Corporate Governance

Audit Committees

The presence of an audit committee does not stop management committing fraud.

A critical evaluation of the role of audit committees within a framework of the recent demise of Vivendi-Universal and Parmalat.

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Executive Summary

This report critically evaluates the role of audit committees within a framework of the recent demise of Vivendi-Universal and the corporate fraud case of Parmalat.

First, it analyses the structure and the major players of corporate governance within the context of the Combined Code of Corporate Governance, while focussing on the roles and responsibilities of the audit committee. It will bring into context the risk monitoring and warning failures of Vivendi-Universal's audit committee and the lack of objectivity and independence of the members of Parmalat's audit committee.

In conclusion, a short analysis of the possible outcomes of an effective audit committee within both Vivendi-Universal and Parmalat will be debated. This will be alternated with a more general evaluation of the current state of the audit committee in today's corporate governance.

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1.) Introduction

According to the Cadbury report of 1992, corporate governance is the system by which companies are directed and controlled. A similar, but more precise definition is given by Dayton in 1984: "By corporate governance, I mean the process, structure and relationships through which the board of directors oversees what its executives do. By management, I mean what the executives do to define and achieve the objectives of the company".

1.1.) The Board

The Combined Code on Corporate Governance 2003 (CCCG) states that, "Every Company should be headed by an effective board, which is collectively responsible for the success of the company"**.**

The board should be responsible for the Company's values and strategic and entrepreneurial objectives. The board and its members must provide the necessary means to meet these values and objectives, and to control risk management, risk assessment, and management performance (Charkham 2005).

The board should also be composed of a mix of executive and non-executive directors to make sure no group or individual can control the decision making process (Charkham 2005). The members of the board or directors determine the strategy of the business, and they design and implement how the company is managed and controlled.

1.2.) Unitary vs Dual Board Structures

A board may adhere to a dual principle or a unitary principle. The unitary principle involves the board of directors being elected by shareholders, which in turn elect a chairman amongst its members. The shareholders also delegate management to a CEO. The division of responsibility, and subsequent balancing of power, between the chairman of the board and the CEO, was formalised by the Cadbury commission in its

1992 report. The legal structure rests on very simple principles. The shareholders appoint directors to run the business, and these in turn, report annually to the shareholders about the running of the company (Charkham, 2005).

The dual or two-tier principle involves a management board and a supervisory board. This form was first formalised in Germany, and it was used as a model when France formalised their two-tier principle. The supervisory board's main role is that of appointment and control of the management board. The management board's main role is that of administration and management of the company (Charkham, 2005). The supervisory board is typically representative of various stakeholder groups, such as owners and workers.

While the United Kingdom never formalised a dual system, the unitary board would often act more as a supervisory board, and have no executive functions. The CEO would form an executive, or operational group around him, which would manage the business. This has caused an informal, two-tier make-up to develop.

1.3.) Executive Directors vs. Non-Executive Directors

The distinction of directors in the two categories of executive and non-executive is a feature usually found in Unitary Boards. Although, sparked by recent spectacular corporate scandals, two-tier board systems are looking at introducing similar roles of non-executive directors (NED) in the day-to-day running of the management boards.

Executive directors (ED), epitomized by Marketing Directors, Finance Directors etc., are directors that are responsible for the day-to-day running of specific functions. NEDs are members of the board of directors, who do not belong to the management team. They are not employees, or even affiliated with the company. According to the Higgs report of 2003, NEDs have to examine the performance of management and supervise the reporting of performance. NEDs should also contribute to the development of strategy. They have to make sure that the financial information is correct and that strong and secure measurements of risk management and financial controls are in place. Another key role of the NEDs is the responsibility of determining adequate levels of remuneration, appointment, and where necessary, removal and succession of senior management.

These pivotal roles are usually structured in the committees outlined in the Cadbury report of 1992.

