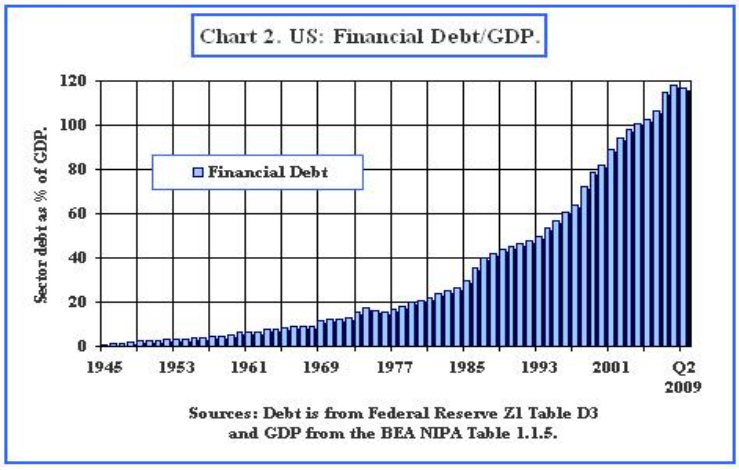
Debt and the data.

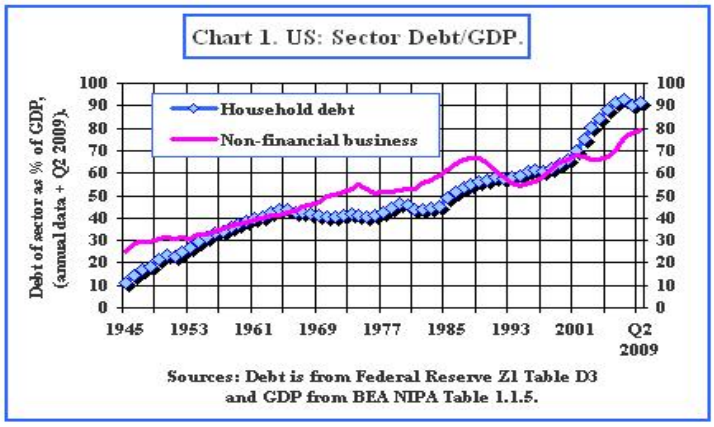
Andrew Smithers has strong grounds for believing that high levels of US business debt pose as big a threat as personal indebtedness

The level of personal debt in the US is widely recognised as a major problem for the economy. The higher the level of debt reached, relative to GDP, the greater is the risk that an increasing number of people will be unable to repay these debts, so that banks and other lenders will suffer large losses. As a glance at Chart 1 shows, US businesses are equally vulnerable. The latest available data are for 30th June 2009 and, as I illustrate in the chart, household debt was then 91.3% of GDP, having come down slightly from its peak, and business debt was at its peak level of 78.8% of GDP.

In fact the underlying situation is almost certainly much worse, if allowance is made for the growth of off-balance sheet debt. Companies can take debt off their balance sheet in a variety of ways. Among the most common are to lease rather than own equipment or properties. By doing this companies do not have to borrow to finance the acquisition of the assets and, instead of having to pay interest and repay the principal, they contract to make lease or rental payments which can last for many years into the future.

The impact of these arrangements is to reduce the apparent, but not the real, leverage of companies. We don't have data on how much debt companies have managed to get off their balance sheet, but we do have data on the growth of financial debt, and this will tend to rise when financial companies own the property or equipment which they lease to non-financial ones. As Chart 2 shows, financial debt has grown even faster than other forms of debt and amounts to nearly 120% of GDP. There is therefore good reason to fear that business debt is every bit as large a problem for the US economy and for its banks as the threat posed by the debts of the household sector.





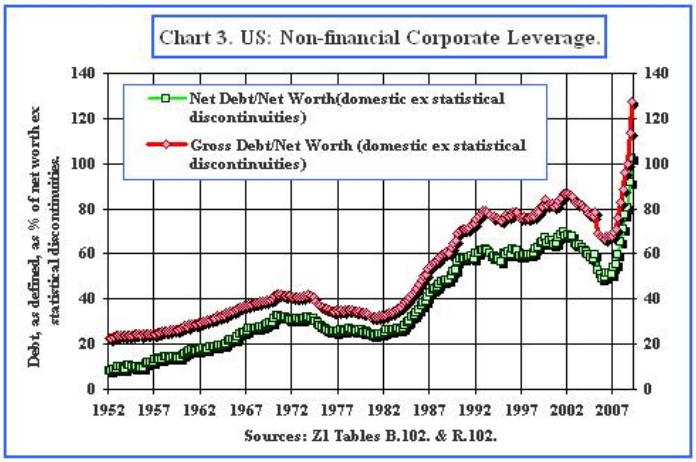
Business debt has, however, received much less publicity than individual debt levels. This is partly due no doubt to the greater attraction of journalists for stories with human interest, but the tragedies thrown up by individual bankruptcies are not necessarily less than those which result from the unemployment that results when companies go bust.

Probably the main reason why the problem of business debt has received so little attention is that investment banks have been fond of claiming "that companies' finances are in good shape." It is of course in their interest to make such claims but, while there is ample cause for justified criticism about the way that investment banks frequently misuse data, I think that in this instance there have also been grounds for some genuine misunderstanding behind the confusion.

