

# PRESS CUTTING

CREDIT CONTROL  
VOL.25 NO.3 & 4 2004



## Parmalat: could it happen here? You bet it could!

Jamie Stewart

*Jamie Stewart, a law graduate, has worked in investment banking since 1986, before which he held academic positions in the UK and abroad. Today, Jamie is head of institutional marketing and research at Eden Group Plc. His research interests focus on fundamental analysis within the broad field of global equities. He is a director of two companies and on the advisory boards of others. In the past, Jamie has held directorships at Baring Securities, Morgan Grenfell International and Inverlat International.*

**Abstract** *The increasing scope for and instances of corporate collapse through shortcomings or fraud have been exemplified by the virtual demise of Parmalat, Italy's erstwhile premier dairy products and foods processing and distribution company, which had grown to global dimensions and developed an almost infinitely diversified base of industrial activities over the 15 years since its IPO in Milan.*

*In this article the author explores the deterioration in management controls and ethics in the group, together with the way in which the opportunities to perpetrate fraud arose and were exploited. The group is examined within the context of its principal and subordinated host industries as well as against the backdrop of a global network of associated companies and the cultural and business hallmarks and stigmata of its home region and of Italy as its country of origin.*

*The author's objective, having identified and defined "what went wrong?", is to assess the potential for the comparable collapse to occur in a UK-rooted corporate group. In addition, he considers the options to group management to adapt corporate structure and deployment in such*

*a way that the risks of such occurrences are minimised systemically rather than by way of fire-fighting, sporadic or routine audits, or actual damage limitation procedures.*

An anthropologist many years hence will find the fossilized files on the Parmalat scandal and will be stunned by the scale, the detail, the critical mass, the ripple effect, the newsbreaks, the contradictions, the agonies, the illnesses and the expense generated by this long-forgotten phenomenon. It has proved a relatively small step in the history of company-kind by any sensible measure, yet the focus and the fall-out have been boundless. Why?

The background to the Parmalat crisis lies in a group of small dairy-product companies assembled in Italy in a formation similar to a classic agricultural cooperative some 20 years ago and more by an ambitious businessman of one of the many powerful dynastic families. The group grew strongly, not least because it was amongst the first concerns to bridge the gulf between individual farming enterprises on the one part and, on the other, the idols of the Nestlés, Unilevers and General Foods which an industrialised world had been spawning elsewhere to answer the needs of the World's over of choosy consumers with more money and appetite than they had time or sense. Italy enjoyed an enviable tradition of superior food production. SME, Cirio, Negrone, Ferrero, Martini, Fernet-Branca and Barilla: all sat comfortably amongst the star Italian designers and manufacturers such as Fiat, Ferrari, Lamborghini, Armani, Pininfarina and Gucci. It was easy enough to coin the catchy name – 'Parma' from the food-producing area which also gave the world Parma ham and Parnigiano (Parmesan cheese); '-lat' from 'latte', milk.

Fuelled by emergent taste, an interest in innovation and in convenience foods, and by the Italian traditional family values which majored in healthy food for children, Parmalat was brought to the market almost 15 years ago as the Milan stock-exchange was burgeoning and Europe had become a compelling region in which to invest in equities. New capital brought new investments, organic and by acquisition, to Parmalat. It invested in more sophisticated plant and distribution networks, explored the virtues of exciting – but expensive – integration, increased headcount, and moved in to value-added foods, albeit many still rooted in dairy products, such as flavoured milk drinks, juices, convenience desserts, yoghurt and processed cheeses.

“ An anthropologist many years hence will find the fossilized files on the Parmalat scandal and will be stunned by the scale. ”

PAGE 1 OF 4

# PRESS CUTTING

## CREDIT CONTROL VOL.25 NO.3 & 4 2004



LEHMANN  
COMMUNICATIONS  
EC3

Very few market and company-watchers really noticed or drew attention to what happened next. It was a series of steps which, even individually let alone in series, is of a sort that has tended over the years to mark rapid-growth companies run by ambitious owner-managers in young and emergent economies, notably with underdeveloped standards in terms of regulatory and supervisory disciplines. The legend-value of the pattern is almost as cogent as that which warns an investor to sell out of the company that is busy building a fountain in front of the window of the Chief Executive's office window.

First, Parmalat began to venture in to new markets – notably Brazil, a corporate stamping-ground for many an Italian entrepreneur keen to harness growth after his home market had begun to mature, and comfortable with the 'meridionale' ethos of Latin America.

Second, the group began gradually to extend, layer and convolute its own organigram – new companies here, new holding structures there, joint ventures in different places. Whether this was driven by internationalisation or led to it, is difficult to tell – classic chicken and egg conundrum. The next step, inevitably, when this happens is SPEs (Special Purpose Enterprises), and those are followed, inevitably in short order, by off-balance sheet debt.