1.4.) Cadbury Report

Sir Adrian Cadbury led the creation of the Cadbury report, which was published by 'The Committee on the Financial Aspects of Corporate Governance' in December 1992. The motive for the report was, "the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected" (Cadbury, 1992). In essence, the Cadbury report aims to be a code of best practice for all company boards to abide by, suggesting a set of guidelines to improve upon the concepts of corporate governance.
The three main recommendations of the Cadbury report are the separation of the chairman and the CEO in order to balance power, the structure of the board in three separate committees, and finally, the need for NEDs. The three committees are: the remuneration, nomination and audit committee.
The Cadbury report further recommends a formal process, accepted by the entire board, to take place when selecting NEDs. Every third year, the NED's contracts should be approved by the shareholders (The Economist, 1992).
If the roles of chairman and chief executive are combined, a leader should be appointed among the NEDs. This is to balance executive authority.
It recommends that auditors should review the interim statements, which should also incorporate balance-sheet details. A complete disclosure of non-audit work should also take place, and audit partners should be alternated.

1.5.) Committees

Committees are primarily used for considering the business in more detail and to increase objectivity in areas of potential conflicts of interest, such as executive remuneration. All these committees should take into consideration the recommendations given by the Combined Code of Corporate Governance of 2003 (CCCG).

1.5.1.) Remuneration Committee

The original purpose was to prevent EDs in setting their own remuneration. The committee should be primarily composed of NEDs. The theory is that NEDs would be more objective and produce moderate and fair remuneration policies. The general guidelines consist of sufficiently remunerating to attract, retain and motivate directors in order to guarantee the best outcome possible. This includes performance related pay schemes. In recent times, due to clamorous executive overpayments, an increase in interest has sparked a heightened desire for transparency in executive remuneration. This has also been recently addressed by the Directors Remuneration Report Regulations of 2002.

1.5.2.) Nomination Committee

The main objective of the nomination committee is to consider the appointment of prospective members of the board and make proposals to the existing board. The board subsequently presents to the shareholders, who will make the final decision. This is to add an order of objectivity and prevent the situation of a CEO or Chairman selecting "sycophants or buddies" (Charkham, 2005) for appointment. This situation has been evident in cases such as the appointment of James Murdoch as CEO of *BSkyB* in 2002. The nomination committee is supposed to greatly improve the selection process by adding not only objectivity, but also an extra layer of transparency.

1.5.3.) Audit Committee

The audit committee first appeared in the 1970s in the US, gaining prominence as a weapon against the financial scandals of the era. One of the most notable being the scandal involving the *Equity Funding Corporation of America*. Following these scandals the NYSE made Audit Committees a listing requirement in 1978. Currently, in the UK, the presence of an audit committee composed of NEDs is essential to the corporate governance function of a company. The audit committee should consist of at least three members. According to the Smith Guidance 2.3 of the CCCG, one of the members should have ‘recent and relevant financial experience’. The Blue Ribbon Report of 2004 expands this idea for companies that have a market capitalisation of at least $200 million. It recommends that each of the members of the audit committee (minimum three person strong) be, “financially literate, or become financially literate within a reasonable period of time after his/hers appointment”. It further advises, “at least one member should have accounting or related financial management experience”.

1.6.) The Roles and Responsibilities of the Audit Committee

The Smith guidance should be interpreted as a direction to the relationship between the audit committee and the board. However, the most important factors of frankness, mutual respect and an open working relationship, cannot be drafted in a code. It also needs to be viewed as a guide and implemented subjectively for the needs of each company. The audit committee <u>must</u> act independently from the executive; this is fundamental for the effectiveness of the committee. It has to be noted that the code provides for a separate section of the annual report describing the work of the committee. This is to heighten the relevance and importance of the audit committee towards both the investors and the board.

Where the external auditors’ role is to certify that the accounts give *a true and fair view* of the company, the audit committee needs to ensure that their preparation was done in an accurate manner. The committee should not carry out functions that are not pertinent to oversight, assessment and review; this includes tasks such as the actual preparation of the annual statements.

These roles and responsibilities of the audit committee, as also outlined in the Smith guidance of the CCCG, should be set out clearly and, at least, include:

- To monitor the integrity of the annual statements.
- To monitor and review the company’s internal audit function, and where not present, review and annually justify the lack thereof.

- To make recommendations to the board concerning the appointment and the remuneration of the external auditors.
- To review and monitor the external auditors' independence and objectivity.
- To develop and implement policy about the external auditors' ancillary, non-auditing roles.

