A Case Study of True and Fair View Override in Financial Reporting

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ABSTRACT: This paper documents a case study of true and fair view override in financial reporting by a multinational firm subject to International Financial Reporting Standards (IFRSs). The 2009 Interim Report of HSBC Holdings plc states that HSBC departed from the requirements of IAS 32 Financial Instruments: Presentation (IAS 32). Notwithstanding its noncompliance with the IFRSs, HSBC (2009) concluded that “the interim consolidated financial statements prepared on this basis presented fairly, and gave a true and fair view of the Group’s financial position, financial performance and cash flows” (p. 2). The purpose of this paper is to evaluate critically the accounting treatment in light of the relevant requirements of the IFRSs and the implications for professional accounting standards arising from this departure.

Keywords: True and fair view, financial reporting, accounting standards, IFRS

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1. **Introduction**

International Financial Reporting Standards (IFRSs) are a set of accounting standards developed by the International Accounting Standards Board (IASB) for the preparation of financial statements, in particular for public companies. The IFRSs have been widely adopted around the world. The American Institute of Certified Public Accountants (AICPA, 2016) reports that “approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies”. For example, Australia, Hong Kong, Singapore, the European Union, and the United Kingdom have all fully adopted the IFRSs.

A recent analysis by the IFRS Foundation (2016) shows that more than half of the domestic listed companies on the major stock exchanges around the world use the IFRSs and most of the companies that do not use IFRSs “are listed in China, India, Japan, and the United States”.

The IFRSs are a set of principles-based standards that contrast with rules-based standards such as the generally accepted accounting principles (GAAPs), produced by the Financial Accounting Standards Board (FASB) in the United States. The IFRSs are built on a *Conceptual Framework* that provides an economic foundation for establishing accounting standards “based on consistent concepts” (IFRS, 2016) rather than a collection of arbitrary accounting conventions such as conservatism, historical cost accounting, prudence, and matching (Ho, 2011).

This paper documents a case study of a true and fair view override in financial reporting by a multinational firm subject to the IFRSs. The 2009 Interim Report of HSBC Holdings plc states that HSBC departed from the requirements of IAS 32 *Financial Instruments: Presentation* (IAS 32). Notwithstanding its noncompliance with the IFRSs, HSBC (2009) concluded that “the interim consolidated financial statements prepared on this basis presented fairly, and gave a true and fair view of the Group’s financial position, financial performance and cash flows” (p. 2). The purpose of this paper is to evaluate critically the accounting treatment in light of the relevant requirements of the IFRSs and the implications for professional accounting standards arising from this departure.

2. **The HSBC Group**

*Company background*

As one of the largest multinational banking and financial services companies in the world, HSBC operates globally in four business areas: Commercial Banking, Global Banking and Markets, Retail Banking and Wealth Management, and Global Private Banking. HSBC serves millions of customers through a network of offices in more than seventy countries and territories. In addition to dual primary listings in Hong Kong and London, HSBC’s shares are traded in New York, Paris and Bermuda (HSBC, 2016).

Presented below are highlights of the case extracted from the 2009 Interim Report of HSBC Holdings plc. Readers who wish to read the full details may download the report from HSBC’s corporate website at [www.hsbc.com](http://www.hsbc.com).
Rights issue
To survive in what HSBC describes in *The HSBC Group: Our story* (2013) as a “period of extraordinary and unprecedented turbulence in economies and markets around the world, in 2009 it announced a rights issue to raise approximately US$17.7 billion to maintain its signature capital strength and enhance its ability to deal with an uncertain world” (p. 28).

On 2 March 2009, HSBC announced its proposal to raise £12.5 billion by way of a fully underwritten rights issue. Under the proposal, HSBC offered its shareholders the opportunity to acquire 5 new shares for every 12 shares held at an issue price of £2.54 per share. For shareholders on the Hong Kong and Bermuda Overseas Branch Registers, this offer was expressed in Hong Kong dollars and US dollars respectively, fixed at the published exchange rates on 27 February 2009. The proposal was authorised by the shareholders at a general meeting on 19 March 2009. The offer period commenced on 20 March 2009 and closed for acceptance on 3 April 2009. Dealing in the new shares began on 6 April 2009.

