Equity out of nothing

by Jon Th. Hilmarsson and Stefan Svavarsson, auditors

Synopsis

The attached article, „Equity out of nothing“, by Jon Th. Hilmarsson and Stefan Svavarsson, Chartered accountants, was published on the online edition of **Vidskiptabladid**, an Icelandic commercial newspaper, on February 2nd, 2018. As experienced public accountants, the authors were approached to form an investigation team in relation to the accounting of the failed banks by the special prosecutor in Iceland. The authors have years of experience in accounting and Svavarsson is furthermore a retired lecturer in accounting and auditing at the universities of Iceland and Reykjavik. The following is a brief summary of the main points raised in the article.

a) The Parliamentary commission (Special Investigatory Commission (SIC)) makes use of the words "weak equity" in its deliberations. We find fault with this phrasing as there is no basis for it, to our knowledge, in accounting or finance circles as equity cannot be described as having varied strength, either there is equity or not.

b) In court, the uncollected claims from the sale of own shares were regarded as regular banking loans, as if money had been created by these loans with a corresponding entry to deposits. An equivalent amount to these deposits was then allegedly used to „pay“ for the own shares sold. This is in fact utterly disconnected from reality as the own shares have not been paid for at all.

c) No information concerning these uncollected claims, referred to as loans, was provided in the financial accounts. They amounted to 230 billion at year-end 2007 and 300 billion at the time of the crash in Oct. of 2008. In some instances the claims represented 40% of total outstanding shares issued.

d) In the cases that were brought to court, the focus was on the legal issues regarding loans to customers while in actuality, the crux of the matter was that the owner‘s equity had been grossly misrepresented in the financial reports.

e) The recorded owners´ equity, as per financial reports, was overstated by 50% at year-end 2007 for the three commercial banks operating in the country at the time after correcting for understated own shares.

f) We contend that the uncollected claims (referred to as loans, usually bullet "loans" for 3-5 years) went against regular collection procedures regarding such sale of shares. The recording of interest income on such "assets", which under European regulation is treated as a "non-asset" and deducted from owners equity, overstated interest income massively. These terms of collection are also in direct violation to the provisions of the Companies´ Act, which states that outstanding claims for sale of original shares and thereafter own shares must be collected within a maximum of one year.

g) The auditors of the Icelandic banks, PWC and KPMG, did not object to the above treatment of own shares, i.e. shown as loans, and issued an unqualified opinion stating that the financial reports provided a true and fair view of the banks´ financial statements.

h) Had the necessary information been made available in the banks' financial accounts, i.e. if the financial statements had been transparent regarding treatment of own shares, this would have greatly influenced the decision making of any potential buyer of shares in the banks.

For some reason the Special prosecutor decided not to pursue these obvious financial reporting and legal shortfalls before the courts. As a result neither the CEO´s nor the Boards of Directors of the commercial banks will be held accountable for the gross misstatements made in the financial reports. On a similar note, the auditors involved, KPMG and PWC, will not be examined for their auditing work and unqualified opinions with regards to said financial reports.

Nearly a full decade has passed since the Icelandic banks published their annual financial statements for FY 2007, on the eve of the crash that crippled the country's banks and led to eventual nationalization, and it has become evident that there will be no court cases or formal charges addressing their accounting shortfalls. Views on their content and presentation may have varied, but substantive criticism has been scarce – if not non-existent. The Annual Reports were endorsed without qualification by both PWC or KPMG, despite numerous topics that should have called for a different audit opinion. We intend to focus on one subject of substantial importance which was never presented in court: the accounting treatment of the banks´ own shares.

Public opinion in Iceland, typically enough, has tended to regard foreign influences as primarily responsible for the crash. However, this is a questionable theory and, as will be argued here, the main forces which catalyzed the crash were first and foremost domestic parties promoting the banks massive purchases of their own shares.

