The Société Générale case study

Michael (Mike) Wells prepared this case study to support class discussion designed to foster the development of capacity to make/audit/regulate/analyse the judgements when the 'fair presentation override' is used in preparing general purpose financial information.

In early 2008 when Société Générale published its 2007 annual financial statements, in which it used the 'fair presentation override' to pull losses incurred in 2008 back to its 2007 financial statements, the international press immediately and sharply criticised this accounting that already seemed to have passed the scrutiny of both it dual auditors and its regulators.

"It is not often that a major international bank admits it is violating well-established accounting rules, but that is what Société Générale has done in accounting for the fraud that caused the bank to lose 6.4 billion euros — now worth about $9.7 billion — in January."[1]

---New York Times (7 March 2008)---

What is the fair presentation override?

Relevant extracts from *IAS 1 Presentation of Financial Statements* (in particular paragraph 19, in which emphasis has been added by the author):[2]

18 An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

19 In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

20 When an entity departs from a requirement of an IFRS in accordance with paragraph 19, it shall disclose:

(a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

(b) that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;

(c) the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Framework*, and the treatment adopted; and

(d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

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[1] See *Loophole Lets Bank Rewrite the Calendar* http://www.nytimes.com/2008/03/07/business/07norris.html?_r=0

[2] source: http://eifrs.ifrs.org/eifrs/bnstandards/en/2016/ias01.pdf

More from the press

Excerpts from *Override that is dividing accountants* by Jennifer Hughes of the FT on 12 March 2008:[3]

> "The issue centres on the dates of the problem trades, which the bank has said were put on afresh in 2008 after Mr Kerviel closed most of his positions at the end of 2007 at a €1.4bn ($2.1bn) profit. Accountants said the simplest treatment would be for the bank to book Mr Kerviel's €1.4bn profit in its recently published 2007 accounts and leave the €6.3bn loss it sustained in unwinding the 2008 trades for this year's books. …
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> Regulators and accounting experts are questioning Société Générale's use of a "get out" clause in accounting rules to book losses from Jérôme Kerviel's alleged fraud in its 2007 accounts. …
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> SocGen has not fully explained its rationale for the tactic, which is a last resort in accounting terms. Soon after it first revealed the losses, the bank indicated that it was seeking to book them in 2007 under a different accounting provision known as a "post balance sheet event". The fact that it has resorted to "true and fair" suggests it struggled to do so and underlines the bank's determination to wrap up the whole affair as soon as possible."…
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> "Separately, SocGen is set to announce today that its €5.5bn rights issue, launched to bolster its capital base, was at least 1.8 times subscribed, a result which is likely to be hailed by Daniel Bouton, chairman and chief executive, as a vote of confidence in its strategy."

Extracts from the notes to Société Générale 2007 annual financial statements regarding its use of the fair presentation override:[4]

> **"Note 1**
> **Significant accounting principles**
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> In accordance with European Regulation 1606/2002 of July 19, 2002 on the application of International Accounting Standards, Société Générale Group ("the Group") prepared its consolidated financial statements for the year ending December 31, 2007 in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union…
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> The Group also continued to make use of the provisions of IAS 39 as adopted by the European Union for applying macro-fair value hedge accounting (IAS 39 "carve-out").
>
> On January 19 and 20, 2008, the Société Générale Group has uncovered unauthorized and concealed trading activities of an exceptional scale involving directional positions taken during 2007 and the beginning of 2008 by a trader responsible for trading on plain vanilla derivatives instruments based on European stock market indices. The identification and analysis of these positions on January 19 and 20 ,2008 prompted the Group to close them as quickly as possible while respecting the market integrity.
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> For the information of the shareholders and the public, the Group considered that the application of IAS 10 "Events After the Balance Sheet Date " and IAS 39 "Financial Instruments: Recognition and Measurement " for the accounting of transactions relating

[3] source: http://www.ft.com/cms/s/0/1aefb1a8-efd7-11dc-8a17-0000779fd2ac.html#axzz3gMyXCENj)

[4] See http://www.societegenerale.com/sites/default/files/documents/Résultats%20financiers/2007%20EN/Societe-Generale_accounts_311207_gb.pdf

to the unauthorized activities and their unwinding was inconsistent with the objective of the financial statements described in the framework of IFRS standards. For the purpose of a fair presentation of its financial situation, it was more appropriate to record all the financial consequences of the unwinding of these unauthorized activities under a separate caption in consolidated income for the 2007 financial year. To this end and in accordance with the provisions of paragraphs 17 and 18 of IAS 1 “Presentation of Financial Statements” the Group decided to depart from the provisions of IAS10 “Events After the Balance Sheet Date” and IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, by booking the estimated consolidated income for the 2007 financial year a provision for the total cost of the unauthorized activities. This treatment has been submitted to the banking supervisory body (Secrétariat Général de la Commission bancaire) and to the market authority (Autorité des Marchés Financiers) to confirm its acceptability regarding the regulatory framework. The consequences of the accounting treatment so applied are disclosed in the note 40. …

