THE CONTEXT OF CORPORATE ILLEGALITY
AND ITS IMPLICATIONS FOR PROFESSIONAL
SERVICE FIRMS

NOVAK DRUCE CENTRE INSIGHTS
In his poem, ‘September 1, 1939’, W H Auden famously cast his eyes back over the pre-war period on a day on which ‘the clever hopes of a low dishonest decade’ expired. Future historians may well characterise the opening years of this century in similar terms. One by one, our institutions have been shown to have feet of clay: Parliament (doctored intelligence reports and bogus expense claims); the Church (child abuse cover-ups); sport (bribery and doping); the media (phone hacking) and media-police relations; even the European Union (fiscal irresponsibility among its peripheral members). Cumulatively, these revelations – often belatedly – have helped undermine public trust in our national and international institutions.

Business stands prominently in the dock. Successive waves of corporate scandals have sapped public confidence: Enron, the Madoff fraud and – most notably – the re-selling in complex and dubiously repackaged forms, of subprime mortgage debt that, coupled with reckless over-exposure, triggered the global banking and financial crisis of 2008. Rows about interbank lending rate fixing, insurance policy mis-selling, fuel and energy pricing and exorbitant executive remuneration rumble on. Corporate illegality – actions that violate administrative, civil or criminal law, and for which the organization is the primary intended beneficiary represent egregious examples of the ‘dark side’ of organizations. In 2003 it was estimated that in the US alone corporate fraud ranges from $200 to $400 billion each year. Moralists might say that humanity is inherently greedy and deceitful and does not change. But there seems across these cases to have been some larger condition at work, some collective suspension of disbelief amounting almost to a conspiracy, conscious or unconscious, between business, the media, regulators and government and society. To trace its operation, rather than consider the now widely aired Anglo-American cases, we turned our lens on a more tightly focused example: Italy’s once-feted international success story, Parmalat.

We asked not only how and why illegality occurs but also how it is actively sustained by organizations despite their being encircled and policed by an elite cluster of gatekeepers. We found that cognitive assumptions generate expectations that can, under specific circumstances, induce organizations to amplify illegal actions and that serve to lessen regulatory scrutiny. We also found that, once initiated, illegal actions can become hidden because of institutionalized practices that enable their concealment and that weaken the prospect of detection. These processes and effects are particularly noticeable in networks of professional regulators. In all these ways the institutional context is an unwitting accomplice in corporate illegality.
THE THEORY OF CORPORATE CRIME

Many studies have tried to trace the motivation behind corporate illegality. Some have suggested poorly performing firms act illegally in order to survive whereas high-performing firms have less incentive to do so. The opposite, however, appears to be the case: in efforts to maintain an upward trajectory of performance even ‘good’ firms engage in illegality.

Structural features, such as an organization’s size, its division of labour and complexity, and the extent to which decision processes are decentralized, have been identified as sources providing opportunities for concealment. Others have pointed to CEO compensation as a possible motivator, but in fact there is no consistent evidence that compensation arrangements are associated with the occurrence or absence of fraud.

Some have suggested that the structure of the board of directors is key because policing by external directors removes opportunities for concealment. In contrast it has been argued that ‘operational governance mechanisms’ – such as accounting procedures, codes of conduct, and human resource practices – play a bigger role than traditional governance mechanisms in preventing white-collar crime.

Fundamental differences in ownership and governance structures certainly shape the kind of fraud that will occur and its likely perpetrators. European firms are typically owned and controlled by small ownership groups and there are fewer shareholder protection requirements, circumstances that offer opportunities for looting by the owners. In the US, widespread share ownership and a range of oversight practices (boards of directors, outside directors, independent audit committees), minimize these opportunities. In the US, therefore, fraud more typically involves the manipulation of earnings in order to artificially increase a firm’s share price in order to benefit CEOs compensated through stock options.

Organizational culture has also been implicated because of the way it can dull moral awareness. Cultures that emphasize ends at the expense of means can lead to moral shortcuts. In the Enron affair the linking of material and symbolic rewards to the attainment of extraordinary levels of performance created norms that institutionalized illegality. Similarly it has been shown how the culture at Salomon Brothers endorsed the portrayal of customers as deserving of exploitation because of their ignorance, how hubris in Wall Street investment banks rationalised questionable professional acts, and how ‘ethical fading’ can occur as lawyers become more accepting of practices as they become more experienced.

Collectively, studies identify three preconditions for corporate illegality: the motivation to engage in corporate illegality, the provision of opportunities for it to occur, and the exercise of choice to exploit those opportunities – all of which were present in the case of Parmalat.

