

Parmalat accounting scandal | summary



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The Parmalat Accounting Scandal

1. What were the events leading up to the Parmalat accounting scandal and ultimately the revelation of the accounting fraud and the reasons behind the scandal?

Evolving from a small dairy shop into an international concern, Parmalat appeared to be a gigantic and stable dairy producer. At some point in time, it may well have been gigantic and stable, but in December 2003, shocking news was broken to Parma, Italy, and the world at large. Parmalat was no longer a success as it once may have been, and it was bankrupt, and had been bankrupt for several years without this ugly truth being exposed. The truth had apparently been concealed due to a number of people being at least somewhat aware that something was amiss with transactions on the books, but had not spoken out. Through the years that Parmalat was going bankrupt, there were several events that took place before Parmalat's condition was finally exposed. To begin with, as early as 1990, there were signs that Parmalat was in debt. In accordance with what has been uncovered, Parmalat's fraudulent activities are said to have 'taken off' in 1990. This was when their stock went public, and reflected the need for a big company like Parmalat to perform in the international market so that their performance improved and met investor expectation (Family Arrests in Parmalat Scandal, 2004).

The following year [1991] the Tanzis purchased Parma Football Club of which Tanzi's son, Stefano, was president, and also was Parmalat board member. With this purchase, the football club rose to fame quickly, but faced large

losses that recorded a deficit of over €77m in 2002. According to investigations, Parma Football Club was the first asset to be sold ^[1].

Another set of purchases that went along with purchasing the Parma Football Club included Tanzi buying up his competitors. Once he had established Parmalat Milk in the global market, his financial ventures proved to be devastating. This included his family's financial interest in football and tourism, as well as his failed attempt to outdo Belosconi when he purchased a TV network, Odeon TV. At this point, Parmalat's finances were a mess.

Purchasing Odeon TV Network was a disaster as Tanzi had to sell the network off for a around £30m. From this point on though, it is said that Parmalat still progressed in spite of its major losses. This was largely achieved through altering the books and attaining bank loans and investments against falsified figures.

Parmalat had spent €130 million on Odeon TV, but it collapsed within 3 years. In order to prevent bankruptcy at this point, Parmalat had to sell itself to a company that was already listed on the Milan stock exchange. This helped to produce €150 million from external investors, and paved the way for Parmalat to be in public view in 1990. It also enabled them to patch up some of its accounts ^[2].

It is thought that Parmalat began altering its books in 1993. If Parmalat had not 'cooked' its books it would have registered financial losses every year. However, they registered profits, which meant that they would still be viewed as a viable organization and one that was worth investing in.

Therefore, they managed to avoid being suspected of any losses and attracted much investment.

Parmalat managed to cover losses through a combination of fictitious transactions and aggressive acquisition. This commenced in 1992, when Parmalat started ‘snapping up’ various companies in Argentina, Italy, Brazil, Hungary and the U. S. However, beyond 1995 it is thought that Parmalat was not able to fund its own needs. Yet it managed to prove to investors that it was registering significant profits. Perhaps, Parmalat’s profits registered were so convincing that the Bank of America alone, in 1997, provided \$1. 7 billion through bonds and private placements for U. S. investors. It also received \$30 million or more as payments and commissions ^[3] .

One of the main events that lead up to the Parmalat accounting scandal exposure includes the company changing its external auditor. In accordance with Italian law, an external auditor can be changed once in 9 years. So, in 1999, Parmalat, in accordance with Italian law replaced Grant Thornton with DeLoitte and Touche.

Grant Thornton was keen to keep working with Parmalat, which was a high profile company, as it would be good for their reputation still being developed. Therefore, they recommended that Parmalat spin off its travel and other businesses, and permit these to be under them [Grant Thornton]. Such an arrangement would be convenient to both Parmalat itself and Grant Thornton. Through such an arrangement Parmalat could then satisfy its new external auditors [DeLoitte and Touche] with Grant Thornton making illicit payments to Parmalat. This was made possible through the executives at

Parmalat creating debts, and Grant Thornton creating false accounts from which Parmalat could be paid. Grant Thornton would then produce these records to DeLoitte and Touche who saw little wrong with them.