Accounting treatment under IFRSs
Despite the fact that HSBC used the US dollar as its functional currency, the rights issue was offered mainly in Sterling and Hong Kong dollars. Hence, the rights issue was not able to satisfy the accounting requirement of an equity instrument in issuing a fixed number of shares for a fixed amount of cash in its functional currency. As a result, HSBC was prohibited under IAS 32 from accounting for the offer of rights in shareholders’ equity. The rights issue would have to be accounted for as a derivative financial liability.

As a derivative financial liability, under IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39), the liability would have been measured at its fair value at the inception of the offer, which was basically the difference between the share price on that date and the issue price. The corresponding entry upon its inception would have been made to shareholders’ equity. Subsequently, the liability would have been re-measured at fair value with movements in fair value recognised in the income statement until the rights were exercised. On the exercise of rights, the liability would have been credited to shareholders’ equity. If this accounting treatment had been adopted by HSBC, a loss of US$4.7 billion would have been recognised in its income statement, primarily due to an increase in its share price during the offer period. There would have been no effect on the shareholders’ equity or distributable reserves.

There was a dramatic effect on HSBC’s profit for the period because US$3.3 billion in profit was reported as an equity treatment rather than a loss of US$1.4 billion that would have been reported under a liability treatment.

Fair presentation
HSBC posited that if the accounting of the rights issue was carried out in accordance with the requirements of IAS 32, it would be so misleading that it would conflict with the objectives of the financial statements set out in the IASB’s *Conceptual Framework*. It concluded that the application of IAS 32 to the rights issue would not have resulted in a fair representation of the transaction it purported to represent, and consequently it might induce an adverse impact on the economic decisions made by the users of the financial statements. Compliance with this specific
requirement was represented as being so misleading that the interim consolidated financial statements would not have fairly represented HSBC’s financial position, financial performance and cash flows.

The offer of rights had been made on equal terms to all shareholders in the currency in which their shares were denominated. In essence, the transaction was one with the existing shareholders. It would reasonably be expected to have no effect on the profit or loss attributable to shareholders for the accounting period. However, the principal factor which, under the requirements of the IFRSs, determined the movement of liability over the offer period was the movement in the HSBC’s own share price. Therefore, the accounting treatment under IAS 32 would have resulted in the amounts shown in the income statement being seen as transactions with existing shareholders when, in fact, movements in the HSBC’s own share price were the primary cause. Further, the financial effect of this accounting treatment was material in terms of the amount, and would cause the profit attributable to the shareholders to become a loss attributable to them.

HSBC accounted for the offer of rights as an equity instrument and therefore did not re-measure this instrument during the offer period. It therefore accounted for the offer of rights in the same way that the IAS 32 would require for an offer of rights in new shares denominated in the functional currency of the issuer. Following the exercise of the rights and the allotment of new shares, the cash proceeds from the rights issue were recognised in shareholders’ equity.

3. Critical review

Under IAS 21 The Effects of Changes in Foreign Exchange Rates (IAS 21), an entity can choose any currency as its presentation currency in its financial statements. However, for measurements, an entity is required to determine its functional currency based on the primary economic environment in which it operates.

Despite the fact that HSBC chooses and determines the US dollar as both its presentation and functional currency, as a multinational bank it operates globally with a number of foreign currencies in its foreign operations such as the Euro, Sterling, and the Hong Kong dollar. Although its functional currency is the US dollar, the rights issue was denominated to a large extent in currencies other than US dollars, principally in Sterling and Hong Kong dollars. These foreign currency transactions were recorded initially at the rate of exchange on the date of the transactions and reported using the closing rate on each subsequent date of the statement of financial position. Exchange differences were reported in the statement of profit and loss. This reporting requirement inevitably creates a translation risk in accounting of the rights issue.

