Parmalat—Europe's Enron – Lack of Integrity and Independence

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Parmalat[1] Finanziaria S.p.A. and its subsidiaries manufacture food and drinks worldwide. Parmalat is one of the leading firms in the long-life milk, yogurt, and juices market. The company became the world's seventh-largest supplier of dairy products and Italy's seventh-largest company, with 146 plants in thirty countries, employing 36,000 people worldwide. In 2002, the company reported €7.6 billion in annual sales. In late December 2003, however, Parmalat was placed under administration and declared insolvent.

Because of its size and its involvement with SPEs, off-balance-sheet, and sham transactions, many regard it as Europe's Enron. In January 2004, it was reported that the company "had net debts of 14.3 billion euros (US$23.47 billion) shortly before its crisis erupted . . . almost eight times the figure given by former managers."[2] PricewaterhouseCoopers also found that earnings for the nine months ended September 30, 2003, were only one-fifth of what had been reported, and bondholders were expected to recover under 7% of their capital. Parmalat's failure is expected to have a stimulative effect on corporate governance reform in Europe for decades.

The company started in Parma, Italy, in 1961. By the 1970s, it had expanded to Brazil and later diversified into the pasta sauces and soups markets. In the 1990s, Parmalat's need for cash made the company go public and sell 49% of its shares to be traded on the Milan Stock Exchange. Calisto Tanzi, Parmalat's founder, kept effective control of the company, and Tanzi family members held several key positions in Parmalat and its subsidiaries.

Parmalat's series of acquisitions in the 1990s left the company with a reported $7.3 billion of debt. The company acquired subsidiaries in Asia, southern Africa, and Australia as well as adding to its North and South American holdings and moving into eastern Europe. The acquisitions were done without planning. The company did not go through a process of consolidation. Many investments were done to support the Tanzi family in areas unrelated to Parmalat's core business, such as the acquisition of the soccer team Parma, A.C.; investments in travel agencies and hotels; and sponsorship of Formula 1 racing teams.

[1] Much of this case was developed as a group assignment by the author's students in the Master of Management and Professional Accounting Program at the Rotman School of Management of the University of Toronto. The students included Sandy Egberts, Shivani Anand, Amanda Soder, Dave Scotland, Ramandeep Shergill, Fiona Li, and Tamer Alibux.
[2] W. Schomberg and G. Wynn, "Parmalat Debt Rises to **€**14.3 B," *Financial Post*, January 27, 2004, FP9.

Over the course of more than a decade, Parmalat Finanziaria S.p.A. misrepresented its financial statements by billions of dollars. The company's founder and former CEO, Tanzi, now stands accused of market rigging, false auditing, and misleading investors and stock market regulators.[3] Tanzi established a series of overseas companies to transfer money among and to conceal liabilities in order to give the illusion of financial liquidity within the Parmalat. The scheme was eventually uncovered when the company was unable to make a bond payment and was forced to admit to having fraudulent assets on its accounts. The case raises a number of ethical issues that impact all stakeholders. The rights of shareholders were violated, and the expectations of stakeholders, with respect to the integrity of company management, were not met.
On December 9, 2003, Parmalat defaulted on a €150 million (U.S.$184 million) payment to bondholders. Rumors began to circulate that the company's liquidity had been overstated, and the credit rating agency Standard & Poor's downgraded Parmalat's bonds to "junk" status. As a result of the downgrade, the company's stock fell by 40%. On December 17, 2003, the Bank of America announced that a U.S.$5 billion account that Parmalat claimed to have had with it in the Cayman Islands did not exist. In a little more than a week, trading in the company's shares was suspended, and it was taken under administration and declared insolvent.

The company initially claimed that the missed payment to bondholders had been as a result of a late payment from Epicurum, a customer that was not paying its bills. Parmalat was eventually forced to concede, under pressure from its auditor Deloitte & Touche, that Epicurum was in fact simply a holding company of Parmalat's, located in the Cayman Islands. Furthermore, it could not access the funds from Epicurum that were required.

Parmalat had begun a period of rapid expansion in 1997, deciding to expand its operations globally and reposition itself in the marketplace. Those expanded operations, however, did not prove to be as profitable as Parmalat had hoped, and the company incurred losses. As a result of those losses, Parmalat began to invest more of its operations into derivatives and other risky financial ventures. The company expanded into tourism with a company called Parmatour and also invested in a soccer club, both of which generated further losses for the company.

