РАЗДЕЛ 3
УГОЛОК ПРАКТИКА

SECTION 3
PRACTITIONER'S
CORNER

INVESTORS TRUST AFTER PARMALAT SCANDAL: THE ROLE OF CORPORATE GOVERNANCE

Giovanni D'Orio

Giovanni D'Orio, Department of Economics and Statistics, University of Calabria – Rende (CS) Italy. Contact: gio.dorio@unical.it

1.1. Introduction

The collapse of the Parmalat food empire reveals a troubling aspect about Italian capitalism - the lack of effective financial control over its family-owned companies.

But was Parmalat scandal a pure problem of corporate governance or was it simply a "fraud"? Bearle and Means (1932 pg. 6) famously explained: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge ....". Is this the case? Were the people who invested in bonds and shares of Parmalat savers, investors or what? Which was the role played in the story by Auditors, CONSOB and Bank of Italy? This paper analyse the current situation of the Italian corporate governance and saving system in a critical view trying to find an explanation to the previous questions.

1.2. Corporate Governance and the legislative decree 19/01/03nr. 6: the alternatives

The Italian system of corporate governance does not fit in either of the categories of the well-known distinction between bank-based and stock exchange based systems. Instead, it can be ranked among the first group of the more recent distinction between insider-dominated and out-sider dominated systems. All the distinctive variables of this group indicated by La Porta et al. (1998) can be found in the Italian system:

- Italian firms depend heavily on bank finance;
- banks have never played an important role in the corporate governance of firms;
- financial markets have historically been shallow and small;
- ownership and control are concentrated;
- the role of the state is important;
- groups of firms are very widespread and used as a mechanism to separate ownership and control;
- there are conflicts of interest between minority and majority shareholders;
- boards of directors play a limited role;
- the market for corporate control is not active,
- hostile take-overs are difficult and unlikely.

The possible way to separate ownership and control has not been based on a unique model but on a set of different models: the system was self-organising given the fact that in Italy there has never been a law on corporate governance issue. The model is actually based on the following devices:

1. *Hierarchical group.* The most frequent corporate governance model; it accounts for 52 per cent of manufacturing activity and is more frequent among larger firms.
2. *Family control*. The second most relevant model. This is the case where family links exist among controlling shareholder.
3. *Coalition control*: is a model quite similar to the previous one but more complex. The trust-link between entrepreneurs and investors is based on their sharing common values (belonging to the same industrial district, to the same political party etc.).
4. *Financial supervision.* Financial guarantees to non-controlling shareholders are represented by the presence of financial companies with privileged information exerting monitoring (banks, merchant banks, institutional investors etc). This model was basically absent among Italian manufacturing firms in 1992 since the Banking law did not allow the banks to own a relevant quota of shares in a firm.

Under Italian Law two main types of company may be incorporated: S.p.A. (Società per Azioni) and S.r.l. (Società a responsabilità limitata).

- **S.p.A**. is the normal form for larger companies (joint stock companies). An S.p.A. may be listed on the Stock Exchange although the absolute majority are not. It is however necessary for a company to be an S.p.A. in order to be listed thereon.
- **S.r.l.** in practice corresponds to a closely held limited company. It is the kind of structure which is more suited to small-to-medium sized enterprises where limited liability is required. This is by far the most common type of company used by Italian entrepreneurs and that most frequently chosen by foreign parent companies when setting up their subsidiaries in Italy.

The governance structure of corporations is two-tired: the managing board (*consiglio di amministrazione*) has the function of ratifying decisions that have been previously taken by the controlling group, and is supplemented by a board of auditors (*collegio sindacale*) who are responsible for internal monitoring. Directors can either be executive or non-executive and there is only a limited number of external directors. They tend to meet only a few times a year and the meetings are frequently of poor quality. In addition, information is generally scarce and incomplete. Even though board members and managers are supposed to use the "*agent's diligence*" in the management of the company, responsibility is effectively taken only in cases of insolvency or incidents of criminal significance.

The board of auditors is composed of either three or five members (sindaci) who are to be chosen among certified public accountants (revisori contabili). The latter are elected by the assembly of shareholders and cannot be revoked without cause before the end of the term. Listed firms are also subjected to an external monitoring and sometimes the two forms of control overlap giving rise to several problems of competence.

Until the Reform of Company Law which was introduced by Legislative Decree 19 January 2003 No. 6 (hereafter the Reform), many of the rules governing an S.p.A. were also applicable to an S.r.l.