In the case of the rights issue, the exchange differences from foreign currency transactions are more nominal in nature. There cannot be any profit measurement from transactions with existing shareholders if the rights issue is accounted for as an equity instrument, or any such profit measurement is at best transitory if accounted for as a liability instrument.

Under IAS 32, a contract that will be settled in an entity’s own equity instruments and is a derivative that will be settled other than by the exchange of a fixed amount of cash or another
financial asset for a fixed number of the entity’s own equity instruments is classified as a financial liability. An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

The foreign currency denomination of the rights issue failed the requirement that the exchange be settled for a fixed number of shares for a fixed amount of cash. The fixed amount of foreign currencies, Sterling and Hong Kong dollars, would inevitably be translated into a variable amount of cash in its functional currency, the US dollar, when the rights issue was exercised.

Under IAS 39, the rights issue had to be classified as a financial liability instrument subject to fair value measurement. IAS 39 was subject to severe criticism during the period of economic crisis from 2007 to 2008, particularly with regard to fair value accounting. The Economist (2008), for example, reported a ‘chorus of criticism’ against fair value accounting, including pressure on standard setters by banks who argued that sound assets had suffered excessive write-downs and that fair value accounting for such assets should be suspended.

Standard setters were thus caught in the position where their standards imposed fair value accounting under an assumption that markets worked well; however, markets were clearly not working well. To address this difficulty, the IASB and FASB issued similar guidance on how to determine fair value when markets are inactive, and the IASB revised IAS 39 to allow reclassification of certain financial assets.

These changes were stopgap measures resulting from political pressure from management and regulators. Subsequently, the IASB embarked on a three-part project to replace IAS 39. IFRS 9, effective 1 January 2013, was the first outcome of this project. However, it backed off somewhat from fair value accounting for financial instruments.

4. Conclusion

HSBC argued its case of noncompliance based on the economic substance of the transaction that the rights offer involved its existing shareholders and no profit should be recognised from this equity transaction. A strict application of the accounting standards would have rendered the financial statements misleading. HSBC chose to depart from the requirements with a true and fair view override. Allan Cook, a UK standard-setter, believes that “the true and fair view has the capability to help evolution of European accounting rules by providing an underlying concept and a degree of freedom to interpret rules which become obsolete” (1997, p. 693).

In fact, a meeting was held by the IASB afterwards to discuss a recommendation made by the IFRS Interpretations Committee (IFRIC) to amend IAS 32. As a result of the meeting, an Exposure Draft was issued by the IASB to amend IAS 32, such that, if adopted, IAS 32 would have required rights issues such as HSBC’s to be accounted for as an equity instrument rather than a derivative financial liability.

Nevertheless, it is very rare to apply the true and fair view override, which relies heavily on professional judgement. Practitioners such as accountants, bank officers and managers tend to “differentiate compliance with GAAP and/or compliance with legal requirements from true and
fair” (Koh & Low, 1996, p. 155). There are pros and cons to equate fair presentation to compliance with accounting standards that are set by professional accounting bodies such as the IASB and FASB, and influenced to a large extent by government regulatory agencies.

In setting accounting standards, the interests of managers, small investors, large investors, and others must be traded off. Value judgments about these trade-offs are difficult to make. These considerations suggest that standard setting is fundamentally as much a political process as an economic one. Such a viewpoint is consistent with the concept of constituencies in accounting and attempts by governments to influence standard setters. It seems natural to expect that the various accounting constituencies would appeal to the political process when their conflicting interests cannot be resolved by contractual or market forces.

This case study also casts doubt on the efficient market hypothesis, which suggests it is the substance of the information that matters rather than the form of its presentation. There was an alternative: presenting or highlighting the nominal and transitory nature of profit in a note disclosure. The management of HSBC, however, would not consider this alternative as viable.
**References**


