

THE SATYAM COMPUTERS SCAM

Project Work – Professional Ethics

by

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Table of Contents

<i>Introduction</i>	<i>3</i>
<i>Case Findings / Facts of the Case</i>	<i>4</i>
<i>Current Verdict of the Case</i>	<i>6</i>
<i>Reforms in Laws & Regulations Post the Scam</i>	<i>8</i>
<i>Analysis of the Case</i>	<i>10</i>
<i>Recommendations</i>	<i>12</i>
<i>Conclusion</i>	<i>13</i>
<i>Sources</i>	<i>14</i>

Introduction

Strong financial reporting standards form the backbone of a thriving and healthy financial sector both domestically and around the world. However, deliberate misrepresentation of one's financial statements constitutes fraudulent financial reporting. It may include the falsification of accounts, deliberately breaking internationally recognized accounting standards, leaving out disclosures and transactions from financial statements. This form of fraud has been, and still always is a point of serious concern for investors and other stakeholders. Financial reporting frauds have also affected many organizations regardless of their size or industry. They have occurred in all regions and countries.

In 2009 in India, the Satyam Scam broke when their chairman and founder of Satyam Computers - Byrraju Ramalinga Raju confessed to the fact that the company's accounts had been tampered with and did not reflect a true and fair view of the company's financial standing. The scam is one of the biggest corporate frauds till date in India amounting to close to INR 13,000 crores.

Satyam Computers Services Limited, was at one point, a stalwart in the Indian IT industry. They offered engineering design, software development, system maintenance, and packaged software integration services. However, due to the gross financial crimes that were committed by their leadership, the company is now defunct. Therefore, this is a detailed case report of Satyam Computers, and the events that led to its downfall will be analysed.

Case Findings / Facts of the Case

Background

The Satyam Scam in essence was due to fraudulent auditing practices that even the auditors knew and took part in. Put simply, the senior management at Satyam, 'cooked' the company's books by overstating and inflating its revenues, and profit figures every single quarter for a period of 5 years, from 2003 all the way to 2008.

The company was founded in 1987 by B. Ramalinga Raju in Hyderabad, India, and a team of less than 20 workers. Ironically, the word 'Satyam' in Sanskrit means 'truth'. In a fairly short amount of time, Raju and his brother were able to take Satyam, which was fairly small at the time, to a company that got listed on the Bombay Stock Exchange in 1991, and had a presence in over 50 different countries around the globe. Furthermore, it was also one of the few companies that was recorded on the NY Stock Exchange as well. Over time, it also developed various other backup organizations such as Satyam Info Way etc., it was also working in collaboration with a lot of international organizations, it acquired several companies as well. All in all, Satyam had earned quite the name for itself and was well respected by its clients.

The Problems Surrounding Satyam

Problems within the company first began in December of 2008, when Ramalinga Raju shockingly made a \$1.6 billion offer for Maytas Infrastructure Ltd. and Maytas Properties Ltd., with the supposed reason that he had to send the money to aid financial specialists. However, the two aforementioned companies were owned by Raju's family, and this move was ultimately not given the nod and he was forced to withdraw within 12 hours due to market constraints. Later in the same month, the World Bank also made a statement that Satyam has been banished from doing business with the World Bank because they offered improper benefits to Bank staff and accused them of information burglary as well. These developments led to a decline in the value of the company.

The Big Reveal

Finally, in what was regarded by the general public as a massive shock, on the 7th of January in 2009, Raju declared in a letter that "He had been manipulating the company's accounting numbers for years." The company's assets on its balance sheet were overstated by \$1.47 billion. Approximately \$1.04 billion of this amount was in bank loans and cash that Satyam claimed to own but was actually non-existent. Liabilities on the balance sheet were also under-reported by Satyam and their income was overstated in nearly every single quarter over the course of multiple years all in a bit to meet the expectations of analysts. For instance, the company's October 2008 financial results were inflated: quarterly revenues by 75% and profits by a staggering 97%.