Had the banks accurately and transparently disclosed the purchases of their own shares by the end of 2007, every depositor, investor, analyst, regulator, and the many entities of the financial food chain reading these Financial Statements could have drawn startling conclusions about the health of these banks. Some would consider this retrospective wisdom, but by October 2007 it had become clear that the banks' financials were deteriorating. The simple fact that the banks were rapidly en route to bankruptcy should not have been missed by any of the accounting experts preparing the banks´ reports. Correct reporting by the banks of their enormous own share purchases was the only disclosure that was needed.

Common shareholders are protected, in general, by the Icelandic Companies Act which is consistent with European legislation and are only at risk of losing their cash price paid for their shares. The Icelandic financial institutions augmented this protection so that chosen, preferred shareholders would not stand to lose any of their investment regardless of share

price movements. This was particularly true for the most senior employees. By giving their unqualified endorsement, the auditors assured everyone that these measures comprised traditional and natural business arrangements.

It is a generally accepted rule in financial accounting that sales of a property or shares in a company are fulfilled when at least two conditions are met: there is a transfer of both (1) the reward and (2) the risk of ownership from seller to buyer. Preferably, only assets that can sensibly be considered the property of an enterprise will be found on its books.

When a bank buys its own shares, its equity is diminished. The transaction does not increase the bank's assets, but only changes its capital structure. When a bank purchases shares of a third-party company, it can expect revenue from these shares in the form of dividends or from the appreciation of its share price. However, if a bank holds its own shares it will receive no dividends on those shares, as they are inactive. Those own shares are duly owned by the remaining outstanding shareholders in the sense that their portion has grown proportionally but not in value.

Domestic practices

These own shares were repurchased by the banks on the market for cash. If a limited liability company buys its own shares, the equity of the company is reduced and there are fewer outstanding shareholders. To state the obvious, the bank gives away the cost in cash, and thereby its assets decrease. It is self-evident that no dividend is paid on own shares. Nor can they be recognized as an asset but must be deducted from equity; in this the banks failed miserably. The banks' purchases of their own shares grossly exceeded the alleged sales of the same shares, so that they failed to comply with the requirements for transfer of risk. This was done on such a scale that it threatened the banks´ financial stability. In addition, the accounting practices followed regarding these shares was grossly misleading for anyone relying on the banks' financial statements to be accurate.

In the case of the Icelandic banks, the financial accounting rules which applied to treatment of sales of the banks' own shares, but subsequently accepted as collateral for the loan agreements funding the purchases, were not followed. The ***rewards*** seem to have been transferred, as the buyers enjoyed the dividends distributed, but the ***risk*** of ownership, however, was almost entirely left with the sellers, i.e. the banks´ themselves.

The transactions in which own shares were sold, were occasionally for cash payment but most often the shares were paid for with loans, for which the same shares were accepted as satisfactory collateral.

As the situation deteriorated, and bona fide buyers became ever fewer, the own shares piled up in massive quantities. The shares had to be disposed of to conceal the erosion of equity to handpicked customers or employees, with reward but no risk as the incentive. This was the banks' attempt to hide the decrease in their equity, which should have been disclosed in their financial reporting. However, selling own shares only in return for loan funds secured by the value of the shares could hardly be considered a sensible course of action.

The Parliamentary Special Investigation Commission (SIC) investigating the financial collapse in Iceland disclosed in a report that loans arising from the banks' selling of own shares totaled ISK 230 billion, and this was reported on their balance sheets as loans to customers. The SIC did not state clearly whether loans made to facilitate purchases of a bank's own shares should be considered as standard loans to customers (i.e. as assets), and in their uncertainty, regarded these loans "weak equity" for the bank. This was a brand-new classification previously unheard of in the accounting and financial world. Under the Companies' Act, equity contributions cannot be of different strengths. Therefore, the classification used by SIC is unacceptable. Such accounting treatment is in direct conflict with accounting principles and the law. Article 104 of the Companies Act does not allow loans to be made to shareholders to buy shares in a company, with the exceptions there stated.

The banks´ purchases of own shares, in the SIC estimation, exceeded 40% of their total shares outstanding, an estimate which appears to have been too low. However, Article 55 of the Companies Act stipulates that 10% of own shares should be the maximum held. In any case, it could scarcely be advisable to decrease the bank's equity by buying own shares when the bank's cashflow was tight, and certainly not commendable to omit full disclosure of this fact in the company's financial reporting.