The audit committee also has a moral obligation and authority to warn the board of any matter that it considers important or pertinent to the wellbeing of the company. This comprises annually reporting to the board, and to include, within the annual statements, their concerns and appraisals of the company's general and financial activities.

As pertinent to this report, one of the main and most important roles of the internal auditing committee is to review the company's internal financial controls and risk management systems. Unless a specific board risk committee is present, the internal audit and the internal control functions of a company should report to the internal auditing committee. This should be achieved through an annual plan, and a report based upon the terms of reference set in the plan.

These collective functions can only be achieved successfully if the audit committee reviews, monitors and has active access to the company's risk management system (RMS) and management information system (MIS). Information is the lifeblood of the organisation. MIS and RMS are nothing but tools to identify and rationalise information, hence the importance of the audit committee receiving information and access to information in an efficient and timely manner.

An ancillary requirement of the audit committee, mentioned in the Smith guidance, is that the audit committee should meet at least three times a year. Annually (at least) recurring meetings with the external and internal auditors, but without management, should also be organised.

Finally, it is very important to bear in mind "that the audit committee undertakes tasks on behalf of the board" (Smith Guidance, 2003). Consequently, the board ultimately holds all decision-making power and responsibility.

2.) Vivendi Universal

The case of the French / American group, Vivendi-Universal, and its CEO Jean Marie Messier, represents one of the biggest scandals of the last few years. In this case, however, unlike Enron and Parmalat, there was no fraud. The collapse of Vivendi-Universal is due to a huge financial debacle. Still, it is believed that the audit committee should have acted much more effectively.

It has to be noted that throughout the Vivendi-Universal example, its corporate governance, based on the 'Vienot' Reports I-II, 1995-1999 and the 'LSF' of 2003, will often be referenced to the British CCCG. This is felt to be a fair comparison, as the two systems are similar enough to be compared to this case.

2.1.) Context

J.M. Messier has had a successful rise from an elite, Parisian school to his role of CEO at Vivendi-Universal. Beginning as a brilliant student, he then became the advisor of Edouard Balladur in the French ministry of economy and finance, before joining the international Bank *Lazard freres & cie* as a senior partner. In 1996, he was named chairman of the giant water utility *Generale des Eaux,* the company he renamed *Vivendi* (Johnsonn and Orange, 2004)

Considered a great leader, his vision of the future, in the sector of media and communication, was admired by many industrialists. The Financial Times wrote that he was at the time: "the world's most dynamic leader in the media and communication sector" (FT12.01). Thinking ahead of his time, he planned to develop an important world-network of integrated companies, distributing and creating information through mainly digital means. He was trying to develop a continuous flow, starting from content creation to Internet and mobile distribution. In order to reach his goal, he merged in 2000 with *Seagram*, owner of *Universal* and *Canal+*, to form Vivendi-Universal. This merger enabled the group to become the second biggest communication company in the world, after *AOL-Time Warner*. To understand the collapse that happened two years later, we have to ask very different questions. How did J.M Messier succeed to form such an outstanding conglomerate? Could this failure have been avoided? Is he the only one responsible? Why was he not better advised by his board?

2.2.) A huge Financial Debacle

(This information has been obtained from an interview with B. Caput, portfolio manager for *Compagnie 1818*, a Paris-based financial institute.)

Messier was originally a successful banker and definitely knew which strategies he was implementing. He was very close to achieving his project, but he never anticipated the burst of the Internet bubble in 2000, which drastically affected his plans.

1) Messier started to buy other companies, financing his acquisitions with share exchanges (e.g. 3 Vivendi-Universal shares for 6 *Seagram* shares). This is a common way to finance acquisitions, especially during bull market conditions. At the time, his policy found agreement amongst his shareholders. Unfortunately, this strategy had, as a consequence, the impoverishment of said shareholders.
2) Supported by many, Messier started an irrational and risky series of company takeovers. This was the beginning of the end of the Vivendi-Universal group. In four years, Messier took over 30 companies totalling a cost of €100 billion! Most of the companies also had a greatly over-valued goodwill. A common misconception was the thought that he had a lot of shareholders' equity. This was a fictitious assumption; he had little cash, and was highly dependent on the market value of the shares acquired from the other companies. The audit committee role of identifying and monitoring risk management, as referred to in point 1.6 of this report, was not properly implemented. Subsequently, a slump in the share value of the company meant very low levels of equity. As a

result, many write-offs had to be made. In addition, the rating agencies increased the debt burden by de-rating. At this time, Vivendi-Universal was just a huge group with high debt. Messier has bought too many companies, too fast for too much value.

