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Author: Simona Alfiero and Silvana Secinaro



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Author: Samina Riaz



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- [December 2006](#)
- [March 2007](#)
- [March. 2007](#)
- [June 2007](#)
- [August 2007](#)
- [October 2007](#)
- [November 2007](#)
- [January 2008](#)
- [March 2008](#)
- [October 2014](#)
- [September 2014](#)
- [March 2014](#)
- [November 2013](#)
- [September 2013](#)
- [May 2013](#)
- [March 2013](#)
- [February 2013](#)
- [January 2013](#)
- [November 2012](#)
- [September 2012](#)

- [July 2012](#)
- [May 2012](#)
- [April 2012](#)
- [March 2012](#)
- [January 2012](#)
- [November 2011](#)
- [September 2011](#)
- [July 2011](#)
- [May 2011](#)
- [March 2011](#)
- [January 2011](#)
- [December 2010](#)
- [November 2010](#)
- [October 2010](#)
- [September 2010](#)
- [August 2010](#)
- [July 2010](#)
- [February 2010](#)
- [November 2009](#)
- [September 2009](#)
- [June 2009](#)
- [April 2009](#)
- [March 2009](#)
- [January 2009](#)
- [October-November 2008](#)
- [August-September 2008](#)
- [June 2008](#)

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The Implication of Adopting the Compliance Program in Italian Holding Companies

Simona Alfiero and Silvana Secinaro

Starting from a prospective of research focused on the analysis of the characteristics and the functioning of the boards of directors and the other organs of government within Italian corporate groups, this paper proposes a framework for the analysis of the systems of governance, with the aim of highlighting similarities/differences and models of best practices to tend towards in the choices of governance adopted by the corporate groups, with particular attention to the implementation of the organisational model provided for by Legislative Decree 231/01 and the influences that the same may have on the regulation of infragroup relations. The objective of the research is that of ascertaining the presence or otherwise of formalised mechanisms for the regulation and control of infragroup relations inside the biggest company aggregations within Italy, and, then, it aims at the identification and theorisation of an optimal model for regulating and controlling infragroup relations in conformity with the provisions of Legislative Decree 231/01.

Field of Research: Corporate Governance and Accountability, Auditing and Assurance

1. Introduction

In the past only a few of the major Italian companies spontaneously adopted selfregulatory tools such as codes of corporate conduct or codes of ethics. As a reaction to national corporate scandals such as those involving Cirio and Parmalat, things started to change as the need for corporate governance reforms was felt at the institutional as well as at the corporate level. In particular, the Legislative Decree 231/2001 has introduced the culture of internal checks in companies as a prevention of offences, into Italy. The regulation imposes sanctions on companies as legal entities responsible for not having prevented its employees from committing offences in the interests of the company (offences against the public administration, IT offences, offences against safety in the work place, false declarations in the financial statements etc.). The organisational model inspired by legislative decree 231/2001 in providing for the administrative accountability of legal entities is founded on *an entity considered individually* and makes no provision in the legislation for groups of companies.

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A significant shortcoming if one considers the growing role of company groupings and the impact their activity has not just on domestic markets, but, in general, on the entire economic, social and environmental scenario in which they operate. It is therefore the job of the interpreter to rebuild the legislative statute as to the administrative accountability of a company belonging to a group of companies, determining the assumptions, limits and guarantees and therefore to determine suitable management and checking organisational models that govern infragroup relations, in the light of the new legislation laid down.

2. Literature review

The role attributed to corporate governance in recent decades has undergone significant evolution that is effectively summed up in the following definitions: [Governance is] “the process of supervision and control intended to ensure that the company’s management acts in accordance with *the interests of shareholders*” (“Cadbury Report. The Financial Aspects of Corporate Governance”, Financial Reporting Council, United Kingdom, 1992); “the governance role is not concerned with the running of the business of the company per se, but with giving *overall direction* to the enterprise, with *overseeing and controlling*, the executive actions of management and with satisfying legitimate expectations of accountability and regulation *by interests beyond the corporate boundaries*” (Tricker 1984). Subsequently, with specific reference to the last ten years, the theme of *corporate governance* has been the subject of great interest by management studies and a great deal of research on the characteristics of boards of directors (Daily, Dalton e Cannella, 2003) and of the control bodies and the ways in which they function.

The companies that can be identified in one group, i.e. linked by a single economic subject are influenced by the action of the economic subject that uses instruments directed at the organisational units.

