Dealing with the Downgrade:
Accounting Principles Are Important

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Accounting principles, like words, do mean something.

How accounting principles are applied as the downgrade of U.S. debt by Standard & Poor's from AAA to AA+ weaves throughout global markets will be interesting, but probably not fun to watch.

The consequences of a potential decrease in asset values – and potential increase in borrowing costs – could be significant.

Of key importance during this time is the proper recording and recognition of financial assets in accordance with accounting guidance and rules.

The accounting requirements during the decline of the real estate market could serve as an omen. The accounting rules were extraordinarily important then and will be now as the markets navigate through the next days, weeks, and months.

The debate regarding the fair value or "mark to market" accounting requirements in collateralized debt obligations (CDOs) and credit default swaps (CDSs) centered on the question, "Did the accounting requirements that initially recognized the mark-to-market decrease become a self-fulfilling prophecy? Was the decrease being properly recognized in an orderly and efficient market?"

It is a tough question but a fair one, and we may never know the truth. The argument was that some banks and financial institutions wrote down those types of assets on their balance sheets to create a market in which they would "short" similar or identical investments. The institutions recognized a loss on the value they held on their balance sheets, but made significantly more in shorting similar, if not identical, assets.

How will the market and holders of U.S. debt respond to the downgrade? Will they respond in an orderly and efficient manner?

This is the concern. Let's say Bank A holds U.S. debt on its balance sheet as an investment. Regardless, it is classified as a financial asset for the fair value accounting requirements. If that debt is downgraded, a significant decrease in its value as a result of mark-to-market/fair value accounting requirements requires recognition of that decrease. Does it become even more troubling for Bank A? It certainly could.

Consider another example. Bank A has a loan on its balance sheet that is secured by a borrower pledging U.S. debt the borrower holds. In all likelihood, the borrower will have a decrease to recognize, and Bank A may also have a decrease to recognize on that loan if the borrower cannot provide additional security to cover the decrease in the value of the U.S. debt pledged as collateral.

The accounting cycle as a result of the initial downgrade will in all likelihood culminate with an adjustment to the value of Bank A's stock held by investors in Bank A. The next turn will be the adjustment to the value the investors in Bank A stock will have to recognize.

It is the same vicious accounting cycle that took place in the real estate market in recognizing the decrease in value of the CDOs and CDSs loss recognition when the real estate that supported those collateralized debt obligations decreased in value.

Was there an orderly and efficient market operating during the decrease in collateralized debt and credit default swap values two or three years ago?

Some argue there was not, and the mark-to-market rules should have been suspended. I personally and firmly believed at that time the market was orderly and efficient. But the more I have read since, I am not sure that was true. Legal experts, bank regulators, FINRA, the SEC, state attorneys general, etc., can make that determination.

We have seen an increase in value and earnings stream of those same CDOs and related financial assets. They have significantly increased in value, although they do not approximate their original value on the market. Ironically, S&P routinely graded these offerings AAA.

Does it make sense that S&P's grading of CDOs years ago was AAA then and today U.S. debt is less than AAA? Those CDOs were made up of mortgage amounts issued to borrowers with the mortgage amount greater than the fair value of the real estate securing the mortgage, other types of subprime mortgages, car loans, student loans, and credit card debt.

The markets will determine the difference in value for U.S. debt at AA+ compared to AAA. Hopefully, those markets will be orderly and efficient. If they are, the application of the current accounting guidance as to fair value and use of mark-to-market accounting will be correct, and there will be no argument regarding the application of those accounting requirements.

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