3) Off-balance-sheet commitments, which do not require any provision within the accounts, have played a major role in the collapse of Vivendi-Universal. These just take into consideration a situation, which may possibly occur. In this case, Messier agreed that if the market value of Vivendi-Universal would drop below a certain level, a specific amount of cash would be owed to *Seagram*. The collapse of the markets, and value of Vivendi-Universal in 2000, entered Vivendi-Universal in a vicious circle, by which they had to pay more and more cash to *Seagram*. The main problem was, that at this time, the majority of stakeholders had underestimated the aforementioned off-balance-sheet commitments.

2.3.) Where was the Audit Committee?

Why did nobody stop Messier at an earlier stage, before taking so many risks?
His finance controller (CFO) in 2001 did not hesitate to use ‘creative accounting’ to show a positive gross profit margin. He managed to do so by taking into consideration the totality of *SFR* (the mobile phone affiliate of Vivendi-Universal) results in Vivendi-Universal’s balance sheet, whereas Vivendi-Universal only owned 44% of *SFR* at this time. However, this was not illegal and did not affect the bottom line, which only took in consideration the 44% owned. The audit committee should have warned the shareholders and the board of this practice (Cotton, 2003). As mentioned in section 1.6 of this report, part of the audit committee’s roles and responsibilities is to check the integrity of the preparation of the accounts. The audit committee should also have warned the board, and through the annual reports, the shareholders of the risks associated with said practices. It is difficult to argue that the audit committee influenced the decision to follow the new American accounting rules, which were primarily taken in the light of the recent internationalisation of Vivendi-Universal. American accounting rules require companies to include the current value of all

acquisitions into their accounts. A first warning was made in 2001, with a record loss of €13.6 billion. During the same time, the market value kept falling.
Ambitious and arrogant, Messier did not deviate from his initial strategy. In 2001 and 2002, cumulated losses represented €37 billion and a total debt of €35 billion. By then, the market value had lost 85% since the inception of Vivendi (Sauvaget, 2004). It has to be noted that the general trend of the bear market, due to the bursting of the Internet bubble, also contributed to this dramatic fall.
Fourtou, who was appointed new CEO in order to save the group, carried out a last minute rescue from a solvency crisis and from certain collapse. His priority was to sanitise Vivendi-Universal by selling some companies at below market prices, or even at symbolic prices, to cut losses in order to rebuild a healthy group.

2.4.) Reasons for the lack of action of the Audit Committee

Why the reticence of Vivendi's French dominated board of directors, who refused to question Messiers strategy or accounting until the situation was irremediable?
First, everybody wanted to believe that a French businessman, at the head of an empire, was capable to compete with the biggest American groups. The French establishment collectively supported this bid. Poorly viewed in the US, the merger with Universal was supposed to consecrate "*L'empereur*" Messier. Many people bought into Vivendi-Universal, both in shares and in vision (Johnsonn and Orange, 2003). A lot of hope and pride was sunk into this project, which lead to the 'wool being pulled over the shareholders' eyes'.
Secondly, the fact that Messier belonged to the boards of directors of his creditors, the banks *BNP Paribas* and *Société Generale*, and these banks had at the same time their seats in Messier's board, was not taken into consideration. The two parts were definitely acting in the interest of each other, in a classic case of consanguinity. The vital characteristics of independence and objectivity necessary to the balance of a board were missing.

2.5.) Was there any fraud?

Fraud litigation was filed against the group on behalf of the shareholders, arguing that Vivendi-Universal repeatedly and deliberately overstated the company's financial health. However, no evidence was found, and all class actions suits failed. The external auditors stated that the accounts were given a *true and fair view* of the company. Nevertheless, it is impossible to deny that Messier did not stretch the boundaries.

2.6.) French Corporate Governance after Vivendi-Universal

The Vivendi-Universal experience has definitely modified the panorama of corporate governance and the role of audit committees in France.