The group member carries out an action with respect to the other members of the group which is variable due to the distance from the local organs set up for management purposes, the instruments employed in the exercising power of an economic nature as well as for the intensity and the direction of the influence exercised, with regard to the particular objectives to be pursued. On the other hand, if we consider the better known “four dimensions of integration”, that summarise the motivational aspects correlated with the existence of a group, i.e. reciprocity, opportunism, expectations and faith, we notice that the sharing of the risk, the exchange of technologies, the rationalisation within the group have common bases of understanding for the development of the group itself (reciprocity). From another point of view, however, opportunism, according to which each subject tends to favour his own interests, it can create serious prejudices at the level of group co-ordination and expectations each entity places in the group and mutual trust. Opportunistic behaviour, regardless of the way in which it manifests itself, produces important consequences: it could induce the increase in the cost of a transaction between the companies with the risk of compromising any economy-of-scale-related benefits. The consequence is the increase in the costs of control since the companies are obliged to dedicate more energy to the monitoring of other people’s conduct. Furthermore the opportunism increases the risk of conflict while reducing the co-ordination of the group.

3. Methodology of the Research

The research is based on the empirical analysis of major Italian groups: they represent the 20% of Italian groups in the stock exchange and they are the most important in the international contest. In particular the sample examined is taken from the classification of the major Italian companies drawn up by the Il Sole 24 Ore newspaper, and shown in the following table.

ITALY				
Position in Italy	Name	Position worldwide	Sales (millions of dollars)	City
1	ENI	26	109,014.20	Rome
2	Assicurazioni Generali	30	101,810.70	Trieste
3	Fiat	84	65,031.10	Turin
4	UniCredit Group	97	59,119.30	Milan
5	Enel	124	48,320.40	Rome
6	Telecom Italia	156	40,150.10	Rome
7	Poste Italiane	334	21,398.80	Rome
8	Intesa Sanpaolo	337	20,790.80	Turin
9	Finmeccanica	454	16,348.10	Rome

Source: Il Sole 24 Ore – September 2008

The analysis is developed, through the tracing and study of all the documentation concerning the organisational models of the groups taken as part of the sample and the relative subsidiaries: in particular the consolidated financial statements of the group and the financial year of the relative subsidiaries, the reports about corporate governance, the organisational models in 231/01 and the codes of ethics. The study of the abovementioned documentation has made it possible, partly through a deep analysis of the scientific contributions present on the subject, to develop a questionnaire/interview to submit to the parties who act as contacts on the board of directors of the groups sampled normally identified in the Internal Audit function. The questionnaire aims at identifying and highlighting the governance-related decisions adopted by the groups of companies with particular attention to the organisational model provided for in legislative decree 231/01 and the influences the same may have on the regulation of infragroup relations with regard to administrative accountability.

The questionnaire is organised into three sections:

- a. general information about the company ;
- b. corporate governance model;
- c. model of organisation, management and control pursuant to legislative decree n. 231/2001.

In particular the third section is structured into ten questions most of them closed:

- 1) Does the parent company adopt the organisational model pursuant to legislative decree 231/2001?

Alfiero & Secinaro

- 2) Do all the companies in the group adopt the organisational model pursuant to legislative decree 231/2001? If not how many of them do not adopt it?
- 3) Does the organisational model pursuant to legislative decree 231/2001 provided for the regulation of intergroup relations?
- 4) If so, in what way?
- 5) Are the group's information systems uniform?
- 6) Is the same access to the group's information technology available to all and any of the group's companies? Who is the party who regulates the operating procedures and the mechanisms of the group?
- 7) What are the infragroup control procedures?
- 8) Have you highlighted limitations and gaps in the organisational model pursuant to legislative decree 231/2001?
- 9) Has it been possible to highlight influences on the economic and financial situation of the individual company or the group following the implementation of the organisational model pursuant to legislative decree 231/2001?
- 10) If so, in what way?

100% of the sample answered the questionnaire making it possible for a sufficiently well organised analysis to be carried out. From the questionnaire, it emerged that 88% of the companies belonging to the single groups examined adopt the organisational model 231. To the question regarding the possibility of regulating infragroup relations through the organisational model pursuant to legislative decree 231/2001 the answers were all the same except in one case. It, in fact, emerged how there are no clear and explicit references to infragroup relations in the models adopted; in most of the cases, only the indication is given of the guidelines, very incomplete about the role the supervisory body should play with regard to the monitoring of a number of processes called sensitive and that involve more than one company in the group.

This gap was also indicated as a response to question eight that aimed at showing up the limitations encountered in the adoption of the said model. Furthermore, the quality information emerging from the questionnaires relative to the institutional-, management- and governance-related aspects was later integrated with the quality information emerging from the analysis of the economical and financial documents of the reference group. The reference sample, in 88% of cases, said it had homogenous information technology systems and certainly highlights the advantages, in economic and financial terms, in the adoption of the organisational model even if it is difficult to see.