By the Reform the legislator has clearly manifested its intention to regulate smaller enterprises in a totally different manner by stressing the importance of the personal contribution provided to the company by shareholders. To a certain extent, this type of company has been equalled to a limited liability partnership but it is still characterised by its capital being divided into intangible shares, which are not represented by certificates.

1.2.1 Corporate Governance in S.p.As

The traditional structure of Italian companies is based upon a clear-cut distinction between different functions assigned to three separate bodies.

The General Meeting of Shareholders, which is responsible for approval of the balance-sheet, the appointment of directors and the determination of remuneration for directors and statutory auditors.

The Directors; this organ may be represented by a sole director or by a Board of Directors and is in charge of management

The Board of Statutory Auditors which invigilates on compliance by the company management with the law and the articles of association, on respect by the management of rules of correct business administration.

According to the Reform, Statutory Auditors will no longer control the company accounts, a function which is now exclusively entrusted to external auditors.

The assignment of the company's functions to three bodies has traditionally been compared with the division of powers in a modern state. Along with this traditional structure the Reform has however introduced two alternative management and control systems, respectively deriving from the German/French and English experience and recommended by the EU Council Regulations on the "European Company By-laws" dated 8 October 2001.

The "dualistic" system (s. 2409 ff., Civil Code)

This alternative provides for

i) a Management Board, with the same type of responsibilities as those which are attributed to the BOD and

ii) a Supervisory Board whose tasks are wider than those of Statutory Auditors, in that it sees to the appointment and revocation of Management Board members and to the approval of the company's accounts. The Supervisory Board is also exclusively enabled to promote actions in liability against members of the Management Board and to waive such actions by way of settlement out of court. Consequently in a company managed in accordance with this two-tier system the functions of the Shareholders' Meeting are confined to appointing and revoking members of the Supervisory Board.

The "monistic" system (s. 2409 ff. Civil Code)

According to this system, management is entrusted to a regular Board of Directors at least one third of which must be represented by independent members. Supervision is attributed by the Board to a Management Control Committee whose members are chosen from among independent directors. In companies which make recourse to the capital market, the Committee must be formed by no less than three members and at least one member must be a registered auditor. In both types of governance, save for small unlisted companies, supervision of accounts is invariably entrusted to an external auditor or auditing firm.

1.2.2 Corporate Governance in S.r.ls

In the view of the legislator an S.r.l. should be the swiftest and most flexible tool in the hands of shareholders. A much greater degree of discretion has thus been recognised to shareholders by the Reform, particularly in laying down the rules for the administration of their company.

Articles of associations will be set forth by shareholders in accordance with their needs. Therefore, they will be less formal and quite probably be drawn up in the form of contracts.

In line with this very flexible structure, the managing body of an S.r.l. may be freely shaped by shareholders by way of recourse to some alternative solutions

- a Sole Director
- a traditional Board of Directors collectively acting as a committee, presided by a Chairman and by a Managing Director
- a Board of Directors not acting as a committee, formed by a plurality of members having the same powers. Depending on the shareholders' choices, such directors may operate a) severally: this alternative, however, carries with it the power of each director to veto resolutions proposed by the other directors; b) severally on certain issues (for instance in matters concerning the day-to-day business); c) jointly; d) jointly on certain matters (for instance as regards the so called "extraordinary administration").

Supervision of accounts will be entrusted to a Board of Statutory Auditors or to a sole auditor only where the company share capital is in excess of € 120,000 or when the turnover or the size of an S.r.l. are beyond a certain threshold determined by law.

1.3 Corporate governance, accounting and auditing after the Parmalat scandal

Was it a forged Bank of America document, allegedly patched together by a Parmalat executive using a scanner and a fax machine, that reveals a troubling aspect about Italian capitalism - the lack of effective financial control over its family-owned companies ?
In Italy, dissatisfaction with the state of corporate governance has seriously increased in recent years and the previously analysed Reform has not changed at all the general feeling about the "quality" of corporate governance. After the privatisation process started in 1988, the Italian system of corporate governance has begun to move towards the U.S. system without reforming three important features that are different between the two systems:

1. the role of institution and institutional investors[62] in controlling management;
2. the different ability to fill in gaps in contingent contracts due to the a less efficient Italian legal system and the absence of protection for investors' rights[63] in Italy;
3. the control model of medium and large firm[64] .

