BUSINESS ETHICS AND CORPORATE GOVERNANCE

Corporate Governance Failures: to what extent is Parmalat a particularly Italian Case?

Prof. Stefania Servalli
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ANGLOPHONE BUSINESS MEDIA: PARMALAT CASE AS A PARTICULARLY ITALIAN SCANDAL (COUNTRY-SPECIFIC)


What is the main Research Question of this paper?

Åto what extent is Parmalat a particularly Italian Case?

ÅItalian case: Policy Makers and international Scholars could disregard the case as a country-specific case
ÅNot an Italian case: Global CG issue to consider for Policy Makers and international Scholars
And related Research Questions?

ÅHow was it possible?
ÅWhy did the CG system fail in preventing?
ÅWhich monitoring mechanism failed?
What is the perspective adopted to consider accounting and CG issues in this paper?

**SUPPLY SIDE OF INFORMATION**
- CG ACTORS
- MANAGEMENT
- EXTERNAL AUDITORS

**DEMAND SIDE OF INFORMATION**
- INSTITUTIONAL INVESTORS
- PRIVATE INVESTORS
- FINANCIAL ANALYSTS
- RATING AGENCIES

*NOT COUNTRY-SPECIFIC*
What was the control structure of Parmalat?

Parmalat was a complex group of companies controlled by a strong blockholder (the Tanzi family) through a pyramidal device.

Common in Italian but also Continental Europe groups:
- Holding company controls the majority of companies belonging to the group
- Ultimate control by a single entrepreneur/family
PARMALAT SPA:
- Not listed;
- Controlled by PARMALAT FINANZIARIA (89.18%)
  Dalmata SPA (totally controlled by PARMALAT FINANZIARIA) owned remaining 10.82%
- Parmalat SPA directly controlled 67 companies and indirectly many others

PARMALAT FINANZIARIA:
- Listed on Milan SE;
- Main shareholder: Coloniale SPA (50.02%: 49.16% directly, 0.86% indirectly by Newport)
- Major minority shareholders:
  - Lansdowne Partners limited Partnership (2.06%)
  - Hermes Focus Assets Managements (2.2%)

COLONIALE SPA:
- Holding company;
- Controlled by Tanzi Family by Luxembourg companies

TANZI FAMILY ULTIMATE SHAREHOLDER CONTROLLING PARMALAT FINANZIARIA AND PARMALAT GROUP
What is the effect of this kind of ownership and control structure (Blockholder) considering CG Theories?

- REDUCTION OF AGENCY PROBLEMS BETWEEN PRINCIPAL AND AGENTS:
  SHAREHOLDERS – MANAGEMENT

- SHIFT OF AGENCY PROBLEMS:
  CONTROLLING SHAREHOLDER – MINORITY SHAREHOLDERS
Let’s compare this shift of Agency problem with the USA Agency problem:

USA Agency problem:
“strong managers, weak owners” (Roe, 1994)

ITALIAN Agency problem:
“weak managers, strong blockholders and unprotected minority shareholders” (Melis, 2000)

Blockholders may divert companies resources from company to themselves (Johnson et al., 2000) (PARMALAT!)
Blockholders may divert companies resources from company to themselves (Johnson et al., 2000)

Parmalat case:
Callisto Tanzi recognized that Parmalat funneled about Euro 500 millions to companies owned by the Tanzi family, especially to Parmatour.

Parmatour was owned by Nuova Holding, a Tanzi family investment company.
The monitoring structure: what are the “gatekeepers” in the Italian context?

Board of statutory auditors

External Audit firm

Country - specific
What is the role of the board of statutory auditors?

Check **the compliance** of acts/decisions of the board of directors with the **law, corporate charter and internal regulation**

Check the observance of the so-called **“principles of correct administration”**

Review the **adequacy of the organisational structure** for matters such as the **internal control system, the administrative and accounting system** as well as the **reliability of the latter in correctly representing any company’s transactions**

Ensure that **the instructions given** by the company to its **subsidiaries** concerning the provision on all the information necessary **to comply with the information requirements** established by the law are **adequate**.
What was the composition of Parmalat Finanziaria board of statutory auditors?

3 members (legal minimum requirement)

Common in Italian listed companies
In 2002: 92% of board of statutory auditors had 3 members

In these cases 1 member is appointed by the minority shareholders
Why is important the size of the board of statutory auditors?

3 members (legal minimum requirement), includes 1 minority members

More than 3 members, includes 2 minority members

2 members are required to convene the General Assembly
What about Parmalat group board of statutory auditors reports?

Never reported anything wrong!

After a claim from a minority shareholder:
«no irregularity was found de facto or de jure»

Problems:
- Lack of access to information
- Lack of independence

In presence of a blockshareholder, the board of statutory auditor can be not effective
What about Audit Firm?

Grant Thorton spa:
auditor of Parmalat Finanziaria 1990-1998
After GT continued as auditor of Parmalat spa and other offshore subsidiaries

Deloitte Spa:
auditor of Parmalat Finanziaria from 1998 on

Auditor rotation (that time): 3 years appointment, you could renew twice

Auditor rotation (now): 9 years appointment, with change of partner at 7 year.
Did the rotation work?

No it didn’t

No claims by auditors in their reports, not to Consob till the end, when they declared not to be able to value the Epicuro Fund investment

Deloitte opinions were mainly based on other auditors reports!
    up to 49% of group total assets and 30% of consolidated revenues came from subsidiaries audited by other auditors
Did the rotation work?