Various techniques were used to carry out the fraud, by both Raju and the company's global head of internal audit, including creating bank statements and using his personal computer to make the documents look like they were made by a real person. Balances that did not exist were shown on the balance sheet through falsified and inflated bank accounts. The income statement was also inflated as interest income was claimed from these fake bank accounts. Raju also later revealed that he had created an excess of 6,000 fake salary accounts over the last few years, whose funds he appropriated after money was deposited in them. The global head of internal audit that was mentioned earlier had also created fake customer identities and fake invoices were generated and these supposed customers to inflate revenues. This global

head had also illegally obtained loans for the company and had forged board resolutions too. It was also made apparent that the cash which was raised in the United States through American Depository Receipts never actually made it to the balance sheets. Investors, stakeholders, and the nation alike were left aghast as these events came to light.

The fiduciary relationship that Mr. Raju had with the company, as a promoter was also breached at various levels, and furthermore, the employment of several persons at different positions within Satyam was also affected. All of the above actions, at the time had led to an increase in the share price of Satyam Computers Service Limited (SCSL), which then led Raju to sell off as many shares as he could in order to make more money, but he still retained enough to still be a part of the company. This selling off of shares allowed Raju to profit greatly.

In the wake of these fraudulent financial reporting practices having been brought to light, Indian financial markets were shocked. The Sensex fell by more than 5%, with Satyam shares falling by more than 70%. SCSL was replaced by Reliance Capital in the Nifty, and the Bombay Stock Exchange also removed it from the Sensex, replacing it with Sun Pharma. Once Raju made the disclosures we just discussed in his letter, traders frantically sold with over 143 million shares changing hands and at the end of the trading day, Satyam finally closed at INR 39.95, down INR 139.15 per share in the BSE. The market value of the company was an estimated \$500 million – a shocking decrease from the \$7 billion valuation placed on it in June. Similarly, in the New York Stock Exchange, Satyam shares which were at one point trading at a high of \$29.10, were down to a mere \$1.80 in March of 2009. Investors lost approximately \$2.8 billion.

The damage that was done once the aforementioned actions came to light was irreparable and Raju had no choice but to confront the situation and deal with the consequences.

Current Verdict of the Case

An investigation was started immediately by the Indian Government into the matter. The first step that was taken was the appointment of a new Board of Directors at Satyam in an effort to salvage the company, with the goal to sell it in the next 3-4 months. In January of 2009 itself, the Securities and Exchange Board of India (SEBI), the regulatory body for securities and the commodity market in India, started with investigations under various regulations. SEBI falls under the jurisdiction of the Ministry of Finance. The Ministry of Corporate Affairs had also commenced with its own fraud investigation through its Serious Fraud Investigation Office. Moreover, the Ministry of Corporate Affairs had also filed a petition to the Company Law Board to prevent the existing set of Board of Directors from being able to appoint new directors of their own. On the 9th of January, only 2 days after Raju came clean, the current board of Satyam was suspended by the Company Law Board, and power was given to the Government to appoint up to 10 new “nominee” directors. As a result, a new 6 member Board appointed a new CEO, and external advisors as well. The accounting firms Deloitte and KPMG were also called upon to restate the accounts of Satyam.

A long and rigorous cycle of investigations ensued, and once the full picture was uncovered, charges were leveled against several groups of people that were involved with Satyam. The Indian authorities arrested Mr. Raju as well as B. Ramu Raju (his brother), its former managing director, its CFO, Srinivas Vadlamani, the company’s head of internal audit on criminal charges of fraud. The authorities also charged and arrested several of the company’s auditors (PwC) for fraud.