The main critics that the Italian system collect is that the duty of loyalty is not an operational concept and that courts have no expertise or inclination to provide protection for non-controlling investors[65]. The Reform did not affect this two points and the words experts have used to describe it are "feeble" and "toothless". That is particularly vulnerable in an economy dominated by family-run businesses and

[62] see Dietl 1998 for a good survey on the role played by institution and institutional investors in an efficient CG system.
[63]In Italy there is not a specific law or a set of recommendations for Corporate Governance. The main document that is used to infer some principles of corporate governance is the law for the OPA (offerta publica d'acquisto) done from the Draghi Committee. This is a very recent law ,1998, but it is subject to numerous critics and there is already a need to revise it. See Bianchi et al. 1999
[64] The success of the Italian economy is due mostly to the large number of small firms that perform very well. A small firm is one with less than 20 workers and in Italy this kind of firm represents 98% of the total number of firms. The solution to corporate governance issue in small firms environment is the simplest possible: they lack the separation of ownership and control that generates agency problems and that basically defines the corporate governance puzzles in more complex systems. Is there a link between these two facts? For sure we cannot exclude it.
[65] See on this point Barca 1995, see also Macey 1998

lubricated by social ties. Although Parmalat was a public company, the Tanzi family controlled it, which is the pattern with many of Italy's large concerns, including Fiat, Prada and Benetton. The Italian government last year decriminalized "false accounting". As a result, Parmalat prosecutors have to turn to other statutes.

Parmalat rarely explained its finances to stock analysts, and because it was family-run it was exempt from certain disclosure requirements. Consob, Italy's securities and market regulator, is viewed as understaffed and ineffective and now the Italian Parliament is discussing a new reform to create a Super Consob and “to protect save”.

In the latest annual corruption perception index by the nonprofit Transparency International, Italy ranked second to last among EU states, edging only Greece. Chile, Botswana and Bahrain were among the 34 nations seen as less corrupt than Italy. Rules require enforcement, and Italy's reputation does not inspire confidence: Parmalat as the final drop that caused the collapse of trust in Italian saving and investment plan.

There is nothing uniquely Italian about balance-sheet fraud, of course. Indeed, hard questions are also being asked of U.S. banks that lent money to Parmalat and of two multinational Big Five accounting firms, Grant Thornton and Deloitte & Touche, which signed off on Parmalat's doctored books.

So, let us raises an all-too-familiar question: where were the auditors?

As part of its third quarter 2003 review of Parmalat’s interim financial statements, **Deloitte & Touche SpA** included a qualification in its review report highlighting the lack of evidence available to support the valuation of the Epicurum investment and alerted regulators. Was it a bit late?

Grant Thorton SpA served as auditors for Parmalat from 1990 to 1999, when the company changed auditors to comply with an Italian law mandating auditor rotation. Italy is extremely unusual, if not unique, in having such a law.

Deloitte & Touche SpA replaced Grant Thorton SpA as the auditors of Parmalat’s parent company, Parmalat Finanziaria. Both auditors insist that they have been the victims of the fraud perpetrated by the company.

The auditor rotation raises some key policy questions. First, did the mandatory rotation contribute to the ultimate discovery of the fraud? The jury is still out on that. Such a conclusion seems difficult to draw, however, given that Deloitte & Touche SpA did not uncover the fraudulent scheme in their prior audits since 1999. Second, did Grant Thorton SpA’s continued involvement with the subsidiary audits contribute to management’s continued concealment of the fraudulent activities during that period? Was the same Grant Thorton partner rotating from the parent company audit now responsible for the audit of the Cayman Island subsidiaries?

In the weeks and months ahead, given the fact that the Parliament is discussing the new reform to protect saving, questions also will focus on the responsibility of auditors to detect fraud. Based on the current professional standards, the auditors’ primary responsibility in a financial statement audit is not to detect fraud but to provide an opinion on the fair presentation of the financial statements. Given the magnitude of the Parmalat deception, however, a new standard is needed. It is necessary to have the auditor’s consideration of fraud blended into the audit process and to expand the procedures to detect fraud.

1.4. Some lessons from the Italian system of corporate governance

In section 1.2 we noticed that Italian firms depend heavily on bank finance but banks and non-bank financial institutions play a minor part in corporate governance in Italy. In spite of their remarkable share in corporate external financing, feeble bank-firm relations jeopardise the bank's role (Ferri and Pesaresi, 1996).

