

**SOCIETE GENERALE: AN INSTRUCTIONAL CASE  
FOCUSING ON INTERNATIONAL ACCOUNTING AND AUDITING ISSUES**

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**ABSTRACT**

In late January 2008, Societe Generale, France's second largest bank, announced that it had incurred a 6.4 billion euro loss over the three-day period January 21-23, 2008. That loss wiped out twenty percent of the bank's capital. Societe Generale's CEO reported that the huge loss was attributable to the unauthorized activities of one rogue trader.

This case focuses on three key issues raised by the Societe Generale fraud. First, this case examines the question of how one low-level employee could circumvent the sophisticated internal controls of a huge bank. A related issue is how Societe Generale's auditors failed to uncover the internal control deficiencies that allowed the massive fraud to be perpetrated. Finally, this case addresses the surprising decision made by Societe Generale to backdate the 6.4 billion euro loss. Although that huge loss occurred in 2008, the bank included the loss in its 2007 financial statements.

Jerome Kerviel was born and raised in Pont-l'Abbe, a small coastal village in the Brittany region of northwestern France. His father was a blacksmith, while his mother worked as a hairdresser. Throughout his adolescent years, Kerviel dreamed of experiencing the excitement of nearby Paris, the City of Lights. Not surprisingly then, after completing undergraduate and graduate degrees in finance, the 23-year-old Kerviel accepted an entry-level position in Paris with Societe Generale, France's second largest bank.

Kerviel's job at Societe Generale involved working in the financial institution's "back office." For four years, Kerviel effectively served as an internal auditor ensuring that the bank's employees were complying with applicable company policies and procedures. His responsibilities included monitoring the bank's securities trades to identify unauthorized trades, for example, trades that exceeded the monetary limits that had been established for individual traders.

Although polite and well-mannered, the handsome Kerviel made few friends within the bank and was thought of as "loner" by most of his co-workers. In 2004, Kerviel accomplished his goal of being promoted to a securities trader. This new position provided Kerviel an opportunity to make better use of his educational background while at the same time allowing him to escape the relative anonymity and boredom of Societe Generale's back office.

Unlike Kerviel, Societe Generale's typical trader was a graduate of one of France's high profile universities and had been immediately assigned to the bank's trading staff when hired. In France's hierarchical society, one's educational background and socio-economic status tend to have a disproportionate influence on not only employment opportunities but also the ability to progress rapidly within an organization once hired. Reportedly, Kerviel wanted to prove that despite his modest credentials and lower-middle class upbringing, he could compete with his more blue-blooded colleagues when he finally landed a job in Societe Generale's trading division.

After joining the trading division, Kerviel worked hard to impress his superiors. Neighbors reported that he left his home in a Paris suburb early each morning and returned late every evening. Kerviel was so dedicated to his job that he refused to take

advantage of the several weeks of vacation time that he was entitled to each year. By late 2007, Kerviel's annual salary was approximately 100,000 euros, an impressive sum by most standards but just a fraction of what many of his fellow traders earned.

In late January 2008, Daniel Bouton, Societe Generale's chief executive officer (CEO) and chairman of the board, startled the global financial markets by announcing that over a period of just three days his bank had suffered losses of more than six billion euros on a series of unauthorized securities trades made by a "rogue trader." According to Bouton, the trader had used his knowledge of the bank's computer and accounting systems to circumvent the labyrinth of internal control policies and procedures designed to prevent and detect unauthorized securities trades. That individual was none other than Jerome Kerviel.

Within two days of Bouton's announcement, Jerome Kerviel was arrested by France's gendarmes. For forty-eight hours, law enforcement and regulatory authorities grilled the young Parisian to uncover the details of the largest fraud in the history of the banking industry. According to his attorneys, Kerviel held up extremely well during the intense interrogations. At one point, the stoic Kerviel offered one of the greatest understatements in the sordid history of crime when he casually told his interrogators that, "I just got a bit carried away."<sup>1</sup>

### **Fraud, French Style**

Societe Generale was founded in 1864 during the reign of Napoleon III, the nephew of Napoleon Bonaparte and France's final monarch. The bank quickly became an important source of capital for the nation's rapidly growing economy during the final few decades of the nineteenth century. By the verge of World War II, Societe Generale

operated 1,500 branches, including branches in the United States and dozens of other countries.

Following World War II, France's federal government nationalized Societe Generale to finance the reconstruction of the nation's economic infrastructure that had been decimated by the war. In 1987, the government returned the bank to the private sector. By the turn of the century, Societe Generale had reestablished itself as one of the world's largest and most important financial institutions. By 2007, the bank operated in almost ninety countries, had total assets of 1.1 trillion euros, and had more than 130,000 employees worldwide.

In the global banking industry, Societe Generale and several other large French banks are best known for developing a wide range of exotic financial instruments commonly referred to as derivatives. "Societe Generale pioneered equity derivatives, which allows investors to bet on future movements in stocks or markets."<sup>2</sup> Because of their leadership role in the development of financial derivatives, French banks control nearly one-third of the global market for those securities, a market that is measured in terms of hundreds of trillions of dollars. These same banks have also become well known for the "sophistication of their computer systems"<sup>3</sup> that are necessary to maintain control over their financial derivatives operations.