Numerous reports reinforce that Grant Thornton was aware of the ‘ shell games’ that Parmalat was playing. One example of these games includes case of “ cooking the books,” that reports the Cayman Islands subsidiary Bonlat claiming to have sold a large quantity of powdered milk in a span of one year to Cuba. It claimed that this quantity was sufficient to produce 55 gallons of milk for every individual on that island.

Another interesting event that lead up to Parmalat’s exposure of the accounting scandal was that Grant Thornton and Deloitte & Touche signed off on its increasingly surreal accounts. In return, it is said that they booked millions of dollars (Parmalat Scandal Deepens..., 2006).

In Parmalat’s final weeks, Deutsche Bank had taken on helping it work with Standard & Poor’s, hardly ten days before the exposure. Around this time, analysts around the world kept encouraging investors to continue purchasing its stocks and bonds.

In 1999, finance director Alberto Ferraris laid out a financing scheme. He managed this through a Delaware company known as Buconero. This was the Italian for “ black hole,” that Citigroup established for Parmalat in 1999 [4] . This company loaned out \$137 million to a Swiss subsidiary of Parmalat. From here, the money was transferred to Parmalat companies. In return for Buconero’s service to Parmalat, it received a return of around 6%, in addition to \$7 million in payments for Citigroup. Just like Parmalat made use of <https://assignbuster.com/parmalat-accounting-scandal-summary/>

Buconero, it also used other offshore companies to dress up its debt till the time of its exposure ^[5] .

Back in 1995, Parmalat also commenced concealing its debt through shell companies. It had been losing \$300 million annually in Latin America, and decided to wipe this debt off the company's financial records. It managed to do so by using 3 shell companies situated in the Caribbean.

The huge debt patchwork through the 90s began to raise concern by the end of the decade. Esteban Pedro Villar, expressed concern and filed an “ early warning report” (Gumbel, 2004). This was regarding Parmalat's Latin American set-ups. He had so many questions that his concerns were termed as “ offensive and ridiculous” (Gumbel, 2004). Then suspiciously, Deloitte's Parmalat business in Argentina was terminated. In response, Deloitte was silenced, and the accounts were certified.

In addition to the above concern that was demonstrated by a Deloitte partner in Latin America, there were others. On March 28th , 2003, Deloitte's Maltese office raised questions regarding a \$7 billion intercompany transfer they suspected was fictitious. Wanderley Olivetti, the Deloitte auditor in Brazil, raised such concern at the Milan office regarding Parmalat's Brazilian accounts that the matter went straight to Deloitte's chief executive in New York City at that time, Jim Copeland. However, Olivetti's objections were mysteriously ignored and he was soon removed from dealing with the Parmalat account. Deloitte claims it behaved within its rights to remove any employee it wishes to, and this may be done for a number of reasons. It also

said that the investigation of Parmalat started in October 2003, after Deloitte Italy had drawn attention to Parmalat's financial dealings ^[6].

Following the suspicions raised by auditors, Epicurum was established in an attempt to show that Parmalat was due considerable amounts of money. However, this attempt to erase debt from the records at Parmalat failed, and the company admitted that it could not retrieve the amount they were due from Epicurum.

One of the key events that led to the exposure of Parmalat includes Tanzi and his son's meeting with private equity firm Blackstone Group in New York. Tanzi and his son Stefano, one of the main executives at many of the family's concerns, met with the Blackstone Group to discuss the sale of 51 percent of the family's share in the food empire. It was in the course of conversation regarding preparation for the books to be opened to a transition team from Blackstone, that Tanzi and his son slipped out with the fact that the cash on hand was less than the 3 billion Euros registered in the company's annual report. In addition to this, they revealed that there were barely any liquid assets. They even further stated that the company was in debt of about 10 billion Euros.

In addition to the suspicion that was brought against Parmalat through observations of its faulty accounting records, it is this final attempt to sell of 51 percent of family shares that marks the end of the road for Parmalat's long trail of fraud.

