

CRITICAL ISSUES ON THE ENFORCEMENT OF THE “TRUE AND FAIR VIEW” ACCOUNTING PRINCIPLE. LEARNING FROM PARMALAT

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Abstract

This paper analyses and discusses the “positive” issues of the overriding international financial reporting standards principle of “true and fair view” in connection with corporate governance mechanisms. The analysis is based on case study evidence. Empirical evidence from the Parmalat case with regards to the role of the information supply and demand side agents is analysed. This study provides evidence on how the relationship between corporate financial reporting and corporate governance mechanisms may influence the enforcement of the international financial reporting standards overriding principle of “true and fair view”. Evidence is found that the enforcement of the “true and fair view” principle is intrinsically flawed when the accountability and the overall corporate governance systems do not work properly. Some evidence is also found for the argument that a lack in the quality of information supplied by the corporate financial system hinders the role information demand side agents as effective monitors.

Keywords: financial reporting, fair value, Parmalat

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Introduction

The aim of the paper is to analyse and discuss the “positive” issues of the overriding international financial reporting standards principle of “true and fair view” in connection with corporate governance mechanisms. Its main purpose is to study how the relationship between corporate financial reporting and corporate governance mechanisms may influence the enforcement of the international financial reporting standards overriding principle of “true and fair view”. A case study approach will be adopted to examine the above-mentioned relationship. The analysis will be based on the empirical evidence emerged from the Parmalat case.

Parmalat was Italy’s eighth largest company, employed 36,000 people worldwide, and was a world leader in dairy food business. Since December 2003, when it collapsed and entered bankruptcy protection, it also represents one of the biggest accounting frauds in corporate history.

However, Parmalat may also constitute an excellent case study for scholars and policy makers to learn: it is more evident how the relationship be-

tween corporate governance mechanisms and financial reporting quality works when something goes wrong than when everything goes smoothly.

Empirical evidence about the role of the information supply side agents (e.g. senior management, internal monitors, such as board of statutory auditors, audit committee and board of directors, and external auditors) as well as of information demand side agents (e.g. institutional investors, financial analysts and rating agencies) in the Parmalat case will be analysed to understand how their roles influenced the enforcement of the “true and fair view” principle.

The paper is structured as follows. Section 2 briefly reviews the theoretical framework and the related academic literature on the relationship between corporate financial reporting quality and governance. Section 3 presents the research methodology adopted in the paper, highlighting major strengths and limitations of the use of a case study approach to attempt to address the research question. Section 4 investigates the role of information supply and demand side agents in the Parmalat case. Section 5 concludes.

Related literature and theoretical framework

From a normative perspective financial statements are considered as an “information medium”, which meets the principles of “neutrality” and overall “true and fair view” (e.g. Dezzani, 1981). In its framework I.A.S.B. (2003) points out that “the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions”.

Nevertheless, since an early work (Amaduzzi, 1949) it has been argued that financial statements, and the overall financial reporting system, are in fact the result of a conflict of interests and balance of powers between different corporate stakeholders.

This argument was raised well before the introduction of the generally accepted accounting principles. However, the institution of generally accepted accounting principles is not able by itself to eliminate the above-mentioned problem.

Firstly, generally accepted accounting principles usually allow the possibility of different accounting treatments being applied to essentially the same phenomena. Naser (1993) points out that such flexibility gives room to subjectivity and may give birth to the so called “creative accounting” phenomenon (also known as “earnings management”⁶⁶). The principle of “true and fair view” is pursued formally, rather than substantially.

Nelson et al. (2003) define three types of earnings management: a) consistent with generally accepted accounting principles; b) hard to distinguish from generally accepted accounting principles; and c) clearly misapplying generally accepted accounting principles.

Healy and Wahlen (1999) provide a wide literature review of the studies concerning creative accounting in the U.S and its implications for standard setters.

Scope for choice of accounting methods may be reduced either by limiting the number of permitted accounting methods or by specifying circumstances in which each method can be adopted. The latest developments in International Accounting Standards are pursuing the objective of reduction in accounting choices (IASB, 2003).

However, even the institution of more detailed (less flexible) generally accepted accounting principles may not be able to enforce the true and fair principle.

Firstly, the elimination of management judgement in financial reporting is neither optimal for investors nor feasible (Healy and Wahlen, 1999). In fact the valuation process of corporate activities (e.g. the period of depreciation of a specific asset) is intrinsically subjective (Melis G., 1995).

Secondly, as Weil (2002) points out, although the institution of specific accounting rules for specific transactions may lead to a more uniform reporting of the covered transactions, such uniformity has a cost: an aggressive corporate management is likely to claim that if an accounting principle (or rule) does not specifically prohibit something, then it is to be considered as allowed.

Palepu and Healy (2003) argue that inflexible accounting standards increase the external auditor’s dependence on specific rules (and eventually weaken its position) as well as they incentive financial engineering specifically designed to get around these rules.

Forker (1992) reports that the presence of a dominant corporate insider is associated with poor disclosure. Oricchio (1997) reviews various cases in which information provided by financial statements did not give a true and fair view of a company, rather information which was functional to the interests of a dominant corporate insider.