The Financial Security Law (LSF 2003) consecrated the separation of audit and board functions, similarly as the separation of powers, a principle established by Montesquieu during the 18th century (*De l'esprit des lois,* 1748). This principle obviously aims to avoid any conflicts of interest that could arise. For example, the same group of people should not carry out auditing and consulting. This is to preserve the independence and objectivity that is required. This important principle is already mentioned in the roles and responsibilities of the audit committee in section 1.6 of this report.

The audit committees, constituted by a majority of independent directors, now take their role seriously and try to be more effective. (Charkam, 2005)

In theory, they are supposed to meet one day before the board closes the accounts. They propose the names of the auditors, establish the accounts and approve any additional tasks given to the auditors. Above all, they must give their opinions to the board.

Each company can implement particular norms and policies as long as it does not affect the established principles of governance. For instance, a company can mention in its status that a director cannot belong to more than 5 different boards. It has also been required, since the Vivendi-Universal case, that corporations give more details about the off-balance-sheet commitments. Following the same trend, shareholders try to limit the access to the board of people coming from the same family amongst the major shareholders.

After the United Kingdom, France has definitely taken the path to rethink its corporate governance system. The next step, already formalised in British corporate governance, will be the capacity of auto-evaluation of the specialised committees in order to reinforce the trust of the investors. See also the UK Smith Guidance 1.6 of the CCCG.

3.) Parmalat

The case of the Italian group Parmalat, and the CEO and owner Calisto Tanzi, represents one of the biggest cases of corporate financial fraud of the last few years. Contrary to *Enron* though, the core operations of Parmalat were, and still are, active and profitable. The inherent structure and history of Parmalat makes the role of the audit committee very difficult. It is believed that the audit committee roles and responsibilities should be enlarged, or at leas adapted, to work in presence of large block holders.

It has to be noted that throughout Parmalat's example, its corporate governance, based on the 'Preda Code' of 2002, will often be referenced to the British CCCG. This is felt to be a fair comparison, as the two systems are similar enough to be compared to this case.

3.1.) History

Parmalat is an Italian dairy food company, infamous for its accounting and corporate governance failure of late 2003. The U.S. Security and Exchange Commission charged Parmalat with, "one of the largest and most brazen corporate financial frauds in history" (Time, 2004). Formerly the 8th largest quoted company in Italy, with 36.000 employees and operations worldwide, it represented the crown jewel of Italian entrepreneurship. In November 2004, slightly less than one year after its collapse, the combined debt and losses were estimated to be around €24 billion.
22-year-old college dropout, Calisto Tanzi, founded Parmalat in 1961. He was the first to adopt two revolutionary technologies from Swedish *Tetra Pak*: UHT pasteurisation and *Tetra Pack* carton packaging. The technologies allowed milk to stay fresh for months without refrigeration and provided an innovative, carton-based packaging. Parmalat took Italy, and subsequently, Europe by storm. By the late 1970's, it had created a world famous brand, in part also thanks to sports sponsoring deals (Ski and Formula 1). They were the first in the world to do so.

3.2.) Finances

After an expensive and fruitless foray (€130 million) in television in 1987, the finances of Parmalat where left in very poor shape. To save the company, Calisto Tanzi engineered a reverse merger, in which he sold Parmalat to a dormant holding company already listed on the Milan stock exchange. The combined firm then raised €150 million from outside investors. This enabled Parmalat to go public in 1990 and plug some of its accounting gaps; at the time, it had a market value of €300 million. This is the key moment where it is said that Parmalat's finances started to "go sour" (Time, 2004). Allegedly, from 1990 to 2003, Parmalat inflated its revenues through double billing and various methods of "creative accounting". This enabled Parmalat to borrow money and fund their extraordinary growth through acquisitions in the late 1990's. In the word of some critics, 'it took its warped finances global' (Time, 2004). At the time of its collapse in 2003, it owed its investors €14 billion. Would it have collapsed in 1995, when it could no longer sustain its funding needs in Italy, it would have been a relatively small failure, at €560 million in debts. Investigators agree that if Parmalat had not committed fraud on the books, it would have consistently posted losses from 1990 onwards.

