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CORPORATE GOVERNANCE FAILURE AT SATYAM COMPUTER SERVICES

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Abstract

"It was like riding a tiger, not knowing how to get off without being eaten," stated B. Ramalinga Raju, the Chief Executive Officer of Satyam Computer Services, in his letter to the Company's Board of Directors after he revealed significant material misstatements in their financial statements (Raju). Raju's statement illustrates the trap that top executives get into when they are trying to cover up a fraud. In situations like these, it is imperative to have a committed and independent board of directors that is dedicated to promoting good Corporate Governance. However, this needed foundation for good Corporate Governance was not in place at Satyam. The Satyam fraud case illustrates the growing disregard for Corporate Governance and how companies in rapidly emerging markets are pressured to continue their unattainable growth. This paper provides the principles for sound Corporate Governance, then enumerates the Corporate Governance failure at Satyam Computer Services, and concludes by providing suggestions for effective Corporate Governance.

Corporate Governance

Corporate Governance is defined by the Securities and Exchange Commission and the Insurance Commission as "a system whereby shareholders, creditors and other stakeholders of a corporation ensure that management enhances the value of the corporation as it competes in an increasingly global market place" (Espiritu S1/4). Another definition that directly links Corporate Governance to the maximization of shareholder value is seen in the Malaysian Finance Committee's Code: "The process and structure used to direct and manage the affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value whilst taking into account the interest of other stakeholders" (Espiritu S1/4). Both these definitions stress the importance of the management's role in enhancing a company's shareholder value while keeping in mind the well-being of all outside parties that are affected by that company. Generally, the group responsible for maintaining good Corporate Governance is a company's Board of Directors. The members of a company's Board of Directors are typically appointed to their positions through voting by that company's shareholders in a General Assembly. As the Apex Body that sets the tone for the organization, the Board of Directors must work towards achieving the goals set forth in these definitions no matter what the political and economic situations are.

Many factors contribute to the composition of a strong Board of Directors that will ensure good Corporate Governance. The first important feature is the size of the Board. There is no predetermined number that is right for every company. Rather each corporation must assess its needs and find a balance in size that works for them. Despite there not being a precise number of needed directors, there is somewhat of a minimum and maximum limit. A Board of Directors with a very small number of members poses the risk of not being diverse enough intellectually and demographically to be able to assess issues from different perspectives. On the other hand, a

Board with too many members might achieve this desired diversity but this high attendance would slow down the decision-making process. The ideal size of a Board would range somewhere between eight and eleven members, taking into consideration the size of the organization and the industry in which it is involved. Companies should review their Board's size when their numbers go below eight or above eleven.

A good Board of Directors must also possess effective and diverse competencies. Members need to have a "good mix of general business background and specialist skills" (Teen). Additionally, directors must possess an understanding of the industry that their organization operates in and a familiarity with other industries that have close ties to their dominant business. All directors do not have to be experts in every industry. Rather, having a mix of members with expertise in varying skills and industries will provide a diverse understanding of the marketplace that their business operates in.

Another attribute of a strong Board of Directors relates to the professional characteristic of its members and their motivation to take their duties seriously. Elected Directors must accept their duties with an understanding of the amount of work and time that is required to fulfill these duties. In addition, members must have an interest and a desire to successfully perform at their position. Board members should not see these elected positions as solely résumé –builders in order to further themselves along in their careers. Rather, Directors should join a Board, with full awareness of their responsibilities, and in the process, their careers will progress due to their work ethic and success at the company. Mark Yen Teen, the Co-Director of the Corporate Governance and Financial Reporting Centre at the National University of Singapore, believes that shareholders should appoint "people who know what they do not know and seek to fill those gaps through continuous learning, and people who are able to accept different views and debate robustly without getting personal" (Teen). Directors must not be content with their current knowledge base, but rather, they must strive to learn more everyday in order to help their corporation find continued success every day. Similarly, members must be open-minded to the perspectives of other directors and contribute with their ideas to create strategies that are best for the business.