In third place, Parmalat management took one decision after another to diversify their operating base. This was not just a question of edging in to fruit yoghurts from plain, for example, nor in to processed foods from fresh: it was a matter of different industries and different sectors: services instead of foodstuffs; new expertise, and no existing management to harness it. Again, this is not an unusual step for aggressive, young companies in less conservative markets. Their minority shareholders don't have much say, there is little corporate governance and non-executive responsibility, and the decision is passed off in the press and to overseas investors who raise their eyebrows as being necessary to establish a counter-cyclical side to the business, a broader base to operations, to take advantage of favourable currency relationships and tax incentives.

And then it all went wrong, 15 years after the initial listing – those tricky, teenage years of a fully fledged public company. One can pick through the debts and the how-and-why of it all with tweezers, or one can step back, establish a sharp focus and concentrate on the core. The latter is worth it in terms of time and space: the former is not.

Essentially, the vast, corporate machine began to grind and groan at the turn of this year when Parmalat's banks became uneasy. Undertakings and reassurances were called for. Auditors were at it – year-end; Report and Accounts. There were delays, hesitation, unreturned calls, unexplained absences. The share price and the bond yield shuddered – the latter upwards, the former down – as the market expressed increasing unease. Then it broke. A large US bank refused to confirm at the request of another bank a deposit of \$4 billion which had been audited many times over as a mainstay of Parmalat's liquidity, and in respect of which, by way of security, myriad other loans had been extended. At the end of it all, the deposit simply did not exist.

The certificate had been fraudulently drawn up and presented – amazing what Tippet, scanners and graphics can do nowadays – and there was nothing there. The entire capillary system of cash throughout the engorged Parmalat corporate organigram came to a halt. It was classic smoke and mirrors – like riding in a lift, four mirrors round the passenger, carefully viewed, can create a population of 100s in the lift at a moment's notice. Individuals play the mirror game with credit and store cards the whole time: open a new account, transfer the balance, pay down one, skip another ... but Parmalat was a far cry from a stretched shopper. An international group with institutional and retail investors round the world was gradually collapsing, like a fatally wounded hot-air balloon: gradually but surely it breathed its last. In history, it is portrayed as lying inert next

“ Amazing what  
Tippet,  
scanners and  
graphics  
can do  
nowadays.”

PAGE 2 OF 4

# PRESS CUTTING

## CREDIT CONTROL VOL.25 NO.3 & 4 2004



LEHMANN  
COMMUNICATIONS  
EC3

to Tyco, Adecco, Ahold, WorldCom, Enron, Versailles, Shell – each story a separate saga, but all sagas with threads in common.

And there the easy bit of the narrative ends. Auditors, lawyers, accountants and regulators are not renowned for their brevity nor succinctness. They cover their backsides, they consult, they investigate, they charge fees. So back to that core. Analysis shows that, when one cuts away the reams of blame, counter-blame, carelessness, negligence, backside-covering and hot air, a few key points explain what happened.

The scene is Italy: a country in which the corporate power-base, the family dynasties, politicians and media barons are more closely interwoven than any equivalents elsewhere (don't get me wrong: some of my best friends are Italian; my wife is one, in fact). The seams of loyalty, obligation, honour, blood, reward, expectation and ambition run rich and deep. It is the land of Agnelli, de Benedetti, Berlusconi and Gardini. Irrelevant? No: it is this web of personal and professional relationships which forms the basis of what happened. In the US and the UK, we are getting used to transparency, to governance, to non-executives, to whistle-blowers, to regulation. In certain other cultures, subterfuge and duplicity is more spontaneous, more robust, longer-lived and enjoys a certain pedigree: values are simply rather different. If you are going to set up a scam within a company, you – at Parmalat or elsewhere – cannot go it alone. For choice, you need at least three senior executives to assemble it and keep it going. Singletons can manage tiny scams for ages or larger ones for a short time, but you can't fool all the others all of the time. The more developed markets have devised systems and defences to prevent this happening: the least developed still have a long way to go. It is not by coincidence that UK Investment Banks contractually oblige all employees to take at least two weeks holiday on end at least once a year. Nothing to do with ensuring health or preserving sanity: it is said to help flush out the lone scamster, who can't devise a way of keeping his racket concealed in the face of checks and controls during two weeks absence.