Beasley (1996) and Dechow et al. (1996) found that firms with more independent boards are significantly characterised by a lower likelihood of financial statement fraud and earnings management.

More recently, Peasnell et al. (2000), Klein (2002), and Beekes et al. (2004) report that board composition is an important factor in determining the quality of reported earnings, and the extent of earnings management permissible within the framework of generally accepted accounting principles.

Carcello and Neal (2003) found evidence of a significant positive relation between the percentage of affiliated directors on the audit committee and optimistic disclosures for companies experiencing financial distress.

Uzun et al. (2004) found that board composition and the structure of a board’s oversight committees are significantly correlated with the incidence of corporate fraud. Abbott et al. (2002) point out that lack of audit committee independence and financial expertise exhibit a significant association with financial reporting fraud.

In an early work, Gordon (1964, p. 262) argued that senior management is likely to select accounting procedures that, “within the limits of its power”, maximise its own utility, by manipulating the information in the financial statements in its own favour, rather than accounting procedures that pursue the “true and fair view” overriding goal.

The “limits of its power” are defined by the level of residual judgement left by accounting principles as well as the effectiveness of the accountability system due to corporate governance mechanism (Melis, 2003).

⁶⁶ Amat and Gowthorpe (2004, p. 4) point out that “the preferred term in the USA, and consequently in most of the literature on the subject is ‘earnings management’, but in Europe the preferred term is ‘creative accounting’... It should be recognised that some accounting manipulation involves primarily balance sheet rather than earnings management”. For the purpose of this paper both terms will be used as equivalents.

Previous theoretical studies (e.g. Whittington, 1993; Melis, 2004a) argue that corporate financial reporting and corporate governance systems are highly correlated, with any improvement in either system having a positive influence on the other, and vice versa. In fact, as presented in exhibit 1 the out-

put produced by one system constitutes the input needed by the other and vice versa. Both corporate financial reporting system and corporate governance system pursue the accountability of corporate insiders towards other legitimate corporate stakeholders.

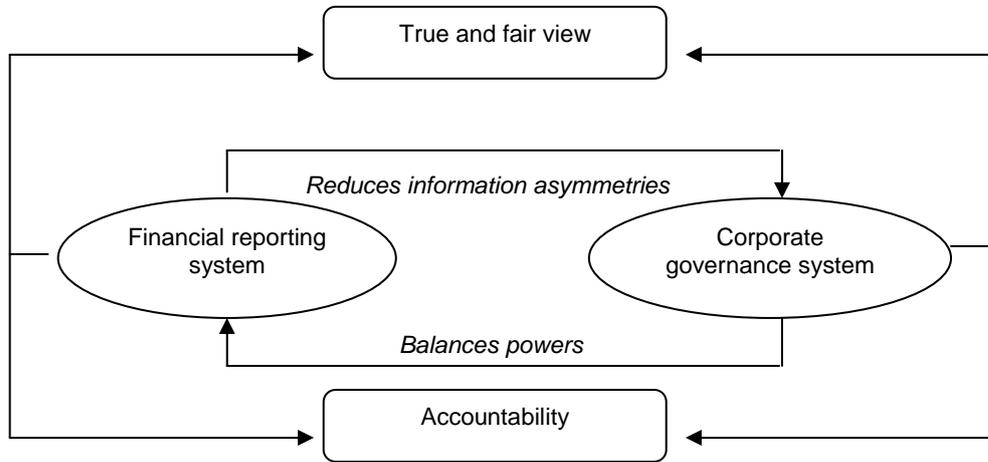


Fig. 1. Financial reporting and corporate governance

Source: Melis (2004a)

Such process is carried out through a network of intermediaries (see exhibit 2) that include institutional investors (e.g. banks, mutual funds, etc.), information analysers (e.g. financial analysts and ratings agencies) on the information demand side as

well as assurance professionals (e.g. external auditors) and internal governance agents (corporate boards, internal auditors, etc.) on the supply side of information.