THE PARMALAT AFFAIR

According to the SEC, Parmalat, a large, multinational Italian dairy and food corporation practised ‘one of the largest and most brazen corporate financial frauds’ in the decade before it filed for bankruptcy in 2003. Investigations revealed that the company’s reported financial condition had long been sustained by systematic and accounting misrepresentation.

Founded by Calisto Tanzi in 1961 as a family-run milk company, it achieved national leadership in the production of UHT (Ultra High Temperature) milk in the late 1960s and then diversified into other dairy products. In the 1980s Parmalat began offering bakery products, tomato sauces, and fruit juices, resulting in a portfolio of more than 250 products. In 1990 the company was listed on Borsa Italiana and in the following decade acquired over 200 companies across 50 countries. By 2002 the company operated 139 industrial plants, had over 36,000 employees and a turnover of 7.6 billion euros. Parmalat’s growth strategy was based on acquisitions financed by debt. During the 1990s 6 billion euros were borrowed through the issue of over 30 bonds. However, it became evident even within Parmalat that this strategy was flawed: most acquisitions and investments had proved to be less profitable than expected; synergies between acquired businesses were not forthcoming; and market leadership usually did not materialize. Acquisitions were sometimes made in countries that later faced serious economic crises, depressing market performance. In consequence, Parmalat’s debt soared from 386,000 euros in 1990 to 5 billion euros in 2000. In order to deliver acceptable returns on its investments and maintain its share price and its ability to raise money through bonds, Parmalat began to overstate its revenues and profits. Net earnings were ‘corrected’ upwards by around 31 million euros in 1990 and by over one billion euros in 2002.

The increasing failure of its growth strategy and the scale of Parmalat’s deception are summarized in Figure 2, which contrasts the firm’s reported and actual net earnings. 1998 was the pivotal year, when a plunging gap between actual and reported earnings opened up. The worsening situation was concealed by inflating revenues and – on the advice of Grant Thornton’s audit partners – transferring debt to shell companies set up in mainly Caribbean offshore tax havens. Such was the success of this that Parmalat’s share price peaked in 2002 at 3.7 billion euros. In 2002 Standard & Poor’s actually raised its outlook for Parmalat from ‘stable’ to ‘positive’, and only one analyst recommended ‘sell’ in contrast to 26 others that recommended ‘hold’ or ‘buy’.

IN EFFORTS TO MAINTAIN AN UPWARD TRAJECTORY OF PERFORMANCE EVEN ‘GOOD’ FIRMS ENGAGE IN ILLEGALITY

PARMALAT, A LARGE, MULTINATIONAL ITALIAN DAIRY AND FOOD CORPORATION PRACTISED ‘ONE OF THE LARGEST AND MOST BRAZEN CORPORATE FINANCIAL FRAUDS’ IN THE DECADE BEFORE IT FILED FOR BANKRUPTCY IN 2003
Parmalat was then forced to reveal that most of its supposed liquidity was invested in Epicurum. Following increasing criticism, Parmalat liquidated its position in Epicurum but almost immediately defaulted on an expiring bond because the necessary funds were not forthcoming, triggering a collapse in its share price. Consob responded by asking Grant Thornton, the auditors of Bonlat (another Parmalat-owned Cayman Island company), to provide details of an account with the Bank of America that supposedly contained 3.9 billion euros (38% of the Group’s total assets). This turned out to be a forgery. Parmalat filed for bankruptcy and was declared insolvent with a deficit of 1.4 billion euros – almost twice the Group’s 2002 annual turnover.

Investigations into Parmalat began in the Court of Parma early in the following year. Several former directors and managers of Parmalat were accused of fraudulent bankruptcy, alleging both criminal operations and looting. Investigation also began in the Court of Milan, the allegations being stock price manipulation, obstruction to controls carried out by the Securities and Exchange Commission and financial misrepresentation by Deloitte & Touche and Grant Thornton.

Calisto Tanzi, the former chief executive officer of Parma, and Fausto Tonra, the former chief financial officer, were respectively sentenced to twenty six and sixteen years imprisonment for stock price manipulation and fraudulent bankruptcy. Accountants from Grant Thornton were also given jail sentences for explicitly assisting the fraud by the creation of the special vehicles by which the fraud could be concealed, and both Grant Thornton and Deloitte Touche were heavily censured and fined.

