Case 6-9 Satyam: India’s Enron

Satyam Computer Services, now Mahindra Satyam, is an India-based global business and information technology services company that specializes in consulting, systems integration, and outsourcing solutions. The company was the fourth-largest software exporter in India until January 2009, when the CEO and cofounder, Ramalinga Raju, confessed to inflating the company’s profits and cash reserves over an eight-year period. The accounting fraud at Satyam involved dual accounting books, more than 7,000 forged invoices, and dozens of fake bank statements. The total amount of losses was Rs (rupees) 50 billion (equal to about $1.04 billion). This represented about 94 percent of the company’s cash and cash equivalents. The global scope of Satyam’s fraud led to the labeling of it as “India’s Enron.” Ironically, the name “Satyam” is derived from the Sanskrit word satya, which translates to “truth.”

Although headquartered in Hyderabad, India, Satyam’s stock was listed on the NYSE since 2001. When the news of the fraud broke, Satyam’s stock declined almost 90 percent in value on both the U.S. and Indian stock exchanges. Several top managers either resigned or were fired and jail terms were given to Raju, the co-founder and CEO, and Sirinivas Vadlamani, the CFO. The auditors—PricewaterhouseCoopers (PwC)—were also implicated in the fraud.

Fraudulent Actions by Raju

Raju stepped down in early January 2009, admitting to falsifying financial figures of the company with respect to nonexistent cash and bank balances. Stunning his well-wishers and investors, Raju revealed the real motive behind the December 16 bid to acquire Maytas companies for $1.6 billion: to swap the fictitious cash reserves of Satyam built over years with the Maytas assets. Raju thought that the payments to Maytas could be delayed once Satyam’s problem was solved. What had started as a marginal gap between actual operating profit and the one reflected in the books continued to grow over the years. It had attained unmanageable proportions as the size of the company’s operations grew over the years. One lie led to another. The problem further worsened as the company had to carry additional resources and assets to justify a higher level of operations, leading to increased costs.

As things got out of hand, Raju was forced to raise Rs 1.23 billion (approximately $25.58 million) more by pledging the family-owned shares to keep the operations going. His woes were compounded with amounts due to vendors, fleet operators, and construction companies. The offloading of the pledged shares by IL&FS Trust Company, a Mumbai-based financial institution, and others brought down the promoters’ stake from 8.65 percent to a fragile 3.6 percent. By the end of the day, Raju was left facing charges from several sides. The Ministry of Corporate Affairs, the state government, and the market regulator, SEBI, decided to probe the affairs of the company and Raju’s role, as well as corporate governance issues.

Going by his confessional statement to the board of Satyam in January 2009, what Raju had done over the years appears to be rather simple manipulation of revenues and earnings to show a superior performance than what was actually the case. For this, he resorted to the time-tested practice of creating fictitious billings for services that Page 398were never rendered. The offset was either an inflation of receivables or the cash in bank balance. The following is a summary of the way financial statement amounts were manipulated:

94 percent (Rs 5.04 billion/approximately $10.5 million) of the cash in bank account balance in the September 30, 2008, balance sheet was inflated, due largely to exaggerated profits and fictitious assets.

An accrued interest of Rs 376 million (approximately $7.82 million) was nonexistent.

An understated liability of Rs 1.23 billion (approximately $25.58 million) resulting from Raju’s infusion of personal funds into the company was recorded as revenue.

Inflated revenues of Rs 588 million (approximately $12.23 million) went straight to the bottom line.

Acquisition of Maytas Properties and Maytas Infrastructure

In December 2008, Raju tried to buy two firms owned by his sons, Maytas Properties and Maytas Infrastructure (Satyam spelled backward is Maytas) for $1.6 billion. Raju tried to justify the purchase by stating that the company needed to diversify by incorporating the infrastructure market to augment its software market. However, many investors thought that the purchases of two firms were intended to line the pockets of the Raju family. Raju owned less than 10 percent of Satyam, whereas Raju’s family owned 100 percent of the equity in Maytas Properties and about 40 percent of Maytas Infrastructure. Stock prices plunged dramatically after the announcement, so Raju rescinded his offer to buy the two companies.

With the prices of Satyam stock and the health of the company declining, four members of the board of directors of Satyam resigned within one month. In his confession, Raju took full responsibility for the accounting fraud and stated that the board knew nothing about the manipulation of financial statements. He indicated a willingness to accept the legal consequences of his actions.

An important question is how independently did the “independent” directors of Satyam act in the now highly questioned and failed decision to acquire the Maytas companies? One board member, M. Rammohan Rao, dean of the prestigious Indian School of Business (ISB) with campuses in Hyderabad and Mohali, claimed that the board had taken an independent view and raised concerns about the unrelated diversification, valuation, and other issues. Two views emerged. The first was, why not stick to our core competencies and why venture into a risky proposition? The second issue was related to the valuation of the companies. Maytas Properties was valued much higher than $1.3 billion, the amount that Satyam’s management came up with for the acquisition price. When asked whether the fact that the target companies—Maytas Properties and Maytas Infrastructure—were led by Raju’s two sons made any difference to the board, Rao said, “We felt the valuation proposed by the Satyam management was lower and conservative, despite the family ties. We took an independent view on this.”1

When asked if the board had taken into consideration the possible impact of the purchase of the two companies on shareholders’ interests and the market reaction, the ISB dean responded, “There were concerns on these grounds as well, especially the market reaction for such an unrelated diversification.” However, according to Rao, there was no way that they could gauge the market reaction at first, so they decided to take a risk. But the way the market reacted was a bit unanticipated, he added.