3.3.) The Collapse

In the late 1990's, the first concerns were starting to appear. During late 1999, *Deloitte & Touche* filed an internal 'early warning' report about Parmalat's Latin American operations, where it was losing over €300 million yearly. After a heated exchange with Parmalat's CFO Tonna, *Deloitte* quickly receded. Similarly, in March 2003, *Deloitte's* Maltese office doubts about a now confirmed, fictitious $7 billion inter-company transfer were swiftly silenced internally. Despite early misgivings, in June 2003, six months before the collapse, Kenneth Lewis, CEO of *Bank of America (BoA)*, paid a marketing call on Tanzi. Working with Parmalat was big business; in 1997 *BoA* received $30 million in commission on a $1.7 Billion bond financing deal.

Citigroup collected $7 million in fees, plus 6% interest, from a $137 million financing scheme. An official accounting by Bondi, the ad-hoc Administrator, shows that €6.5 billion, half of Parmalats debt, went to pay interests. Of that €2.8 billion went to banks alone. By mid-2003, peculiar transactions, such as the *BoA* orchestrated $300 million refinancing of a 1999 Brazilian deal, had become too much for some big investors. By now Parmalat's debts were too big to hide; in 1999, the beginning of the end started. Shell companies were set up in tax havens, to shield the increasing debt from affecting Parmalat's bottom line. Parmalat executives transferred the activities of three shell companies to a single company in the Caymans, *Bonlat*. The fictitious assets grew so large that *Bonlat* had to further invent a fictitious investment fund (*Epicurum*), to justify the fictitious €8 billion in credits. A fictitious letter, drawn up by management (probably by Tanzi, Ferrari and Tonna, Investigation Report 2005), on *BoA* letterhead, also confirmed the existence of a fictitious *BoA* bank account with fictitious funds of over €3.94 billion. The final straw that exposed Parmalat's fraud was a €150 million bond repayment, upon which the company defaulted. This finally attracted the attention of the auditors and of *CONSOB*, the Italian stock market regulator.

Most of the money that moved in, out, and around the company has been traced, although the final destination of some of it is still elusive. Calisto Tanzi has admitted transferring some €500 million to family firms, although investigators put the estimate of Tanzis bounty at €1.3 billion.

These numerous and long-term illicit activities beg the question of: Where were the audit committee and the external auditors during the last 17 years? Fraud was perpetuated on a gargantuan scale from 1989 to 2003. Part of the answer and the problems inherent with implementing the roles and responsibilities of the audit committee, detailed in section 1.6 of this report, will be discussed in the following sections of this report.

3.4.) Separation of Ownership and Control

According to Shleifer and Vishny (1986), as quoted in Mellis (2005), large shareholders have adequate incentives to exercise monitoring.

As shown in Melis (2005), ownership and control of Italian listed companies are characterised by tightly integrated structures, combined with limited numbers of shareholders, linked either through familial or contractual ties. Parmalat itself consisted of a complex group of companies controlled mainly by Calisto Tanzi (51%), also its CEO (see the Appendix, Parmalats ownership structure). The lack of separation between ownership and control, although quite widespread in continental Europe, was one of the main reasons why the corporate governance structures in place (detailed in section 1.5 and 1.6 of this report) failed in pre-emptively spotting and controlling the collapse of Parmalat.

The other main shareholders of Parmalat were the notorious activist funds *Lansdowne Partners Limited Partnership* and *Hermes Focus Asset Management*, which owned 2.0% and 2.2% respectively. On a relative side note, it has to be pointed out that funds such as *Hermes* are supposed to be the knights in shining armour of shareholders, helping to enforce quality corporate governance. In fact, in December 2002, *Hermes* filed a civil claim regarding 'related-parties' transactions against Parmalat. Monitoring and reporting these 'related-parties' transactions should have, in fact, been part of the responsibilities of the audit committee outlined in both the Preda report, CCCG section 2.3 and in section 1.6 of this report.

3.5.) Where were the Monitoring Structures?