Second, financial analysis and investors ought to have spotted that something was structurally wrong. The figures in the accounts *did* (seem to) stack up, and the story was plausible enough to withstand scrutiny. What did not – admittedly, with the wisdom of hindsight – make sense was that the overall financial picture portrayed a company with high investment and capital expenditure levels, yet revenues based largely on inherently low-margin products. One could argue that the (significant) level of financial gearing bridged the gap, but an operational core of producing and distributing dairy-based products, however much embellished with flavourings, colourings and premium packaging, cannot run for long on that sort of balance between investments, revenues and debt and pay out enough interest and dividends to keep the banks, bondholders and equity investors (especially the controlling families and their hangers-on) happy for any length of time. Why was it not spotted in time? The more developed the country, the more sceptical, cautious and pessimistic its investors – including analysts – will be. Corporates and investors in less mature markets are more optimistic by nature, and more credible, with a higher risk appetite, than their longer-in-the-tooth counterparts. When the two ends of the spectrum come together – i.e. London or Boston analyst meets new-ish Parma corporate –

reassurances, blandishments, accounting differences and credible explanations can do a lot to pacify suspicions. (Try and find out who *did* actually spot that something was adrift: only one comes to mind – Howard Schill, principal of CFRA, the US-based forensic accounting specialists, outstanding independent research providers, whose European product, in splendid isolation, threw up the dangers.)

PAGE 3 OF 4

### PRESS CUTTINGS NOTICE

Reproduced by permission of Lehmann Communications plc. The contents of the publication from which the above extract has been taken are copyright works and without prior permission may not be copied further.

# PRESS CUTTING

## CREDIT CONTROL VOL.25 NO.3 & 4 2004

Third, the perennial problem of audits and auditors. They are seen too simplistically as necessary evils with fat cat expressions and lappos. They deserve some sympathy and protection. Why? Because they are one of those professions, such as compliance officers and bodyguards, who never get any recognition for anything they do correctly, but the skies fall in on them and the writs fly – when something slips through the net. There is not the scope here to start analysing auditors; suffice it to say that, although fairly remunerated, their task is thankless. How easy is it to work out, busting one's auditor's gut, that Shell's reserves are below the stated quantity, on a category-by-category basis – seismology and mineralogists notwithstanding? That the money which Nick Leeson asked to have remitted by Baring Brothers to Singapore was not, in fact, to be applied as margin payments for a big client? That black holes, theft and billings or orders booked as revenues are not what they seem to be? Parmalat's auditors went almost as far as one could reasonably expect: amidst a mound of papers, they accepted a certificate of deposit as genuine when in fact it was not. It happens the whole time – but not in quoted companies, not in values of \$4 billion and not when they are the lynch-pin underlying mountainous debt. A real eager-beaver auditor could have approached the US bank – thousands of miles away, in a different time-zone – to ask them the attention-seeking, time-wasting question as to whether that certificate is really real ... in your dreams. He should have done: he didn't. It goes for all the other corporate crises in which auditors loom large: tiny, reasonable oversights can have catastrophic after-effects in that profession. It can happen anywhere and everywhere, and will go on doing so, regardless of country, market, culture, auditors, GAAPs and SAPs. Where there is a Will, there is a Way. Necessity is the Mother of Invention; Assumption is the Mother of all f\*\*k-ups; proverbs which make it embarrassingly inevitable that a determined rogue will fool an auditor somehow, somewhere if there is enough reason and leeway to do so.

Fourth, a sceptic with an efficient rear-view mirror would tell us that a corporate which sets up an unnecessarily complex group structure is either very inefficient or has something to hide. Parmalat used its different countries, varied product-lines and complex operations to 'good' effect: management saw the opportunity to support the mirror-images of their purported liquidity situation by spawning new subsidiaries, networks and shareholdings which offered harbours, caves and shadows in which lurked the figures that didn't really add up. Lesson: suspect, dissect and challenge corporate structures which are more complex than their operations necessitate. If you don't, SPEs emerge.

Back to our thesis: can it happen to me? Yes; unfortunately, Parmalat could, in theory, happen here, to me, to you, to us. We can't expect everyone to be 100% honest all the time, and we can't find angelic auditors who never make mistakes. There is no limit to deviousness: greed and fear drive certain people to inventiveness and imagination that

would win Nobel prizes, differently applied in a different context. Can we do anything about it? Equally and emphatically, yes. What? The DNA of Parmalat – and, for that matter, common to almost every other comparable corporate crisis through which we have lived recently – represents one malaise: the formation of a stable cluster of executives who are able to pool their objectives and activities over a significant period of time to disastrous effect. At the same time, the appropriate counterplay exists in the form of a management convention that is astonishingly inadequately deployed.

Quite simply, shunt, exchange and circulate selected executive responsibilities regularly but unpredictably. Many companies do it; it is interesting, it discovers new talent, it keeps people on their toes, new challenges invigorate. You can't turn the lift-boy in to the Managing Director overnight, but you can ask the accounts clerk to do a stint in the west end office, Counsel to support the Head of Compliance for a bit, and the Sales Director to work with Design or Production for a month to hone his product knowledge whilst his deputy holds the fort. A bit of fluster and movement as the musical chairs are activated the first few times – but it's worth it any day to keep Parmalat II definitively at bay.

PAGE 4 OF 4



LEHMANN  
COMMUNICATIONS  
EC3