

The great deception

Satyam's accounting scandal offers salutary lessons to companies

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in collaboration with *Asialaw*



Corporate India will never be the same again. What transpired at Satyam Computer Services in January, culminating in the historic confession letter of former chairman B Ramalinga Raju, admitting a fraud of Rs78 billion (US\$1.6 billion), has caused investors and regulators everywhere to re-examine corporate governance standards.

The multi-billion dollar scam is unprecedented and idiosyncratic for more than one reason. That a company which was audited by one of the most prestigious audit firms and adopted the most advanced accounting and transparent International Financial Reporting Standards (IFRS) accounting systems much ahead of time can perpetrate such a colossal and global fraud is clearly eye opening for corporate counsel worldwide.

It started with Satyam's bid to acquire Maytas Companies for US\$1.6 billion. This revealed the self-aggrandizing policies of the promoters, which caused severe investor backlash. While the bid to acquire the Maytas Companies was aborted within 12 hours, it raised serious doubts about the credibility of Satyam. Independent directors resigned and regulators were alerted. But much before the investigations were even initiated, Raju faxed the historic 5 page confession letter to the stock exchanges and the Securities and Exchange Board of India (Sebi) on January 7, revealing his own fraud – a letter which left everyone connected or unconnected with Satyam in complete shock and utter disgust.

In his confession addressed to the board of Satyam, Raju wrote, *"It is with deep regret, and tremendous burden that I am carrying on my conscience that I would like to bring the following facts to your notice:*

1. The Balance Sheet carries as of September 30, 2008
 - a. Inflated (non-existent) cash and bank balances of 50.40 billion rupees (\$1.04 billion) (as against 53.61 billion reflected in the books).
 - b. An accrued interest of 3.76 billion rupees which is non-existent.
 - c. An understated liability of 12.30 billion rupees on account of funds arranged by me.
 - d. An overstated debtors position of 4.90 billion rupees (as against 26.51 billion reflected in the books)
2. For the September quarter (Q2) we reported a revenue of 27.00 billion rupees and an operating margin of 6.49 billion rupees (24 pct of revenues) as against the

actual revenues of 21.12 billion rupees and an actual operating margin of 610 million rupees (3 percent of revenues). This has resulted in artificial cash and bank balances going up by 5.88 billion rupees in Q2 alone."

Why did he commit the fraud? Raju explains *"As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten..."*

Clearly, if Satyam hadn't attempted to acquire the Maytas Companies, the false accounting would have continued for longer. As Raju reveals in his confession *"The aborted Maytas acquisition deal was the last*



Satyam's marketing materials:
no irony intended

attempt to fill the fictitious assets with real ones. Maytas' investors were convinced that this was a good divestment opportunity and a strategic fit. Once Satyam's problem was solved, it was hoped that Maytas' payments can be delayed. But that was not to be. What followed in the last several days is common knowledge..."

Although there is fierce speculation as to what prompted Raju to write the confession,

the bigger question is how this happened and whether the current laws are adequate to counter such frauds? The Indian corporate governance regime is fairly detailed and similar to most developed countries. But it is because of this that corporate counsels need to be more careful post-Satyam, because if a Satyam can happen in India, it can happen elsewhere as well.

A post mortem is clearly essential. Where did the systems fail? Whose fault was this? Will the shareholders and investors receive any pecuniary compensation for the losses that they suffered? An insight into the corporate governance regime is much warranted, and this article attempts to analyze certain key aspects of the Satyam Scandal - the greatest corporate scandal ever in Indian corporate history.

The crumbling pillars of governance

The concept of corporate governance emanates from Clause 49 of the equity listing agreement as entered into between listed companies with the stock exchanges in India. While several institutions are vested with the responsibility of ensuring good corporate governance, the corporate and securities laws in India, just like in any other market, rely heavily on the institution of auditors, audit committees and independent directors to ensure good corporate governance.

Auditors

Any listed company in India is required to have two sets of auditors – an internal auditor and an external auditor. While both the internal and the external auditors are appointed by the board, their roles differ. An internal auditor is meant to be the first level of check that is required to escalate its findings to the audit committee, which is the second level check to ensure accurate financial reporting and proper internal control systems. The external auditors – the third level of accounting check – then perform their independent audit on the books of accounts of the company, taking into account

"It was like riding a tiger, not knowing how to get off without being eaten..."

