Afropolitan Journals

ISSN: 3027-2971 www.afropolitanjournals.com

Ethical and Corporate Governance Issues in Multinational Companies: A Review of Parmalat Scandal

Mgbemena, Ijeamaka Charity[1]; Eze, Ogechi Mishelle[2]; Nwankwo, Nkechi Catherine[1]; and Onah Benedict Chikwendu[3]

Nnamdi Azikiwe University, Awka, Anambra State, Nigeria[1]. Glasgow Caledonian University, Glasgow[2]. University of Abuja, Nigeria.

Corresponding author: *ic.mgbemena@unizik.edu.ng*

DOI: *https://doi.org/10.62154/1s1gps70*

Abstract

The events that caused Parmalat, a multinational conglomerate, to commit a big accounting fraud and go bankrupt are discussed in this case report from the perspectives of ethics and corporate governance. The report also discusses the steps that multinational corporations should take to ensure ethical practices and solid governance structures and processes to lessen their exposure to the repercussions that other corporations that have collapsed, with a specific focus on Parmalat, have experienced. It emphasises how Parmalat's failure was ultimately caused by a poor and inadequate corporate governance system that also contributed to other issues, leading to its demise. Following this, the first section outlines the scandal facts, including what fraudulent acts occurred, who committed them, the scandal's impact, and the measures taken to resolve the problems. The second section discusses the key theoretical ideas that explain why the scandal occurred, and the final section provides an overview of the major issues, implications, and suggestions.

Keywords: Corporate Governance, Ethics, Parmalat, Stewardship, Business Failure.

Introduction

The fall of well-known businesses has become a subject of debate amongst regulators, investors, and academics in contemporary years. Given that it is regarded as a major scandal in terms of financial cost, the Parmalat scandal presents a great opportunity to research how the efficacy of corporate governance contributes to failure of companies in developing economies as well as in the US and Europe. Jones (2011) claimed that Parmalat was a well-known instance of accounting fraud that took place in contemporary Italy, fuelled by avarice on the part of the founder and top management team, a week corporate governance process and structure, as well as the auditors' failure to exercise due diligence. Parmalat became involved in a dizzying complex of borrowings, dishonest accounting, and fraudulent and misleading reporting to regulators (Boland, 2008).

Parmalat's Beginnings, Progression, and Key Failings

Parmalat was a family-run farm in Northern Italy when it was created in 1961. It grew to be now a renowned international dairy enterprise. Parmalat decided to go global in 1997 and launched a significant acquisition campaign in the markets of Northern and Latin America, primarily financed by debt (Segato, 2006). While the corporation embarked on a growth spurt that saw it diversify into numerous industries and acquire over a dozen additional businesses in only two years, a number of significant flaws are linked to its downfall.

At Parmalat, board chair and chief executive officer (CEO) responsibilities were combined. Tanzi filled both positions. The choice of an impartial Chair might signal to interested parties that the CEO is liable to a single board led by a renowned figure (Bader, 2013). The case for maintaining effective checks and balances that the board, and in particular the board's Chair, are meant to impose on management led by the CEO, is the foundation for proponents of CEO and Chair independence. In Italy, when a group of shareholders controls a firm, some of the directors must be independent of the controlling owners. Parmalat violated these requirements. It was crystal clear that Parmalat's non-executive directors lacked independence. Eight of the thirteen directors of the firm, including Calisto Tanzi (Chairman and CEO), his son, brother, nephew, CFO-Fausto Tonna, and top managers Luciano Del Soldato, Alberto Ferraris, and Franseco Giuffredi, were executives, according to Parmalat's 2003 report. Parmalat employed a strategy to deliberately inflate its assets while underplaying its liabilities, including claiming nonexistent bond repurchases, misclassifying loans, or just forgetting to declare them (Solomon, 2007). They employed financial engineering to move debt off of the balance sheet or portray it as equity in the financial statements. At that time, the founder and CEO of Parmalat, Calisto Tanzi, had participated in unethical behavior, which included transferring approximately €500 million from Parmalat to Permatour, a business affiliated to his daughter.