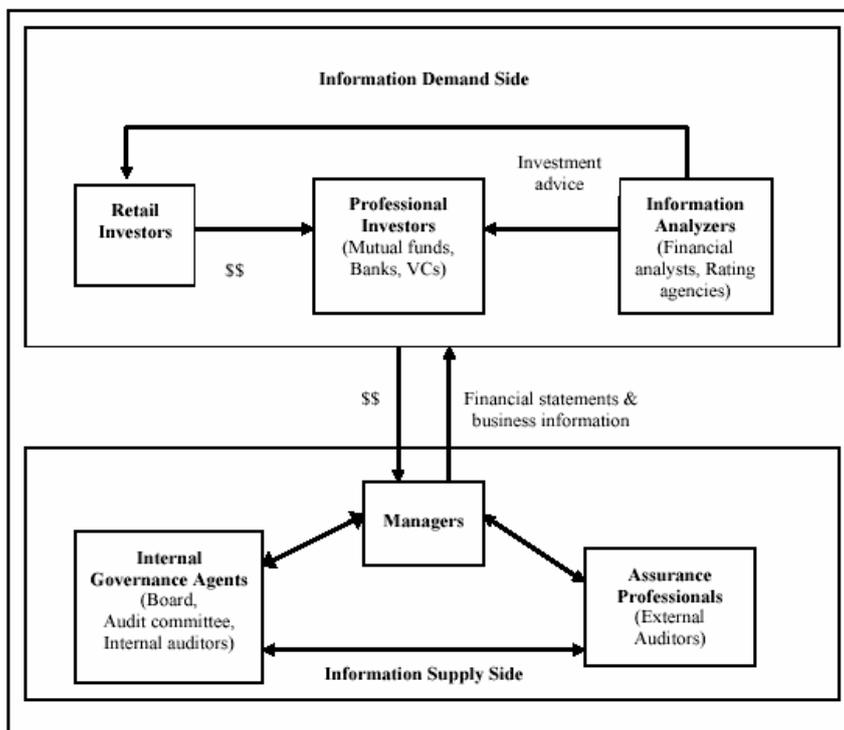


Fig. 2. The information market: intermediation chain between senior management and investors

Source: Palepu and Healy (2003).

Bushman and Smith (2001) provide a good attempt at documenting the studies on the relationship between financial reporting and corporate governance in the U. S.

Amat and Gowthorpe (2004) point out that accounting regulation without enforcement is likely to be ineffective in preventing corporate insiders from employing misleading reporting practices.

Palepu and Healy (2003, p. 2) note that the well-functioning capital market should create adequate linkages of information, incentives, and governance between corporate insiders and outsiders.

However, when the corporate governance system does not work properly, in presence of a dominant corporate insider the enforcement of the generally accepted accounting principle of “true and fair view” seems to become a critical issue.

Research methodology

The paper adopts a case study as research method. The case study does not represent a sample. In fact, case study research is not sampling research (e.g. Stake, 1995, Yin, 1989). It deals with analytic rather than statistical generalisation, i.e. its main goal is to expand and generalise theories rather than to enumerate frequencies (Yin, 1989).

Yin (1989, p. 146) points out that a case study is able to give a relevant contribution to the state of art when the underlying issues are at least nationally important, either in theoretical terms or in policy or practical terms.

The Parmalat case seems to meet the above-mentioned criterion, since it is relevant to an international audience: Melis (2004c) reported that although Parmalat is to some extent a particularly Italian case, this does not imply that the problems emerged at Parmalat may be disregarded and catalogued as country-specific, since they may also affect other firms around the world.

Scapens (1990) argues that the use of case studies can serve two very different research agendas: either of descriptive-explorative or of descriptive-interpretative style. It also is believed that such research agendas are not necessarily in conflict (e.g. Onida, 1951; Rusconi, 1986; Gabrovec Mei, 1999).

Therefore, in the research presented in this paper, the empirical evidence from the case study will be adopted for “hypothesis testing” (in terms of analytic generalisation) as well as “hypothesis generation” purposes.

Furthermore, case study is considered as one of the most effective research methods to investigate on qualitative questions, such as “how may X influence Y?” (Yin, 1989).

Thus, evidence from the Parmalat case potentially presents a very good test case (although extremely negative) to study how the relationship between corporate financial reporting and corporate governance mechanisms may influence the enforce-

ment of the international financial reporting standards overriding principle of “true and fair view”.

It has been argued (e.g. Rusconi, 1986; Yin, 1989; Hamel et al., 1993) that, in order to be successful, a case study needs to rely on a wide variety of sources of evidence, rather than being limited to a single one. Starkey (1997) points out that access to corporate data is a key condition to the success of a case study. However, interviewing as data gathering method is fundamentally flawed with regards to a bankrupted company as Parmalat in which prosecutors are still investigating and some of the main corporate actors are accused of fraud.

Despite difficulties to access data, this case study relies on a good variety of sources, such as corporate financial statements (including board of statutory auditors’ report, external auditors’ report, etc.), corporate ownership and control data, corporate governance reports, board of directors’ minutes, shareholders’ annual meetings’ minutes, corporate conference presentations to institutional investors, reports of the public authority responsible for regulating and controlling the Italian securities markets and, last by not least, financial analysts’ reports.

The enforcement of “true and fair view”: role of information demand and supply side agents at Parmalat

Empirical evidence from the Parmalat case seems to support the argument that the relationship between corporate financial reporting and corporate governance mechanisms influences the enforcement of the international financial reporting standards overriding principle of “true and fair view”.

By analysing Parmalat Finanziaria’s consolidated financial statements there is very little evidence that the letter of current accounting standards was violated. For example, the accounting of an alleged income received from a currency swap with the Epicurum fund that, in accord to the International Accounting Standards (IASB, 2003), should have been reported as a liability in the balance sheet while the carrying value would have be adjusted based on fair value assessments at future reporting dates.

However, few accounting issues were found in Parmalat’s consolidated financial statements. Even so, they clearly did not give a true and fair view of the corporate group’s financial situation and performance. Although, they did not misapply the letter of the generally accepted accounting principles, they violated their overall “spirit”: the overriding principle of “true and fair view” was clearly not enforced.