As mentioned, the banks often unloaded own shares from their balance sheets by lending buyer the total purchase price in the form of a bullet loan with a high implied interest rate. Transactions of this form increased rapidly the last two to three years before the crash in October 2008. At the time of the crash (Oct. 2008) "weak equity" of this nature amounted to ISK 300 billion according to the SIC report.

It can be stated with some certainty that if the banks' accounting had been correct, with proper disclosures, all foreign and domestic lender interests would have vanished around this time. It is also highly likely that the liquidity of these banks' shares would have disappeared, had it been known how high a proportion of the banks´ outstanding shares were inactive.

Four examples of own share transactions:

a) A commercial bank establishes a holding company with the minimum required capital. The holding company buys the bank´s own shares for large notional amounts, having been granted a loan from the selling bank to finance the whole deal. The loan granted was frequently a bullet loan with the tenure of multiple years, and the sole collateral for the loan were the shares sold. The holding company took no risk at all but did receive dividends on the shares. The holding company clearly benefits in this risk-free transaction.
b) An employee of a commercial bank establishes a limited liability company. The company buys the bank´s own shares, which are fully financed by a loan from the bank selling the shares. The employee takes no personal risk on the transaction, but enjoys the dividend paid on the shares to his/hers limited liability company. In these instances, the loans made, and their implied annual interest could amount to multiple times the employee's annual salary.
c) A bank buys own shares to hedge against vested employee stock options. A standard purchase of these shares for cash would have decreased the equity of the bank. To

avoid disclosing the effect on equity, the bank establishes on offshore shell company to buy the shares on the bank´s behalf whereby the direct ownership of the shares by the bank is hidden. The offshore shell company´s purchase of the shares is fully financed by a loan from the bank.

There is no doubt that in each instance the bank´s managers were responsible for these own share transactions at their bank. These deals were made to appear to be done with independent third parties, when in fact the bank was dealing with itself. Therefore, consolidated financial statements should have been prepared which included these subsidiary companies. This would have revealed the decrease in equity from the own share purchases in the bank´s reporting. However, the subsidiary companies were omitted from consolidated annual reporting, resulting in a gap between the banks´ stated and true equity equal to the own shares sold and financed by the bank.

d) In one high-profile transaction shortly before the crash a portion of these own shares was sold to Sheik Al Thani of Qatar for ISK 26 billion. The public was led to believe the assumed "incoming cash flow" would improve the bank's liquidity, but it was merely window dressing. The bank in question financed the entire deal itself.

Only after the financial crash did the Icelandic Financial Supervisory Authority initiate a thorough investigation of the banks´ own share transactions. This investigation brought to light the fact that the banks were far and away the most active buyers of their own bank shares. Own shares may be bought for several reasons, which do not include propping up the share price and thus skewing the normal pricing of markets. Cases on these findings were taken to court, and the market manipulation confirmed.

In their normal lending activities to customers, banks have flexibility to decide the terms and length of time for repayment in accordance with regulations. This does not apply to loans granted packaged with the selling of their own shares, as this now concerns the bank financing itself, not an external customer. Such a transaction disadvantages the other common shareholders, who paid cash for their shares on the market, while buyers of the own shares with packaged loans collected dividends from "ownership" of shares that they never paid for. It can even be maintained that when these packaged loans were issued, the banks considered it unimportant whether the loans were ever repaid at all.

Foreign practices

How were such own share transactions treated outside of Iceland? After all, there were numerous foreign financers and shareholders of the Icelandic banks; in fact, they provided the greatest share of the total funding. In other countries, banks' lending to shareholders to buy shares in their own bank is either illegal, or the shares would not count as equity for the bank unless paid for in cash.

One foreign subsidiary of an Icelandic bank was given stern warnings regarding lending to buy its own shares, and consequently the problem was solved by transferring all such loans to the parent company in Iceland.

American lawyers at the SEC have stated that according to US regulations shares can only count as equity if paid for with cash.