Along with having diverse competencies, a high-quality Board of Directors should also incorporate diversity in the demographics of its members. This can be achieved by electing people "from different backgrounds, different gender, different races and nationality, and the like" (Teen). While achieving a broad mix of personalities is important, companies must first consider the intelligence and seriousness of each candidate. Too often, shareholders vote individuals onto their Board solely based on the title of their occupation or what country they are from without finding out if that person possesses the qualities that are needed to steer their company in the right direction. Once someone, who is not fit for the job, is elected to the Board of Directors, it is often quite difficult to remove him. Directors may be removed by the shareholders' vote in a General Body Meeting or by a decision of other directors. However, majority of directors' contracts include clauses that entitle them to compensation if removed from their position. This compensation clause discourages the company from removing a member from the Board in a casual manner.

Putting together a Board of Directors with these aforementioned characteristics is an important process, but these boards must also operationalise their mission set for them in their organization's mission statement. A Board has the following functions: "Strategic guidance, risk management, audit, nomination, compensation, performance evaluation, and capability building. The Board must carry out these functions with fairness, accountability, transparency, and competence" (Espiritu S1/4). Boards are responsible for organizing forecasts for their company and presenting ideas on how to achieve those goals. Moreover, boards must be competent enough to foresee potential risks in the industry that could affect their company and put in place controls to minimize those risks. When risks arise that were unforeseeable, directors must be able to quickly handle those threats so that the impact on the company is minimized. Boards are required to set up an Audit Committee which is responsible for overseeing the financial reporting process, hiring and overseeing the performance of external auditors, monitoring the internal control and internal audit functions, and examining the accounting practices that are used. In addition, boards are responsible for nominating new members, setting compensation packages for management, evaluating the performance of management, and exploring all opportunities that could lead to maximization of value for shareholders. While all of these responsibilities are important, it is imperative that boards ensure that they are accomplishing these duties within Government and Regulatory Directions. Companies, in the past, have lost focus on complying with the law and have maximized shareholder wealth through illegal means. In the end, however, businesses that operate in this manner eventually collapse, resulting in significant financial loss for all stakeholders, legal consequences, and sizeable economic impacts.

Corporate Governance Failure at Satyam Computer Services

Satyam Computer Services Ltd. was initially incorporated as a Private Limited Company in 1987 by B. Ramalinga Raju and one of his brothers-in-law, DVS Raju. B. Ramalinga Raju studied at Ohio University where he received a Masters in Business Administration. He also attended the Advanced Management Program at the Harvard Business School. After working in several different industries, Raju decided to venture into the information technology sector through the creation of Satyam whose initial intent was to secure contracts for IT projects. In 1991, Satyam was recognized as a Public Limited Company, and then the company went public in 1992. Since their public listing, Satyam quickly grew to having a global presence in the information technology industry and by 2005, they were "serving over 144 Fortune 500 and over 390 multinational corporations". From 2001-2004, Satyam expanded their operations by founding Satyam Business Process Outsourcing (BPO) which assists their clients by providing outsourcing services to help eliminate unnecessary costs. Overall, Satyam "offers a range of services, including consulting, systems design, software development, system integration, and application maintenance" .The company's Headquarters is located in Hyderabad, India and as the company developed, the number of employees grew from only twenty in 1987 to around 53,000 in 2009.

Accompanying Satyam's rapid expansion was a similar growth in their financial figures over the years. When the company entered into the Bombay Stock Exchange in 1991, their initial public offering was oversubscribed seventeen times, illustrating the immense demand for their stock early on in Satyam's operations. By the time the corporation had expanded world-wide, their financials were still showing immense signs of success. For the year ending March 31, 2008, "Satyam reported $2.1-billion in sales and $427.55-million in profit," representing "a growth of 48 per cent in revenue and 35.5 per cent in profit from the year before" (Sheth B8). Because of their continued success, the company and its management received numerous awards for their innovation in technology and Corporate Governance. B. Ramalinga Raju was awarded the Ernst & Young (India) Entrepreneur of the Year Award in both 1999 and 2007. Satyam was awarded the 2008 Golden Peacock Award for Corporate Governance, given by the World Council on Corporate Governance (Razak). The Golden Peacock Award is a highly sought after achievement given to top Indian companies that demonstrate business excellence in their industries.

