

Satyam's long shadow and the future of corporate governance in India

Corporate India has finally come of age, though not because one of its leading companies has recently completed a spectacular mega-deal. Instead, the country's business environment is now under a microscope because of Satyam Computers, which recently hit the headlines for committing India's largest-ever corporate fraud, an event many are calling 'India's Enron'.

The country's information technology (IT) export sector is currently worth around \$40 billion and, as the most visible element of a 'new economy', is also the poster child for the Indian growth story. As such, news of the \$1.47 billion fraud perpetrated by its fourth-largest IT services firm surprised even cynical observers. Satyam was supposed to be a modern company that symbolised India's liberalised face – professional, meritocratic and entrepreneurial – not like the old family-run conglomerates, comprising myriad subsidiaries and labyrinthine ownership structures. It had listed successfully on two international bourses and boasted clients such as GE, Nestlé, Sony and Ford. As recently as Q2 2008, operating profits were stated to be \$137 million. Yet, this whole picture unravelled in less than two weeks.

The fraud ran as follows: Satyam's balance sheet for September 2008 showed cash balances of about \$1.1 billion which never existed, as well as revenue numbers that had been inflated by \$122 million. Its operating margins, which were actually at around \$13 million, had been exaggerated to \$135 million. Worse, B. Ramalinga Raju, Satyam's founder-chairman, admitted that this book-cooking had been going



on for years, right under the noses of India's corporate regulators, as

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well as Satyam's own bankers and auditors. The sheer magnitude and seeming effortlessness of the fraud to which Raju has confessed calls into question India's corporate governance norms. After all, the country's standards were at one point ranked third in the region by the Asian Corporate Governance Association.

Satyam's importance to India has three core elements. First, as a company that employs 53,000 people – most of whom are reasonably affluent and politically savvy – the government can ill afford to see them lose their jobs mere weeks ahead of a general election. Second, IT is the most visible sector

of India's economic 'miracle' and the Satyam fraud threatens to reflect on the entire sector. Finally, the IT boom has led to the development of an urban economic ecosystem, underpinned by real estate and an organised service sector; that cannot be allowed to collapse in the midst of a general economic slowdown and an impending election.

IT is, after all, the sector that has produced some of India's fastest-growing companies, such as Infosys, TCS and Wipro. But more critically, it is these very companies and some second tier competitors (in terms of size) like I-flex and Mindtree Consulting that have provided the industry with the appearance of clean, highly professional and transparent corporate structures, all of which are now in danger of being turned on their head. But the Indian IT sector is putting up a confident face, at least so far. One of the incoming government-appointed Satyam directors told us, 'While some of Satyam's customers might be looking at other vendors, they are still looking at vendors in India and that is a vote of confidence.'

The ramifications of the Satyam fraud investigation will almost certainly impact upon not just India's IT industry, but also investor confidence towards India more generally. A veteran business analyst advised us, 'What happens next is going to affect the confidence aspect of investors looking at India. The question to be asked is whether this is a one-off or a systemic failure.' If such a fraud could continue undetected for so many years, it casts considerable doubt upon the company's auditors at PricewaterhouseCoopers, its banks (some of India's leading lenders), its board, its senior management, and of course, regulatory agencies. But while admitting there could well be loopholes in the regulatory area, most observers would still like to see Satyam as an outlier or a 'bad apple'. A senior Indian bureaucrat involved in the IT sector tells us, 'Many people might now be saying that our governance norms aren't the best, but there are checks and balances and one Satyam does not mean it is all rotten. And if there is scope for mending something,



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is scope for mending something, the government will ensure it gets done.'

In this context, the Indian government's prompt reaction to the fraud should be seen as a confidence-building measure, to show decisiveness and resolve in the face of a potentially significant embarrassment. It has appointed a six-member board of directors for Satyam, comprising some of India's most well-respected business leaders, and the appointment of a new CEO is also on the cards. Raju has been arrested and investigations into him and his family are well underway.

To shore up Satyam's balance sheet after investors pulled out of the company's shares (its market capitalisation is currently at about \$500 million, down from \$7 billion last summer), the government is considering a loan to service working capital requirements and ensure that Satyam's clients, employees and shareholders are not left out in the cold. However, an outright bailout has been rejected by the government. The objective is to normalise the situation to the extent possible before making a call on what next to do with the company, whether sell it off whole or attempt to break it up.

Given the magnitude of the stakes involved, individuals close to developments are attempting to strike a tone of balance and moderation. One of the incoming board-members told us that, as far as the fallout from this scandal is concerned, the wider effect should be marginal. He said, 'at most, companies will certainly and very rightly look into details closer and do more due diligence before going into a contract. But beyond that it won't be an issue.'

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There are already indications that this may well be the case: several Chief Information Officers of international companies, buoyed by the government's robust response, have indicated that they will be more careful in choosing their IT vendors, but will not stop looking at opportunities in India.

Indian companies themselves are gearing up to face closer regulatory scrutiny. The Securities and Exchange Board of India is already investigating the clause

that currently governs the writ of independent directors on company boards to assess whether rules can be tightened. Markets will be watching these regulatory developments closely before fully discounting the impact of the fraud.

The developments at Satyam – and Wipro, another IT major which was recently banned from participating in World Bank tenders for providing IT services – could not have come at a worse time for the sector. Exposure to the sharply declining fortunes of global financial companies was dampening sentiment, even before the Satyam and Wipro scandals broke. The fall-off in confidence threatens more than short-term earnings: it severely undermines the image of information technology as the most dynamic and well-managed sector in India's trillion-dollar economy.

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