Rather than an exploitation of loopholes of the accounting standards that allowed concealing the “true” corporate financial results, what emerges at Parmalat is a major falsification of corporate accounts.

Parmalat is about creative accounting in the sense that, among other items, some assets were “created” in order to give a “rosier” picture of the

corporate group, rather a “true and fair” view of its financial position and performance.

Senior management, or at least part of it, falsified company accounts to manage assets, liabilities and earnings which could not be managed otherwise (According to PriceWaterhouseCoopers, which serves as external auditor after the bankruptcy, Parmalat’s financial statements included created assets and sales, overstated profits, while debts were under reported.). Parmalat’s former chief finance officer (Tonna) acknowledged to Italian prosecutors a nearly fifteen year long systematic falsification of accounts at the company.

By examining and discussing the roles of information supply and demand side agents at Parmalat

the paper attempts to understand how the relationship between the corporate financial reporting and corporate governance influenced – negatively – the enforcement of the “true and fair view” accounting principle.

Role of information supply side agents

Senior management, external auditors and internal corporate governance bodies are the key information supply side agents.

Parmalat’s ownership and control structure was characterised the presence of a large shareholder (the Tanzi family) that, either directly or indirectly, controlled the majority of voting shares (50,02%).

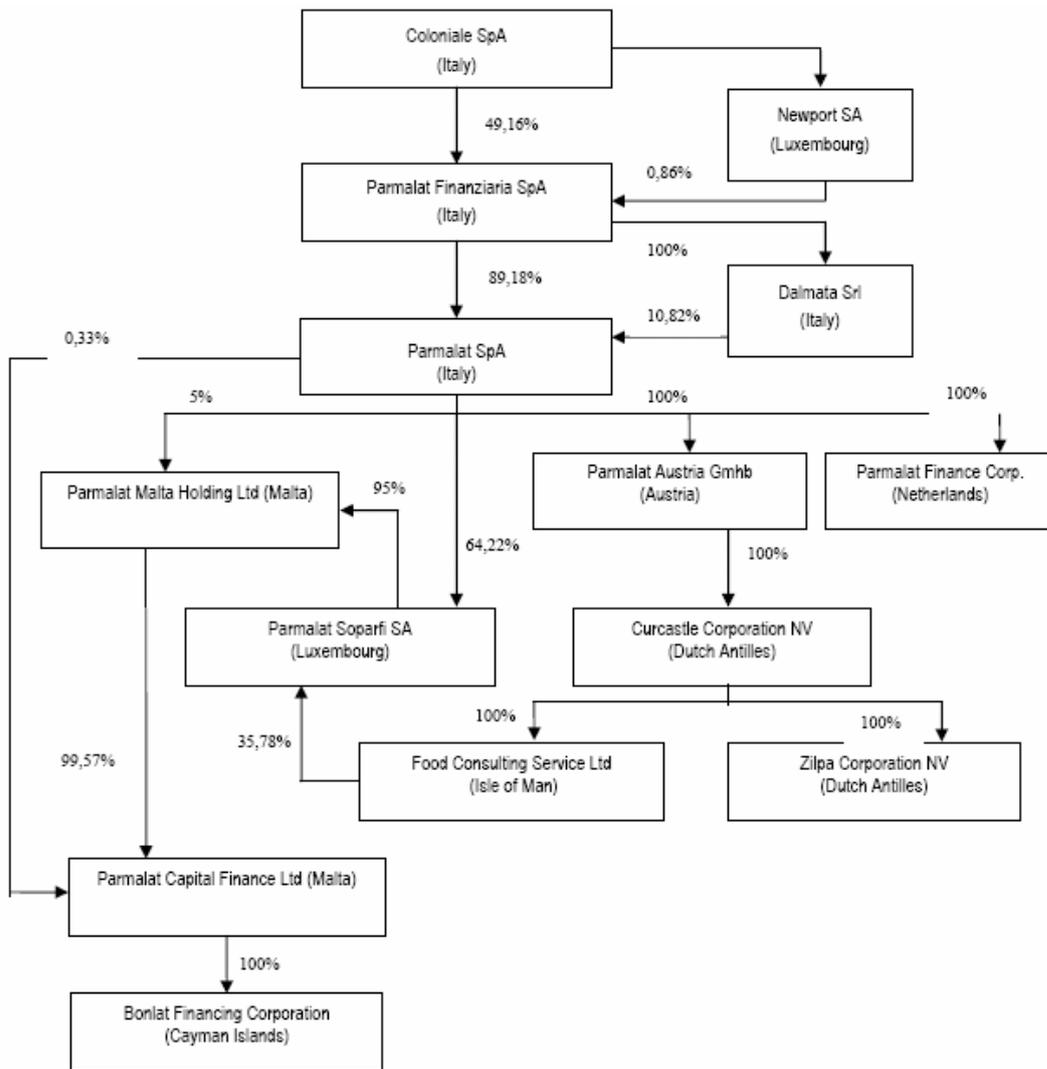


Fig. 3. Parmalat group’s ownership and control structure: a simplified version

Such structure provided a solution to the classical agency problem between senior management and shareholders⁶⁷. Senior management was accountable

to the controlling shareholder (who also held the positions of C.E.O. and Chairman) and did not select

⁶⁷ As noted in La Porta et al. (2000) and Melis (2000) the presence of a blockholder reduces the agency problem be-

tween senior management and the controlling shareholder, but it creates an agency problem between the controlling shareholder and minority shareholders.

accounting procedures to manage the information in the financial statements according to its own interests at the expenses of the controlling shareholder.