Societe Generale's 2007 annual report revealed that nearly 3,000 employees were assigned to control and manage the risks posed by the institution's around-the-clock and around-the-globe market trading activities. The most important of these activities are housed in the bank's equity derivatives division, the large bank's most profitable

operating unit. The majority of these control specialists work in Societe Generale's so-called "back office" where Jerome Kerviel began his career with the bank.

When he left Societe Generale's back office, Kerviel joined a relatively minor department within the bank's equity derivatives division. The mission of Kerviel's new department was to mitigate the risks that Societe Generale faced due to its high volume of derivatives trading. Kerviel's job involved making "plain vanilla hedges on European stock-market indices."<sup>4</sup>

Beginning in 2005, Kerviel began exceeding the maximum transaction size in euros that he had been assigned for individual securities trades as well as engaging in other unauthorized transactions. Because he was very familiar with the electronic and manual control procedures used in the bank's back office to monitor trading activities, he was able to use a variety of means to circumvent those controls and thereby conceal his unauthorized trades. These measures included creating phony emails from superiors authorizing illicit transactions, intercepting and voiding warning messages triggered by unauthorized trades that he had made, and preparing false documents to corroborate such trades.

In the weeks following the disclosure of Kerviel's fraud, the bank's board of directors established a "Special Committee" to investigate the fraud—the board retained PricewaterhouseCoopers to assist this committee. The interim report of that committee revealed that Kerviel was particularly adept at manufacturing impromptu explanations for apparent irregularities discovered in his trading activities by back office personnel. Kerviel's explanations were laced with impressive but nonsensical jargon intended to confuse those personnel and discourage them from pursuing the given issues any further.

In addition, the report suggested that back office personnel were intimidated by Kerviel and his trading colleagues, which caused them to be reluctant to vigorously investigate apparent trading irregularities.

The lynchpin of Kerviel's fraud was a technique that has been used in several previous stock market frauds, namely, recording fictitious transactions that appeared to be hedges or offsetting transactions for unauthorized securities trades that he had placed. For example, if Kerviel purchased a large block of securities, he would then record an offsetting but fictitious sale of similar securities. When he "shorted" a large block of securities, the fictitious hedge transaction that he recorded would be a "long" position in those securities or similar securities. These fictitious hedge transactions made it appear as if Societe Generale faced only minimal losses, at worst, on the large securities positions being taken by Kerviel.

The ease with which he could subterfuge Societe Generale's back office controls emboldened Kerviel. By 2007, he was placing what Societe Generale executives would later refer to as enormous "bets" on future near-term moves that he anticipated in major European stock market indices. At one point, Kerviel had outstanding positions that far exceeded the bank's total stockholders' equity of 33 billion euros. In late 2007, he produced more than a one billion euro gain on a series of unauthorized transactions.

During the first few weeks of January 2008, Kerviel made several huge trades predicated on his belief that European stock market indices would turn sharply higher by late January. Instead, those markets declined, resulting in an unrealized loss of one billion euros for Societe Generale. On Friday, January 18, 2008, Kerviel's open positions

were discovered and reported to Daniel Bouton. Over the weekend, Bouton decided that the positions should be closed to avoid potentially catastrophic losses for the bank.

Over the three-day period January 21-23, the open positions on Kerviel's unauthorized trades were closed. Unfortunately for Societe Generale, European stock market prices fell sharply during that three-day period. Those falling stock prices caused the loss on Kerviel's January trades to sky to more than six billion euros, a figure that wiped out approximately twenty percent of the bank's equity capital.

After closing Kerviel's open positions, Societe Generale publicly reported the massive loss and the fraudulent scheme that had produced it. That disclosure unsettled stock markets worldwide, causing stock prices to fall around the globe. French president, Nicholas Sarkozy, reacted angrily to the announcement of the Kerviel fraud. "We have to put a stop to this financial system which is out of its mind and which has lost sight of its purpose."<sup>5</sup>

Jerome Kerviel's fraudulent scheme caused the international business press to shower Societe Generale's management team and independent auditors with a wide range of probing and embarrassing questions. Among these questions was how could Societe Generale's supposedly sophisticated internal control system be routinely and repeatedly undermined by one "rogue trader." Likewise, how could the bank's independent auditors fail to uncover what appeared to be pervasive deficiencies in that control system. Finally, the business press also questioned the auditors' decision to approve the highly unusual manner in which Societe Generale reported the massive fraud loss in its audited financial statements.

### **Internal Controls, French Style**

Shortly after the turn of the century, the Enron and WorldCom fiascoes in the United States undermined the confidence of the investing public in the nation's capital markets. Congress acted swiftly to restore that confidence by passing the Sarbanes-Oxley Act in the summer of 2002. This new federal statute forced public companies to spend enormous sums to overhaul and strengthen their financial reporting functions and internal control systems.

Each of the world's major economic powers closely monitored the reaction of the U.S. Congress and regulatory authorities to the Enron and WorldCom debacles. Many of these countries passed legislation intended to mimic the reforms embedded in the Sarbanes-Oxley statute. One such country was France.