As a result of Parmalat's management failing to put in place an efficient monitoring system, abuse of power and fraudulent actions were made easy. In 2008, Tanzi was discovered to have embezzled an estimated €800 million from the business. Ferrarini and Giudici (2005) laid the blame at the feet of the auditors, claiming that Parmalat's auditors Grant Thornton International and Deloitte Touche Tohmatsu missed any illegal activity within the company. The auditors, in particular, disregarded the obvious governance flaws in the Parmalat company. Parmalat began on an expansion drive, acquiring more businesses through political influence, which resulted in enormous losses and debt (Ferrarini and Giudici, 2005). With little accountability to the interests of stakeholders, the Parmalat group continued to pursue its strategy of maintaining significant cash reserves for use in mergers and acquisitions while also funding its financial requirements through bonds. To hide their losses and support the group's financial status, the management developed a fictitious hydra-head of offshore subsidiaries and specialty corporations (McCahery and Vermeulen, 2005).

Summarily, Parmalat had the following shortcomings in corporate governance and unethical behaviour: complex governance structures, cryptic operating processes, deliberate self-interestedness, a controlling and exploitative shareholder, and faked financial accounting and reporting methods and procedures. Analysts became perplexed by Parmalat's situation when it became impossible to pay a €150 million bond while it was supposed to have €3.95 billion in cash on hand. With an account deficit of €14 billion, Parmalat failed in 2003. It was the largest bankruptcy in Europe (Buchanan and Yang, 2005). End of December 2003 saw the Italian government adopt the "Parmalat decree" to handle the Parmalat issue and prevent the Italian Group from going bankrupt while accelerating the emergency administration process. Given that the corporation, though fragile, could be self-sustaining as it had a positive operating margin, a strategy was put out to liberate Parmalat from its obligations. The plan highlighted the promising future of the divisions chosen to serve as the foundation of the new Parmalat and called for the establishment of a joint-stock company to pay secured creditors in cash using the sixteen Parmalat Group firms' assets, and distribute shares to all other creditors in proportion to their claims against one or more of the companies.

Theoretical Underpinnings

Failures in governance, particularly the conflict of interest involving unprotected minority shareholders and the dominating shareholder, were a factor in Parmalat's demise (Buchanan and Yang, 2005; Melis, 2005). This biggest corporate failure was caused by Parmalat's management's failure to define corporate governance concepts and apply them to the company's operational environment. No organisation, regardless of its size, industry, or management calibre, can exist without at least two extremely strong pillars: (1) a solid governance process and framework; (2) a steadfast and upheld ethical climate (Jones, 2011). The rules and expectations that govern board operations assist the decision-making procedures and mechanisms of the boards (Huse, 2007 in Nielsen and Huse, 2010). At Parmalat, the governance system was blatantly flawed. It was flawed enough to allow a controlling shareholder to exploit to further his interests rather than those of Parmalat (Ferrarini and Giudici, 2005) by committing a deliberate and egregious distortion of facts with the purpose to deceive. The number of autonomous directors and the makeup of the board of directors, two of the most significant requirements of Italian corporate governance best practices, were not met by the corporate governance structure of Parmalat.

Parmalat's Tanzi had less concern for the interests of other owners than he had for himself. The agency theory of management provides a suitable foundation upon which Tanzi's behaviour may be anchored, as Parmalat failed to develop a sufficient and effective monitoring mechanism (Roberts, 2015). According to the hypothesis, corporate managers cannot use their discretion to maximize their own benefits if adequate incentives or monitoring are ineffectual at discouraging them from doing so (Clarke, 2005). This theory aids the comprehension of corporate governance failure. It portrays managers as agents of the owner-principal. According to the theory, problems occur when these actors act solely in their self-interest and do not keep the best interests of the owners in mind. Parmalet is a typical illustration of how self-centered managers may drain a company's assets, such that deceived shareholders may be left with little or nothing of their money. Differently, this theory's central tenet—that the owner and the agency are distinct—was challenged by the Board Chair and CEO of Parmalat's dual roles. In this instance, Tanzi covered both positions.