The following facts presented date-wise are interesting to note as they map the path that Parmalat took since its inception till its end on 13th December 2003:

- 1961 Parmalat was founded by 22-year-old Calisto Tanzi. It was established as a small family food business that pasteurised and sold milk
- 1963 Parmalat introduces Tetrapak for packaging its 'long-life' milk products.
- 1980s Parmalat starts producing fruit juice, biscuits and ready-made sauce.
- 1990 Parmalat is listed on the Milan stock exchange.
- Through the 1990s Parmalat grows after flotation. It then reaches into America, Brazil, few South American countries, and Eastern Europe and Australia. Tanzi aims at expanding a television network to outdo tycoon Prime Minister Silvio Berlusconi. However, his Odeon television foray flops and costs Parmalat £30m. Parmalat products also get sale in 20 countries.
- 1999 Parmalat's Bonlat subsidiary is established in the Cayman Islands.
- 2003
- 11 November Crisis escalates when shares are hit after auditors raise questions regarding accounting of transactions with mutual fund Epicurum [a Cayman-based company linked to Parmalat].
- 15 November Alberto Ferraris resigns from the position of Finance director.

- 8 December Parmalat admits failure to recover €496.5m from Epicurum. This amount was needed to service debt.
- 15 December Tanzi resigns as chairman and CEO.
- 16 December Enrico Bondi takes control of the company.
- 17 December Bank of America denies the credibility of documents that affirm Bonlat account existence.
- 24 December Parmalat files for irregular administration operations.
- 27 December Italian authorities hold Tanzi in their custody in Milan ^[7]
- 29 December Tanzi admits to siphoning off €500m of company funds; Bondi takes charge as Parmalat administrator; US Securities and Exchange Commission bring charges against Parmalat for fraud.
- 30 December Tanzi is formally charged with fraud.
- 31 December Parmalat officials are arrested. These included former CFO Fausto Tonna and Luciano Del Soldato, and two officials from Grant Thornton's Italian branch that audited Bonlat.

2. How was fraud perpetrated and how was the company able to continue with the fraudulent practice for such a long time?

Parmalat started out as many other businesses have. It was first a small dairy shop that slowly progressed and expanded its range of products, and finally turned into a large dairy producer that sold its products in several countries. From the early 1990s and onwards, Parmalat appeared to make significant progress, registering profits annually that was encouraging enough for investors to go on investing in the company. However, the truth of the matter was that these very investors were all being deceived due to Parmalat's fraudulent practices largely perpetrated by Tanzi, top managers, <https://assignbuster.com/parmalat-accounting-scandal-summary/>

the Parmalat's external lawyer, Gian Paolo Zini, and two external auditors, Maurizio Bianchi and Lorenzo Penca. However, Zini, Bianchi and Penca claim that they are innocent ^[8].

Falsifying Credibility and Obtaining Loans and Investments:

Tanzi and all those who were allegedly involved in what is known to be one of the biggest scams, managed to borrow money from banks and even justified these loans for Parmalat through inflating revenues and fictitious sales in records between 1990 and 2003. They would also 'cook' its books in order to make debt vanish. They managed to do this through transferring debt to offshore 'shell' companies. In addition to covering up debt in this manner, there were other tactics that Parmalat resorted to (Parmalat Dream Goes Sour, 2004).

One of the other methods Parmalat used in order to cover their debt when it got too big to cover with the offshore shell companies included their invention of a bogus milk producer, supposedly situated in Singapore. Parmalat claimed that the company had supplied 300, 000 tons of milk powder to Cuba. This process included Bonlat, a Caymen Island subsidiary of Parmalat. Bonlat had a fictitious account in the Bank of America. This whole setup is so surprising that it has left many baffled as to how could such a fraudulent concept have been so successful and convincing when there was no concrete evidence in it ^[9].

Looking at the above example of the manner in which Parmalat faked transactions, it can be observed that the whole concept is such that it would

have an ordinary person believe that it was authentic. Who would have suspected that any of it was fictitious, particularly because Parmalat had been a company in operation for several years? Ordinarily, one would suspect a company if it had a single concern that was being publicized. However, since Parmalat was projecting trade being conducted that included different physical points, there was little suspicion raised. There was the exporter in Singapore, the importer in Cuba, and Bonlat involved too in the Caymen Islands. The scheme thought up was very believable also because of the fact that Bonlat supposedly had an account in the Bank of America.