According to the foreign regulations quoted, a bank cannot lend to the buyers of its own shares to pay for those shares, because this undermines the financial strength of the bank. A claim arising from sale of own shares is not an independent loan to customers in the conventional commercial banking sense and should be recognized with a corresponding decrease in equity, not as an independent balance sheet asset. The same applies to uncollected claims for new shares issued by a bank, which also require a bookkeeping entry for a decrease in equity. By this method, shares sold by the bank are not recognized as equity until paid for in cash or assets with equivalent value. This is also clearly outlined in the Icelandic Companies Act, in which the relevant provisions call for the collection of cash as underpinnings of real equity.

More on the nature of the business practices

The words “loan” and “lending” above are used when a bank sold its own shares against a loan agreement. In those transactions no money was created nor was any used. The claim that money was created by setting up a deposit account on the books, which in turn was used to pay for the purchase of own shares, is utter nonsense. The collateral for those loans granted as payment for own shares were the very shares themselves. It is a complete misconception to imagine that cash changed hands on these deals, when in fact one worthless item was exchanged for another equally worthless item.

The item at risk here was the inactive and hard-to-sell own shares of the banks. Real ownership of the own shares was in most cases not transferred to the alleged buyer, as the shares were fully financed and collateralized by the banks and under their control, and the risk was borne solely by the banks. Quid pro quo, no sale had in fact occurred, and the lending packaged with the own shares was a fabrication, not a loan transaction in the traditional banking sense.

The problem which needed to be solved was the pending decrease in equity as downward pressure on share price from the market increased. But shares sold in the above manner could not change anything: they had to be treated as own shares regardless. The obvious conclusion is that only shares sold against cash or confirmed valuables can be regarded as equity.

In buying up huge quantities of their own shares as fast as they came on the market the banks intended to buoy up their share prices. Eventually those shares had to be disposed of, but by this point the market for these shares was illiquid or non-existent.

Some countries ban lending to a third party when buying shares of the same bank. This was confirmed by a statement from an official of the Financial Supervisory in Belgium when the Dexia Bank case surfaced, where the bank did lend one and half a billion Euros to institutional investors when it sold its own shares. It was stated that according to Belgian laws, self-financing was illegal.

A similar statement appeared in the UK media when it was disclosed that Barclays Bank was being investigated for an alleged deal with Sheik al Thani due to the bank’s financing of his purchase of the bank´s shares.

The Icelandic banks' massive buying of own shares was indeed an admission by their managements that the banks could not survive the selling pressure of their shares on the open market. The bona fide shareholders and lenders to the banks suffered huge losses after the financial statements for the year 2007 were published, but there were no clues of the hidden, unacceptably low equity ratios of these banks because of the own shares bought.

Side effects

It just may be thought as blunt irony to compare this with Baron Munchausen´s effort to extricate himself from the bog by pulling up his own hair, but in all reality the same was basically being done with the banks´ equity, it was being increased out of nothing. Raising capital without any cashflow at all is not in accordance with any civilized nation's law. The table below shows the accounting impact under the rules of three different financial reporting standards:

	Figures in billions of ISK		
	European rules	American rules	Icelandic method
Owners´ equity			
Share capital..	230	0	230
Uncollected claims from sale of own shares............	(230)	0	0
	0	0	230
Assets			
Loans to customers...	0	0	230
	0	0	230

The banks´ equity was overstated or misrepresented by approximately ISK 230 billion at 2007 year-end according to SIC; this estimated misstatement is in all likelihood too low in our estimation. Even according to this, however, the equity of the banks had to be corrected and lowered by 50%, which cannot be regarded as other than significant.

As if this doesn't look bad enough, there is more to the story. The table above shows that according to foreign rules and practices, no asset and no equity rights exist until the share capital has been collected in cash and in full. Given this, it is hardly proper accounting to accrue interest income on the banks´ customer loan portfolio as it was calculated and recognized, i.e. including billions in loans made for non-cash purchases of own shares. "Non-assets" would be the more appropriate phrase here, and it would be counterintuitive to record revenue on such assets as per accounting theory, or even common sense. The banks' interest revenue for 2007 was therefore overstated by billions of ISK in the year 2007 due to purported interest revenue accrued on these claims. Instead it would have been substantively consistent with accounting theory to record only claim amounts exceeding the purchase price of the own shares as paid-up-capital in excess of par under owners´ equity. But in fact, however, in many instances own shares were sold at a net loss in a falling market.