RAJU'S CONFESSION LETTER



The rise and fall of Satyam

1987: Ramalinga Raju establishes Satyam Computer Services

1991: Satyam listed on the Bombay Stock Exchange, IPO oversubscribed 17 times.

2001: Satyam gets its American Depository Receipt listed on New York Stock Exchange.

2006: Revenues cross US\$1 billion.

2007: Raju named Ernst & Young Entrepreneur of the Year.

April 2008: Satyam adopts the most advanced IFRS. It is one of the first Indian companies to do so even though the Indian Institute of Chartered Accountants plans to adopt IFRS throughout the country only by 2011.

September 2008: Satyam receives Golden Peacock Global Award for excellence in corporate governance – Highest honor awarded by The World Council for Corporate Governance.

December 16, 2008: Satyam announces plan to buy Maytas Companies substantially owned by family of Satyam's promoter Ramalinga Raju for US\$1.6 billion.

December 17 2008: Within 12 hours of making the announcement to acquire Maytas, the board retracts its decision to acquire as Satyam's ADRs plunge by 55% in the US. It is clear that the acquisition did not find favor amongst Satyam stakeholders.

December 18 2008: Satyam board says will meet on December 29 to consider a share buyback in a bid to restore investor confidence.

December 23 2008: Satyam barred from business with the World Bank for eight years for providing "improper benefits" to its staff and "failing to maintain proper documentation."

December 26 2008: Independent director Dr. Mangalam Srinivasan, who was the longest serving director on the board of Satyam resigns, taking moral responsibility for not objecting to the decision to acquire Maytas.

December 28 2008: Satyam defers board meeting until January 10.

December 29 2008: Independent directors Krishna Palepu, Vinod Dham and Mendu Rammohan Rao resign from the board of Satyam.

December 29 2008: Satyam appoints DSP Merrill Lynch for considering strategic options

January 2 2009: Satyam says its founder's stake fell to 5.13% as lenders sell pledged shares. In a letter to the BSE, the Satyam Company Secretary, G. Jayaraman, intimated that 21,148,503 shares of the promoters mortgaged with the lenders through a family-owned holding firm were sold in the market "for an undisclosed sum".

January 7 2009: DSP Merrill Lynch terminates its engagement with Satyam; Raju writes the historic five page confession letter.

January 9 2009: Government takes control of Satyam; notices issued to auditors Price Waterhouse

January 12 2009: New board of directors appointed at Satyam comprising of Mr. Deepak S. Parekh, Mr. Kiran Karnik and Mr. C. Achuthan.

January 15 2009: Deloitte and KPMG appointed as auditors for restatement of accounts.

January 15 2009: Additional board members appointed Mr. Tarun Das, Mr. T.N. Manoharan and Mr. Suryakant Balkrishna Mainak

January 22 2009: CID alleged Raju of creating 10,000 fictitious employees on the company's rolls to siphon off Rs200 million every month

January 23 2009: Larsen & Toubro along with L & T Capital Company Limited aggregates its stake to 12.04 percent in Satyam

January 24 2009: Price Waterhouse partners S. Gopalakrishnan and Srinivas Talluri who signed off on the Satyam financial statements arrested; suspended by Price Waterhouse.

January 27 2009: Goldman Sachs and Aventus Capital appointed as investment bankers; Boston Consulting Group appointed as management advisors

Raju in happier times



the findings of the internal auditors and the audit committee and report to the board. If the fraud escaped these three levels, the conclusion is fairly clear - laws are adequate, but lack on account of implementation.

In many ways the Satyam scam is worse than Enron and WorldCom. In these, figures related to revenues were fudged to show income which was never there. But in Satyam's case even the bank balances were manipulated. Did the auditors get the certificates or statements from the banks confirming the existence of the balance? If third party confirmation from banks was received by the company's auditors, the issue of non-existent deposits would have been detected a long ago. This leads to another question: did Satyam forge deposits receipts? Did the auditors get the confirmations from the debtors confirming their outstanding receivables?