Different Roles Played to Conceal Debt:

Considering the debt that was actually showing up in the books, Parmalat had to have people who could cover it up well enough. This called for people on the inside as well as the outside to co-operate. External auditors, internal auditors as well as the top-notch individuals at Parmalat had to play their roles. On the inside, the books were maintained in the hands of trusted people. External auditors were told to keep this quiet. In this case, it was chiefly Grant Thornton that aided Parmalat in carrying out its fraudulent practice for so long.

Grant Thornton's Role:

Grant Thornton played a major role in helping Parmalat continue its long-term fraudulent practice. It did so because it had a great deal to gain from Parmalat, and so did Parmalat have a lot to gain from Grant Thornton working with them.

Grant Thornton was and up and coming auditing firm that needed to be have sound clients in order to help its reputation in the market. Parmalat paid Grant Thornton considerable amounts to conceal debts. Quite obviously, this seemed to work for several years, and did so till 1999, when Parmalat were compelled to replace Grant Thornton with DeLoitte and Touche. This was necessary because by Italian law, an external auditor should be changed every nine years. Parmalat abided by the law, but was also proposed a way of continuing its fraudulent practice.

With DeLoitte and Touche taking charge as external auditors meant that debts would no longer be concealed, and Parmalat could be exposed. This could have happened in 1999. However, since Parmalat maintained Grant Thornton for its spin offs [its travel and other businesses], they were able to continue tricking everyone far and wide. This scheme was simple as well, and included another series of false records in order to show that Parmalat was still making profits annually. This was possible through illicit payments that these spin offs could make to Parmalat. Executives at Parmalat would create debts while Grant Thornton would create false accounts from which they could make payments to Parmalat. They would produce these records to DeLoitte and Touche, and they would be approved ^[10].

More Actions that helped to Conceal Parmalat's Debt:

Basically, it could be asserted that it was the executives on the inside of Parmalat and the external auditors that were hand in glove; together they managed to conceal debt. However, in addition to this practice that lasted for many years, the innovative idea of offshore concerns enhanced

credibility. In addition to this, the fact that Parmalat products were popular in several countries meant that fewer questions would be asked. Also, for a whole decade none of the auditors in any location raised any concerns. It is thought that the amount concealed by 1995 amounted to \$300 million annually in just Latin America. By this time, debt was already enormous and it is obvious that a great deal was being done to conceal it well enough. However, since Parmalat's increasing debt went unnoticed for a few more years, it is obvious that more action needed to be taken in order to make sure that it stayed covered. This meant that Parmalat had to transfer debt off its financial statements. In order to do this, it had to make use of 'shell' companies in the Caribbean. These companies had to show sales, and Parmalat would send them fictitious invoices in order to legitimize the sales. Parmalat would then make out notes to banks in order to show them that they were owed so much finance. Against these notes, Parmalat would be granted loans, as it appeared that the Parmalat was making profits. In order to make their debts disappear, Parmalat transferred its debts to its offshore subsidiaries that were based in tax havens (Parmalat Dream Goes Sour, 2004).

The Beginning of the End:

Parmalat had been making use of offshore shell companies until 1999. Parmalat shifted operations of its three offshore shell companies to Bonlat, in the Cayman Islands in 1999. This is thought to be the beginning of the end for Parmalat. At this point, debt was so high that it was becoming difficult to conceal it. Fictitious assets at Bonlat amounted to around \$8 billion, which forced Parmalat to create a Cayman Islands-based investment fund,

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Epicurum, which would take over part of the fictitious credit. It was Epicurum that caught auditors' attention as well as Italy's stock market regulator [November 2003]. It was just a matter of a month before everything was exposed and the company officially was declared bankrupt ^[11].