Grant Thornton audited the Cayman Islands based Bonlat Financing Corporation.

It held the now well-known fictitious Bank of America account.

Grant Thornton claimed to have sent a request to Bank of America in December 2002 asking for confirmation of the bank account.

Grant Thornton received a reply in March 2003, which was printed on Bank of America letterhead and signed by a bank employee. (It was forged by Parmalat management).
What is required to auditors by ISA about banks accounts?

ISA require for auditors to write independently to banks for confirmation of banks accounts!

And what about skepticism?
Board of Directors’ Composition

Parmalat Finanziaria: 13 members
- 8 EXECUTIVE (4 with family ties)
- 5 NEDs

NEDs less than EXECUTIVE: unusual

Table 3: Composition of board of directors by type of control of listed companies

<table>
<thead>
<tr>
<th>Type of control (1)</th>
<th>Executive</th>
<th>Non-executive</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority control</td>
<td>3.1</td>
<td>6.3</td>
<td>9.4</td>
</tr>
<tr>
<td>Working control</td>
<td>3.4</td>
<td>7.5</td>
<td>10.9</td>
</tr>
<tr>
<td>Under shareholders’ agreement</td>
<td>4.5</td>
<td>7.1</td>
<td>11.6</td>
</tr>
<tr>
<td>No controlling shareholder(s)</td>
<td>4.7</td>
<td>8.1</td>
<td>12.8</td>
</tr>
<tr>
<td>Total</td>
<td>3.5</td>
<td>6.8</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: Elaborated from CONSOB (2003). Data updated at December 2002. (1) Percentage ratio of the market share value of the ordinary share capital of the companies subject to each type of control to the market value of the ordinary share capital of all the companies listed on the Italian Stock Exchange.

Significant weight of NEDs (Preda Code)?
Executive Committee

Parmalat Finanziaria Executive Committee:
7 members, including
- 3 Tanzi Family members
- 1 NED Mr Barili (top manager in Parmalat)

And ....

Parmalat spa Board:
- All 7 members of Parmalat Finanziaria Executive Committee
- 1 NED
Independent Directors

Preda Code (2002): an adequate n. of NEDs should be independent

Parmalat Finanziaria: 3 Independent Directors (on 5 NEDs)

Italian listed companies usually had 5 independent (Cavallari et al., 2003)
Split Roles

When the two positions are not separated or the Chairman is delegated some executive powers, the board of directors is only recommended to provide adequate information in its annual report about the duties and responsibilities of the Chairperson and the executive directors.

Now Preda Codes recommends the institution of a lead independent director.
Split Roles in Parmalat Finanziaria?

Parmalat Finanziaria Spa:
No split Roles
Chairman and CEO: Mr. Callisto Tanzi

In Parmalat Finanziaria the Chairman of the executive committee periodically (quarterly) reported to the board of directors on the activities performed in the exercise of his powers this report was done quarterly.

It was compliant with the Preda Code
Appointment of Directors and Nomination Committee

Preda Code:
Nomination committee to propose candidates for election in cases when the board of directors believes that it is difficult for shareholders to make proposals.

Parmalat Finanziaria:
No compliance with Preda Code
(explaining that shareholders never faced difficulties in proposing candidates for elections).

Italian listed companies (that time): Only approximately 10% cent set up a nomination committee (Cavallari et al., 2003).
Remuneration Committee

Preda Code:
Recommendation to set up a **remuneration committee mainly composed by NEDS**

Parmalat Finanziaria:
**Compliant** with Preda Code
Remuneration Committee of 3 members (2 NEDs and 1 Executive).

Italian listed companies (that time):
More than 80% per cent of the companies (in 95% per cent of cases these committees have mostly been composed of non-executive directors) (Cavallari et al., 2003).
**Internal Audit and Internal Audit Committee**

**Parmalat Finanziaria:**
Internal Audit Committee: 3 members
- 2 Executive
  one of these was Mr Tonna the Chief Financial Officer and also Chairman in Coloniale (holding Company)
- 1 NED:
  He was the Certified Accountant of Tanzi Family and their close friend (Not independent)

Not compliant with Preda Code (recommending all NEDs, majority of Independent)
No adequate explanation in CG report

NONE INDEPENDENT!!!
Confidential Information
Preda Code recommends adoption internal procedures for the internal handling price-sensitive information.

Parmalat Finanziaria had informal internal procedures until 2002, In 2002 it set up a more structured system, under the responsibility of Mr. Tanzi:

Compliance with Preda? Just formally

Transaction with Related Parties
Parmalat Finanziaria:
Claimed to have set up a procedure to deal with transactions with related parties (compliance (?) with Preda Code)
Evidences show that these transactions were not treated with “substantial” and “procedural” fairness

Relations with Institutional Investors
Parmalat Finanziaria:
Claimed to have set up a responsible for these relations (compliance (?) with Preda Code)
Is Parmalat a particularly Italian Case?

No, it is another global CG issue, not very different from Enron or other Anglo-American or continental European corporate scandals.
Why?

No split roles
Conflict of interests
Internal Audit failure
External Audit failure
Absence of independence
Learning outcomes

Discuss different CG aspects involved in Parmalat scandal

References