While it is yet to be proved whether the auditors were negligent in identifying the discrepancies or connived with the promoters, the arrest of Price Waterhouse partners S. Gopalakrishnan and Srinivas Talluri who signed off on the Satyam financial statements is critical. It appears likely that the investigation agencies may have found reasonable evidence substantiating involvement of the auditors in the fraud as arrest of audi-

It would come across as little surprise if the audit firm bails itself out of this multibillion dollar scam by paying a mere US\$200 in penalties

Statutory violations

CORPORATE LAW

Companies Act, 1956

Section	Breach	Penalties prescribed	Persons liable for punishment
209	Failure to maintain proper books of account	Imprisonment up to 6 months and/or fine up to Rs10,000	Director or any such person who has been assigned the responsibility of maintaining the books of accounts of the Company
233	Non-compliance by auditor with duties of the auditors	Fine up to Rs10,000	Auditor concerned and any person signing the report
628	Penalty for false statements	Imprisonment of up to 2 years and/or fine.	Every person making such false statement

SECURITIES LAW

Securities (Contract) Regulation Act, 1956

Section	Description	Penalties prescribed	Persons liable for punishment
23E	Penalty for failure to comply with provisions of listing agreements	Penalty up to Rs250 million	The Company would be liable
23 A	Penalty for failure to furnish information, return, etc.	Penalty up to Rs1 million per day or Rs10 million, whichever is less.	Person responsible to manage and furnish such information

SEBI Act, 1992

Section	Description	Penalties prescribed	Persons liable for punishment
15HA	Penalty for fraudulent and unfair practices relating to securities	Penalty up to Rs250 million or three times the amount of profit made out of such practices, whichever is higher.	Any person who is held liable for unfair practices relating to securities
24	Contravention of the provisions of the Sebi Act, 1992 or rules or regulations made thereunder	Imprisonment up to 10 years and/or with fine up to Rs250 million	Any person who is held liable for such contraventions

CRIMINAL LAW

Indian Penal Code, 1860

Section	Description	Penalties prescribed	Persons liable for punishment
406	Criminal Breach of Trust	Imprisonment up to 3 years and / or fine.	Any person who is held liable for criminal breach of trust
418 and 420	Cheating	Imprisonment up to 7 years and/or fine.	Any person who is held liable for the offence of cheating
463, 464 and 465	Forgery	Imprisonment up to 2 years and/or fine.	Any person who is held liable for the offence of forgery
477 A	Falsification of accounts	Imprisonment up to 7 years and/or fine.	Any person who is held liable for the offence of falsification of accounts

tors in corporate frauds is extremely rare, at least in the Indian corporate history. While the Andhra police claim that the partners have confessed to their involvement in the fraud, PricewaterhouseCoopers (PwC) as a firm has denied any such development.

The problems PwC is currently facing are similar to Arthur Andersen's in 2005. Back then, Arthur Andersen was alleged to have conspired with Enron in fudging its books of accounts and even shredding of documentary evidence. Even though the US Su-

preme Court absolved Arthur Andersen of all such charges, the reputational blow to the accounting firm alone was so severe that it was wiped out globally. A similar fate looms for Price Waterhouse in light of its role in the Satyam debacle.

From a pecuniary liability perspective, actions that can be initiated against Price Waterhouse are as follows:

- Institute of Chartered Accountants of India (ICAI) may debar or inflict a maxi-

mum penalty of Rs500,000 (US\$10,000) only on individual members proved involved in the fraud. ICAI may not be able to inflict any penalty on Price Waterhouse as an entity.

- Ministry of Corporate Affairs may impose a fine up to Rs10,000 (US\$200) on the audit firm under section 233 of the Companies Act, 1956 (Companies Act), the only section providing for auditor liability under the Companies Act.
- Satyam will not be able to sue the audi-

Resurrecting Satyam

The government has played an exemplary role in trying to salvage and revive Satyam. The incumbent board has been disbanded and replaced with six stalwart directors.