Seen through their growing financial figures and numerous awards, Satyam appeared to be the model corporation until on January 7, 2009, when B. Ramalinga Raju wrote a letter to Satyam's Board of Directors, stating that:

1. The balance sheet carries as of September 30, 2008
   a. Inflated (non-existent) cash and bank balances of Rs. 5,040 crore [US$1,066 million] as against Rs. 5,361 crore [US$1,134 million] reflected in the books
   b. An accrued interest of Rs. 376 crore [US$79.5 million] which is non-existent
   c. An understated liability of Rs. 1,230 crore [US$260 million] on account of funds arranged by me.
   d. An overstated debtors position of Rs. 490 crore [US$103 million] as against Rs. 2,651 [US$560 million] reflected in the books
2. For the September quarter (Q2), we reported a revenue of Rs. 2,700 crore [US$571 million] and an operating margin of Rs. 649 crore [US$137 million] (24 per cent of revenues) as against the actual revenues of Rs. 2,112 crore [US$446.8 million] and an actual operating margin of Rs. 61 crore [US$12.9 million] (3 per cent of revenues). This has resulted in artificial cash and bank balances going up by Rs. 588 crore [US$124 million] in Q2 alone. (Raju)

For financial conversion purposes, Rs is the abbreviation for India's currency, the Indian Rupee, and a crore is an Indian numbering unit equal to ten million. The exchange rate used for conversion was the rate on September 30, 2008, the date of the financial statements, of 0.021160 Rs to USD. Raju's revelation shocked the Indian economy and had similar effects on the global economy as Satyam was listed on multiple stock exchanges around the world. However, this fraud could have been prevented if there had been a better Corporate Governance Structure within Satyam.

Multiple events, leading up to Raju's statement, occurred that should have caused a closer investigation of the financial status of the company. The first incident happened, on December 16, 2008, when Satyam announced their acquisition proposal of two companies, Maytas Properties Ltd and Maytas Infra Ltd (Sheth B8). This plan valued the two companies together at $1.6 billion. The problem with this plan was that these two companies were owned by two of Raju's sons, Raju had a stake in the companies, and the companies were involved with property development. This proposed acquisition should have raised red flags as to why an information technology-based corporation was trying to acquire two companies outside its realm of operations and this obvious case of nepotism should have alerted the Directors. This proposal was Raju's attempt to obtain actual assets in order to replace Satyam's fictitious asset numbers and Directors acquiesced in this fraud. However, despite these concerns, Satyam's Board of Directors still approved this acquisition, which was abandoned only a few hours after the approval because shareholders raised objections to it. Another event that should have raised suspicions occurred in December of 2008 when the World Bank barred Satyam from doing "business at the [World Bank] for eight years for 'improper benefits to bank staff' and 'lack of documentation on invoices'" (Sheth B8). Satyam had maintained all the software for the World Bank, serving as one of Satyam's largest clients. This severe punishment raises concern about the ethical tone of the organization.

The composition of Satyam's Board of Directors also draws attention to the question, whether or not the members were really appointed to be a Governing Body over the company. The size of the board did not appear to be too small or large as it was composed of six independent directors along with other directors from the company (Muhuideen). The real issue relates to whether or not the independent directors were the right people for the job. Satyam adopted the mindset of appointing people to their board based on their titles. One member of the board is the Associate Dean at the Harvard Business School, while another member was the Dean at the Indian School of Business (Teen). Placing together highly intelligent people, with their reputations on the line, can impede the Board's responsibilities because they might not have the courage to express their concerns about certain issues because this could tarnish their respectable status. Additionally, appointing a Board like this "can give a false sense of security to investors or even auditors" because these stakeholders might be compelled to agree with the company solely because of the status of their board's members instead of digging deep into the problems further (Teen).

Satyam failed to achieve diversity in demographics which, in the end, resulted in failure to attain a diverse set of competencies. While the board members included an innovator and a political figure, the independent directors were primarily Professors. Additionally, all the members were from India. Even though Satyam was an India-based company, appointing directors from different countries would have brought different perspectives to the table. Along the same lines, only one of the independent directors was a female. All these factors created a single-minded setting that was not beneficial in the attempt to provide good Corporate Governance. Another issue that could have possibly helped avoid this fraud was that Raju served as both the Chairman of the Board and the Chief Executive Officer of Satyam. Placing an independent figure as the Chairman and taking some of the power away from Raju would have created a more independent decision-making environment.