This cause a lack of interim and ex-post monitoring via share or debt capital or via financial services. The Bank of Italy holds virtually no stake in non-financial companies. No other financial institutions have taken over the role of banks in the ownership structure of Italian companies, partly due to the absence of pension funds as a consequence of the country’s broad coverage pay-as-you-go public pension system.

In the absence of financial institution, fiduciary duties and the market for corporate control, corporate governance in Italy has relied on three main actors (Barca and Trento 1997): the state, that played a double role as owner and a source of resources for the private sector; pyramidal groups and, last but not least the family and/or coalition control.

The failure of financial and non-financial institutions to act as advisers or intermediaries and the high concentration of ownership, as well as the lack of rules concerning public offers, have prevented the development of the exit device. Company law, securities law and investment regulations do not provide a framework for institutional investors to play much of a role in corporate governance. The information available to shareholders is also inadequate. Corporate bodies have exercised no independent monitoring. The Board of Directors in Italian companies is generally fully identified with controlling shareholders. One of the main characteristics of the Italian model, the system of state-owned enterprises has come under particular attack and in 1992 a process of privatisation was initiated. Major problems have been encountered in replacing the old system with alternative devices (see Barca and Trento 1997).

Institutional investors in general and even banks are characterised by the lack of activism that they perform in their role as creditors. Italy’s particular bankruptcy law plays an important role in explaining this behaviour. Banks play a relevant role in the transfer of control when a company is in financial distress but they do not monitor entrepreneurs' long term strategies (Sarcinelli 1997) and they do not appear particularly active in soliciting the adjustment of companies' ownership structures.

As previously said, pyramid control is another device widely used in Italy. This way of achieving separation puts the interests of minority shareholders in all subsidiaries of the groups at particular risk. The head of pyramid looks to the group as a whole but the shareholder of a particular firm of the group wants good performance for his own firm. The company at the top of pyramid if private have been governed by family control and coalition control (Bianco *et al.* 1997).

To assess the static efficiency of Italian corporate governance, reference can be made to two specific stages in a company's life when corporate governance is especially important: fast growth (and entry) and crises. While an a-priori judgement of the static efficiency of Italian corporate governance is therefore ambivalent, there seems no doubt about the negative dynamic efficiency of the system. Dynamic can be defined as a concept of efficiency that takes into account not just existing entrepreneurial skills but also those which would develop if all individuals were given fair access to control.

Several factors played a role in impeding turnover within the entrepreneurial establishment:

- financial obstacles to entrepreneurs, particularly new entrants;
- stickiness of the family control model;
- the strong collusion between top managers of enterprises (not only state owned) and top politicians who have helped each other to stay in power.

In Parmalat we observed all of these factors.

As regards fast growth and entry, family and coalition control allows accumulated savings to be channelled to investment since formal institutions are lacking. But these devices are inadequate to govern the growth of both small and large companies when there are shortages of capital, which should be matched by long-term debt or by private risk capital (or, like in Parmalt, by fraud). The preponderance of short term debt and wide use of collateral are particularly unsuitable for financing fast growth, especially when firms do not have much of a record. Similarly, both family and coalition control tend to prevent the raising of new "outside" risk capital. For an entrepreneur to attract funds to finance his projects, qualities that most people do not possess are required: families' ties or political and social links with well-off members of society. Growth tends to be limited by the capital of incumbent families and coalitions. Several facts seem to corroborate this evaluation: the limited diffusion and high concentration of ownership; the very small size of the stock exchange; and the lack of medium sized firms.

However, in a series of other aspects, the Italian experience may offer some insights of general use, especially in analysing transitional economies. When a crisis occurs, all 3 models, family, coalition and state, tend to reduce the risk that signals of bad performance might too easily unsettle an allocation of control, even when there is no misallocation. This is possibly one of the main advantage of Italian governance environment. On the other hand, due to lack of continuous monitoring, these models may increase the risk of the opposite error: that a misallocation of control, though signalled by bad performance, does not lead quickly enough to transfer control.

The state in Italy gave to firms (owned or not) flow of resources. It has transferred substantial funds to overcome situation of financial distress, has bought out mismanaged companies, has provided subsidies to achieve delayed restructuring and has granted subsidised credit. Now, in order to re-create trust, the State must provide strong institutions, laws, regulations and improved practices designed to prevent new scandals from developing from this date forward.