This new board has multiple options to revive Satyam, but considering the peculiarity and precariousness of the situation, neither appears to offer an easy way out:

Bailout: A direct bailout doesn't seem to be on the cards for two reasons. Firstly, it might set a bad precedent as public money will be used for paying for corporate sins. Secondly, with several strategic investors and acquirers interested in investing in Satyam, a bailout may not even be required.

Asset purchase: Considering the inherent liabilities associated with the acquisition of the company as a whole, peer companies have shown interest in acquiring certain standalone business of the company. The new board has however expressed its disinclination to sell Satyam in parts and the option is therefore not being evaluated currently.

Merger/Takeover: The new board is most amenable to this option. But since Satyam is a listed company, acquisition of shares aggregating to more than 15% will mandate the acquirer to make an open offer for acquisition of at least 20% shares of Satyam at the six monthly average price of Satyam. This six monthly average computes to about INR 270 per share as against the current share price of INR 49.85.

Interestingly, Larsen & Toubro has hiked its stake in Satyam from 4.48% to 12.04% in a bid to takeover Satyam competing with several private equity investors and IT firms. Though unprecedented, Sebi is considering reducing the cut-off for the open offer price from 26 week average to a two week average owing to the peculiar and precarious condition that Satyam is faced with currently.

tors in light of the Bombay High Court ruling in the case of Tri Sure India where the court held that the company could not sue its auditors for failure to detect its own fraud.

- Shareholders, not being privy to the contract between the company and the auditors, may initiate an action against auditors in common law for breach of statutory duty. However, the sustainability of such an action is debatable, and the prospect of being lost in lengthy courtroom battle – very high.

Because of this, it would come across as little surprise if the audit firm bails itself out of this multibillion dollar scam by paying a mere US\$200 in penalties.

Independent directors

The Companies Act does not define an independent director, and therefore doesn't differentiate between a non-independent and an independent director. Though India's definition of independent directors is in-step with most other markets, independent directors and auditors are usually appointed and paid at the discretion of promoters who mostly dominate the board and shareholder meetings.

This probably explains why the independent directors who are required to carry out independent assessments while deciding on matters sometimes play a passive role in the company and are biased towards the executive management. Another reason for independent directors playing the so-called rubber stamp role appears to be their mini-

Most of the Satyam directors believed the decision to acquire Maytas companies would need shareholder approval as well, which was clearly not the case.

mal involvement in the day-to-day business of the company, which clearly needs to be enhanced now.

However, post-Satyam, independent directors will have to assume a more responsible position in the company and not just act as mute spectators approbating all management decisions without proper diligence or application of mind. They should exercise discretion and distinguish between promoter interest and shareholder interest. In short, they need to perform their role not just by the script, but 'diligently'.

While the roles that an independent di-

rector and an interested director play are fairly different, the implications on both, unfortunately, are the same in case of a default.

Audit committee

An audit committee is required to have two thirds of its committee members as independent directors. Satyam outdid the proportion by appointing four independent directors on committee – so it was made up only of independent directors.

The committee plays a key role, standing, as it does between management, internal and external auditors, and the board of directors. Traditionally, the committee's role has been to oversee the audit function, and review related party transactions and financial statements.

Under the Companies Act, recommendations of the audit committee are binding upon the board of directors. If the board does not accept them, the reasons need to be put on record and communicated to the shareholders. But these are powers which are rarely exercised by members of audit committee. This has left some observers wondering whether such committees are redundant and should be abolished.

Apart from the pillars mentioned above, institutional investors or private equity players have played a significant role in encouraging good corporate governance. Most of these investors negotiate information rights prior to investing in the company to ensure that they have a say in the activities of the company even if they do not involve themselves in its day to day affairs. These information rights are required to be utilised by

the funds to ensure that the company is adhering to the prescribed standards of corporate governance.

However, at least in the Indian context and particularly Satyam, where a substantial stake was held by institutional investors, most of these rights appear to be only on paper and the funds often rely on the decisions taken by the incumbent management. Most of these funds will now have to tender explanations to their investment committees and investors as to the reason why they did not exercise proper diligence earlier and expose the fraud earlier.



Tested framework

The audacity and extent Satyam's transgressions has clearly tested the scope of every law that the fraud touched upon (see statutory violations box-out).