However, the Tanzi family had adequate power (and interests) to exploit private benefits from the corporate group via financial statements that gave information which was functional to its own interests. This happened at the expenses of minority shareholders, whom did not have enough powers to have their interests safeguarded⁶⁸.

In order to try to counterbalance the power of the Tanzi family and have adequate information to make their economic decisions (e.g. sell their shares), minority shareholders would have needed well-functioning internal governance agents and an external auditor able and willing to foster the enforcement of the “true and fair view” accounting principle.

Board of directors, board of statutory auditors and internal control committee were the major internal governance agents at Parmalat. Together with the external auditors, they all failed in assuring corporate financial reporting quality.

In the next paragraphs, empirical-based analysis will show that this happened because their structures, as well as their members’ *modus operandi*, were not functional to the enforcement of the “true and fair view” accounting principle.

4.1.1 Role and composition of board of directors

Parmalat Finanziaria’s board of directors was dominated by corporate insiders.

Composed by thirteen members, in its reports on corporate governance Parmalat Finanziaria claimed that five members of its board of directors were to be considered as non-executive directors⁶⁹. Thus, eight of them were executive directors. Four members (one N.E.D. and three executive directors, including the C.E.O-Chairman) were linked by family ties. Moreover, an executive committee was set up and composed by seven directors, including the three Tanzi family members that held executive positions (see exhibit 4).

Eight of Parmalat Finanziaria directors also sit at the board of directors of Parmalat S.p.A., including

the members of the executive committee and one non-executive director (who had family ties with the Tanzis).

Among its five alleged non-executive directors, Parmalat claimed that three of them were to be considered as independent directors.

The Preda code (2002, para 3) defines as independent a director that: a) does not entertain, directly, indirectly or on behalf of third parties, nor have s/he recently entertained, with the company, its subsidiaries, the executive directors or the shareholder or group of shareholders who control the company, business relationships of a significance able to influence their autonomous judgment; b) does not own, directly or indirectly, or on behalf of third parties, a quantity of shares enabling them to control or notably influence the company or participate in shareholders’ agreements to control the company; c) is not close family of executive directors of the company or person who is in the situations referred to in the above paragraphs.

Further analysis based on data not provided by the company reveals that one of the alleged independent directors (Silingardi), who was also the Chairman of the internal control committee, was in fact the chartered certified accountant of the Tanzi family as well as an old personal friend of the Chairman-C.E.O. Tanzi. Thus, he cannot be considered as truly independent.

Dominated by the Tanzi family, no surprise that the Parmalat’s board of directors did not safeguard minority shareholders (none of them could appoint one representative on the board). The board had no interest in assuring corporate financial reporting quality, thus it did not foster the enforcement of the “true and fair view” accounting principle.

⁶⁸ Melis (2000, p. 351), paraphrasing Roe (1994), points out that the key corporate governance issue in Italy concerns “weak managers, strong blockholders and unprotected minority shareholders”. This is not suggesting that Parmalat is a particularly Italian case (Melis, 2004c), as it represents an extremely negative example that could have happened elsewhere.

⁶⁹ This fact is rather unusual among Italian listed companies. C.O.N.S.O.B. (2003) reports that non-executive directors usually represent the majority of members in Italian listed companies board of directors (average 70% of the members), even when the company is controlled by a majority shareholder (average ratio non executive - executive 2:1).

Exhibit 4. Composition of Parmalat Finanziaria's board of directors

Name (1)	Position (1)	Notes
Tanzi Calisto	Chairman / C.E.O.	Founder and major shareholder of the company.
Baracchini Enrico	N.E.D.	Chairman of the remuneration committee.
Barili Domenico	N.E.D.	Member of the executive committee. Senior manager from 1963 until 2000. Member of the remuneration committee.
Del Soldato Luciano	Executive director	Joined the board in March 2003. Chief Financial Officer since November 2003. Previously Chief Administration and Control Officer.
Ferraris Alberto	Executive director	Chief Financial Officer from March until November 2003. Previously country manager (Australia).
Gherardi Antonio	Executive director	Left the board in January 2003.
Giuffredi Francesco	Executive director	Member of the internal control committee. Senior manager.
Mistrangelo Piero	N.E.D.	
Sciumé Paolo	N.E.D.	Member of the remuneration committee.
Silingardi Luciano	N.E.D.	Chairman of the internal control committee. Tanzi's chartered accountant and close friend.
Tanzi Giovanni	Executive director	Son of Chairman-C.E.O. Manager.
Tanzi Stefano	Executive director	Son of Chairman-C.E.O. Manager.
Tonna Fausto	Executive director	Chief Financial Officer from 1987 until March 2003. Member of the internal control committee.
Visconti Paola	N.E.D.	Family ties with the Tanzi family.