NOTE 40 NET LOSS ON UNAUTHORIZED AND CONCEALED TRADING ACTIVITIES

On January 19 and 20, 2008, the Group has uncovered unauthorized and concealed trading activities of an exceptional scale involving directional positions taken during 2007 and at the beginning of 2008 by a trader responsible for trading on plain vanilla derivative instruments based on European stock market indices. The identification and analysis of these positions on January 19 and 20, 2008 prompted the Group to close them as quickly as possible while respecting the market integrity. The analysis of these unauthorized activities established, before the closing of the accounts for the financial year ended December 31, 2007, that the mechanisms of concealment used throughout the 2007 financial year continued until their discovery in January 2008. At the balance sheet date, Corporate and Investment Banking's activities are currently the subject of various investigations internally and externally and any new fact will be taken into consideration.

The application of the provisions of IAS 10 " Events after the balance sheet date" and IAS 39 " Financial instruments : Recognition and Measurement", for the accounting of transactions relating to these unauthorized activities and their unwinding would have led to recognizing a pre- tax gain of EUR 1,471 million in consolidated income for the 2007 financial year and only presenting the pre-tax loss of EUR 6,382 million ultimately incurred by the Group in January 2008 in the note to the 2007 consolidated financial statements.

For the information of its shareholders and the public, the Group considered that this presentation was inconsistent with the objective of the financial statements described in the framework of IFRS standards and that for the purpose of a fair presentation of its financial situation at December 31, 2007, it was more appropriate to record all the financial consequences of the unwinding of these unauthorized activities under a separate caption in consolidated income for the 2007 financial year. To this end and in accordance with the provisions of paragraphs 17 and 18 of IAS 1 “Presentation of Financial Statements” the Group decided to depart from the provisions of IAS10 “Events After the Balance Sheet Date” and IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, by booking in estimated consolidated income for the 2007 financial year a provision for the total cost of the unauthorized activities.

In order to provide a relevant information about the understanding of the financial Group performance in 2007, the total net loss related to the unwinding of the directional positions pursuant to these unauthorized activities is presented under a separate caption of the consolidated income statement entitled *Net loss on unauthorized and concealed trading activities*:

(in millions of euros)	**December 31, 2007**
Net gains on financial instruments at fair value through profit and loss and entered on unauthorized and concealed trading activities	1,471
Allowance expense on provision for the total cost of the unauthorized and concealed trading activities.	(6,382)
Total	(4,911)

The loss thus recognized in this way has been considered as tax deductible. However, the loss covered by the provision mentioned in the previous paragraph will be deducted in the 2008 financial year tax return. This tax position is based on both tax law and relevant jurisprudence and has been supported by the advice received from tax lawyers.

As a result, the impact on 2007 income tax is the following:

- Net gains on financial instruments at fair value through profit and loss and entered on unauthorized and concealed trading activities create current tax expense of EUR 507 million.

- Allowance expense on provision for the total cost of the unauthorized and concealed trading activities create deferred income tax of EUR 2,197 million (recorded in deferred tax assets in the balance sheet)."

You are required to:
Critically evaluate Société Générale's use of the fair presentation override. In doing so consider the following questions:

- For Société Générale's 2007 financial statements what is the economics of the transactions Jérôme Kerviel (the rouge trader) entered it into?
  - what elements (assets, liabilities, equity) exist at the end of the reporting period and what amount/s faithfully represent Société Générale's financial position at the end of 2007?
  - what elements (income or expenses) reflect performance for its 2007 reporting period?
- What information about that economics would be relevant for primary users making resource allocation decisions on the basis of the information in its 2007 annual financial statements?
  - Would your answer be different had the rouge trading losses affected Société Générale's going concern?
- Is there decision-useful information that does not meet definition of an element in 2007?
- What are the relevant IFRS requirements?
- What judgements are necessary to apply those IFRS requirements?
- Entering into and closing out the derivative positions in 2008 before the 2007 financial statements are authorised for issue are? Choose one of:
  - adjusting events;
  - non-adjusting events (disclosure only events);
  - basis of preparation events;
  - ignorable events; or
  - it depends… (specify)?
- Did Société Générale's contravene IFRS?
  - If so, why do you think management inappropriately used the fair presentation override?