Finally, it may be asserted that it was the auditors through which Parmalat managed to deceive everyone for so long with the help of top-level management at Parmalat. If Parmalat had not been able to get Grant Thornton to work in their favor along with their internal auditors and top-level management, the entire scam would not have been possible. This dates back to the beginning of the fraud when Parmalat first began to conceal its debt. If it did not have an external auditor on its side to conceal the large debt it incurred because family business and unnecessary purchases, Parmalat's debt would have been in public view in the early 1990s. However, this was not to be due to a ring of people working to conceal debt. Though there were several people involved in making debt disappear off the records, it can be observed that it was the auditors that made each of Parmalat's fraudulent schemes possible. This is true to say whether one looks at the debt covered in the earliest days of fraud or towards the end. The fictitious transactions with shell companies too were made possible due to the auditors who 'cooked' the books. However, it can also be asserted that the auditors were not solely to blame in making sure this fraud lasted for so long, as there had to be others in on these schemes too. This included key people of Parmalat such as the executives, its CEO, its internal auditors as well as external auditors and individuals at key financial institutions. In order for a fraudulent scheme to last as long as it did in the case of Parmalat, there had

to be a whole ring of people involved, which also explains why it took such a long time and deep investigation to uncover all those were responsible for the scandal.

3. The role and the responsibility of auditors in preventing financial scandals and ensuring and upholding the principles of good corporate governance.

In organizations such as Parmalat and other large organizations where there are several shareholders and many people dependent on the progress of these corporations, executives and top-level managers have a responsibility towards them. Generally, it can be asserted that corporate governance refers to ways in which rights and responsibilities are shared between various corporate participants, the management and the stakeholders ^[12].

Governing corporations such as Parmalat consists of fixed processes, customs, policies, laws and institutions that impact the way it is directed and administered. These are processes that should have been conducted responsibly in order to make sure that Parmalat made progress. If Parmalat was facing debt, executives and all those concerned should have been honest and made sure that these debts were made known (Gumbel, 2004). This would have saved the organization in its earliest days of trouble. Therefore, it can be asserted that being honest and responsible in corporate governance is important.

It is important to assert that corporate governance also encompasses the relationships among the many participants involved in the process (the stakeholders) as well as the goals for which the corporation is managed or governed. The principal participants are the shareholders, management and

the board of directors. In addition to these main players there are other stakeholders: employees, suppliers, customers, banks and other lenders, regulators, the environment and the even community ^[13]. This is because all these people and institutions are affected in one way or another by the actions and repercussions of a corporation and the decisions it makes.

In view of the many people that corporate governance impacts as in the case of Parmalat, accountability, fiduciary duty and mechanisms of auditing and control are of immense importance.

Responsibility of Auditors:

Auditors, whether they are external or internal auditors, have responsibility towards all those involved with a corporation. Particularly, it may be asserted that there are many individuals who are not directly involved with the operations of a corporation, but they may be dependent on its operations significantly. These are the kinds of people that really need to be protected, and auditors have a great responsibility towards them (Gunz and McCutcheon, 1996, 7-15).

To begin with, a very basic and generally stated duty of auditors is to make sure that a corporation's operate efficiently, their records are maintained properly, and its taxes are handed in on time. Auditors generally offer these services to their clients, which include government, public and management accounting. In offering these services, their role includes preparing reports, analyzing, and verifying financial statements and documents for the purpose of providing information to their clients. By performing these tasks honestly and not concealing any information auditors fulfill their duties (Gunz and <https://assignbuster.com/parmalat-accounting-scandal-summary/>

McCutcheon, 1996, 7-15). This is precisely what is required of them when they deal with huge corporations like Parmalat. The role of auditors would include exposing whether the corporation is actually making huge annual profits or whether they are concealing their debts ^[14].

In addition to the roles that auditors play in offering their services to corporations, other services they provide include financial and investment planning, budget analysis, information technology consultation, and limited legal services. However, these are services can only be carried out if they perform their fundamental duties responsibly. This is because the figures that they provide after performing their fundamental tasks impact these additional processes. For example, if debts of a corporation are not presented accurately and annual profits are fictitious, how can an authentic and realistic budget be prepared? Therefore, it can be asserted that auditors cannot work and produce any realistic figures if they distort debts and profits made annually. In recent times, this is what has been occurring.