The old adage that "he fell on his head when young and believes what he reads in the newspapers" could be updated by substituting "company annual reports" for "the newspapers".

The basic cause for confusion lies in the large changes that have been made in the way corporate balance sheets and profit and loss accounts are compiled. In the past, profits or losses generally reflected the difference between the original book cost of an item and the proceeds from its sale. Today, asset prices are designed to represent their current value and changes in these values are reflected in profits. As the net worth of companies rises with retained profits, different definitions of profits will result in different balance sheets and the impact is enhanced by the impact of tax and dividends. If the tax charge is unchanged, a 7% increase in profits before tax will easily cause profits after tax to be 10% higher and, if profits after tax are increased by 10% and half profits are paid out in dividends, then retained profits will be 20% higher. The method used to calculate profits can thus have a large impact on the net worth of companies over 10 years or so.

As companies' leverage is usually calculated by comparing debt to net worth, changes in accounting practice mean that leverage with company accounts prepared under today's "mark to market" convention should not be compared with those of earlier years, in



which profits were determined by reference to costs. Because of the change in accounting practices, comparing balance sheets of companies made at different times is comparing apples with pears rather than apples with apples.

From time to time companies record special losses, called write-offs, which are usually the result of overstating profits in the past. They can also be used to overstate profits in the future, which is why chief executives like to write down asset values when they are newly appointed. After a prolonged period of profit overstatement, however, the scope for writing down asset values tends to be limited, because companies are usually required to have assets on the books at values which are a multiple of their debts. We know that the profits of quoted companies have in recent years been grossly overstated, because they have recently been forced to make huge write-offs. In the 12 months to June 2009 profits after tax in the national accounts, which do not use "mark to market" accounting, fell by 10%, while those of companies in the S&P 500 fell by 85%. Profits in the national accounts are not based on "mark to market" accounting and the main cause of this huge difference is therefore likely to be that modern accounting practices, which have allowed the past profits as published by companies to be massively overstated, compared with those which were used before.

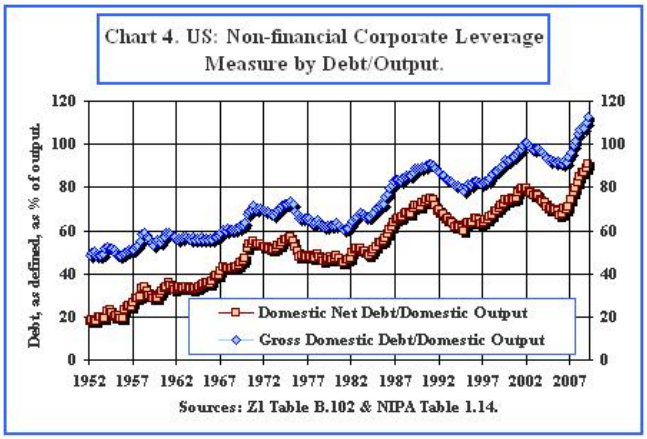
The implications of these changes do not seem to me to have been adequately appreciated. As a result past claims that "corporate balance sheets are in good shape" have led to serious misconceptions, even though such statements are far less frequently heard than they were a couple of years ago. It has been well remarked that no-one's judgement is better than their information and if, as seems likely, the claims about strong balance sheets have been accepted as information, rather than propaganda, many errors of judgement about lending to the non-financial sector are likely to have been made in the recent past and will probably lead to large losses by banks and other lenders.

It is worth remarking that, over the past 12 months, the views of central banks on the soundness of commercial banks' balance sheets has moved from a complacent assumption that they were well financed to massive concern that they are in bad shape. Similar complacency about the balance sheets of non-financial companies is now giving way to widespread concerns and I think these concerns are likely to become stronger.

As today's company balance sheets cannot be sensibly compared with those of some years ago, we clearly need an alternative way to assess how leveraged non-financial companies are today, compared with their leverage in earlier years. While we cannot do this by looking at the data published by companies, we should be able to use the national account data for which the accounting system has not changed. Doing this properly is, however, quite complicated. An important but highly technical issue involves the question of the correct treatment of the "statistical discontinuities" which are set out in the Flow of Funds Accounts of the United States ("Z1") published by the Federal Reserve. If these are excluded, the current leverage ratio of US non-financial companies is way above any former level as I show in Chart 3. If, however, they are excluded, leverage is still at record high levels but similar to the previous peak levels.

There are other ways of measuring leverage, for example, by comparing debt levels with the output of the non-financial sector, as I do in Chart 4, rather than with GDP as I did in Chart 1. As the amount of capital needed to produce a given amount of output does not vary too much, this gives a quite sensible estimate of leverage. The result, as can be seen in Chart 4, is that leverage is about half way between the alternative ways of measuring debt relative to corporate net worth, which can be derived from the US Flow of Funds Accounts.

Whatever method is preferred, however, each one points to the conclusion that debt levels of US non-financial companies are at or well above their former peak levels and probably pose just as great a threat to the economy as the high debt levels of individuals.



Andrew Smithers *is the chairman of Smithers & Co.*