

Global Fraud Report



All in the Family: Who may have gained from the Satyam fraud?

On the surface, the Enron and Satyam scandals appear to be very similar. Digging deeper, however, shows certain differences, in particular the importance of family links in the latter. Indeed, it would not be difficult to replicate the Satyam fraud in many emerging markets today, where a large number of businesses are controlled by families and friends of the directors and senior management.

When Satyam declared its results for the quarter ending September 2008, things looked rosy for India's fourth largest IT export firm: it reported \$1.2 billion in cash reserves and operating profit margins of over thirty percent.

Then the disturbing news began. In December 2008, the company proposed to use its cash for the purchase of two companies established and controlled by sons of Satyam's founding

chairman, B Ramalinga Raju: Maytas Infrastructure Limited and Maytas Properties Private Limited. Financial institutions holding stakes in Satyam, however, immediately protested against these acquisitions. They argued that the core business of the Maytas entities was in sectors – infrastructure and real estate – which had lost a significant proportion of their market value during 2008, and that both firms were facing a liquidity crunch. On December 17, 2008, within 12 hours of the announcement of its intention to acquire the Maytas companies, this pressure from investors led Satyam to reverse its decision.

Soon after, on January 7, 2009, Mr. Raju confessed to years of fraudulent accounting: the stated cash reserves were largely imaginary. It is plausible, however, that family, friends, and a few key investors were told before the

announcement, and had the chance to act accordingly. At the start of January 2009, the founding family held a little under nine percent of Satyam's shares. By the date of Mr. Raju's confession, however, this figure was down to just over three percent. Moreover, Mr. Raju reportedly pledged six percent of his own Satyam shares to financial institutions as collateral throughout 2008, when the price was much healthier, enabling him to raise significant funds. The companies which held this collateral, however, had sold off all of these shares on the open market by January 5. So, when Mr. Raju declared to the public that ninety-four percent of the reported \$1.2 billion in cash simply did not exist, he, his family, and even his creditors had already seemingly made a lucrative exit from their Satyam shareholdings. The media has reported that Mr. Raju gained \$421 million from the transactions.

A further interesting potential irregularity arising out of this fraud relates to the remuneration which Satyam paid to its auditors. The authorities, in their investigation, have discovered that the firm in question received in fees nearly twice the amount paid by Satyam's peer and competitor IT companies. According to media reports, on January 14 police visited the auditor's offices in Hyderabad.

Although not limited to emerging markets, the risk of another Satyam scandal is more prevalent in companies which are family-managed and which operate in environments where the dividing lines between politics and business are blurred.

A culture of excessive trust: The roots of the Satyam fraud



The roots of the Satyam accounting fraud lie in how Indian information technology (IT) companies report their earnings and the ready acceptance given to these pronouncements.

At the turn of the millennium, one of India's leading software export and outsourcing companies, began the trend of self-reporting a range of non-standard data to investors. Since then it has become common for IT companies to present, in addition to the usual income statements and balance sheets, a set of operational metrics which they themselves create, and their own assessment of performance achieved against them.

These metrics can obviously be very helpful in tracking the performance of a complex and innovative business like IT. They include such information as: trainees' and experienced engineers' billing rates per hour; the percentage of revenue earned from the top ten, twenty, or one hundred clients; and the geographic mix of the client base. Similarly, income statements may contain profit guidance for the forthcoming accounting period.

But these are arbitrary and self-reported measures, entirely controlled and assessed by the company, which add an opaque layer to disclosures through which investors and analysts cannot objectively probe.

Of these measures, analysts and investors have been most interested in guidance on likely profits during the next accounting period, particularly as

IT companies have recorded consistent increases in revenue and profit – as high as thirty percent annually – for almost as long as they have existed. This growth caught investors' attention over the years for two reasons: it has been unparalleled in any other industry in the country; and Indian IT companies have built a record of surpassing their profit guidance time after time.

Missing, however, has been objective investor scrutiny of the reported performance in these self-developed measures. It has been difficult, sometimes impossible, to verify claims such as ones on employee utilization or client mix. When questioned on operational performance, corporate executives rarely reveal anything more than that which has already been announced. Moreover, accounting statements have not, as a matter of course, been compared against the reported performance metrics. Even whether auditors have been obliged to scrutinize the latter is unclear.

Stock market regulators, for their part, monitor only reported earnings and data on stock trading by insiders, as well as timely disclosures related to these, to ensure conformity with compliance norms. They do not typically follow investor conference calls, corporate media announcements, and metrics such as profit guidance for forthcoming accounting periods.

In hindsight, investors, analysts, and observers of corporate performance could clearly have been more alert in conducting their due diligence and

rigorous in pursuing any unsatisfactory responses by Satyam management.

Certain checks against potential fraud in India, however, contain various weaknesses. To begin with, people may accept the assertions of Indian IT companies too easily. These firms have developed a sterling image as the best exemplars of corporate governance precisely because they volunteer these unaudited measurements of their own invention. Stock analysts, meanwhile, when faced with unsatisfactory responses when doing research into a company, simply lower their stock price estimates by a certain percentage and move on.

Finally, questions should be asked about the role of independent directors. While a large number of emerging market companies are family managed, the boards of directors usually include both family members and independent directors. In India, the latter normally come from a community of former senior bureaucrats, retired bankers, academics, or well-networked industry veterans. The Satyam scandal suggests that corporate governance concerns do not always rank as high as they should in the selection criteria for these directors. Indeed, Satyam's independent directors have already made an early exit and washed their hands of the problem, leaving the regulatory authorities to deal with other directors.

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