FINANCIAL STATEMENT FRAUD & CORPORATE GOVERNANCE

THE SATYAM CASE

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By

T.N.Manoharan

Dean’s Distinguished Visitor, USQ

CHALLENGING TIMES

- Number of financial statement frauds on increase
- Frauds against organizations are increasing
- Some recent frauds involve multiple individuals colluding to defraud
- Many investors have lost confidence
- More interest in fraud than ever before -now a course on many university campuses
- Forensic accounting and auditing/ IT Systems Audit - Security/Controls/risks assessment

Fraud is a Costly Proposition

- Fraud Losses Reduce Net Income $ for $
- If Profit Margin is 10%, Revenues Must Increase by 10 times Losses to Recover Effect on Net Income
  - Losses……. $1 Million
  - Revenue….$1 Billion

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- Fraud Robs Income

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Revenues	$100	100%
Expenses	90	90%
Net Income	$ 10	10%
Fraud	1	
Remaining	$ 9	

To restore income to $10, need $10 more dollars of revenue to generate $1 more dollar of income.

Impact of Fraud -Two Examples

- General Motors
  - $436 Million Fraud
  - Profit Margin = 10%
  - $4.36 Billion in Revenues Needed
  - At $20,000 per Car, 218,000 Cars

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- Bank
  - $100 Million Fraud
  - Profit Margin = 10 %
  - $1 Billion in Revenues Needed
  - At $100 per year per Checking Account, 10 Million New Accounts

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Fraud leads to Stock value crash

- Financial statement fraud causes a decrease in market value of stock of approximately 300 to 1,000 times the amount of the fraud.

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$7 million fraud → **$2 billion drop in stock value**

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Types of Fraud

- **Fraudulent Financial Statements**
- Employee Fraud
- Vendor Fraud
- Customer Fraud
- Investment Scams
- Bankruptcy Frauds
- Miscellaneous

The common element is deceit or trickery!

Financial Statement Frauds

ENRON

WORLDCOM

xerox

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Global Crossing

Satyam

Cashed

Satyam
First in India

- Madoff
- Many others

  (Cendant,
  Lincoln Savings, ESM, Anicom,
  Waste Management,
  Sunbeam, etc.)

Satyam Case- Basic Facts

- Fourth largest Indian IT Company listed in India & US
- Over US $ 2 billion annual revenue size Co
- Established in mid 1980s, grown to 53,000 employees;
- 600 plus customers including 185 fortune 500 Cos
- Operations in 66 countries across the globe
- Financial advisor: Merrill Lynch (now Bank of America)
- Auditors: Price Water House Coopers
- Bankers: Citi bank; BNP Paribas, HSBC & HDFC

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Confession – January 7th , 2009

"I did it"

INDIA'S LARGEST CORPORATE FRAUD

Chairman Raju's Version

- Inflated billing to customers
- Non-existent cash & bank balances $ I bn
- Overstated Debtors $ 100 million
- Operating margin shown high at 24% in Q2 (Sept 2008) as against 3% real profit margin
- Such manipulation done in earlier years(6 yrs-$ 1.2 Bn)
- Increased costs to justify higher level of operations
- Attempt to merge Son's Company 'Maytas' with huge land Bank to bridge the gap failed

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Why Confession ?

- Recession drained the liquidity to run the show
- Out standings were piling up
- Since listed in US, SEC rigors would take over
- Unmanageable gap between actual and book profit
- “Every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten”.

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Consequences of confession

- Investors- Panicked as Stock plummeted &
  Class action suits filed in US
- Employees- stranded in many ways- morally, financially, legally and socially
- Customers- shocked and worried about the project continuity, confidentiality and cost over run
- Bankers - concerned about recovery of financial and non-financial exposure and recalled facilities
- Government- worried about image of the Nation & IT Sector affecting faith to invest or to do business

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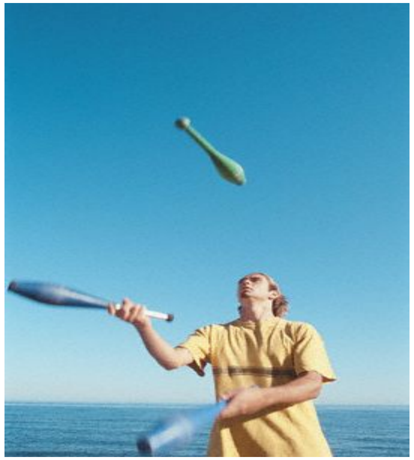
Action after Confession