The scandal has also highlighted that the pledging of shares did not warrant disclosures under any of the securities laws in India. This came to light when the company's promoters on December 29 2008 announced that all their shares in the company were pledged with institutional lenders, and that some lenders may exercise or may have exercised their option to liquidate shares at their discretion to cover margin calls since September 2006. This announcement highlighted the deficiency in the disclosure requirements in India regarding transactions by directors and other insiders.

Promoter shareholding in a company is sometimes seen as an indication of their faith in the company, and may therefore become critical for the investors to ascertain the fundamentals of the company. The fact that the extant securities laws did not mandate disclosures was severely criticised, causing Sebi to relook at the regulations.

Shareholder remedies

Apart from the criminal liabilities that the State may inflict upon those involved, shareholders remedies to make good their losses are fairly limited.

Aggrieved shareholders may either write to Sebi for securities law violations or petition the courts under section 397 and 398 of the Companies Act seeking remedies against oppression and mismanagement against the company. In such cases, courts usually direct

the board of the company to maintain discipline and stop or reverse any oppressive act. However, in light of the government taking control and reconstituting the board of Satyam under section 408 of the Companies Act, this remedy may be fruitless as the government has already initiated steps to restore corporate discipline.

From a pecuniary damages perspective, unlike the US shareholders who have already filed class action suits against the company, Indian law does not provide for any such remedy to Indian shareholders. The only remedy where Indian shareholders can pray for pecuniary damages is under the common law regime which may be discouraging considering lengthy court procedures in India. As for remedies available to US shareholders, since the US is not notified as a reciprocating jurisdiction, the decrees passed in the US cannot be enforced directly in India. The US shareholders will therefore have to obtain a decree in a competent court in India and file for an execution proceeding for enforcement of that decree.

What now?

The government is still trying to cope with the effects of the colossal fraud but has some immediate tasks at hand. It will first have to deliver justice to those involved in the fraud while attempting to salvage the value in Satyam to protect the interest of the stakeholders.

The investigations are being carried out by the Andhra Pradesh Police, Serious Fraud Investigation Office (SFIO), Registrar of Companies and Sebi. However, with multiple bodies investigating the same offence,

Regulatory reaction

Satyam's downfall has also drawn attention to Sebi. Although the regulator's probe is in its nascent stages, it is working with the Registrar of Companies office to comb through records to ascertain the scandal's scale.

"They took some time to carve out responsibilities between themselves and the Registrar... which was required to speed things up and avoid the duplication of efforts," says one Mumbai-based lawyer.

Criminal proceedings have been launched by the government which has been proactive in the matter and Satyam's pre-scandal board has been replaced with six new directors. While it took the federal government 48 hours to act, India's constitutional structure requires state authorities to act first before the central government can intervene.

"It is disappointing to note that the Sebi and SFIO, which are the most competent to investigate the fraud haven't even been given the access to interrogate Raju, while the state police, which lacks the expertise to investigate such sophisticated white collar crimes is leading the investigations," says Ruchir Sinha, at Nishith Desai Associates. He adds that such bureaucratic shackles which obstruct investigations should be removed, and a more efficacious regulatory regime needs to be developed.

All of the lawyers contacted by *Asialaw* believe Sebi's conduct has been exemplary.

One partner believes that it was good that the fiasco has prompted Sebi to be stricter with promoters.

According to Sinha, Sebi has amended the Takeover Code to make disclosure of shares by promoters mandatory, but it remains to be seen how it addresses the issue as no amendments have yet been notified.

The main concern now is the false reporting of financial statements which impacts share prices and hurts investors – whom the regulator is supposed to protect.

"The Satyam scandal is likely to cause the regulators to be more proactive and vigilant. Compliance costs are likely to shoot up as auditors will be far more diligent than they have been, rely less on management explanations and may insist on independent verifications," says Nishchal Josphipura, also of Nishith Desai Associates. **Ajay Shamdasani, *Asialaw***

agencies are getting in the way of one another, which is affecting the investigation. For instance, Sebi, which has the cachet to investigate Raju from a securities laws perspective, is unable to do so because Raju continues to be in the custody of Andhra Pradesh police which, analysts believe, may not have the requisite expertise to investigate financial offences.