As the company's expansion continued, its need for more funds, in the form of debt financing, grew. To give the appearance of greater liquidity to its bankers and other investors, the company created a series of fictitious offshore companies that were used to conceal Parmalat's losses. Parmalat disassociated itself with the companies by selling them to American citizens with Italian surnames, only to repurchase them later. The phony liquidity generated by these actions gave investors the assurance they needed to continue purchasing bonds from the company and enabled Parmalat to continue to issue debt to the public.

[3] "Q&A Parmalat's Collapse and Recovery," *BBC*, 2005, accessed November 16, 2005, at http://news.bbc.co.uk/2/hi/business/3340641.stm.

In a classic example of the type of fraudulent action that Parmalat perpetrated, one such company, Bonlat, alleged that it was owed $767 million by a Cuban firm that had ordered 300,000 tons of powdered milk. This money was then alleged to be owed to Parmalat. The entire transaction, however, did not exist and was created to maintain the illusion of liquidity in Parmalat.[4]

Auditors failed to properly determine that roughly 200 companies created by Parmalat, such as Bonlat, did not exist. The fraud was perpetrated by, among others, CFO Fausto Tonna, who produced fake documents that he faxed to the auditors in order to falsify the existence of the subsidiaries.[5]

Calisto Tanzi admitted to having falsified Parmalat's accounts for over a decade and to having stolen at least $600 million from the publicly traded company and funneling it into family businesses. The Parmalat Board of Directors, which consisted mostly of family members of Tanzi and controlled 51% of Parmalat, did not raise any questions regarding how the company was run.

By 2003, some shareholders began lobbying Tanzi for an independent member, chosen by the minority shareholders, to be put on the company's Audit Committee. Even though it was their legal right, Tanzi refused this request, and the issue was dropped. This led some to become more suspicious of Tanzi. Many bankers, however, had been suspicious of Parmalat since the mid-1980s because of the company's practice of continuously issuing debt despite an abundance of cash. At the time of the Parmalat disaster, members of the Audit Committee of an Italian company were elected by the board in such a way[6] that the controlling shareholder could determine who was successful. They did not have to be either independent or a director of the company, and in fact, in Parmalat's case, they were neither.

In March 2003, Tanzi sent a thirty-four-page complaint to Consob, the Italian regulatory agency, claiming that he was being slandered by Lehman Brothers, Inc., who had issued a report that cast doubt on Parmalat's financial status. Tanzi stated that Lehman Brothers were doing this to deflate the price of Parmalat's shares in order to buy them at a cheaper price. The stir led to the publication of a series of articles critical of Parmalat and its management, which in turn had forced Parmalat to cancel a $384 million bond issue in February 2003.

Despite this, some banks, including Deutsche Bank and Citibank, were still optimistic about Parmalat and were willing to buy more debt and promote their bonds as sound financial assets. The actions of the banks raises questions about possible collusion between them and the management at Parmalat and the nature of the fiduciary duty of the banks.

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[4] David McHugh, "Parmalat's Scandal Not Very Clever," *Seattle Times*, January 20, 2004, accessed November 16, 2005, at http://seattletimes.nwsource.com/html/businesstechnology/2001839930_parmalat200.html.
[5] Ibid.
[6] Michael Gray, "ITALY: Corporate Governance Lessons from Europe's Enron," accessed April 11, 2005, at http://www.corpwatch.org.

After the critical December 9 default to bondholders, Tanzi appointed a turnaround specialist named Enrico Bondi. It was Bondi who decided to liquidate the U.S.$5 billion Bank of America account, which was revealed to be fictitious and which eventually led to the bankruptcy of the company.

Tanzi was accused of dealing in fraudulent complex financial deals and bond deals, creating nonexistent offshore accounts to hide losses, and false bookkeeping. He misled investors and stock market regulators into believing that Parmalat was not in crisis. By doing so, he ensured financing from individuals who believed that Parmalat was a sound company. Tanzi claimed, in his defense, that he was too far up the hierarchy to have known what top executives were doing, whom he blames for all Parmalat's problems.[7]

The story of Parmalat reveals many weaknesses in governance at both the corporate and the professional accounting levels. One major weakness in corporate governance was a lack of oversight on the part of the Board of Directors. Despite the many suspicious aspects of Parmalat's business, the Board of Directors never demanded answers to any questions that they may have had, nor did they ever worry about the close relationship between management and its original auditors. By placing too much faith in the integrity of the Parmalat's managers and the competence of its auditors, the company became susceptible to fraud.