4. Discussion

The adoption of the organisational models pursuant to legislative decree 231/01 has the function of exempting the body that provides for its adoption from accountability in the commission of offences of fraud, bribery or corruption committed by its directors/employees. And what if the company, part of a group of companies is responsible for a offence such as to involve the whole group? What are the protections of the group before the offences committed by the individual companies? Is the model pursuant to law 231/01 adopted by the single subsidiaries enough to protect the group?

Alfiero & Secinaro

There are offences for which the error of the individual involves the group. As an example it is sufficient to consider the offence of false declarations in the financial statements: if this is committed by a company in the group it follows that the reflections on the consolidated financial statements of the group are devastating. Who answers for it? In what way should the group be protected and the real culprits shown up? It is a complex mechanism of protection that must be identified in the interests of the all the group's stakeholders.

The process of risk management and risk assessment must be based therefore on :

- identifying the risks of the group in relation to the offences of the subsidiaries that might be committed;
- in designing a preventative system of checking by the parent company, implemented through the construction of an adequate organisation system and the setting up of procedures for certain activities;
- in the adoption of a group code of ethics and a system of disciplinary sanctions that can be applied in the case that the measures provided for by the model are not complied with for the purpose of maintaining its effectiveness;
- in the identification of the criteria for choosing an internal control organisation equipped with the necessary functions that shall supervise the efficiency, the adequacy and the application of compliance with the model.

For the purposes of creating a risk management system, the aim is to divide the activities that pose a risk of offence for the group up into a series of procedures in order to prevent it being committed.

To activate a risk management system the company must therefore:

- map the company areas at risk
- determine the potential methods by which offenders can operate , in the areas specified above
- describe the system of controls activated and the adaptations for enhanced operation necessary.

In particular, it should be monitored the elements showing the involvement of the group can be broken down as follows:

- the systematic nature with which the people at the top of the company have had recourse to the instrument of corruption to win public contracts;
- the capacity of companies to create large availability of slush funds indispensable for being able to pay bribes to public functionaries able to influence the awarding of contract;
- the illegal management of the accounts of group companies with frequent and unjustified movement of capital between the various companies;
- the full agreement with the use of corruption by the reference shareholder;
- the serious, concrete and current danger of commissioning illicit acts of the same type as those for which proceedings are instituted.

The determination of the activities in the context of which offences might be committed presupposes an in-depth analysis of the company situation with the aim of establishing the areas that are involved in the potential cases of offence. It is just as necessary to have an analysis of the possible ways of carrying out the said offences. This analysis must lead to an exhaustive representation of how offences can be

Alfiero & Secinaro

committed with regard to the internal and external operating environment in which the company operates. In this analysis it will be necessary to take into account the history of the company – that is to say its past vicissitudes, even of a legal nature – and of the characteristics of the entities working in the same sector.

The analysis of the company's history and the corporate reality is essential for being able to determine offences that are easier to commit in the context of the company and the way they are committed. This analysis makes it possible to establish – on the basis of historical data – at which moment in the life and operations of the company risk factors are more likely to arise; what therefore are the moments in the life of the company that must more specifically be parcelled up and subject to procedures in order to be adequately and efficiently checked: for example the moment of the presentation of bids for the companies who take part in public appeals; the contacts with the competition; the methods of carrying out the contracts; the analysis of the attributes of external consultants (particularly concerning their cost and effectiveness), the management of economic resources, the movements of money inside the group etc.

The guidelines developed by a number of associations representing companies suggest the separation of tasks between those who carry out crucial phases in the context of a process at risk, the attribution of authorising signatory powers and powers of signature coherent with the organisational and management responsibilities, the existence of a monitoring system that can indicate critical situations. It is also suggested in the specific sector of relations with the public administration, that a manager be appointed inside the company for each individual operation that falls into areas of risk, with the obligation to produce specific documentation for the activities carried out; the adoption of further internal control thresholds when being a member of a consortium or a temporary association of companies, the adoption of instruments aimed at checking the existence, not merely accounting, of the services carried out by consultants, the adoption of instruments and mechanisms that make the management of the financial resources transparent and that, in synthesis, prevent the creation – through the issue of invoices for non-existent operations, through unjustified movements of money between companies belonging to the same group, through payments for consultancy never actually supplied or if supplied, supplied at a value far below that declared by the company – hidden availability of cash. It is in fact evident that the committing of a wide variety of those offences that the compliance programs should try to impede presupposes the company's availability money that does not emerge from the official accounting and that therefore can be spent without any form of control.

The need for a group organisational model that clearly regulates the infragroup relations is clearly greater the faster the rate at which the risk is growing of offences being committed. But how must the risk be determined? Are there elements that can determine the level of criminal-administrative risk to which a group is subject?