Following the passage of the Sarbanes-Oxley Act in the United States, leaders of the French business community commissioned a study to determine what measures were necessary to strengthen financial reporting, internal controls, and corporate governance among France's large companies. Many of France's most prominent business leaders were asked to serve on the committee that would carry out this study. Societe Generale's Daniel Bouton was chosen to chair the committee. In fact, the committee's lengthy report came to be referred to as simply the "Bouton Report."

According to the Bouton Report, many of the reforms included in the Sarbanes-Oxley legislation were unnecessary in France. "French companies find themselves in a very different situation from that of their U.S. counterparts. In many respects, French companies are better protected against the risks of excessive or misguided practices."<sup>6</sup> Despite that observation, the Bouton Report contained an impressive list of proposals.

Many of these proposals were adopted by the French Parliament in 2003 when it modified the nation's federal securities laws that collectively are referred to as the French Commercial Code (*Code de Commerce*).

One of the Bouton Report recommendations incorporated into the French Commercial Code requires each public company's chairman of the board to include a report on his or her organization's internal controls in the company's annual financial report. Among other disclosures, this report should discuss a company's broad internal control objectives, key internal control procedures intended to accomplish those objectives, and factors that may limit the effectiveness of those procedures. In addition, the company's independent or "statutory" auditors must prepare an accompanying report that comments on the completeness and reliability of the chairman's internal control report. Statutory auditors are also required to disclose major control deficiencies that they discover during their annual audits to the chairman. The chairman must then include these items in his or her internal control report.

Exhibit 1 presents a brief excerpt from the seven-page internal control report included in Christian Dior's 2007 annual financial report. Christian Dior is a prominent Paris-based company founded by the famous fashion designer of the same name. The company's many well-known brand names include Louis Vuitton, Givenchy, and, of course, Christian Dior. The excerpt in Exhibit 1 provides a concise summary of the internal control procedures employed by Christian Dior. Included in Exhibit 2 is the report issued by Christian Dior's statutory auditors on their client's 2007 internal control report.

**--Insert Exhibits 1 and 2--**

The internal control report included in Societe Generale's 2006 annual financial report, the company's final annual report released prior to the discovery of Jerome Kerviel's fraud, included the following definition of internal control: "Those resources that enable the [bank's] management to ascertain whether the transactions carried out and the organization and procedures in place within the Company are compliant with the legal and regulatory provisions in force, professional and ethical practices, internal regulations and the policies defined by the Company's executive body." The report, which was the responsibility of Daniel Bouton, also identified the organization's three key internal control objectives:

- To detect and measure the risks borne by the Company, and ensure they are adequately controlled;
- To guarantee the reliability, integrity and availability of financial and managerial information;
- To verify the quality of the information and communication systems.

An important focus of the 2006 Societe Generale internal control report was the principal risks faced by the bank. These risks were intended to be mitigated by the large number of employees that staffed the bank's risk management functions, which included more than 1,100 internal auditors. A primary "operational" risk faced by the bank, according to the report, was the "risk of loss or fraud or of producing incorrect financial and accounting data due to inadequacies or failures in procedures and internal systems, human error or external events."

The 2006 internal control report provided no indication that the integrity of the bank's accounting data could be undermined by one employee. To the contrary, the report noted specifically that "accounting data" were compiled "independently" by the bank's accounting staff "thereby guaranteeing that information is both reliable and

objective.” The report went on to note that “the economic reality” of that data was subject to “daily verification” by the bank’s internal control specialists. In their accompanying report, Societe Generale’s statutory auditors did not challenge the accuracy of the bank’s internal control report.

Following the public disclosure of Kerviel’s fraud, the business press chastised Societe Generale’s management team for failing to implement and maintain proper internal controls for the bank. Daniel Bouton responded to those critics by insisting that Societe Generale, in fact, had maintained strong internal controls. He then went on to suggest that Kerviel’s fraud was so ingenious that even the most sophisticated internal controls would have been no match for the scheme. According to Bouton, Kerviel’s fraudulent scheme had been comparable to a “mutating virus” since the nature of that scheme was constantly changing and evolving. “And when the controls detected an anomaly, he managed to convince control officers that nothing was wrong.”<sup>7</sup>

Bouton’s assertion that Societe Generale had strong internal controls was challenged by several parties. For example, the decision to allow Kerviel to transfer from the back office to the bank’s trading division was questioned. “He [Kerviel] knew what the cops were looking for. That’s what I find surprising about this – to let someone who knew how a fox might act, who knew the best way for a fox to act, get into the henhouse.”<sup>8</sup> Another critic questioned why Societe Generale had neglected one of the most fundamental control procedures, namely, requiring employees in sensitive positions to take annual vacations.