Charges of cheating, forgery, criminal conspiracy, inflating invoices and profits, breach of trust, faking accounts, and violating numerous income tax laws were leveled against the persons accused in the Satyam scam. The charges were so vast that the CBI had initially filed 3 separate charge sheets in the case, however these were all later clubbed into one single charge sheet which spanned a staggering 55,000 pages. An excess of 250 witnesses and 3000 documents were parsed over the 6 years that the case was open. Ultimately, on the 9th of April in 2015, a special CBI court, sentences B. Ramalinga Raju, his two brothers, and seven others to seven years in prison in the Satyam fraud case. A fine of INR 5 crore was also imposed by the court on Raju, and his brother who were the main conspirators, and a fine of 20-25 lakh on each of the other remaining accused. All in all, the 10 people that were finally found guilty in the case are: B. Ramalinga Raju; his brother and Satyam’s former managing director B. Rama Raju; former chief financial officer Vadlamani Srinivas; Satyam’s former internal chief auditor V.S. Prabhakar Gupta, Raju’s other brother, B Suryanarayana Raju; former employees (G. Ramakrishna, D. Venkatpathi Raju and Ch. Srisailam); and former PwC auditors Subramani Gopalakrishnan and T. Srinivas.

In addition to the verdict about, SEBI also ordered in 2014 that Mr. Raju and 4 other people will be barred from dealing in the financial markets for 14 years, and also asked for INR 1,849 crores which were unlawful gains with interest. Interest was also charged at a high 12% per annum rate from the date on which Raju made the initial confession. This amount was mandated to be deposited within 45 days from the date of the initial order. SEBI, along with the Securities Appellate Tribunal (SAT) acknowledged the actions as fraudulent under the Prohibition of Fraudulent and Unfair Trade Practices Act. However, SEBI in a fresh order in November of 2018, decreased the penalty amount to INR 813 crores.

Lastly, in the immediate aftermath, PwC had claimed initially that their failure to catch the fraud was only because of the reliance that they placed on the information that was provided by the management. Meaning that they accepted everything in blind faith. However, PwC was found guilty and its license was revoked temporarily for 2 years. Other investors also became wary of other companies that were audited by PwC too as their reports could not be trusted anymore.

Reforms in Laws & Regulations Post the Scam

Following a scam that was nicknamed ‘India’s Enron Scandal’, there were substantial changes that were made especially with respect to corporate governance in India. The scam sent shockwaves through the financial landscape and the country in general. However, at the same time, it highlighted several loopholes and grey areas in the Indian corporate governance structure. Fraudulent accounting, unethical conduct, insider trading, ineffectiveness of the Board, oversight by the auditors, failure of the independent directors, and the non-disclosure of material facts to the stakeholders are some of these loopholes.

Despite the fact that the persons convicted above are out on bail right now due to them appealing the decision and that appeal still being pending, a multitude of measures were taken by the government and the regulators to address these issues.

In 2009, a task force was set up by the Confederation of Indian Industries which was headed by former cabinet secretary Naresh Chandra to suggest reforms. Based on the recommendations from this task force, the MCA issues Voluntary Guidelines for Corporate Governance in 2009. The National Association of Software and Services Companies also established a governance and ethics committee headed by Narayana Murthy. This committee later suggested reforms pertaining to shareholder rights, audit committees and whistle-blower policies.

SEBI also took a host of actions in the aftermath of the scandal. Their committee on disclosure and accounting standards issued a discussion paper in 2009 to deliberate on the voluntary adoption of international financial reporting standards; the rotation of auditors every 5 years so that familiarity doesn’t lead to corporate malpractice and mismanagement; the appointment of CFOs by audit committees based on qualifications, experience, and background. Additionally, they also framed the SEBI Listing Obligations and Disclosure Requirements Regulations in 2015, which was applicable to all listed companies and made for stringent guidelines relating to reporting/disclosure of material events and actual and suspected fraud.

The Companies Act of 1956 was also repealed and amended into the new Companies Act 2013. The new Act brought in several measures that had the intention of benefiting the larger stakeholder community, with the resulting increase in compliance costs for the company. Most importantly, the Act states that corporate fraud is a criminal offense. The Act clearly defined the responsibility and accountability of the independent directors, and that of the auditors (both parties are expected to play a more active role than they previously were); a system of checks and balances was also introduced to ensure proper governance and management in the company; it also required companies to have a vigil mechanism and mandated a Directors’ Responsibility Statement to be a part of the Report of the Board of Directors. It also provided for the compulsory rotation of individual auditors after 5 years and audit firms after 10 years to rule out malpractice and financial oversight on anyone’s part and to ensure their independence; auditors were also required to report instances of fraud noticed by them during the performance of their duties now; the Institute of Chartered Accountants of India also came out with a guidance note on Reporting on Fraud in 2016; and lastly, the Act crucially put forward a strict framework for related party transactions.