Questions can be raised about corporate governance with respect to the failed acquisition of the Maytas companies. A conflict of interest arose when Satyam’s board agreed to invest $1.6 billion to acquire a 100 percent stake in Maytas Properties and a 51 percent stake in Maytas Infrastructure. The Raju family, which ran the Maytas companies, also invited family or close friends to serve on the board of directors. These bonds created independence issues and questions about whether directors would be confrontational with top management when warranted.

Litigation in the United States

Securities fraud class action lawsuits were filed on behalf of a class of persons and entities who purchased or acquired the American Depositary Shares (ADSs)1 of Satyam on the NYSE and/or were investors residing in the United States who purchased or acquired Satyam common stock traded on Indian exchanges between January 6, 2004, and January 6, 2009 (the class period).

Page 399The complaint alleged that Satyam, certain of its directors and officers, and the company’s outside auditors (PwC) made false and misleading public statements regarding Satyam’s financial condition and performance, which artificially inflated the stock price. On January 7, 2009, Satyam’s chair, Ramalinga Raju, sent a letter to the company’s board confessing to a massive accounting fraud. Raju admitted that the company’s balance sheet and other public disclosures contained numerous false statements. For example, Raju wrote that, as of September 30, 2008, the company overstated revenue by approximately 22 percent and reported cash and bank balances of Rs 53.61 billion (approximately $1.1 billion), of which Rs 50.4 billion (over $1 billion) did not exist.2

Reports issued since the January 7 confession indicate that Raju likely understated the scope of the fraud, and that he and members of his family engaged in widespread theft of Satyam’s funds through a complex web of intermediary entities.

The complaint also asserted claims against PricewaterhouseCoopers International Ltd. and its Indian partners and affiliates including Price Waterhouse Bangalore, PricewaterhouseCoopers Private Limited, and Lovelock & Lewes (PW India firms). Satyam’s outside auditors from the PW India firms were aware of the fraud but still certified the company’s financial statements as accurate. A document (the charge sheet) filed in a Hyderabad court by the Indian Central Bureau of Investigation (the equivalent of the U.S. Federal Bureau of Investigation), detailing charges against numerous Satyam employees and two partners of PW India firms, alleged that the auditors received documentation from Satyam’s banks that showed that the company’s disclosed assets were greatly overstated. The charge sheet further alleged that these auditors received fees from Satyam that were exorbitantly higher than the fees similarly situated Indian companies paid to their outside auditors; the Central Bureau of Investigation cited these fees as evidence of a “well-knit criminal conspiracy” between Satyam and the auditors.

The complaint asserted claims against other defendants as well. In particular, the complaint alleged that members of the audit committee of the Satyam board of directors—who were responsible for overseeing the integrity of the company’s financial statements, the performance and compensation of the outside auditors from PW India firms, and the adequacy and effectiveness of internal accounting and financial controls—were responsible for the publication of false and misleading public statements due to their extreme recklessness in discharging their duties and their resulting failure to discover and prevent the massive accounting fraud. The complaint also alleged that Maytas Infrastructure and Maytas Properties and Raju’s two sons were responsible for the false and misleading public statements. The Raju sons’ false and misleading statements concerning Satyam’s financial condition and performance artificially inflated the prices of the company’s publicly traded securities during the class period, and caused significant damages to investors when the prices of the company’s securities both in the United States and in India experienced severe declines as a direct result of disclosures regarding Satyam’s true condition.

Actions Against PwC

PwC and its Indian affiliates initially hid behind “client confidentiality” and stated that it was “examining the contents of the statement.” Realizing that this was not enough, PwC came up with a second statement claiming that “the audits were conducted in accordance with applicable auditing standards and were supported by appropriate audit evidence.” This is somewhat troublesome because an audit in accordance with generally accepted auditing standards (GAAS) calls for examining the contents of the financial statements. Given that the firm did not identify the financial wrongdoing at Satyam, it would appear that the firm, at the very least, was guilty of professional negligence as follows.

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Fictitious invoices with customers were recorded as genuine.

Raju recorded a fictional interest credit as income.

The auditors didn’t ask for a statement of confirmation of balance from banks (for cash balances) and debtors (for receivables), a basic procedure in an audit.

On January 24, 2009, Indian police arrested two partners of the Indian arm of PwC on charges of criminal conspiracy and cheating in connection with the fraud investigation at Satyam. Furious Indian investors had pressured the authorities to take such an action in light of the more than $1 billion fraud. Investors couldn’t understand how a reported $1 billion in cash was really only $78 million, and how it wasn’t detected by PwC. The company’s financial statements were signed off by PwC on March 31, 2008.3