Source: (1) Elaborated from company information and C.O.N.S.O.B. database.

4.1.2 Role and composition of internal control committee

Lack of independence also flawed the role of the internal control committee at Parmalat.

Preda code (1999, 2002, para 10.2) recommends the internal control committee to a) assess the adequacy of the internal control system, b) monitor the work of the corporate internal auditing staff, c) report to the board of directors on its activity at least every six months, and d) deal with the external auditing firm.

Set up in 2001, the composition of the Parmalat Finanziaria's internal control committee did not comply with what recommended by the Preda code (1999, 2002, para 10) with regards of the presence of independent non-executive directors.

It was composed by three members. Two executive directors and one N.E.D. (Silingardi), who was close to the Tanzi family. That is non-executive directors did not represent the majority of the committee, in addition there was no really independent director on the committee, besides the chief finance director (Tonna) was a member of the internal control committee.

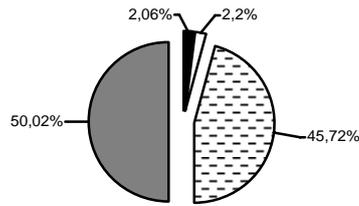
Such composition clearly flawed the role of such committee as a monitor. In its corporate governance reports, Parmalat has never given any explanations about it.

It is now evident that the committee' composition was functional to maintain concealed the fraud, rather than fostering the enforcement of the "true and fair view" of the group's financial situation and performance.

4.1.3 Role and composition of board of statutory auditors

Until 2003 Italian law required listed companies to set up a board of statutory auditors⁷⁰. According to the 1998 company law (Draghi reform, 1998, Art. 149) its main tasks and responsibilities include: a) to check the compliance of acts and decisions of the board of directors with the law and the corporate bylaws and the observance of the so-called "principles of correct administration" by the executive directors and the board of directors; b) to review the adequacy of the corporate organisational structure for matters such as the internal control system, the administrative and accounting system as well as the reliability of the latter in correctly representing any company's transactions; c) to ensure that the instructions given by the company to its subsidiaries concerning the provision on all the information necessary to comply with the information requirements established by the law are adequate.

⁷⁰ Company law changed in January 2004. It allows companies to maintain the traditional board structure with the board of statutory auditors or select either a British-like unitary board structure (with an audit committee within the board of directors) or a two-tier board structure (with a management committee and a supervisory council, without labour representation). See Ferrarini et al. (2003) and Romano and Taliento (2003) for a discussion.



■ Colonialia S.p.A. ■ Landedowne Partners Limited Partnership ■ Hermes Focus Asset Management Europe Limited ■ Free float (1)

Exhibit 5. Parmalat Finanziaria's ownership structure

Source: Elaborated with data based on C.O.N.S.O.B database updated at 30th June 2003. (1) Free float includes all shareholdings with less than 2 percent of the voting capital at the end June 2003.

The size of the board of statutory auditors has a direct influence over the level of protection on minority shareholders because the following powers may be exercised only by at least two statutory auditors jointly⁷¹: a) to seek the cooperation of the company's employees in performing its tasks; b) to convene a shareholders' meeting because of a directors' decision. Only in a five-member board of statutory auditors minority shareholders are given the right to appoint two auditors⁷².

Parmalat Finanziaria's board of statutory auditors was composed by three members. Corporate by-laws set up a threshold of 3% of company voting shares for minority shareholders to appoint a statutory auditor. Given Parmalat Finanziaria's ownership structure (see exhibit 5) this rule made appointing a statutory auditor harder for minority shareholders. The Parmalat Finanziaria board of statutory auditors never sent any alert in their reports to shareholders. Nor reported anything to courts, or to C.O.N.S.O.B.⁷³ (Cardia, 2004).

In December 2002 Hermes Focus Asset Management Europe Ltd filed the board of statutory auditors a demand to investigate about a) the accounting of preference shares; b) the disclosure about some put options related to Parmalat Administracao Ltd, c) the related party transactions between Parmalat Finanziaria and a Tanzi owned company that operated in the tourism sector (H.I.T. S.p.A.); d) the accounting of some intangible assets of Parma Football Club.

The board of statutory auditor answered denying that any irregularity ("atypical" and/or unusual re-

lated party or inter-company transaction"), either *de facto* or *de jure*, was going on⁷⁴.

Either because of lack of resources, independence or incentives, the board of statutory auditors failed to assure corporate financial reporting quality.

4.1.4 Role of external auditors

External auditors at Parmalat failed to exercise their role of monitors. Not only they failed in assuring that the corporate financial reporting was giving a true and fair view of Parmalat's financial situation and performance, but also did not uncover the accounting fraud that went on for approximately fifteen years.

Before its collapse, Parmalat was audited by three chief auditors in the last two decades: Hodgson Landau Brands (an Italian auditing firm), Grant Thornton and Deloitte & Touche. Hodgson Landau Brands was the first auditor, then Grant Thornton took over and served as auditor for Parmalat Finanziaria, and other companies belonging to the Parmalat group, from 1990 until 1998.