One of the most striking features of the Parmalat case was the duration of the fraud. According to the Public Prosecutor, it began in 1990 and continued undetected for twelve years. Few, if any, financial observers saw through it. Standard & Poor’s maintained an investment grade rating up to ten days before Parmalat sought bankruptcy protection. Similarly, the leading international banks that received substantial fees for processing bonds and private placements for US investors raised no concerns or doubts about Parmalat’s financial situation. Further, neither of Parmalat’s auditors – Grant Thornton and Deloitte & Touche – raised any questions about the company’s financial health until November 2003.

Almost all financial journalists and securities analysts sang enthusiastically from the same song sheet. In the three years prior to 2003 only 92% of journalists’ articles were positive or neutral in tenor. Securities analysts consistently issued positive recommendations. Over the whole 1993-2003 period only 7% made ‘sell’ recommendations and 78% of their ‘buy’ recommendations were actually made in the three years before the company went broke.

In short, despite dealing with the world’s largest banks, highly sophisticated investors and analysts, and two of the largest international audit firms, and despite regular coverage from the business media, Parmalat was able to conceal its illegal corporate behaviour for over a decade. How could this sustained strategy of deception have succeeded?
CONCLUSIONS

In the case of Parmalat we identified three main preconditions for corporate illegality:

1. MUTUALLY REINFORCING INSTITUTIONAL ENDORSEMENTS

Institutional expectations played a key role in the formulation and execution of Parmalat’s strategy. Parmalat retained its growth strategy – even as the firm became aware of its shortcomings – because it believed it was important to behave as analysts expected in order to receive their endorsement and access further resources. As Parmalat’s commitment to its demonstrably failing growth strategy lurched in the mid-1990s towards deliberate deception, its alignment with conventional expectations of analysts continued to generate institutional endorsement, which in turn facilitated more borrowing, thus further fuelling the cycle of concealment and deception.

Analysts accepted Parmalat’s argument that growth and debt go hand-in-hand because it was consistent with their perceptions of what constitute appropriate corporate behaviour. By apparently doing what financial institutions believed to be appropriate and complying with their financial logic Parmalat’s strategy was perceived as legitimate and repeatedly endorsed, and the group was able to continue raising funds. Endorsement of debt as a natural consequence of a strategy of acquisition-led growth encouraged Parmalat to renew its commitment to the same strategy even as its financial position worsened – initially because the group believed in it, and later because doing so reduced the risk of inspection.

2. REGULATORY LOOPHOLES

The regulatory conventions of audit and investment analysis provided Parmalat with many loopholes for exploitation. In forming opinions of complex corporations, securities analysts and institutional investors typically do not collect and examine accounts embracing all the companies within a corporate group. Instead, they rely on the group’s consolidated accounts and the accounts of its major subsidiaries. Parmalat deliberately exploited this in two ways. First, it boosted its consolidated revenues by inflating the results of an off-shore company whose financial statements were not available to market analysts. Second, it concealed the accumulated debt by means of intra-group transactions.

A further regulatory convention exploited by Parmalat was the financial market’s emphasis upon ‘net debts’ – the difference between financial debts and liquidity and ‘net financial interests’. The deception worked. Parmalat was repeatedly able to draw attention to its (apparently) growing liquidity. These reserves, however, were non-existent. Parmalat was simply constructing its accounts in ways that passed scrutiny when assessed against the conventional metric – net debt – used by the markets.

Regulatory loopholes allowed Parmalat to appear successful even as its financial performance worsened. But these loopholes could only have been exploited so successfully if regulators and analysts were lax in their vigilance. So why were the institutional gatekeepers surrounding Parmalat so sleepy in undertaking their roles?

3. THE ASCRIPtion OF CELEBRITY STATUS

Status acts as a signal of merit and worthiness, a surrogate of competency and probity that removes the glare of inspection that might otherwise occur. Parmalat deliberately associated itself with elite members of the financial community, publicly displaying its relationships with large, high status banks such as Deutsche Bank, Citicorp, Schroeder Investment Management and Hermes Investment Ltd.

This had an interesting side-effect: Parmalat was hailed as the ‘Italian’ success story. Its international presence was reported with more than a hint of national pride. Il Sole 24 Ore described Parmalat as one of the very few Italian companies to ‘conquer the world’ and with the ability to ‘represent Italy in the landscape of the major European dairy competitors’.