The exploitation of the agency theory by Parmalat's executives was made possible by the non-executive directors' apparent lack of independence. Non-executive directors are supported by the agency theory, according to Alam (2011), because they direct management to please shareholders as objective monitors and controllers. Parmalat management's morality to pursue financial success over other social and environmental factors reverberates ethical egoism. Tanzi's individualist actions were motivated by self-interest, which is the dominant principle in ethical egoism, a crucial idea that supports the agency theory. Putting one's interests first is how Jetton (2013) describes ethical egoism. Those who only consider their own interests when making moral decisions are described as egoists. While Ayn Rand, the most prominent proponent of ethical egoism, supports selfishness (James, no date), Mahrik (2018) contends that ethical egoistic behaviour should not be mistaken for selfish behaviour because it falls outside the purview of this theory. According to Fang et al. (2018), ethical egoism does not dictate how a person should behave; rather, it just prescribes a set of ideals. The case of Parmalat, in which out-of-control management was able to evade the oversight of analysts, regulators, and ultimately the market, verified theories that stress the importance of monitoring company management to address the agency issue.

Stewardship theory, like the agency theory, examines how directors behave in the interest of achieving company goals. (Chrisman et al 2007). According to the stewardship theory, managers will take care of the assets they are given responsibility for on their own, and when the wealth of the shareholders is maximized, the stewards also get financial rewards. (Klepczarek, 2017; Yusoff & Alhaji, 2014). Directors are capable of meeting their personal demands by aiding the success of the company (Sundaramuthy and Lewis 2003; Kluvers and Tippett 2011). Here, the principals' primary motivation is their desire to deliver exceptional work (Keay, 2017). The stewardship theory suggests that managers will typically always act in the firm's best interest, regardless of whether there are principles of monitoring or accountability in place, as the success of the company is highly dependent on management commitment and shareholders' trust in the management, even though the accountability of directors is the foundation for the success of other corporate governance principles (Makuta 2009). This stewardship principle justifies Parmalat's refusal to allow for the oversight of its operations and the accountability of its principals. The stance on accountability taken by this theory favours Parmalat's choice to shutdown inquiries about its governance. This does not, however, negate the fact that this was immoral and harmful to the company's overall profitability. The key corporate governance principle of accountability is invalidated if stewardship theory accurately analyzes and conceptualizes the role and behavior of directors toward the management of their organizations. This therefore calls into doubt the need for any kind of board accountability provision.

Stewardship advances a system that allows for effective harmonization between directors and shareholders. Thus, the stewardship theory has addressed challenges related to organizational identification, goal congruence, and trust (Van-Puyvelde et al, 2013). It claims that goal convergence is important (Van-Slyke 2006) and that managers' interests

are already in line with those of the principals (Pastoriza and Arinio 2008). This explains the scenario at Parmalat, where the directors' and the company's largest shareholder's interests were clearly in line, enabling them to make and carry out unethical decisions. Only because of the overlap in responsibilities between the CEO and the chairman of the board of directors, as well as the directors' lack of independence, was the goal convergence between Tanzi and the directors conceivable. Thus, on the one hand, the founders' and the major shareholder's objective alignment satisfied the need for stewardship; on the other hand, the non-alignment of interests between the principals and the minor shareholders negated the presence of stewardship in Parmalat.
The Parmalat incident would seem to have more than a little challenged the theories that support managers' ability and willingness to reconcile divergent viewpoints in the expert pursuit of corporate strategy. The Parmalat executives were most reckless in their fundamental disregard for their stewardship and fiduciary obligations. While Tanzi's dishonest actions resulted in short-term financial success, they did not allow for the long-term sustenance of the business. Parmalet’s pursuit of quick gains could have been perceived as beneficial to every stakeholder of the company at the time. Parmalat's stock price rose temporarily as a result of the accounting tricks they utilised to inflate their profitability. The interests of the stakeholders were temporarily served by this. This however does not excuse the executives of Parmalat from their unethical behaviour because their activities were immoral regardless of the justification just as Seider et al. (2009) suggests that those who can express the ideals and values with which they undertake their roles as members of a broader community are those whose ethical minds have indeed evolved. The stakeholder hypothesis can be used to justify Parmalat's dishonest and unethical actions up until it became obvious that it was impossible to shield the minor shareholders from the long-term effects of these unethical actions.The stakeholder theory favours a company's sustainability over its profits (Shim, 2014; Forbes and Hodgkinson, 2014). According to Crane and Matten (2016), it is arguably the most influential and current theory of business ethics, arguing that businesses should consider the interests and welfare of all of their stakeholders, including their customers, employees, investors, and community members when acting (Letza, Sun and Kirkbride, 2004). The actions of the executives supported the plausibility of this theory. The company's decisions produced reverberations that affected different stakeholders in different ways (Fisher and Lovell, 2009). While it helped some people achieve their short-term selfish goals, it had a negative long-term effect on the workforce and minor stockholders. The majority shareholder and executives in this case self-benefited at the expense of the minority stockholders.