A low-level French employee who declines to take his vacation entitlement is already an extraordinary anomaly, enough that Kerviel’s superiors should have gone on immediate and full alert. As Kerviel himself acknowledged to French police investigators, “It’s one of the elementary rules of internal control. A trader

who doesn't take any days off is a trader who doesn't want to leave his book to another.”<sup>9</sup>

Several skeptics maintained that given the size of the trades made by Kerviel that someone other than him, possibly even top management, had to have been aware of them. Kerviel gave credence to this theory during his interrogation by law enforcement authorities shortly after he was arrested. The unfazed and self-assured Kerviel told those authorities that, “I accept my share of responsibility, but I will not be made a scapegoat for Societe Generale.”<sup>10</sup> Kerviel testified that his superiors had “turned a blind eye” to his unauthorized trades “as long as he was in the black”<sup>11</sup> and only took exception to them when he incurred the huge loss in mid-January 2008. Kerviel went on to maintain that “his activities were part of a culture of lawlessness among other SocGen traders which had the bank's broad approval.”<sup>12</sup>

Daniel Bouton and his fellow Societe Generale executives were not the only third parties who were held at least partially responsible for the massive loss incurred by Jerome Kerviel. Shortly after Kerviel's scheme was revealed, the *New York Times* questioned why Societe Generale's statutory auditors had not uncovered the fraud.<sup>13</sup> Throughout the time frame that Kerviel's fraud was ongoing, those auditors had issued unqualified opinions each year on the bank's annual financial statements.

The failure of Societe Generale's auditors to uncover the fraud was particularly perplexing to many parties since France's federal securities laws require that public companies retain not one but rather two independent accounting firms to audit their periodic financial statements. So called “joint-auditing” is not unique to France but the history of the nation's independent audit function is very different from that of other major economies. To better understand the role of Societe Generale's auditors in the

Kerviel affair it will be helpful to review the history of independent auditing in France with a particular focus on the nature of joint-auditing in that nation.

### **Independent Audits, French Style**

The accounting profession within France consists of two distinct disciplines. Statutory auditors (*commissaries aux comptes*) perform independent audits, while public accountants (*experts-comptables*) provide a wide range of accounting and related professional services. Most statutory auditors are also public accountants but these individuals cannot provide auditing and accounting services to the same client.

Although the accounting profession has existed in France for several hundred years, the nation's independent audit function was slow to evolve. A reputable independent auditing discipline was not firmly established until the late 1960s. According to a French academic, independent auditing was effectively a "laughing stock" in the country until that time because of the absence of any meaningful oversight by a regulatory body or professional organization.<sup>14</sup>

To help modernize the French economy and integrate it into the European Economic Community, now referred to as the European Union, the French government adopted several reform measures in the late 1960s. The goal of these reforms was to create a regulatory infrastructure for the nation's financial reporting function that was comparable to that of the U.S. and the United Kingdom. These reforms included the creation of the *Commission des Opérations de Bourse* (COB), a federal agency equivalent to the U.S. Securities and Exchange Commission. The French government also established a federal agency to oversee the nation's independent audit function. This latter agency is *La Compagnie Nationales des Commissaires aux Comptes* (Institute of

Statutory Auditors), which is commonly referred to as the CNCC.<sup>15</sup> The CNCC was given a wide range of responsibilities. These responsibilities include establishing standards of ethical conduct for statutory auditors, sanctioning auditors who violate those standards, establishing educational requirements for statutory auditors, and issuing professional auditing standards.<sup>16</sup>

Since the creation of the CNCC in 1969, the French government has periodically adopted measures to further strengthen the nation's independent audit function. The 2003 reforms prompted by the Sarbanes-Oxley Act included several new rules intended to strengthen the independence of statutory auditors. The French government now prohibits statutory auditors from providing public clients any services that are "unrelated" to the annual audit and requires such clients to have audit committees. Statutory auditors are also limited to one six-year "mandate" with each public client, that is, auditor rotation is mandatory after six years. During the term of the six-year mandate, audit clients can dismiss their auditors only under very rare circumstances.<sup>17</sup> When an auditor-client engagement terminates, five years must elapse before statutory auditors can accept employment with the former client. Finally, public companies must disclose in their annual reports the total fees paid to their statutory auditors each year. In 2007, Societe Generale paid its statutory auditors approximately 26 million euros.

In 2001, two years prior to the auditor independence reforms adopted by the French government, Societe Generale's board implemented several new policies to enhance the independence of its statutory auditors. These voluntary measures included prohibiting the bank from purchasing non-audit services from any member of its statutory auditors' worldwide networks.

When the French government initiated the reforms to modernize the nation's economy in the late 1960s, the U.S.-based Big Eight accounting firms targeted France as a potentially lucrative market. The aggressive client development activities of the Big Eight firms caused France's domestic accounting firms to feel threatened. To mitigate the impact of the Big Eight's intrusion into their market, the domestic accounting firms lobbied the government to require public companies to have joint audits.<sup>18</sup>

The lobbying efforts of the domestic firms were successful. The requirement that French public companies be jointly audited doubled the size of France's audit market for those companies and increased the domestic firms' chances of retaining a significant number of them as audit clients. Although the Big Four firms are easily France's largest audit firms in terms of annual revenues, most public companies in France have at least one French domestic accounting firm serving as their statutory auditors. By comparison, in Italy, which does not mandate joint audits, the Big Four accounting firms audit more than 95 percent of all public companies.

Christian Dior is an example of a major French company that retains a Big Four accounting firm and a domestic accounting firm to serve as its joint auditors. Mazars & Guerard, one of Christian Dior's joint auditors and France's largest domestic accounting firm, is a French accounting firm that has benefited significantly from the joint audit requirement.