Considering the peculiarity and precariousness of the matter, it may be advisable to setup a specialised agency to investigate the offence. Government may consider empowering the SFIO as the sole agency to investigate and curb fraudulent market practices. The SFIO can investigate the scandal from different aspects and report its findings to Sebi or the police department. Considering the lackadaisical track record of Indian courts, it may also be advisable to setup fast track courts which can decide on the matter quickly.

Next steps

While there are adequate levels of checks and balances ingrained in the system to prevent frauds, it is the sometimes slack attitude of each institution responsible for upholding corporate governance that made such a fraud possible. Unless heavy fines and strict liabilities are provided for, if not in the statute then in the internal code of conduct, each of these institutions, namely the internal auditors, the audit committee, the independent directors and the external auditors could continue to remain “rubber stamps” approving all management actions.

The Satyam scandal has reiterated the importance of checks on related party transactions. Stringent checks and balances on these ought to be incorporated into the Indian corporate and securities laws to prevent transactions like Maytas in future. Pending statutory incorporation, companies can incorporate adequate checks and balances in their own code of conduct as a measure of ensuring good corporate governance.

It is natural to expect an enhanced level of scrutiny of the financial and governance aspects of Indian companies, and to a lesser extent, any Asian-based companies. The role of a corporate counsel will assume added pressures, with a higher emphasis on preventing frauds. Below are some tips on staying safe.

Independent directors

Appointment and evaluation: Establish a nomination committee comprised solely of independent directors or a majority of the independent directors and give them the

powers to appoint the board and evaluate its performance. Evaluating the performance of independent directors is critical. While it's not a mandatory requirement under the extant corporate governance regime, it would be sensible. Evaluation by a peer group comprising the entire board, (excluding the director being evaluated) may be considered.

Tenure: There should be a fixed tenure beyond which an independent director should

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not be associated with a company. While an aggregate limit of nine years has been prescribed under Clause 49 VII (ii) of the equity listing agreement, such a requirement is not mandatory.

Remuneration: Pecuniary payouts to an independent director in Indian companies are usually incommensurate with the onerous role that they are expected to perform. Adequate remuneration may ensure that the directors discharge their duty with care and diligence, rather just playing an ornamental role in the organization.

Proactive boards: The agenda of each board meeting must be prepared with consensus of the independent directors and must be mandatorily required to be circulated to each director well in advance so that board members have access to information.

Independent meetings: Independent directors should meet separately without any member of the management to discuss the affairs of the company. This will help them decide on matters without being euphemistically ‘guided’ by the management. In the Satyam case, most of the directors believed that the decision to acquire Maytas companies would need shareholder approval as well, which was clearly not the case.

Auditors

Compulsory rotation of auditors: Though there are views that periodic rotation of the audit firm may be enough to break the collusive links between company and auditors. The alternatives to rotation are joint audits, rotation of managing partners, harsh pen-

alties for collusion and regulation that will make it difficult for companies to sack auditors who insist on qualifying fudged accounts.

Joint audits: A joint audit is an audit on a legal entity by two or more auditors to produce a single audit report, thereby sharing responsibility for the audit. The work allocation may be rotated after a set number of years to mitigate the risk of over-familiarity. Work performed by each auditor

is reviewed by the other, in most cases by exchanging audit summary reports. The flipside to this is the increased cost because of excessive time spent by both the audit team.

Public companies accounts oversight board (PCAOB): In the US, PCAOB, an independent body oversees the audits of public firms. A similar supervisory structure may be mandated for Indian audits as well as ICAI is not vested with such powers.

Risk management

Companies need to devise a strong risk management framework to systematically manage and regularly review the risk profile at a strategic, operational and functional level.

Conglomerate policy: Companies operating under the jurisdiction of one or more regulators and those with a significant presence in their business segments should have a group conglomerate policy. This would ensure reliable, timely and comprehensive management information systems, help introduce scientific risk management systems and practices, ensure proper disclosures of risk concentrations for the multiple regulators.

Whistleblower policy: While a few corporations in India have a whistleblower policy ingrained in their model code of conduct, such provisions should be mandatory for all listed companies to encourage transparency.

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