Summary and Recommendations

Tanzi clearly showed little interest in corporate governance, and as a result of his activities, the company finally collapsed and governance principles began to erode. The downfall of Parmalat ultimately resides in the CEO, CFO, and board of directors' corrupt and unethical corporate governance procedures. Due to the family-based nature of Parmalat's governance, it lacked the necessary non-executive director oversight. This demonstrates that effective ethical and corporate governance practices go beyond written protocols to include the actual functions performed by institutional investors, auditors, and non-executive directors. The summary issues in Parmalat and consequent recommendations are highlighted below:

- There have been several ethical missteps over the years, even though it is widely understood that ethical considerations should be at the top of every company's priority. It was challenging to determine the structure of the Parmalat group, particularly at the global level. To maintain a strong governance process, a corporation's ownership model must be easy to understand; otherwise, a powerful shareholder could exploit this to further fraud, hide illegal behavior, and oppress minority shareholders.
- An efficient compliance procedure that guarantees a firm complies with the pertinent rules and regulations in order to promote good governance is at the center of a robust governance system. Ensuring adherence to key laws and regulations should be the main focus of a sound governance process implementation.
- The board should hold management accountable for compliance with all relevant rules and laws. Auditors are to exhaustively perform the crucial role of improving corporate governance as watchdogs, particularly for shareholders, by ensuring that corporations' internal control and financial information processes are adequate, effective, and free from material errors.

References

Alam, M. (2011). Corporate Governance: The Role of Non-Executive Directors and an International Perspective. *SSRN Electronic Journal*.

Bader, G. (2013). *Separating the positions of CEO and Chairman: The debate rages on. In The Securities Edge*. [online]. Available from: http://www.thesecuritiesedge.com/2013/02/separating-thepositions-of-ceo-and-chairman-the-debate-rages-on/ [accessed 17 March 2023].

Boland,V. (2008). 'The Saga of Parmalat's Collapse'. *Financial Times*. Available from: http://www.ft.com/content/c275dc7c-cd3a-11dd-9905-000077b07658 [accessed 18 March 2023].

Buchanan B., and Yang T. (2005), The benefits and costs of controlling shareholders: the rise and fall of Parmalat, *Research in International Business and Finance*, 19, pp. 27-52.

Chrisman, J., Chua, J., Kellermanns, F., and Chang, E. (2007). Are family managers agents or stewards? An exploratory study in privately held family firms. *Journal of Business Research,* 60, pp. 1010-1038.

Clarke, T. (2005). Accounting for Enron: shareholder value and stakeholder interests. *Corporate Governance: An International Review*, Wiley Blackwell. 13(5), pp. 598-612.

Crane, A. and Matten, D. (2016). *Business Ethics.* 4th edition. Oxford: Oxford University Press.

Fang, J., Jin, B. and Salvin, N. (2018). Ethics - When the East meets the West. *Business Press*, 1(1), pp.2-7.

Ferrarini, G. and Giudici, P. (2005). Financial Scandals and the Role of Private Enforcement: The Parmalat Case. *European Corporate Governance Journal* [online]. **3**(6), pp.43-49.Available from: http://web.efzg.hr/dok/pra/hhorak/Financial%20scandals%20and%20the%20Role%20of%20Private%20Enforcement.pdf [accessed 15 March 2023].

Fisher, C. & Lovell, A., (2009). *Business Ethics and Values: Individual, Corporate and International Perspectives.* 3rd edition. Essex: Pearson Education Limited.

Forbes, W. & Hodgkinson, L. (2014). *Corporate Governance in the United Kingdom*: Past, Present and Future. UK: Palgrave Macmillan.

James, R. (NA). 'Ethical Egoism' in *the Elements of Moral Philosophy, 4th Edition,* Birmingham: McGraw Hill,pp. 76-90.

Jetton, M. (2013). Egoism and/or Altruism. *The Journal of Ayn Rand Studies*, 13(2), pp.105-108.