Due to the compulsory auditor rotation (Draghi reform, 1998, art. 159)⁷⁵, Parmalat Finanziaria had to change its chief auditor and Grant Thornton was replaced by Deloitte & Touche in 1999.

The main purpose of mandatory auditor rotation is to foster auditors' independence from their clients, thus reinforcing its role as monitor. However, in this case it has hardly contributed to the unveiling of the fraud.

With this regards, what happened at Parmalat is worth noting. Empirical evidence shows that auditor rotation was not in fact fully adopted at Parmalat.

⁷¹ See Melis (2004b) for further analysis on the relationship between the composition of the board of statutory auditors and the level of minority shareholders' protection.

⁷² Corporate by-laws are required to provide the number of auditors (three at least) and shall ensure that one statutory auditor (or two, when the board is composed by more than three auditors) is appointed by the minority shareholders (Draghi reform, 1998 Art. 148).

⁷³ C.O.N.S.O.B. (Commissione Nazionale per le Società e la Borsa) is the public authority that is responsible for regulating and controlling the Italian securities markets.

⁷⁴ See attachment of the board of statutory auditors' report at the 2003 shareholders' meeting.

⁷⁵ Italian law makes lead auditor rotation mandatory after three appointments, leading to a maximum of nine years for audit engagement. Italy is the only large economy to have made auditor rotation compulsory. The external auditing firm is appointed by the shareholders' meeting, although the board of statutory auditors has a voice on the choice of the firm.

Firstly, further investigation shows that Penca and Bianchi, (respectively, President and partner of Grant Thornton in Italy since 1990), the two Grant Thornton auditors that dealt with Parmalat, had worked for Hodgson Landau Brands until 1989, for which they audited the Parmalat group since 1980s.

Moreover, in 1999 Parmalat found a loophole in the 1998 company law that allowed an incumbent auditor to remain as a “subcontractor” even after the nine-years engagement period. While Deloitte & Touche took over as chief auditor, Grant Thornton (specifically the two above-mentioned auditors) con-

tinued to audit Parmalat S.p.A. as well as some Parmalat off-shore subsidiaries even after 1998. In particular, they audited the Cayman islands based Bonlat Financing Corporation, which held the now sadly-known fictitious Bank of America account as major asset. Deloitte & Touche never took overall responsibility for Parmalat’s consolidated financial statements, underlying that their opinion was basely solely upon other auditors’ reports with regards to the part of the group’s total assets and consolidated revenues (see exhibit 6) which came from subsidiaries that were audited by other auditors (i.e. Grant Thornton).

Exhibit 6

Year	1999	2000	2001	2002
Total assets of the group non audited by the chief auditor	22%	40%	42%	49%
Consolidated revenues non audited by the chief auditor	16%	23%	23%	30%

Source: Elaborated with data based on Deloitte & Touche reports

Deloitte & Touche S.p.A. never reported any alert in their reports, nor directly to C.O.N.S.O.B. until 31st October 2003 (two months before Parmalat collapse). They issued a review report on the interim financial information for the six months ended June 2003 in which they claimed to be unable to verify the carrying value of Parmalat’s investment in the Epicurum Fund. Cardia (2004) notes that such decision was a consequence of C.O.N.S.O.B.’s pressure on the auditor.

Parmalat’s accounting fraud became public only after Bank of America stated that bank account that Parmalat claimed to have (with some millions of euro deposited) did not exist.

As noted in Melis (2004c), it seems reasonable to argue that auditors could have discovered the fraud if they had acted according with general auditing standards and exhibited the proper degree of professional “scepticism” in executing their audit procedures.

In fact, bank deposits are not complicated items to audit. They are to be matched to a bank statement as part of a company’s reconciliation procedures in order to assure that bank statements received by the client and used in the reconciliation process have not been altered. This did not happen at Parmalat: prosecutors reported that Grant Thornton auditors relied on the Parmalat’s internal mail system, rather than getting in contact with Bank of America directly.

Grant Thornton auditors’ role reminds the Enron case, in which auditors proved to be not independent from their client. Parmalat former C.F.O. (Tonna) reported to prosecutors that the idea of the setting up of Bonlat Financing Corporation was proposed by Grant Thornton auditors in order to maintain concealed Parmalat’s financial crisis at the eyes of the incoming chief auditor Deloitte & Touche.

4.2 Role of information demand side agents

Financial analysts, ratings agencies are the key information analysers. Together with institutional investors are the agents that characterise the demand of information in capital markets. Retail investors are not likely to have adequate ability and resources to analyse and influence the information provided by the corporate financial reporting system, nor having their “voice” heard by corporate insiders.

Empirical evidence seems to show that they all failed to understand what was going on at Parmalat.

4.2.1 Role of information analysers

Standard & Poor’s published its first rating on Parmalat in November 2000. The rating assigned was BBB-, which the lowest level of the investment-grade category, with a stable outlook. The rating took into account the stability of Parmalat’s business sector, the company position in the market, its good geographical diversification and increasing focus on higher value-added products. These positive factors were counterbalanced by mitigated by Parmalat’s lack of growth prospects in major markets and its use of debt to fund acquisitions in 1997-2000 (Pierdicchi, 2004).