To answer the questions referred to above, a set of variables must be taken into account that have a greater and an objective impact on the penal and administrative risk of the group;

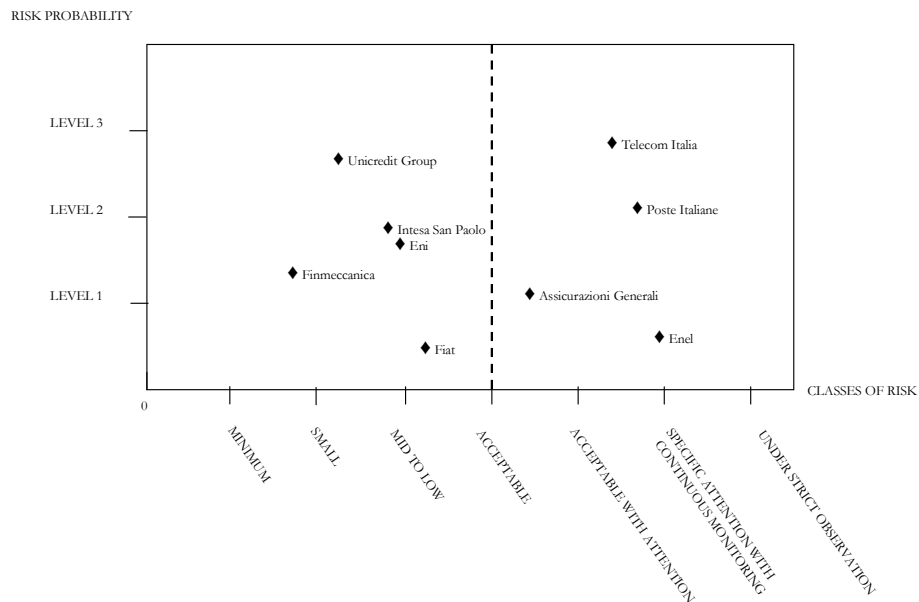
- the number of subsidiaries in the group: the greater the number of subsidiaries in the group the greater the need for supervision of the infragroup actions;

Alfiero & Secinaro

- life cycle of the group: it is necessary to identify the phase of development in which the group finds itself, reconstructing the group's history
- analysis of the sector the group is part of: it is advisable to analyse the number of penal and administrative offences committed by the companies in the sector and compare them with the number of companies in the sector (the result can be called a judicial rating of the sector);
- the number of criminal – administrative priors the companies in the group have placing them in proportion to the number of companies in the group (judicial rating of the group).

The analysis of the four variables, that can be compared on the matrix leads to the determination of the group's degree of litigiousness and consequently the level of risk of being involved in administrative-penal offences pursuant to law 231/2001.

From the analysis effected it has emerged that the sectors characterised by the greatest litigiousness are the utility industries, services and communications. The graph below comes out of the combination of the four variables observed and suitably weighed for each group that give rise to the establishment of risk classes that can be cross-checked with three levels of the probability of their being implemented. The x-axis shows the seven classes of risk that can be seen within the group, while the y axis shows for the purposes of better positioning inside the class itself three levels of riskiness relative to the probability of the potential risk occurring. With the increase in the level of the likelihood of risk occurring (from level 1 to level 3) and the shift onto classes of risk positioned to the right of the origin (from minimum under strict observation) the risk that can be configured as a potential offence inside the group will be more intense.



Source: Developed by the authors, using Spss 12.0, on data supplied by groups picked as samples

5. Conclusion

The research highlights the need to adopt specific techniques and instruments that are suitable for identifying and analysing all risks that could concern the group of

companies. It emerges in fact that Italian companies invest in systems to monitor performance and compliance, trying an integrated approach at group level. The objective is in fact the transversal and exhaustive nature of risk evaluation that leads to models of group organisation that are efficient and effective. Efficient, in such a way that the costs of managing the system are less than the benefits obtained in terms of risk coverage; effective in as much the organisational models integrated at group level increase the protection of the administrative and criminal accountability of the entire company group.

An unitary organisational model thus involves an integrated internal auditing system that must be well established inside the group of companies.

Furthermore, it becomes necessary for the group will have to entrust itself to an autonomous body of the company, imbued with its own powers of initiative and checking, the task of supervising the functioning and observing of the model and ensure it is updated. With regard to this control organism this body may not be identified within the Board of Directors or group of directors without proxies; the solution proposed is that of entrusting such a task to the Internal Auditing function of the parent company. In companies of medium to large scale quoted or otherwise, the institution of this function that is an independent and objective activity of “assurance” and consultancy aimed at the improvement of the efficiency and effectiveness of the organisation.

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Alfiero & Secinaro

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