To close out this discussion, the accrued interest as well as the related unsecured "loans" associated with the sale of the banks' own shares should at the very least have been considered in determining credit loss provisions. It would not have been an easy task: An

internal analyst would have had to assess the impairment on these loans to third parties, as the value of the collateral, i.e. the bank itself, would have to be subjected to close analytical scrutiny. That alone suffices to show the absurdity of the situation the banks were in.

Dividends

Dividends are not paid on own shares, as they are by definition inactive. Shareholders who can legitimately claim to be the owners of the shares are entitled to dividends paid, not alleged buyers or fake shareholders. The vast majority of the claims against those alleged buyers in the bank's liquidations were totally lost. Despite the fact that the bogus shareholders were previously paid dividends, in some cases amounting to tens or even hundreds of millions ISK at the cost of the real shareholders and creditors.

It is a fact that at the peak almost 50% of the shares in the banks were not paid for and should not have been eligible for dividend payments. Those who rightfully paid for their shares in cash were fleeced of dividends that wrongly went to the unentitled owners of unpaid shares.

Not surprisingly, internal criticism from senior management was rare, as most of them were recipients of handsome bonuses and/or share dividends.

Legal recourse

As pointed out, the rules applied to ordinary customer loans cannot be used here, as these are very different business dealings. Nonetheless, there were court cases in Iceland concerning the self-financing of banks to which the rules on customer loans were applied and, in effect, the prosecution based its case on the wrong page in the law book.

This could lead to the conclusion that an important opportunity was lost. But what was the core of the matter? The following questions should have been submitted to the courts for deliberation and to investigate where by law the banks were given the authority:

- To tie up massive amounts of cash, long term, in their own shares?
- To sell shares in the banks packaged with long term bullet loans?
- To accept sold shares as the only collateral for a loan?
- To sell shares and loans to parties financially incapable of paying for them?
- To pay dividends on shares to buyers who did not pay in cash?
- To lend to share buyers on irregular terms without the other shareholders' consent?
- To omit having experts estimate the market value of the loans agreed to??
- To recognize interest revenue on loans when the loans could not be capitalized?
- To disregard any possible provisions or write-downs on these loans?
- To call for upfront cash payments from only half the shareholders?
- To grossly discriminate between shareholders by these practices?

The following questions can be asked of the prosecutor of the banks:

- Was there no reason to have the above questions answered?

- Can it be suggested that the above issues were deemed to be not punishable?
- Do International Accounting Standards not apply in Iceland in these cases?
- Are legal shareholder protections non-existent?
- Can employees of financial institutions, in probable future criminal cases, find protection from the current non-action of the authorities?

Although financial reporting is by no means a simple matter or one that usually makes headlines, we need to be concerned that these cases were not presented and argued before the courts. They involved large-scale misinformation targeted at shareholders so as not to provide a true and fair view of the paid-up capital and total equity of the banks. The size of the error at 2007 year-end, in our opinion, was at least ISK 230 billion, equal to 50% of the banks' correctly measured equity at that point in time, which we calculate to be 465 billion ISK after correcting for the overstatement of equity.

Final words

History shows that when entities are underperforming some CEOs fail to accept the reality of the corresponding financial reporting and are tempted to "adjust" the books to their liking. In all these cases the actions taken affect not just one area of financial reporting but the totality of the report. This can, for example, be seen in the cases of Enron, Pharmalat, Hafskip, World-com, BCCI, and Mattel, to name just a few. This comprehensive approach to "creative accounting" also seems to be true in the case of the Icelandic banks in 2007, although we have only touched on one topic in this article. The major difference between those foreign cases and that of the Icelandic banks, however, is that the accounting fraud in the foreign cases was regarded a serious matter and therefore responded to with specific court action, while in Iceland no serious effort seems to have been made to do the same.