Jones, M. (2011). Creative Accounting, Fraud and International Accounting Scandals. Chichester, West Sussex, England: Wiley.

Keay, A (2017) Stewardship Theory: Is Board Accountability Necessary*? International Journal of Law and Management,* 59 (6). pp. 1292-1314.

Klepczarek, E. (2017). Corporate Governance Theories in the New Institutional Economics Perspective. The Classification of Theoretical Concepts. *Studia Prawno-Ekonomiczne,* Available from: https://doi.org/10.26485/spe/2017/105/14 [accessed 21 March 2023].

Kluvers, R. and Tippett, J. (2011) An exploration of stewardship theory in a Not-for-Profit organisation. *Accounting Forum* 35, pp. 199-276.

Letza, S., Sun, X. and Kirkbride, J. (2004). Shareholding Versus Stakeholding: a critical review of corporate governance. *Corporate Governance*. 12(3), pp. 242-262.

Máhrik, T. (2018). The golden rule of morality – an ethical paradox. *Ethics & Bioethics*, 8(1-2), pp.5-13.

McCahery J., and Vermeulen E. (2005). Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda. Available from http://www.accf.nl/pages/members/mccahery/corp%20gov%20crises%20and%20related%20party%20transactions.pdf

Makuta, E. (2009) Towards Good Corporate Governance in State-Owned Industries: The Accountability of Directors. *Malawi Law Journal* 3(6), pp. 55-68.

Melis, A. (2005), Corporate Governance Failures: to what extent is Parmalat a particularly Italian Case? *Corporate Governance: An International Review*, 13(2), pp 478–488. Available from: http://users.metropolia.fi/~minnak/ipw/Monika%20KovarovaSimecek/To%20what%20extent%20is%20Parmalat%20a%20particulary%20Italian%20case.pdf [accessed 13 March 2023].

Nielsen, S. and Huse,M. (2010). The Contribution of Women on Boards of Directors: Going Beyond the Surface. *Corporate Governance an International Review*, 18(2), pp.136-148

PARMALAT annual reports (2003) various issue and sources

Pastoriza, D. and Arinio, M., (2008) When Agents Become Stewards: Introducing Learning in the Stewardship Theory. Available from: http://www.iese.edu/en/files/640618.pdf [accessed 21 March 2023].

Roberts, J. (2015). Agency Theory, Ethics and Corporate Governance. Corporate Governance: Does Any Size Fit?*Advances in Public Interest Accounting* [online]. 11(3), pp.249-269. Available from: https://emeraldinsight.com [accessed 15 March 2023].

Segato, L. (2006). A comparative analysis of shareholder protections in Italy and the United States: Parmalat as a case study. *Northwestern Journal of International Law & Business*, 26(2), pp. 373-446.

Seider, S., Davis, K., and Gardner, H. 2009. 'Morality Ethics, and Good Work: Young People's Respectful and Ethical Minds', in Ambross, D. and Cross, T. (ed.), *Morality, Ethics, and Gifted Minds*. London, New York: Springer, pp. 209-222

Shim, E. (2014). Sustainability, Perspective and Corporate Success: A Paradigm Shift. *International Journal of Business, Humanities and Technology* [online]. 4(5), pp.64-67. Available from: http://www.ijbhtnet.com Stakeholder [accessed 17 March 2023].

Solomon, J. (2007). *Corporate Governance and Accountability*. John Wiley & Sons, Ltd., Hoboken.

Sundaramuthy, C. and Lewis, M., (2003) Control and Collaboration: Paradoxes of Governance. *Academy of Management Review* 28(6), pp. 317- 397.

Van-Puyvelde, S., Caers, R., Du Bois, C. and Jegers, M., (2013) Agency problems between Managers and Employees in Nonprofit Organizations. *Non-profit Management and Leadership* 24(1), pp. 51- 63

Van- Slyke, M., (2006) Agents or Stewards: Using Theory to Understand the Government Non-Profit Social Service Contracting Relationship. *Journal of Public Administration Research and Theory* 17, pp. 132-157.

Yusoff, W. F. W., & Alhaji, I. A. (2014). Insight of Corporate Governance Theories. Journal of Business & Management, 1(1), 52– 63. https://doi.org/10.12735/jbm.v1i1p52 [accessed 22 March 2023].