Italian listed companies typically employ two 'key gatekeepers' as monitoring structures: the board of statutory auditors and the external-auditing firms. The role of the external auditor is very similar to the Anglo-Saxon model, with the notable exception of compulsory auditor rotation (every nine years). *Grant Thronton s.p.a.*, served as auditors for Parmalat from 1990 to 1998. *Deloitte & Touche s.p.a.* took over as chief auditors in 1999. It is difficult to argue that auditor rotation contributed to the discovery of the accounting fraud, since it did not discover it during the pre-2003 audits. In fact, there are concerns over corroboration and potential liabilities, since they did not report any problems at all, even during the Latin American and Maltese incidents (as detailed above in section 3.3). It has to be noted, however, that *Deloitte & Touche* always rendered a "non-standard" report, where 49% of assets and 30% of consolidated revenues where abroad, thus audited by other auditors (*Grant Thornton*).

Within the roles and responsibilities of the audit committee, detailed in section 1.6 of this report, the responsibility of ensuring auditors independence and objectivity lies with the audit committee.

While the board of statutory auditors is a particular Italian device, its role closely mimics the Anglo-Saxon internal auditing committee. Parmalat's board of statutory auditors was composed of three members, although not ideal in size (Mellis, 2005), it still obeyed legal minimum requirement of three members. Two of the members also sat on the executive committee; this is in conflict with the recommendations to the Italian equivalent of the CCCG, the Preda Code. No adequate explanation was ever presented. Further, one of the committee members was Tonna, Parmalat's acting CFO from 1987 to 2003, and chairperson of *Coloniale s.p.a.*, Calisto Tanzis financial vehicle for Parmalats control (see Appendix 1, Parmalat's simplified ownership structure). The third member and chairman of the committee, allegedly independent, was in fact, the chartered certified accountant of the Tanzi family! Contrary to all recommendations of CCCG and corporate governance in general, none of the members of the internal control committee can actually be considered independent. Other than the general failure in monitoring Parmalat, a further example is the dismissal of the above mentioned civil claim regarding related-parties transaction, filed in December 2002 by *Hermes*. The statutory auditors found no irregularity 'either *de facto* or *de jure*' Melis (2005). This seems to underline the argument that in a corporate governance system characterised by the presence of a strong block holder such as Calisto Tanzi, owner and manager of Parmalat, the board of statutory auditors seems to provide a <u>legitimating</u> rather than a <u>monitoring</u> device.

4.) Conclusions and Recommendations

Within the framework of the cases analyse, there were catastrophic monitoring and warning failures of Vivendi-Universal's audit committee, and a lack of objectivity and independence of the members of Parmalat's audit committee.
Vivendi-Universal's demise can be largely attributed to J.M Messier's risky business practices. An effective audit committee would have probably been able to raise a flag at an earlier stage, preventing the tragic implosion of Vivendi-Universal. Key factors, such as the consanguinity between member's boards, might have influenced the general lethargy of the audit committee.
Parmalat's fraud scandal can be traced to a collective warped behaviour of top management. The audit committee's inability to stop or prevent this from happening, can be largely attributed to the fact that it was composed by that same top management. The key problem in the audit committee's lack of independence can be credited to the lack of separation between ownership and management, in a large block holder configuration. It is clear that an independent and objective audit committee would have been able to stop, or at leas identify, the fraudulent behaviour of Parmalat.
It has to be noted, that if the roles and responsibilities of the audit committee are being effectively carried out, the audit committee plays a crucial role in the running of the corporate governance function.

From a practical, rather than solely theoretical point of view, the recommendations of the various codes and reports have difficulty addressing the day-to-day running of corporate governance. This can be specifically seen within the recommendations of the roles and responsibilities of the audit committee in organisations. The main difficulties can be attributed to the inherent problem of NEDs, who are not even to be 'affiliated with the company', finding out what people are doing. Awareness is always more challenging, when not within an actual structure. This is an increased concern when addressing top management, due to both the larger involvement of those in the running of the company, and the inherent exertion of power of figures with authority. Other problems not to be discounted are the relative little frequency of meetings, the

problematic nature of the quantity and belated provision of information and the commitment of relatively poorly paid NEDs. Another obstacle is the intrinsic predicament of the provision of information by the same people that are being audited. This presents an all too easy opportunity of bias and, even inadvertent, modification.
One of the principal weapons to combat these quandaries is the constant investigation by NEDs. ‘Always ask questions and more questions’.

We feel that by virtue of all the afore-mentioned problems, difficulties and situations, there seems to be a general feeling of hypocrisy towards corporate governance in the business world. From our research and experiences in preparing this report, we think that more often than not, the business world is distorting the true essence of audit committees. It seems that they are being used as legitimising and marketing devices, employed to promote a responsible image, rather than in the originally intended monitoring role.