In June 2002, the rating’s outlook was revised to positive from stable. However, after the release of the company half-year interim report In September 2003, Standard & Poor’s revised its credit outlook to stable from positive due to the delay in balancing its financial structure (high gross debt position). On 11th November, the outlook was revised to negative “because of concerns about the quality and transparency of the groups accounts and how it invested liquidity” (Pierdicchi, 2004). Parmalat was rated as a speculative investment only on 9th December, when the rat-

ing was lowered to B+, because of “severe concerns about the company’s liquidity”⁷⁶. The day after the rating was further lowered to CC, “in order to reflect a clear risk of default” (Pierdicchi, 2004).

It was only two weeks before the company filed for bankruptcy. Standards & Poor’s claimed to a victim of the fraud, having systematically received false and misleading information by Parmalat (Pierdicchi, 2004) and stated that their rating methodology relies on the quality of information provided by the company, i.e. they rely on the supply side of information agents.

Alike in the Enron case, financial analysts seem to have not detect Parmalat’s collapse until the very penultimate moment. The lack of financial reporting quality hindered their role: when financial statements are false, as in the Parmalat case, financial statement analysis techniques are intrinsically flawed. Parmalat’s “numbers” were forged adequately to portray a “rosy” picture of the group’s financial situation and performance.

Only on 5th December 2002, a financial analyst (Merrill Lynch’s London office) released a research report in which Parmalat was downgraded to a sell rating (and the volatility risk was raised to high). Merrill Lynch issued other seven public reports in 2003 reinforcing its sell recommendation. Nevertheless, the rest of the financial analysts’ community seems to have not been aware of what was going on at Parmalat. However, using financial statements analysis techniques on data publicly available at the time Melis and Melis (2004) found some evidence that might have lead a sophisticated analyst to have some doubts on Parmalat’s financial situation. Further investigation is needed to understand whether sell-side analysts had only a “passive” role, or rather they also contributed to the lack of the financial reporting quality.

4.2.2 Role of institutional investors

Very little institutional investors’ voice concerning Parmalat’s financial statements was publicly heard.

The only exception is Hermes Focus Asset Management Europe Ltd, which, in December 2002, filed Parmalat Finanziaria’s board of statutory auditors a demand to investigate about specific irregularities (as mentioned in 4.1.3).

It is not clear yet to what extent institutional investors had their potentially active role in Parmalat’s corporate governance hindered by the misleading information provided by the corporate financial reporting, or by their ties with banks.

In fact, prosecutors have placed some banks, which either sold Parmalat’s bonds or helped it to obtain financing, under investigation in order to find out whether such banks were aware of the true financial situation of Parmalat. Not to mention that, alike in the Enron case, some banks were earning high fees from Parmalat, the key the problem with such banks is that they were major long-term lenders of Parmalat. Therefore, they might not have had adequate incentives to uncover the fraud. As Diamond (2004, p. 1448) points out, a Parmalat lender who learns of the senior management’s actions is likely to have incentives to keep secret for a significant period, because as lender it has much to lose if the actions become public immediately.

5. Final remarks, limitations and future research

The paper has analysed and discussed the issues of the enforcement of the overriding international financial reporting standards principle of “true and fair view”. It has been argued that financial reporting quality needs to be analysed in connection with corporate governance mechanisms.

This study was based on the empirical evidence provided the Parmalat case.

Empirical evidence about the role of the information supply side agents (e.g. senior management, internal monitors, such as board of statutory auditors, audit committee and board of directors, and external auditors) as well as of information demand side agents (e.g. rating agencies, financial analysts, and institutional investors) at Parmalat has been explored and analysed.

This study provides evidence on how the relationship between corporate financial reporting and corporate governance mechanisms may influence the enforcement of the international financial reporting standards overriding principle of “true and fair view”. Evidence is found that the enforcement of the “true and fair view” accounting principle is intrinsically flawed when the accountability system and the overall corporate governance system do not work properly. In the Parmalat case information supply side agents’ structures and *modus operandi* were not functional to foster the enforcement of the “true and fair view” accounting principle, rather they were well-designed to pursue Tanzi’s own interests, by concealing the “true and fair” financial situation and performance. Some evidence is also found on the argument that a lack in the quality of information supplied by the corporate financial system hinders the role information demand side agents as effective monitors of corporate insiders.

The main limitation of the paper relates to questions on the degree of “generalisability” of the interpretive framework developed. The findings in the paper are based on single case study evidence, thus the degree to which they apply to other firms needs being further explored. Despite this shortcoming of

⁷⁶ On 8th December Parmalat failed to pay on time a bond for a relatively modest amount of € 150 million. It seemed unjustified in light of the reported liquidity (over three billion euro). Thus, major concerns arose about the existence of such liquidity.

the research, the interpretive framework developed can serve as a preliminary stage in the process of theorisation. In fact, Parmalat presents an extreme negative example. Future research could investigate the relationship between the corporate financial reporting and the corporate governance systems, with particular regards to the issues of *de facto* enforcement of the overriding principle of “true and fair view”, in positive cases, i.e. cases in which an effective accountability system is able to foster the enforcement of the above-mentioned accounting principle.

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