The Serious Fraud Investigation Office mentioned previously was also given a statutory status and has recently been given the power to arrest. In the years since, they have been

investigating cases of corporate fraud more actively. However, there were a multitude of reasons which ultimately led to the downfall of Satyam, and that provided an environment where Raju could conduct business the way he did that will be analyzed next.

Analysis of the Case

It was greed for money, for power, for competition, and for success and prestige that led to Mr. Raju to act the way he did. Raju had an initial desire and love for owning land which was the first domino in my opinion. His attempted investment in Maytas is a prime example of this. Maytas incidentally just reads Satyam backwards, which just goes to show how much of a fanatic Raju actually was. It was so well executed that neither the analysts or auditors could figure it out for themselves until Raju came clean. The spark that started it all however was when he tried to merge Maytas with Satyam. When it broke, it took a period of 2 years and over a hundred experts for its scale and damage to be fully analyzed. Once his acquisition of the infrastructure company run by his sons failed in December of 2008, Raju himself confessed to the irregularities on his own and was arrested merely two days later. Raju was able to pull off this elaborate fraud because of multiple practices from maintaining records to fake invoices and bills.

Before Raju maintained a highly detailed and intricate set of records of accounts and minutes of meetings dating all the way back to 2002. The records for the latest year however were stored on his personal computer server called – “My Home Hub”. The exact details of the records between 2002 and 7th January 2009 were cleverly stored in two different IP addresses.

The notorious fake invoices and bills were created using the Ontime software. The software is used for calculating the hours worked by an employee. However, a secret program was supposedly planted in the source code of the official invoice management system which created a ‘Super User’ who had the power to hide and show invoices in the system at will. Raju falsely created over 13,000 employees and admitted to faking revenues, clients, receipts, and profits. He obviously tampered with the invoice management system which allowed him to get away with INR 8,000 crore.

He also created a web of over 350+ investment companies in order to be able to divert funds from SCSL. These companies had multiple transactions such as advances and loans, intercorporate investments, within and among them. One of these companies, which only had paid-up capital of INR 5 lakh, had made an investment of INR 90.25 crore and had received unsecured loans of INR 600 crore!

Ultimately, Raju wanted all of this money to be able to acquire more and more land. He bought several acres of land across Andhra Pradesh in order to be able to benefit off a rapidly growing real estate market. For him to be able to do this, he had to doctor the profits to show the company as still financially healthy, and that it was growing in scale and size. However, attempts to bridge this gap failed, and Raju called the exercise like ‘riding a tiger, not knowing how to get off without being eaten’. The last straw was when he sold Maytas Infrastructure and Maytas properties to cash out for INR 7,800 crore.

Unlike the Enron Scandal where Enron executives used complicated methods like derivatives account and off-balance sheet transactions, the top management at Satyam simply cooked the books and overstated and inflated figures. They were thus able to project a rosy picture to investors and keep growing. They made up fake clients, and created over 7,000 fake invoices for sales that just never existed. However, over the years, these imaginary clients were never able to pay their bills and so a big began to get created in the Satyam balance sheet. Sales of INR 5,200 crore were reported when Satyam was only making around INR 4,100 crore.

When the company finally ran out of all cash was when Raju decided to jump of his proverbial tiger.

His investment of \$1.6 billion into Maytas Properties and Maytas Infrastructure failed because investors were left outraged that he was making an investment this large into companies owned by family and also appalled at the fact that the board approved it. Stocks plummeted in the NYSE and Nasdaq, and even though the Satyam board reconvened and called off the investment, the matter didn't die out there as Raju might have hoped it would. In the 48 hours that followed December 16th, 3 independent directors resigned, and Satyam's non-executive director also put in his resignation. The show was over, and Raju made his incredible confession only 3 weeks later.