Affiliates of two Big Four accounting firms, Ernst & Young Audit and Deloitte & Associates, served as Societe Generale's statutory auditors throughout the time period that Kerviel made unauthorized trades. The rule limiting audit engagements to one six-year mandate went into effect in August 2006. The previous year, Societe Generale agreed to

a final six-year mandate with its auditors, meaning that Ernst & Young and Deloitte would serve as the bank's auditors through 2011.

France's joint audit requirement for public companies has been controversial. In fact, in 1984, the CNCC recommended that joint audits be voluntary rather than mandatory for public companies. The CNCC recommended the change because it believed that the joint audit rule unnecessarily increased the cost of independent audits for large French companies. That proposal was never enacted, largely because domestic accounting firms strongly objected to it.

Despite the CNCC's decision to retain the joint audit rule, critics of that rule continued to insist that it unnecessarily increased the cost of independent audits while having little impact on their overall quality. In recent years, academic researchers have addressed each of those issues. In terms of cost, one academic study demonstrated that joint audits performed in France are generally no more costly than comparable single-firm audits performed in other countries.<sup>19</sup>

Another academic study found the surprising result that the quality of joint audits may actually be lower than that of single-firm audits, particularly when a company retains two Big Four firms, which was true of Societe Generale during the course of the Kerviel fraud.<sup>20</sup> The researcher in the latter study speculated that when both joint auditors are Big Four firms it is possible, if not likely, that neither firm will subordinate its judgment to the other firm. Such a lack of cooperation between the firms could impair the quality of an audit. An alternative explanation for the surprising result is that when Big Four firms serve as joint auditors, they may rely too heavily on each other, thus reducing audit quality.

The ongoing investigations of the Societe Generale fraud have provided few insights regarding the nature of the company's joint audits performed by Ernst & Young and Deloitte and whether the relationship between the two firms affected the quality of those audits. Despite being badgered and widely criticized by the press, neither firm has publicly commented on those audits. To date, a focal point of the criticism of Ernst & Young and Deloitte has been those firms' decision to endorse the unusual manner in which Societe Generale reported the massive loss due to Kerviel's fraud in its audited financial statements.

### **Creative Accounting, French Style**

When Societe Generale released its 2007 financial statements in March of 2008, the global investing community was shocked to discover that the 6.4 billion euro loss incurred by Kerviel in January 2008 had been recorded by the company's accountants in fiscal 2007, which ended December 31, 2007. Even more puzzling, Societe Generale's two audit firms had acquiesced to that financial statement treatment of the loss and issued an unqualified opinion on those financial statements.

As explained in Exhibit 3, which contains an excerpt from Note 40 to Societe Generale's 2007 financial statements, Societe Generale netted the 1.5 billion euro gain that it realized from Kerviel's unauthorized trades in 2007 against the 6.4 billion euro loss that his illicit trades produced in January 2008. Recognize that the 6.4 billion euro loss incurred by Kerviel in January 2008 resulted from the sale of securities that he had purchased that same month. None of that loss related to securities purchased by Kerviel during 2007.

**--Insert Exhibit 3--**

In justifying its decision to shift the 6.4 billion euro loss from 2008 to 2007, Societe Generale invoked the “fair presentation override” included in *International Accounting Standard No. 1 (IAS 1)*, “Presentation of Financial Statements.” That override clause allows reporting entities to depart from an accounting or reporting standard if compliance with the given standard would result in misleading financial statements. Societe Generale maintained that Kerviel’s January 2008 trades on which he incurred the 6.4 billion euro loss were a continuation of the “unauthorized activities” that resulted in a 1.5 billion gain in 2007. As a result, the bank concluded that the net gain or loss on those activities should be recorded in the year in which the unauthorized activities had been initiated. Note 40 failed to point out that Kerviel’s unauthorized activities had actually extended back to 2005 when he joined the bank’s securities trading division.

Exhibit 4 presents the audit report that Societe Generale’s joint auditors issued on the bank’s 2007 financial statements. That audit report contains the three standard sections of a French audit report; the actual audit opinion is included in Section I of that report. The audit opinion was unqualified, although the joint auditors included an explanatory paragraph relating to the Kerviel affair. In Section II of the 2007 audit report, “Justification of Assessments,” the auditors reveal that they “reconsidered and extended our audit procedures” after learning of Kerviel’s unauthorized activities. In that section, the auditors also note that they “assessed” Societe Generale’s reliance on *IAS 1* as the justification for the accounting treatment applied to the net loss produced by Kerviel’s unauthorized activities during 2007 and 2008.

**--Insert Exhibit 4--**

Critics of Societe Generale's decision to backdate the 6.4 billion euro loss incurred in January 2008 speculated that the bank did so to "clear the decks," that is, to put the embarrassing incident behind it as quickly as possible. If the loss had been included in the bank's 2008 financial statements, the incident would have lingered and resurfaced again when the bank released those financial statements in March or April of 2009.