In several instances, flaws were also exposed in the accounting governance of the company. In 1999, Parmalat was required to change auditors (and did so but only partially) from Grant Thornton to Deloitte. This was due to a new Italian law—the "Draghi" law, passed in 1998 to improve corporate governance[8]—whereby a public company is required to change auditors every nine years. At the time of the auditor switch, Tanzi moved a series of offshore companies that he had created during the 1990s from the Dutch Antilles to the Cayman Islands. By effectively shutting down and reopening those companies in the new location, Tanzi was able to retain Grant Thornton as his auditor for seventeen offshore companies, including Bonlat,[9] and not require any new eyes to view the transactions of them. Furthermore, the Grant Thornton audit managers who had been auditing Parmalat since 1990 had been auditing the company for six years prior to that as managers with another auditing firm.

The testing procedures that the auditors used while auditing Parmalat were inadequate. Many of the company's assets were overstated and its liabilities understated, which had not been noticed by the company's auditors. For example, when Deloitte sent a confirmation to the Bank of America in regard to the fabricated $5 billion account, they sent it through the Parmalat internal mail service. It was intercepted, and a favorable response was forged by the CFO

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[7] "Q&A Parmalat's Collapse and Recovery."

[8] In 1999, Italian companies were also asked to *voluntarily* comply with a new noncomprehensive set of governance rules known as the "Preda Code."

[9] Navigant Consulting, Canadian Institute of Chartered Accountants, and the American Institute of Certified Public Accountants, "Milk Gone Bad," *Report on Fraud* 6, no. 5–6 (March 2004).

Fausto Tonna (or persons under his direction) on scanned Bank of America letterhead.[10] Another example involved Deloitte's apparent inability to locate and/or audit what is referred to as Account 999, which held a debit of £8 billion (U.S.$12.83 billion) representing the "'trash bin' for all faked revenues, assets and profits that Parmalat had accumulated over the years. To cover up the fake transactions, the entries were transformed into intercompany loans and credits."[11] In December 2003, executives "took a hammer to a computer at headquarters" in an attempt to destroy Account 999—but a printout survived.[12]

Parmalat sponsored an American Depositary Receipts (ADR) Program to raise funds in the United States and therefore came under the scrutiny of the U.S. Securities and Exchange Commission (SEC). The SEC charged Parmalat with securities fraud on December 30, 2003, and filed amended charges on July 28, 2004, covering the following:

- Parmalat Finanziaria consistently overstated its level of cash and marketable securities. For example, at year end 2002, Parmalat Finanziaria overstated its cash and marketable securities by at least €2.4 billion. As of year-end 2003, Parmalat Finanziaria had overstated its assets by at least £3.95 billion (approximately $4.9 billion).
- As of September 30, 2003, Parmalat Finanziaria had understated its reported debt of £6.4 billion by at least £7.9 billion. Parmalat Finanziaria used various tactics to understate its debt, including (1) eliminating approximately £3.3 billion of debt held by one of its nominee entities; (2) recording approximately £1 billion of debt as equity through fictitious loan participation agreements; (3) removing approximately £500 million of liabilities by falsely describing the sale of certain receivables as nonrecourse when in fact the company retained an obligation to ensure that the receivables were ultimately paid; (4) improperly eliminating approximately £300 million of debt associated with a Brazilian subsidiary during the sale of the subsidiary; (5) mischaracterizing approximately £300 million of bank debt as intercompany debt, thereby inappropriately eliminating it in consolidation; (6) eliminating approximately £200 million of Parmalat S.p.A. payables as though they had been paid when, in fact, they had not; and (7) not recording a liability of approximately £400 million associated with a put option.
- Between 1997 and 2003, Parmalat S.p.A. transferred approximately £350 million to various businesses owned and operated by Tanzi family members.
- Parmalat Finanziaria transferred uncollectible and impaired receivables to "nominee" entities, where their diminished or nonexistent value was hidden. As a result, Parmalat Finanziaria carried assets at inflated values and avoided the negative impact on its income statement that would have been associated with a proper reserve or write-off of bad debt.
- Parmalat Finanziaria used these same nominee entities to fabricate nonexistent financial operations intended to offset losses of its operating subsidiaries. For example, if a subsidiary experienced losses due to exchange rate fluctuations, the nominee entity would

[10] Ibid.

[11] F. Kapner, "Parmalat's Account 999 Points a Finger at Deloitte," *Financial Post*, April 12, 2004, FP16.

[12] Ibid.

fabricate foreign exchange contracts to offset the losses. Similarly, if a subsidiary had exposure due to interest rate fluctuations, the nominee entity would fabricate interest rate swaps to curb the exposure.