Corporations hire auditors to check their statements. Somehow, these auditors have gotten involved in illegal behavior and have hidden debts and elevated profits. Based on these figures they helped in painting pretty pictures for the corporation's reputation in the market. This is how Parmalat managed to remain in the global market for a long time without being suspected of having immense debt.

Having asserted the above, it is also important to consider the fact that in the US there are limitations imposed on auditors that investigate a corporation's financial statements. Due to the fact that there have been corporate scandals that have involved auditors being involved, it is now <https://assignbuster.com/parmalat-accounting-scandal-summary/>

illegal for an accounting firm that audits a corporation's financial statements, to advise areas such as investment banking, legal matters, etc. of that firm. One exception to this prohibition is that auditors may provide advice on tax issues that would benefit the company (Young, 1997).

Forensic Auditing:

Having asserted the necessity of making accurate reports of financial figures regarding a corporation's annual budgets or debts, it must be asserted that one major and specialized accounting practice is forensic accounting.

Several public accountants specialize in this, as it is of growing importance in today's world where corporate scandals appear to occur frequently.

Forensic accounting includes investigation and interpretation of white-collar crimes. This type of crime includes bankruptcies, securities fraud and embezzlement, and contract disputes. In addition to this, criminal financial transactions, such as money laundering, are also included in white-color crime. It can be asserted that auditors who specialize in forensic accountancy play an important role in preventing corporate scandals such as the one that took place with Parmalat. However, it should be remembered that auditors who do not specialize in forensic accountancy are no novices. This means that if there are any unusual entries and irregularities in records, any auditor should be to detect them, and this is why all auditors are said to have responsibility to report any irregularities ^[15].

Though auditors generally are able to detect any irregularities, those that specialize in forensic accounting make use of accounting and finance knowledge, law and investigative techniques. They use this combination in <https://assignbuster.com/parmalat-accounting-scandal-summary/>

order to detect illegal activity in a corporation, and it is obviously a greater advantage to them as they are more specialized.

It is known that there are several forensic accountants that work in tandem with personnel from law enforcement departments during investigations. However, this occurs normally after a corporate scandal has been detected. Considering this, it might be a good idea for forensic accountants to work in this manner as part of regular and standard procedure in order to safeguard everyone involved with a corporation. If such a practice were adopted as standard procedure, it would become more difficult for financial scandals to take place. This is considerate of acknowledging that corporations usually appoint their own auditors. Auditing firms might be required to adhere to practices that would make regular procedures more thorough and transparent as a result ^[16] .

Aside from considerations for current practices of audit firms and ones that could be included in order to prevent financial scandals, the general concept of internal and external auditors reviewing and analyzing financial statements of firms aims at doing the same thing.

Fundamental Responsibilities of Auditors:

It is the primary responsibility of internal auditors to make sure records are accurately maintained. These records are also checked for any form of irregularity, which may include things like mismanagement or even fraud.

Internal auditors are not only supposed to maintain records of financial figures, but their roles also encompass examining the firm's operations with

regard to finance and information systems, management, and internal controls. Examining these operations are important as they help to make sure that financial records are accurately maintained. In addition to this, these steps also examine the adequacy of controls to protect the firm against financial scandals (Gunz and McCutcheon, 1996, 7-15).

Further, it can be asserted that internal auditors have the responsibility of evaluating important areas of the corporation such as effectiveness, compliance with all standards and corporate policies and procedures, efficiency, laws, and government regulations.

Since there are so many types of operations to take care of in a corporation, there are areas of specialization for internal auditors as well. Some of these may include environmental, engineering, electronic data-processing, legal, insurance premium, banking, and healthcare auditors.

The reason for specialization in these areas is because there are technical procedures that need to be understood in order to evaluate things like efficiency and effectiveness. Having deeper understanding of individual industries helps internal auditors to evaluate a corporation's operations more specifically (Bavly, 1999, 25-30).

Among the important steps that internal auditors may take towards better controls within a corporation, recommendation of better controls is high on the list of priorities for better auditing processes. An example of recommendations that internal auditors may make in a firm, internal auditors may help managers through co