares the accounting principles used for financial reporting of companies to evaluate the economic developments in countries. As the author compares the country finances to company finances, he replaces stockholders with stakeholders, the general US public. The author concludes that because the US has been increasing its liability during the recent financial crisis, it will impact the stakeholders such that their standard of living will go down and those holding cash and/or investing in US treasuries will suffer losses; therefore one must invest in equities and some other commodities to reap benefits. However, using principles of financial accounting of companies to evaluate the financial position of countries is not appropriate and the conclusions in the article are incorrect due to several reasons.

Firstly, the author says that the US has taken on too many liabilities and will not be able to cover them with the existing assets. Using the accounting equation, Assets = Liabilities + Equity, this means that from financial standpoint, the US is in a negative equity position. This is in contradiction to the fact that the US GDP has continued to grow positively since the last quarter of 2009 (Trading Economics, 2011). It is therefore evident that using financial accounting principles to evaluate countries is not correct. The underlying reason is that the asset and liability position of a country is quite dynamic. The liabilities increase when government raises money from the market by selling bonds; however, unlike most companies, the government is much more active in buying back these bonds from the same entities (banks) when it wants to reduce the money supply.

Secondly, the author’s key assumption is the increased long-term liability on one side has been balanced only by cash. However, the government has used the liability to increase its other assets too. It has increased the money supply in the market to spur growth in the economy. This increased growth will bring higher demand and therefore higher revenue to the government. Next, the author assumes that the liability taken up now will not be able to be met through existing assets. However, the government has several ways to increase their revenue to meet the liabilities. It can increase taxes and/or reduce spending. In the case of a company, it compares to increasing product prices and reducing costs. For a government, it is much easier to take these steps than for companies which are bound by the competition and internal fixed costs. Therefore, the government can easily increase its revenue to pay for these liabilities. This is also evident from the recent developments in the US where policy makers are actually considering a tax increase (Bloomberg, 2011).

Further, the author assumes that the treasury bonds will suffer from defaults, and that equity and commodities are the instruments to invest in. This is based on two assumptions – total assets at present will not cover the total liabilities of the US, and equity and commodity markets will necessarily give better return. However, for a country, assets and liabilities are more dynamic and given the volatility in the equity and commodity markets, people are much safer investing in bonds than in equity markets.

Finally, in saying that the standard of living of the people in US will go down, the author assumes that the value of the US Dollar (USD) will drop significantly. However, he does not take into account the fact that all the countries have been forced to pump money into the economy, and not just the US. Europe is doing the same and so are most other countries in Middle East and Asia. Therefore, to assume that the value of USD will go down seems to be pre-mature. This is also evident from the fact that the value of USD has not fallen significantly over the last months - the Nominal Broad Dollar Index (an index that evaluates the USD against a basket of several foreign currencies) made by the Federal Reserve was at 98. 8 in October 2010, and is currently at 101 (Federal Reserve, 2011).

The use of financial accounting equation to evaluate the financial position of a country is inappropriate. The environment they operate in and the way they handle their accounts are completely different which is why the same accounting principles cannot be applicable for both. For example, in taking the author’s metaphor of comparing countries and companies, the situation of the financial crisis is actually like the industry demand has dropped; therefore all companies in the industry will suffer and not just one. However, drawing conclusions from studying the financial account of one country ignores many other important socio-economic factors that affect how countries manage their finances. In essence, applying the financial accounting equation to evaluate the health and finances of countries is not appropriate.

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A Basic Accounting Equation Applied to Financial Markets Today

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Assets = Liabilities + Equity

This " basic accounting equation" is spoon fed to Accounting 101 students around the world. But many investors appear to lose sight of its meaning when applied broadly to financial markets. Generally speaking, under the double-entry bookkeeping system, when an asset is created/increased (absent retained earnings or equity issuance), an offsetting liability is entered. For the U. S. government and governments around the developed world, the liability entry has grown hopelessly large. Accordingly, in response to the developing financial crisis in 2008, governments began printing money to boost the asset side of the equation with hopes of minimizing the relative significance of the liabilities over time. In other words, they are attempting to beat the system by papering over the liabilities, knowing they will be unable to generate net income sufficient to retire existing and future debt loads.

Advocates of fundamental analysis seek to value a firms assets, net out the liabilities to determine the firms intrinsic equity value, and compare the result to the current market value. Large liabilities relative to assets serve to reduce or even eliminate the intrinsic equity value of a firm. While the U. S. government may not have stockholders equity in the conventional sense, it certainly has stakeholders in its more than 300 million citizens and billions around the world with direct or indirect exposure to its financial position. It is these stakeholders who stand to suffer as the " intrinsic value" of the U. S. collapses. The standard of living for many U. S. citizens will decline as their cash savings are rendered useless by currency debasement. It is for this reason, that the recent flight to safety into non-yielding cash and the paltry yields offered by Treasury securities will not preserve wealth or protect purchasing power long-term.

Investors seeking protection should direct their investments to specific equity sectors, excluding financials, real estate, and discretionary consumer goods. Also worthy of consideration are emerging nations, currently trading a deep discounts due to their struggles with inflation, because they ultimately have stronger growth prospects in light of manageable debt loads and untapped consumer bases with high personal savings rates. Precious metals offer valuable protection, though investors should be prepared to endure violent price declines in both bullion and mining stock positions.