In commenting on Societe Generale's use of the true and fair override to justify its controversial decision, the *New York Times* reported that, "There is nothing true about reporting a loss in 2007 when it clearly occurred in 2008."<sup>21</sup> The newspaper went on to berate the bank's management team and auditors for apparently attempting to "appease" investors and other parties by backdating the January 2008 loss. A former member of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) flatly stated that the bank's reporting of the 6.4 billion euro loss was "inappropriate" and that the prominent bank was "manipulating earnings."<sup>22</sup> A member of the IASB at the time added to that sentiment by noting that, "This raises a question as to just how creative they are in interpreting accounting rules in other areas."<sup>23</sup> Finally, another critic noted that, "What Societe and its auditors have perpetrated would be regarded here [the United States] as the accounting equivalent of pornography."<sup>24</sup>

Societe Generale's controversial decision was untimely and extremely embarrassing for the IASB, the London-based rule-making body that issues *International Financial Reporting Standards* (IFRS)—earlier versions of these standards were referred to as *International Accounting Standards*. Over the past two decades, the IASB had been involved in a contentious struggle with the FASB to determine whether IFRS or U.S.

GAAP would emerge as the pre-eminent set of international accounting standards. Prior to the Societe Generale incident, the IASB had clearly gained the upper hand in that struggle. However, that incident made many parties question the wisdom of adopting IFRS as the worldwide standard for financial reporting.

A Canadian journalist suggested that the Societe Generale incident had exposed just one of many “tricks” that IFRS would make available to creative accountants around the globe and suggested that “there is mounting evidence that IFRS is a step backwards for financial comparability.”<sup>25</sup> In the United States, the editor of an accounting periodical observed “Investors should be troubled by this in an IASB world”<sup>26</sup> and suggested that the range of accounting and financial reporting decisions permitted under IFRS encourages self-interested accounting and financial reporting decisions. The latter point was reinforced by another IASB critic who noted that, “Simply put, if you give management and auditors the opportunity to obfuscate, they will take it.”<sup>27</sup>

The *New York Times* argued that the most troubling facet of the Societe Generale incident was not the IFRS loophole that permitted the bank to backdate the large trading loss incurred by Jerome Kerviel. Instead, the newspaper maintained that the primary issue raised by the incident was the absence of a worldwide international regulatory body for the accounting and financial reporting profession: “How well can international accounting standards be policed in a world with no international regulatory body?”<sup>28</sup>

## **Epilogue**

The final report of the Special Committee appointed by Societe Generale’s board to investigate the Jerome Kerviel affair largely contradicted Daniel Bouton’s assertion that the bank’s internal controls had been adequate and had simply been victimized by an

ingenious fraud scheme. The *New York Times* summarized the lengthy report by observing that “weak management and insufficient risk controls” permitted Kerviel to sustain his fraud for several years.<sup>29</sup> Shortly after this report was released, Bouton resigned as Societe Generale’s CEO and Kerviel’s two former supervisors were dismissed by the bank.

Civil and criminal litigation stemming from the Kerviel fraud will no doubt continue for many years to come. Charges pending against Kerviel include breach of trust, preparing false documents, and illegally accessing a computer. Kerviel faces a maximum prison sentence of three years if convicted of all of those charges.

**Exhibit 1****Excerpt from Internal Control Report Included  
In Christian Dior's 2007 Annual Financial Report**

## II. Internal Control Procedures

The purpose of internal control procedures at Christian Dior is as follows:

- To ensure that management and operations-related measures, as well as the conduct of personnel, are consistent with the definitions contained in the guidelines applying to the Company's activities by its management bodies, applicable laws and regulations, and the Company's internal values, rules and regulations.
- To ensure that the accounting, financial, and management information communicated to the Company's management bodies reflect a fair view of the Company's activity and financial position.

One of the objectives of the internal control system is to prevent and control risks resulting from the Company's activity and the risk of error or fraud, particularly in the areas of accounting and finance. As with any control system, however, it cannot provide an absolute guarantee that these risks are completely eliminated.

**Source: 2007 annual financial report of Christian Dior**

**Exhibit 2****Statutory Auditors' Report on Christian Dior's 2007 Internal Control Report**

To the Shareholders,

As Statutory Auditors of Christian Dior and in accordance with Article L. 225-235 of the French Commercial Code (*Code de Commerce*), we hereby report to you on the report prepared by the chairman of your Company in accordance with Article L. 225-237 of the French Commercial Code for the year ended December 31, 2007.

In his Report, the Chairman reports, in particular, on the conditions for the preparation and organization of the Board of Directors' work and the internal control procedures implemented by the Company.

It is our responsibility to report to you our observations on the information set out in the Chairman's report on the internal control procedures relating to the preparation and treatment of financial and accounting information.

We have performed our work in accordance with the professional guidelines applicable to France. These guidelines require that we plan and perform procedures to assess the fairness of the information set out in the Chairman's report on the internal control procedures relating to the preparation and treatment of the financial and accounting information. These procedures notably consisted of:

- obtaining an understanding of the objectives and general organization of internal control as well as the internal control procedures relating to the preparation and treatment of financial and accounting information, as set out in the Chairman's Report;
- obtaining an understanding of the work underlying the information set out in the report;
- assessing whether major deficiencies related to internal control procedures and treatment of financial and accounting information have been appropriately reported in the Chairman's Report, if any.

