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The Satyam Fiasco – Impact on Corporate India

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Following the revelations of fraud and misdemeanour in the financial accounts of Satyam Computers, a public-listed company with over 50,000 employees and a market leader in the Indian information technology (IT) industry, the Indian Ministry of Company Affairs moved swiftly to replace the company's Board of Directors. Several investigations, regulatory as well as criminal, have been launched by different state and central agencies, and the promoter, Mr R. Raju, has been arrested. Three professionals, Mr Kiran Karnik, former head of the National Association of Software and Service Companies, the IT industry association, Mr Deepak Parikh, head of HDFC Bank and Mr C. Achuthan, a former member of the Securities and Exchange Board of India (SEBI), have been appointed as directors. The government has allowed this group to increase the number of directors further, as needed, up to 10 members in all.

The government used provisions under Section 388 (B to D) of the Companies Act to push its intent to appoint 10 nominees on the Satyam board. The section provides for a change of management in case the existing personnel are found to be guilty of fraud, malfeasance, persistent negligence or default in carrying out their obligations and functions under the law, or for breach of trust. The government can use the ground that the business is not being run in a prudent manner and the management can cause, or has caused damage to the business. Such a board is independent in nature and the appointment of a new Board of Directors does not mean government acquisition of the company.

It is a provision which is used as a last resort. The government's nominee-directors will have the powers to appoint new statutory auditors. The government is empowered to issue directives to the board. The nominee-directors are immuned to any prosecution and they are not subjected to the requirement that they hold any qualification shares or are liable to retire by rotation.

The supersession of a company's board does not automatically lead to the appointment of fresh directors. Under Section 408 of the Companies Act, the central government has the power to appoint a completely new board or appoint additional directors once approved by the Company Law Board (CLB). The directors can be appointed for a period of up to three

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years. Apart from the government, the CLB can ask for a change in the board if 10 percent of the shareholders seek its intervention on the grounds of oppression and mismanagement.

Satyam remains the biggest case of board supersession in corporate India. There have been instances of such supersession in the past, for example, CRB Capital and WH Bradey. In many cases, the government had only appointed nominee-directors and not superseded the board.

There was public pressure on the government to act after Mr Raju made public a letter to the regulators that he had not been truthful in reporting the performance of the company. The letter stated that its operating profits were overstated by an amount of 22 percent of its total revenues. Cash balances were also overstated and liabilities understated.

However, even the latest ‘confession’ may not represent the true picture. For example, the company’s operating margin of three percent now reported appears to be far below industry standards. The company’s September 2008 financials state that it had as many as 690 clients, suggesting a large number of small clients. It does not have many clients who are billed more than US$100 million a year. It has claimed that it specialises in enterprise-based solutions, where margins in the industry are close to 20 percent. The only explanation for the low revenues earned could be that Satyam was heavily discounting its services to its clients in order to secure orders and clients. The sizeable dressing up of both its revenues as well as financials makes it difficult to value Satyam as a business. However, even with a new Board in place, and investigations launched by SEBI, the Ministry of Corporate Affairs and the police, it would be difficult for Satyam to do ‘business as usual’. New clients may be difficult to come by, employees may look for alternatives and existing order books may vanish. Any merger or takeover would also have to take note of the class action suit in the United States as well as the suit by Upaid in the United Kingdom.

There are also issues relating to other companies linked to Satyam such as Maytas Estates and Maytas Infrastructure, and the inter-corporate investments. Some of these transactions would have to be written off, as the underlying cash is no longer in the business. Unraveling the transactions and the flow of funds is likely to take considerable time.

There are several key issues arising from the Satyam case. Firstly, the government has superseded the Board of Directors and has nominated three independent people to act as the new Board. The persons appointed are respected public figures and the market has reacted favourably to the names. However, there is concern that the government can, by notification, change the management of a publicly-listed company and remove the representatives of the shareholders by executive direction. In this particular case, though a criminal case has been registered, investigations are still going on and no formal charges have been laid. There is concern that the due process of management changeover has not been transparent. It is not clear whether this is an interim measure and that the shareholders would have their say in management. There would inevitably be concerns that such an exercise could be repeated for other private companies, given subjective justification for the government, a conclusion that would shy away investors to India.