The risk of erroneous ascriptions of soundness is heightened by the excessive closeness between analysts and those whom they are investigating. It has long been argued that for various reasons auditors are at risk of ‘client capture’. As auditors become overly reliant upon clients for more lucrative consulting engagements, they too often treat the audit itself as a loss leader and in consequence provide only cursory audit analysis. Client capture involves a willingness to compromise an audit scrutiny in order to gain future or additional engagements. The underlying rationale is cognitive: a form of calculated cost-benefit analysis. The Parmalat case, in contrast, underlines the importance of maintaining due ‘social distance’.

But more importantly, the Parmalat story illustrates a second aspect of status ascription: the unhealthily close relationships between members of a financial network. This vulnerability is exacerbated by the tendency to observe and follow the behavior of other members of the network. Particularly important in the Parmalat network were the two audit firms: Grant Thornton, and Deloitte & Touche. As these analysts pronounced favourably on Parmalat, others followed suit. But, rather than the outcome of independent analysis and scrutiny, these confirmations reflected what has been called ‘mimetic herding’, the tendency of a group to copy and adopt common beliefs and behaviour.

Such a network of relationships was certainly present in the Parmalat case – most analysts knew each other, had similar educational backgrounds, met regularly at corporate presentations, attended the same events at the Milan Stock Exchange, and were members of the same professional association. They read each other’s reports and informally exchanged views when they met. In consequence, their views converged.
THE WIDER IMPLICATIONS

Undoubtedly, Parmalat’s position was buttressed by the norms of ‘Third Italy’, that central-northeastern region of the country that saw a proliferation of small and medium firms in the 1970s and 1980s. The common background of the actors there strengthened social cohesion, enhanced reciprocal trust and fostered strong personal ties between firms, the local community, and public authorities. In this context the processes of status ascription were particularly pronounced.

But we should hesitate before treating Parmalat as a particularly Italian case. The same processes played a role in North America. Enron pursued the same growth strategy as Parmalat and received the same positive market endorsement. Enron also used loopholes in accounting principles and audit practices, including the division of responsibilities between two audit firms. And, significantly, Enron was strongly embedded within a network of professional gatekeepers who signal failed to penetrate Enron’s behavior.

Another aspect of the Parmalat story that deserves more detailed attention is how actions are reinforced and contribute to an escalation of commitment, even when the illegality of those actions becomes clear. In the case of Grant Thornton, for example, their initial suggestions for concealment were not expected to be long-term. The underlying motivation may be one of reluctant entrapment rather than acceptance. But once ‘caught’, the practice of concealment escalates and cannot be reversed. It would be interesting to learn more of how initial, seemingly innocuous adjustments become patterns from which it is difficult to withdraw.

Parmalat’s story raises a range of serious questions about the behaviour of financial markets as currently designed. It cautions against our own ascription of trust to them, and calls for fuller exploration.

PARMALAT’S STORY RAISES A RANGE OF SERIOUS QUESTIONS ABOUT THE BEHAVIOUR OF FINANCIAL MARKETS AS CURRENTLY DESIGNED

It would be informative to explore more fully the mechanisms that underlie the collective blindness of gatekeepers and the processes of celebrity ascription. Do regulators, ratings agencies and financial journalists perform an accurate and objective job or do they merely act as the echo chambers of other interested constituencies?

Clearly, the role of professional networks is also a key issue here. But in the functioning of the financial market is that role a mutually valuable one? Or does it rather represent the detrimental consequence of socialization within the financial community? We have mentioned ‘mimetic herding’, but other factors may come into play. Outside members of boards of directors often do not express their concerns over a firm’s performance because of ‘pluralistic ignorance’: individual members may have concerns but mistakenly believe that all other members do not. A similar mechanism may occur within gatekeeper networks.

It would be informative to explore more fully the mechanisms that underlie the collective blindness of gatekeepers and the processes of celebrity ascription. Do regulators, ratings agencies and financial journalists perform an accurate and objective job or do they merely act as the echo chambers of other interested constituencies?

Derived from academic papers and books and written primarily for practitioners, the series is designed to be thought-provoking and challenging yet also highly readable.

To obtain other titles in the series please contact the Centre Manager at novakdruce.centre@sbs.ox.ac.uk

Series Editor: Peter Snow
Design: SampsonMay www.sampsonmay.com
BASED AT OXFORD UNIVERSITY’S SAID BUSINESS SCHOOL, THE NOVAK DRMCE CENTRE IS A HUB FOR ACADEMIC RESEARCH INTO THE MANAGEMENT OF PROFESSIONAL SERVICE FIRMS. ITS MEMBERS WORK CLOSELY WITH TOP PRACTITIONERS TO EXPLORE THE KEY CHALLENGES CONFRONTING THE PROFESSIONAL SERVICES SECTOR.