1.5 Conclusions

The Parmalat situation started out as a fairly standard - if stunningly large - accounting fraud. Managers allegedly used various accounting tricks to avoid disclosing sizeable losses, possibly with the collusion of at least some auditors and lawyers.

The presence of a strong controlling shareholder introduces a new divergence of interest. In fact, it is very easy for the controlling shareholder to extract non-pro rata benefits for itself at the expense of the minority shareholders and, furthermore, stakeholders. If the prosecutors are right, Parmalat controlling shareholder and CEO Tanzi joined that club sometime ago.

The discussion on the effectiveness of outsider and insider systems received two big shots: some commentators took at Anglo-Saxon capitalism after Enron scandal, now it is tempting to do the same after Parmalat scandal. The discussion on the convergence between the two CG systems (see Balling et al. 1998 for a survey) seems to have one common point: both produce scandals. The problem of majority shareholder abuses is no respecter of national boundaries. In juxtaposition to Parmalat, for example, one could cite the Anglo-US example of Hollinger, or the domestic US example of Adelphia.

There are no easy solutions to the problem of dealing with a controlling shareholder. Forcing a majority shareholder to give up control is no answer, both because of the enfringement on contract and property rights and because it solves one governance problem by restoring the agency problem associated with dispersed ownership.

The key of the discussion is on transparent accounting rules (Dimsdale 1994 is a never too old work on this). Once this is achieved it will be much easier to solve the problem of enforcement. Accounting fraud will be with us as long as there are unscrupulous businessmen and dishonest or incompetent lawyers and auditors. Attempts to drive out every last residue of fraud are more likely to burden honest corporations with undue regulations than to prevent bad actors from acting badly. Instead, what we should strive for is a cost-effect system of better accounting rules and responsible enforcement that strives only to reduce the problem to manageable proportions.

Reference

1. BALLING,M.; HENNESSY,E.; O'BRIEN,R., EDS., (1998). “*Corporate governance, financial markets and global convergence”*; Financial and Monetary Policy Studies, vol. 33. Dordrecht; Boston and London: Kluwer Academic, 1998, pages xxvii, 336.
2. BARCA F., S. TRENTO (1997): "*State ownership and the evolution of Italian corporate governance*", Industrial and corporate change, 6, 533-559.
3. BARCA (1997): *Storia del capitalismo italiano dal dopoguerra ad oggi*, Donzelli editore, Roma.
4. BEARLE A.A., MEANS G.C., (1932). “*The modern corporation and private property”*, New York: MacMillan;
5. BERNDT M., (2000). “*Global differences in Corporate Governance systems. Theory and implications for reforms”*; Harvard law school Cambridge Discussion Paper nr. 303, November
6. BIANCHI M; ENRIQUES L., (1999). “*Corporate governance in Italy after the 1998 Reform: what role for institutional investors?”*; CONSOB working papers December 1999
7. BIANCO,M.; PAGNONI,E., (1997). “*Interlocking Directorates across Listed Companies in Italy: The Case of Banks”*; Banca Nazionale del Lavoro-Quarterly-Review; 0(0), Sp. Iss. March 1997, pages 203-27.
8. DIETL, H. M., (1998). “*Capital Markets and Corporate Governance in Japan, Germany and the United States*”; London and New York, Routledge 1998
9. DIMSDALE,-N.-H., (1994). *“The Need to Restore Corporate Accountability: An Agenda for Reform; in Dimsdale,-Nicholas; Prevezer,-Martha. Capital markets and corporate governance”*, Oxford and New York: Oxford University Press, Clarendon Press, 1994, pages 13-41.
10. FERRI, G.; PESARESI,N., (1996). “*The Missing Link: Banking and Non Banking Financial Institutions in Italian Corporate Governance”*; Fondazione Eni Enrico Mattei Note di Lavoro: 04/96, February 1996, pages 21-43
11. LA PORTA R., F. LOPEZ-DE-SILANES AND A. SHLEIFER (1998): "*Corporate ownership around the world*" NBER Working Paper
12. PARMALAT annual reports (1996-2003) various issue and sources.
13. SARCINELLI,M., (1997). *“Bank Governance: Models and Reality”*; Banca Nazionale del Lavoro Quarterly-Review; 0(0), Sp. Iss. March 1997, pages 249-79