Secondly, Mr Raju’s confessions and the subsequent processes have turned public attention away from two other major events associated with this company. One was that the company was debarred by the World Bank for a period of eight years from further contracts, due to unethical behaviour. The other is a suit filed by a United States company against the firm for

leaking out confidential data to competitors. Internationally, unethical behaviour and issues of trust and reliability are likely to weigh heavily on future seekers of services from this company. It is not surprising that the IT industry in India is calling it an isolated incident, for it would like to distance itself from Satyam's actions to limit collateral damage to the industry. At a time of a slowdown in outsourcing services, these concerns are likely to weigh on the minds of future clients of the company. WIPRO Technologies' recent disclosure that the World Bank had declared it ineligible for contracts for the period up to 2011, mainly due to some unethical practices, deepens the concern about Indian IT companies. There is likely to be much greater due diligence done by clients in the future before sensitive tasks are outsourced.

Thirdly, the investor community is likely to be worried about these developments. The financial markets have come to depend on foreign institutional investors to shore up equities and to give range and depth to markets. It is likely that these investors will become more cautious. In the trading days following the Satyam exposé, investors went back to shares where they had confidence in the management such as BHEL, Siemens, ITC and the like, and went away from the shares where they felt less confident about the results such as DLF, Unitech, IVRCL and India Bulls. The clear differentiation in the minds of the investors between the better managed companies and the others is visible in the market sentiments now.

There could be some welcomed developments arising out of the Satyam saga. Firstly, investors are likely to become more discerning and cautious, and hopefully, more demanding of transparency. Secondly, company managements are likely to be more diligent and demanding of auditors and more risk averse. These developments are likely to result in a more mature, objective and balanced evaluation of the performance of the companies, and the chase after fictitious valuations is likely to be dampened.

The next question relates to governance. It is clear that the management and the Board of Directors have been remiss and the auditors poor. Market leader, PricewaterhouseCoopers, has been the auditor of this company, while the valuation of Maytas Group was done by Ernst and Young, another international company. The confidence in the community of auditors is shaken. There is also concern that the Board of Directors was either misled or did not act with professional objectivity. There are big names in the Satyam Board but none of them saw through the machinations of the management – indeed a matter of worry.

The real question is whether this would have repercussions for the IT industry, for investments in India and, indeed, for the Indian economy. It is a fair comment that the open media, the habit of public debate and the firm underpinning of democratic institutions have been responsible for the considerable publicity for this incident. It is possible to argue that a similar event in a company in China would not have attracted a similar public attention – one has seen the way in which embarrassing situations arising out of the Bird Flu, the milk scandal and the like have been handled by the Chinese authorities. In other countries, barring the United States and a few other developed countries, the matter would have been much less under public glare.

This is perhaps a strength of the Indian system. It was public criticism and pressure that made the government act last week. It is the need to make accountability transparent that has ensured that all investigations are launched as soon as possible. Public behaviour in the financial markets points to aversion to such corporate behaviour. Finally, even if it is argued

that the levels of governance are low, the levels of public awareness have risen considerably, and there are several incidents in corporate management where the public has taken corporates to account.[1] There will be some churning. However, it is quite clear that there would be small damage to corporate India. More importantly, there would be more and more openness about disclosures and this would reflect in the prices of shares of these companies. Systemic damage is, therefore, likely to be short term.

The Satyam issue is a wake-up call for India. Although the systemic damage may be short term, India needs to look seriously at issues of transparency, accountability and governance if it wants to truly become the financial hub of Asia. The Indian regulatory institutions need to ensure that such an event does not recur. It is important that the auditors and the Board of Directors are held to account and pay the full penalty. At the same time, regulatory bodies such as the SEBI and the CLB need to take steps to become more pro-active and put in place better monitoring and supervision systems.

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[1] Recent cases of the Vedanta share offering and the Nagarjuna Finance misdemeanours, where public outcry stopped the management, come to mind.