These aforementioned factors, that contributed to the improper composition of Satyam's Board of Directors, had a first-hand effect on the failure of the audit process. The Audit Committee is responsible for overseeing the financial reporting process as well as monitoring the internal and external audits. The four members of the Board, who were appointed to the Audit Committee, either were not competent enough for their position or were aware of the fraud that was occurring because the financial statements were materially misstated since 2000. While Satyam bears much of the blame for this audit failure, Satyam's external auditors, Pricewaterhouse Coopers India, is responsible as well. On the topic of PwC's performance, the President of India's Institute of Chartered Accountants, the Industry Regulator, stated that "either 'the auditor has been negligent' or 'the auditor was aware and intentionally overlooked it'" (Razak). PwC clearly did not independently work enough to provide a reasonable assurance of the financial statements, seen by the amount of time that these material misstatements existed on the books.

Following B. Ramalinga Raju's revelation of the fraud, many remedial measures have taken place. The Central Government barred the current Board of Directors and appointed ten nominal directors. The Minister for Corporate Affairs, Prem Chand Gupta stated that "the current board of Satyam has failed to do what they were supposed to do" (Dolnick). PwC stepped down from their duties while the auditing firms of KPMG and Deloitte Touche Tohmatsu were brought in to perform a forensic investigation of Satyam's misstatements. In terms of the continued existence of Satyam's operations, Tech Mahindra, an information technology service provider, offered approximately 17.6 billion Indian Rupees (US $354 million) for a 31% stake in Satyam ("Tech Mahindra"). This bid was selected by the new Board of Directors on April 13, 2009, and on June 21, 2009, a new corporate identity, "Mahindra Satyam," was released in an effort to combine the strengths of both Tech Mahindra and Satyam and to separate themselves from the fraud case.

Along with these efforts to correct the situation, there were also many consequences that have taken place. The company's stock price, which had peaked right above US$29 in 2008, plummeted to a closing price of US$1.07 on January 22, 2009, causing investors to lose almost all their investments. This drop signifies the loss of confidence in Satyam and the difficult road ahead for Mahindra Satyam as they move forward. On April 7, 2009, India's Central Bureau of Investigation finished their investigation of the case and proceeded to charge "six people from Satyam Computer Services, two suspended auditors from PricewaterhouseCoopers and an outside adviser with 'criminal conspiracy, cheating, cheating by personification, forgery of valuable security, forgery for the purpose of cheating, using a forged document as genuine, falsification of accounts and for causing disappearance of evidence'" (Timmons). The Satyam employees who were charged, included the two founders, the former Chief Financial Officer, and three finance employees. Based on these charges, the Institute of Chartered Accountants of India has found two Satyam executives and four PwC auditors guilty of misconduct. One of the Satyam executives is the former CFO of Satyam, Srinavas Vadlamani ("ICAI"). Additionally, the 2007 Ernst & Young (India) Entrepreneur of the Year Award and the 2008 Golden Peacock Award were revoked after the news of the fraud was released. Since Raju's revelation, the image of PwC has been tarnished, causing financial troubles for them as some clients changed auditors after their year-end because of this lack of trust. The major consequence that Satyam's fraud had was on the confidence of the consumers in the Indian market, mainly in the information technology sector. India's IT sector had shown significant growth and achievements, serving as one of the country's most promising markets. Satyam's fraud stunted this expansion and it is causing shareholders to rethink their investments.

Conclusion

"Whoever commits a fraud is guilty not only of the particular injury to him who he deceives, but of the diminution of that confidence which constitutes not only the ease but the existence of society," stated Samuel Johnson, a famous English author and moralist ("Quotes"). Johnson's statement further illustrates the impact that fraud has on not only the perpetrators but also on society as a whole. In the economy today, there is a need for good Corporate Governance because of the lasting effects that a fraud can have on all stakeholders. Unfortunately, corporations have become more interested in meeting their financial forecasts than with complying with their Corporate Governance Policies. Businesses need to reassess their strategies to ensure that they are achieving their financial figures through legal and transparent means. The first step to doing this is by taking a closer look at who companies are placing on their Board of Directors, since they are the ones who are directly responsible for good Corporate Governance. Businesses must ensure that their directors are committed to serving as independent advisors who are willing to stand up for what is right. Companies need to recognize all the negative consequences that a potential fraud would have and start operating responsibly to help bring confidence back to the marketplace.

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