**Exhibit 2, Cont'd****Statutory Auditors' Report on Christian Dior's 2007 Internal Control Report**

On the basis of the procedures we have performed, we have nothing to report with regard to the information concerning the internal control procedures of the Company relating to the preparation and treatment of the financial and accounting information, as included in the Report of the Chairman of the Board of Directors, prepared in accordance with the Article L. 225-237 of the French Commercial Code.

Courbevoie and Paris-La Defense, March 10, 2008.

The Statutory Auditors:

Mazars & Guerard Ernst & Young

**Source: 2007 Annual Financial Report of Christian Dior**

**Exhibit 3****Excerpt from Note 40 Accompanying  
Societe Generale's 2007 Financial Statements**

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 related to those 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 in accordance with provision of paragraphs 17 and 18 of IAS 1 “Presentation of Financial Statements” the Group decided to depart from the provisions of IAS 10 “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.

**Source: 2007 Annual Financial Report of Societe Generale**

**Exhibit 4****Statutory Auditors' Report on Societe Generale's 2007 Financial Statements**

To the Shareholders,

In compliance with the assignment entrusted to us by your Annual General Meeting, we have audited the accompanying financial statements of Societe Generale for the year ended December 31, 2007.

These consolidated financial statements have been approved by the Board of Directors on February 20, 2008. Our role is to express an opinion on those financial statements based on our audit.

**I – OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS**

We conducted our audit in accordance with the professional standards applicable in France; those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used by the management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the assets, liabilities, financial position and results of the consolidated group in accordance with IFRS as adopted by the European Union.

Without qualifying the opinion expressed above, we draw your attention to:

- notes 1 and 40 to the consolidated financial statements that describe the accounting and tax treatments of the net loss on unauthorized and concealed trading activities and the reasons which led the Group to make use of the exception under IAS 1 in order to present fairly its financial position as at December 31, 2007;
- note 40 to the consolidated financial statements that indicates that, on the date the accompanying financial statements are authorized for issue, Corporate and Investment Banking operations are currently the subject of various internal and external investigations as a result of which new facts, unknown to date may emerge.

**Exhibit 4, Cont'd****Statutory Auditors' Report on Societe  
Generale's 2007 Financial Statements****II – JUSTIFICATION OF ASSESSMENTS**

In accordance with the requirements of Article L. 823-9 of the French Commercial Code (Code de Commerce) relating to the justification of our assessments, we bring your attention to the following matters:

***BACKGROUND OF THE FINANCIAL STATEMENTS CLOSING PROCESS***

Following the uncovering of the unauthorized and concealed activities described in note 40, we have reconsidered and extended our audit procedures to be in a position to issue an opinion on the consolidated financial statements taken as a whole, keeping in mind that the purpose of these procedures is not to issue an opinion on the effectiveness of internal control over financial reporting. Accordingly, we have:

- extended the scope and nature of the audit procedures performed on Corporate and Investment Banking trading activities;
- reconsidered the General Inspector's intermediary conclusions and work performed following its assignment as of January 24, 2008, which was primarily intended to check that all unauthorized positions and related losses have been comprehensively identified and which conclusions have been endorsed by the Special Committee after receiving the comments of its advisor;
- reviewing the documentation supporting the amount of the recorded loss.

***ACCOUNTING POLICIES***

Note 1 to the financial statements describes the reasons that led the Group to depart from the application of IAS 10 and IAS 37 on the basis of the exception provided under IAS 1 for purpose of providing with a fair presentation of its financial position as at December 31, 2007, by recording a provision for net loss resulting from the unwinding on January 23, 2008, of the unauthorized and concealed activities. As part of our assessment of accounting principles applied, we have assessed the basis for applying these provisions of IAS 1 as well as whether appropriate disclosure is included in the notes.

***ACCOUNTING ESTIMATES***

- As detailed in Note 1 to the financial statements, the Group uses internal models to measure financial instruments that are not listed on liquid markets. Our procedures consisted in reviewing the control procedures related to the designed models, to assess the data and assumptions used as well as the inclusion of the risks and results related to these instruments.

## Exhibit 4, Cont'd

### Statutory Auditors' Report on Societe Generale's 2007 Financial Statements

- In the specific context of the current credit crisis, the Group discusses in note 3 its direct and indirect exposure to the US residential real estate market, the procedures implemented to assess this exposure as well as the process for measuring related financial instruments. We have reviewed the control procedures implemented to identify and measure such exposure, as well as whether appropriate disclosure is included in the notes with respect thereto.
- As mentioned in note 3, the Group assessed the impact relating to changes in its own credit risk on the measurement of certain financial liabilities measured at fair value through profit and loss. We have reviewed that appropriate data have been used for that purpose.
- For purpose of preparing the financial statements, the Group records impairments to cover the credit risks inherent to its activities and performs significant accounting estimates, as described in note 1 to the financial statements, related in particular to the assessment of the fair value of financial instruments accounted for at amortized cost, of goodwill and pension plans and other post-employment benefits. We have reviewed these processes, the underlying assumptions and valuation parameters and assessed whether these accounting estimates rely on documented procedures consistent with the accounting policies disclosed in note 1.

These assessments were performed as part of our audit approach for purpose of expressing the audit opinion on the consolidated financial statements taken as a whole that is stated above in the first part of this report.