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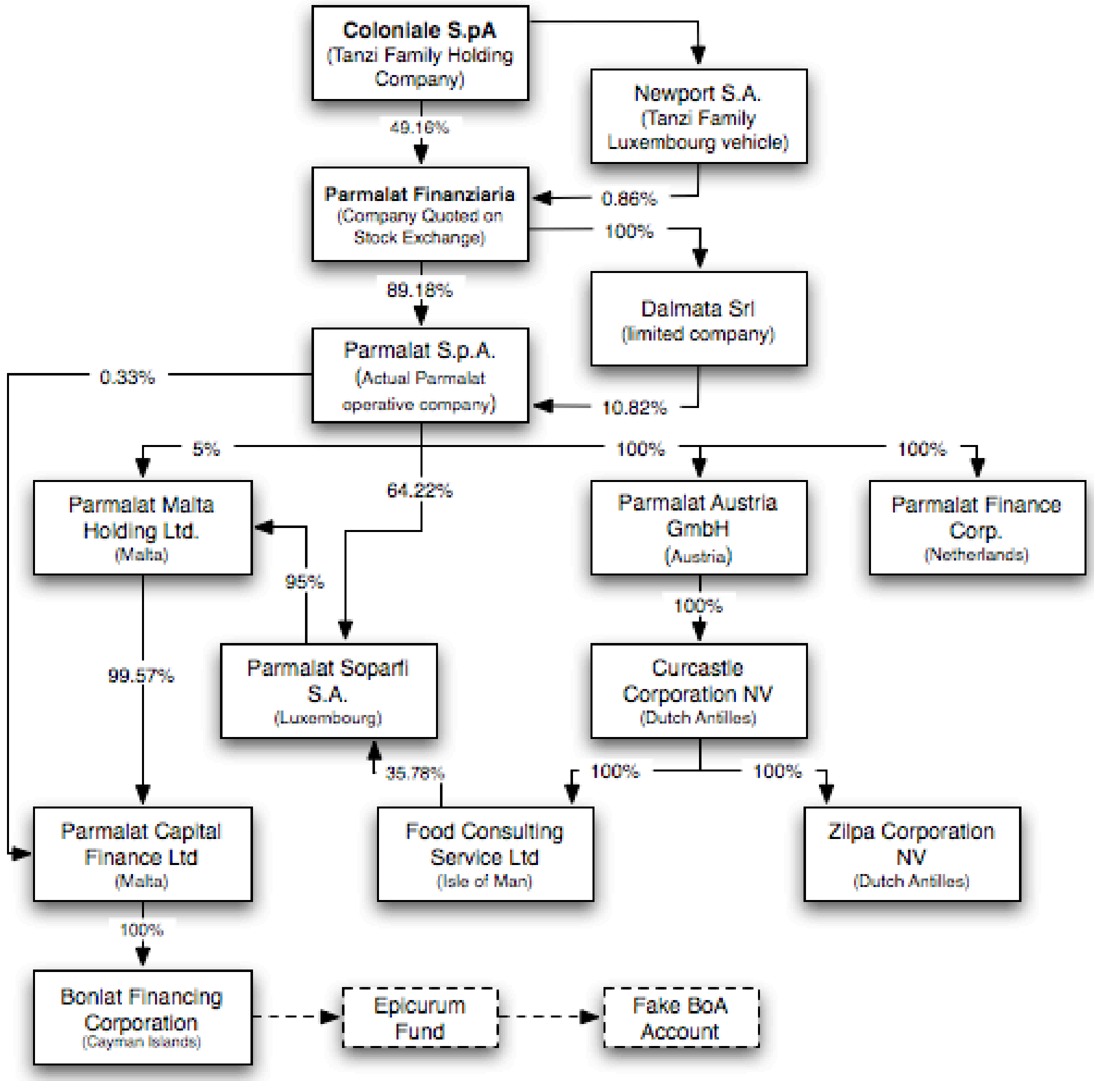
6.) Appendix, Parmalats simplified Ownership Structure



Parmalats simplified ownership structure, adapted from Mellis (2005)