- Parmalat Finanziaria used the nominee entities to disguise intercompany loans from one subsidiary to another subsidiary that was experiencing operating losses. Specifically, a loan from one subsidiary would be made to another subsidiary operating at a loss. The recipient then improperly applied the loan proceeds to offset its expenses and thereby increase the appearance of profitability. As a result, rather than have a neutral effect on the consolidated financials, the loan transaction served to inflate both assets and net income.
- Parmalat Finanziaria recorded fictional revenue through sales by its subsidiaries to controlled nominee entities at inflated or entirely fictitious amounts. In order to avoid unwanted scrutiny due to the aging of the receivables associated with these fictitious or overstated sales, the related receivables would be transferred or sold to nominee entities.[13]

On January 29, 2004, PricewaterhouseCoopers took over as the auditor of Parmalat. They discovered that cash had been misstated by billions of euros and that Parmalat's debt was eight times what was claimed. Further reinforcing suspicions that the company had been altering its financial statements since the 1980s, an independent auditor for the prosecutor in Milan found that Parmalat had been profitable for only one year between 1990 and 2002. Parmalat had claimed to be profitable all of those years. This material misstatement had not been noticed by either Grant Thornton or Deloitte. It was also found that there were many instances where Deloitte's Italian office did not apply aggressive enough audit procedures despite being informed of irregularities with Parmalat, uncovered by other Deloitte offices around the world.[14]

It appears that at least some of Parmalat's auditors were in collusion with the company's managers to keep the fraud under wraps. By March 2004, eleven people from Grant Thornton had been arrested, and more arrests may follow.[15]

A number of large banks were also complicit in the fraud, according to Enrico Bondi, who was appointed as Parmalat's government-appointed administrator. His report stated,

> that banks facilitated the inflow of resources that hid Parmalat's deteriorated financial condition through the use of bonds placed in tax havens.[16]

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[13] U.S. Securities and Exchange Commission, "SEC Alleges Additional Violations by Parmalat Finanziaria S.p.A.," *Litigation Release No. 18803*, July 28, 2003, accessed March 11, 2005, at http://www.sec.gov/litigation/litreleases/lr18803.htm.

[14] Y. Richard Roberts. P. Richard Swanson, and Jill Dinneen, "Spilt Milk: Parmalat and Sarbanes-Oxley Internal Controls Reporting," *International Journal of Disclosure and Governance* 1, no. 3 (June 2004): 215–26.

[15] Morgan O'Rourke. "Parmalat's Scandal Highlights Fraud Concerns. Risk Management," *New York* 51, no. 3 (March 2004): 44.

[16] T. Barber. "Parmalat Chief Slams Big Banks," *Financial Post*, July 23, 2004, FP12.

Bondi went on to estimate that Parmalat obtained

> £13.2 billion from banks between Dec. 31, 1998 and Dec. 31, 2003. International banks supplied 80% of the funding, with the rest from Italian lenders. By contrast, Parmalat generated only £1 billion in gross cashflow. Mr. Bondi calculates Parmalat spent about £5.4 billion on acquisitions and other investments, £2.8 billion on commissions and fees to banks, £3.5 billion on payments to bondholders, £900 million on taxes and £300 million on dividends. The remaining £2.3 billion was apparently siphoned off for other purposes. . . .
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> The Bondi Report suggests that, as early as 1997, there was sufficient information available about Parmalat's true condition for the financial community to have realized the company was in trouble. . . . As a result, while Parmalat might still have collapsed in 1997– 98, the scandal would have cost investors less money.[17]

Under Italian law, banks and financial institutions can be sued for damage caused by and recovery of improper transactions. It is noteworthy that "Citigroup . . . had been instrumental in setting up the insolently named 'Buco Nero' ('black hole') as an offshore account for Parmalat"[18] and has found "itself under investigation by the SEC and the subject of a class action lawsuit."[19]

Questions:

1. What risk factors in the Parmalat case should have called for heightened awareness of the need to apply professional skepticism?
2. Why didn't the external auditors, the Audit Committee, the internal auditors, and the chief legal officer perceive these risk factors and take action to protect the public interest and investors?
3. What should each of the parties in question 2 have done if they had been sufficiently professionally skeptical to uncover the wrongdoing mentioned in the case?
4. What are the key lessons to be learned from the Parmalat Case by investors, auditors, investigators, and other employed professional accountants who are expected to demonstrate professional skepticism?

Additional questions are available in the source publication: Business & Professional Ethics for Directors, Executives & Accountants, 9e, Leonard J. Brooks & Paul Dunn, published by Cengage Learning, Inc., ©2021, ISBN: 978-0-357-44188-6.

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[18] Navigant Consulting, "Milk Gone Bad."
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