Outside of Raju's actions, the scandal also shed light on the role and effectiveness of independent directors. In Satyam's case, both the directors, and crucially the auditors had failed to do their jobs well. After all, it is the auditors that make sure that the numbers presented are accurate and reflect a true and fair view of the company's accounts. Unfortunately, in this case, the PwC auditor was also part of the gambit. The actual situation at Satyam was only known by very few people and the scam was closely managed by Raju himself. In the end it was simply his greed and resulting unethical practices that led to his downfall.

Recommendations

As of today, Satyam is now merged with Mahindra & Mahindra as part of the latter's diversification strategy, however before that, it had been added to a list of notorious companies which had been involved in fraudulent financial reporting practices. Despite this, the fact that a scam of this scale was able to run fairly successfully without being caught for a period of 5 years without any red flags or alarms is worrying. All relevant parties, the auditors, the analysts, the media, the stakeholders, even got a whiff of suspicion. It was only once the whistleblower approached the media that people started to raise their eyebrows. The scam brought to the forefront how important it is to have strong corporate governance practices within any company, as well as a robust audit committee.

It is the responsibility of the Board of Directors ultimately to prevent, detect, and investigate corporate and financial frauds within the company, and it is of paramount importance that they adopt preventive steps. A clear anti-fraud strategy needs to be defined by the Board, along with the necessary fraud mitigation steps, and lastly, employees need to be trained to combat these kinds of frauds too. It is admittedly difficult to develop a system that is completely foolproof, but it is possible to have a system that ensures transparency, and accountability. The Board of Directors need to be suitably picked with the right qualifications, experience, and moral compass to guide an organization in the right direction. International regulatory bodies can also have a more rigid and stricter framework but in order for that framework to be implemented and work as intended, all parties involved need to do their job well.

The regulatory changes that have been made since then such as the 2013 Act, and the various guidelines that have been published allow companies to be held to a higher standard with less of a chance for fraud or for unscrupulous business practices to go under the radar. The Satyam Scam was seen as more of a corporate governance failure than an auditing failure and it is my opinion that since then a lot of necessary and useful measures have been taken.

There are still further remedial steps that can be taken in order to strengthen the internal processes further. Auditors for one can ensure that the audit is conducted in accordance with the Auditing and Assurance Standards (AAS). The AAS is the gold standard with which the audit performance can be measured. Forensic auditors can also be used to uncover any form of wrongdoing. They can include a team of lawyers, audit experts, ex police officers etc. Furthermore, investigative audit techniques can also be implemented where a weakness in the internal controls are discovered. Additionally, since the remuneration of the auditors can

affect and influence the auditor's report, the appointment and remuneration of auditors should not be in the hands of the companies that they are auditing. Instead, money can be pooled and given to the stock exchanges who will then appoint and remunerate the auditors. Lastly, firms should also introduce a policy of partners' audit review and partner rotation to make sure there is always healthy participation by the partners. The following steps, and adhering to the existing guidelines and frameworks, along with strong leadership will go a long way in avoiding fraudulent financial reporting in the future.

Conclusion

The Satyam Computers Scam was the ideal example of abuse of power and misconduct. Mr. Raju along with the company's top management simply cooked the books by inflating sales, revenues, and profits without anyone noticing, every quarter over a period of 5 years. There was also tremendous oversight on part of the auditors who were found to have been compensated higher than usual. Furthermore, the scam also brought to light systemic insider trading. Therefore, in the years following the scam, it has been an issue of paramount importance for there to be more stringent laws and regulations formulated in order to avoid another situation like this one. Even though the firm was acquired in 2013 by Mahindra and Mahindra, a total loss of INR 9386 crores was still recorded. The scam raised eyebrows all around for the lack of judgement and improper execution of duties of the accounting and audit firms, as well as accounting practices in India as a whole. The Central government in response released fresh guidelines, improved existing ones, increased oversight over financial activities of companies, and more regular and routine investigations of possible frauds in the country as a whole. An attempt was made to bring the guilty parties to justice through fines, jail sentences, exclusion from participating in the financial markets. Even though Ramalinga Raju may be out on bail right now and justice may not have been completely served, the financial and auditing landscape has improved in India drastically, and there seem to have been steps taken in the right direction.

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