### III – SPECIFIC VERIFICATION

In accordance with professional standards applicable in France, we have also verified the information given in the Group management report. We have no matters relating to report regarding fair presentation and conformity with the consolidated financial statements.

Paris – La Defense and Neuilly-sur-Seine,  
February 29, 2008

The Statutory Auditors

Ernst & Young Audit  
Deloitte & Associes

**Source: 2007 Annual Financial Report of Societe Generale**

## Questions

1. Research relevant databases to identify important recent developments within France's accounting profession, including the nation's independent audit function. Summarize these developments in a bullet format.
2. Societe Generale maintained that because Jerome Kerviel's "unauthorized activities" were initiated in 2007, the 6.4 billion euro loss that he incurred in January 2008 should be recorded in 2007. Do you agree with that reasoning? Why or why not?
3. Societe Generale was criticized for invoking what is referred to as the "true and fair override" in IFRS. Is there a comparable clause or rule in GAAP? If so, identify two scenarios under which a departure from GAAP would be necessary to prevent a set of financial statements from being misleading.
4. Compare the general format and content of the audit report shown in Exhibit 4 with the standard audit report issued under U.S. GAAS. What are the key differences between those two audit reports? Which report format is the most informative?
5. This case lists Societe Generale's three principal internal control objectives. Compare and contrast those objectives with the primary internal control objectives discussed in GAAS.
6. Identify countries in addition to France where joint audits are performed. What economic, political, geographic or other characteristics are common to these countries?
7. Identify audit risk factors common to a bank client. Classify these risk factors into the following categories: inherent, control, and detection. Briefly explain your classification of each risk factor that you identified.

### Footnotes

1. P. Allen, “‘I Just Got A Bit Carried Away,’ says Trader Behind EUR5BN Fraud,” *The Mirror* (online), 6 February 2008.
2. J. Eyal, “Breaking the Bank, French Style,” *The Straits Times* (online), 2 February 2008.
3. *Ibid.*
4. S. Kennedy, “France’s SocGen Hit By \$7.1 Billion Alleged Fraud,” *Marketwatch.com*, 24 January 2008.
5. Eyal, “Breaking the Bank, French Style.”
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7. D. Jolly and N. Clark, “Greater Details Emerge of Bank’s 4.9 Billion Loss,” *International Herald Tribune*, 28 January 2008, 1.
8. A. Hanes, “Suspect ‘A Fragile Being;’ Trader’s Best Intentions Can Go Wrong, Prof Says,” *National Post*, 25 January 2008, A3.
9. J. Peterson, “Societe Generale’s 2007 Annual Report—Jerome Kerviel Is So Last Year,” *jamespeterson.com*, 17 March 2008.
10. Allen, “‘I Just Got A Bit Carried Away.’”
11. *Ibid.*
12. J. Lichfield, “‘Rogue Trader’ Freed on Bail after Judges Drop Fraud Charges,” *The Independent*, 29 January 2008, 18.
13. N. Clark and K. Bennhold, “French Inquiry: Bank’s Inaction Grows as Issue,” *The New York Times* (online), 29 January 2008.
14. C. Ramirez, “Exporting Professional Models: The Expansion of the Multinational Audit Firm and the Transformation of the French Accountancy Profession Since 1970.” Working paper, HEC School of Management, Paris, January 2007, 23.
15. The comparable federal agency that regulates the practice of public accounting is the Order of Chartered Accountants or *l’Ordre des Experts-Comptables* (OEC).
16. In 2000, the CNCC began effectively requiring French auditors to apply International Standards of Auditing (ISAs). In May 2006, the European Parliament, which is the legislative arm of the European Union (EU), decreed that independent audits throughout the EU must be performed in compliance with ISAs. Member countries of the EU were required to adopt this new rule by 2010.
17. Likewise, statutory auditors are effectively prohibited from resigning during the term of a six-year mandate.
18. Publicly, the domestic firms justified the proposal for joint audits as a measure to enhance the overall quality of independent audits.
19. J. Francis, C. Richard, and A. Vanstraelen, “Assessing France’s Joint Audit Requirement: Are Two Heads Better than One?” Presented at the International Symposium on Audit Research, Sydney, Australia, 2006.
20. S. Marmousez, “Conservatism and Joint-Auditing: Evidence from French Listed Companies.” Working paper, HEC School of Management, Paris, October 2006.
21. F. Norris, “Loophole Lets Bank Rewrite the Calendar,” *The New York Times* (online), 7 March 2008.

22. F. Norris, "Societe Generale Invokes Special Accounting Rule to Absorb Kerviel Losses," *International Herald Tribune* (online), 6 March 2008.
23. *Ibid.*
24. *Accountingonion.typepad.com*, "IFRS Chaos in France: The Incredible Case of Societe Generale," 7 March 2008.
25. A. Rosen, "SocGen 'Rogues' Show Flaws in Accounting Rules," *National Post*, 9 April 2008, FP11.
26. F. Norris, "Loophole Lets Bank Rewrite the Calendar."
27. Rosen, "SocGen 'Rogues' Show Flaws in Accounting Rules."
28. Norris, "Loophole Lets Bank Rewrite the Calendar."
29. K. Bennhold, "Rogue Trader May Have Had Help, Audit Finds," *New York Times* (online), 24 May 2008.