- Chairman, MD and CEO, CFO, Chief accountant and two of his associates arrested
- Two Partners of PW (Audit Firm) were also arrested
- Options before Government: i. Allow market forces to decide; ii. Announce bail out plan; iii. Think out of the box
- Government dissolved existing Board &

  nominated 6 of us
- Gave us complete freedom



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Prioritized Plan of Action

- Restore cash flow to secure Financial Stability
- Customer retention and infuse confidence to continue
- Employee motivation and Management restructure
- Legal advisors- In India and USA appointed
- Internal audit entrusted to an external firm
- Management Consultants and Board Advisors appointed
- Forensic investigation to facilitate restatement of accounts initiated

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SWOT Analysis

STRENGTHS

- World class infrastructure
- Leadership and talent pool
- Premium Customers
- Low debts

WEAKNESS

- Tainted image
- Class action suits
- Silos in management structure
- Third party claims

THREAT

- Investigating agencies
- Media
- Revenue Department
- New tendering-BGs, Solvency certificate, Audited statements

OPPORTUNITIES

- Pledge assets to raise funds from Banks
- Persuade clients to pay up
- Create charge on receivables to continue existing debts

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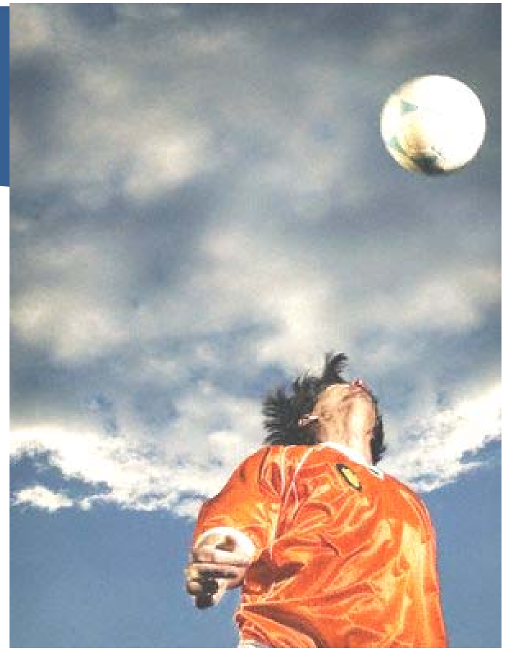
For about 15 weeks there was no owner in control

Modus Operandi



- Held weekly Board meetings-TN was stationed at Satyam round the clock
- Raised $135 million from 2 banks to supplement internal accruals
- Cleared all statutory dues; Paid global salary including insurance and taxes; Released payments to other dues
- Kept meeting, talking to and reaching out to employees and customers
- Video clippings; teleconference calls; personal meetings; E-News letter & Weekly Bulletin

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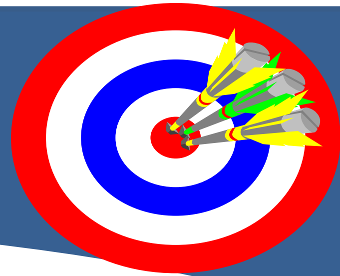
Two critical options



- Continue to run the Business, clean up and restate the accounts, re-audit, enable valuation, due-diligence and offer for take over; or
- Immediately identify a strategic investor who will infuse capital and take over control & management
- Chose the second option after due deliberation
- Investment Bankers appointed, Bidding process set in motion with Former Chief Justice of India as Observer
- SEBI and CLB were moved for appropriate relaxations

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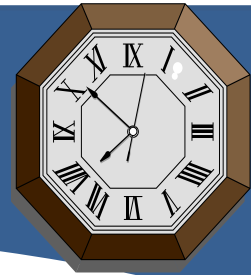
Bidding Process



- Press release on 9th March inviting registration
- RFP was sent to 141 registered- only 10 submitted EOI
- Out of 10, 7 met the criteria and were sent documents for execution
- 5 submitted documents but later 2 withdrew for want of internal approvals leaving 3 in race
- Thus, WL Ross; L&T and Tech Mahindra competed
- Information had to be given to Bidders to facilitate quoting price per share for preferential allotment

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Strategic Investor Selection

- Virtual and Physical data room created & access provided
- Site inspection of 2 main campuses arranged
- Management presentation made for each bidder exclusively show casing the facts and potentials;
- Conference call slots were given to clarify on legal matters and again on financials separately
- One meeting between each of the bidders and the Government nominated board on 3rd April
- Technical and Financial bids received on 13th April and highest bidder Tech Mahindra selected

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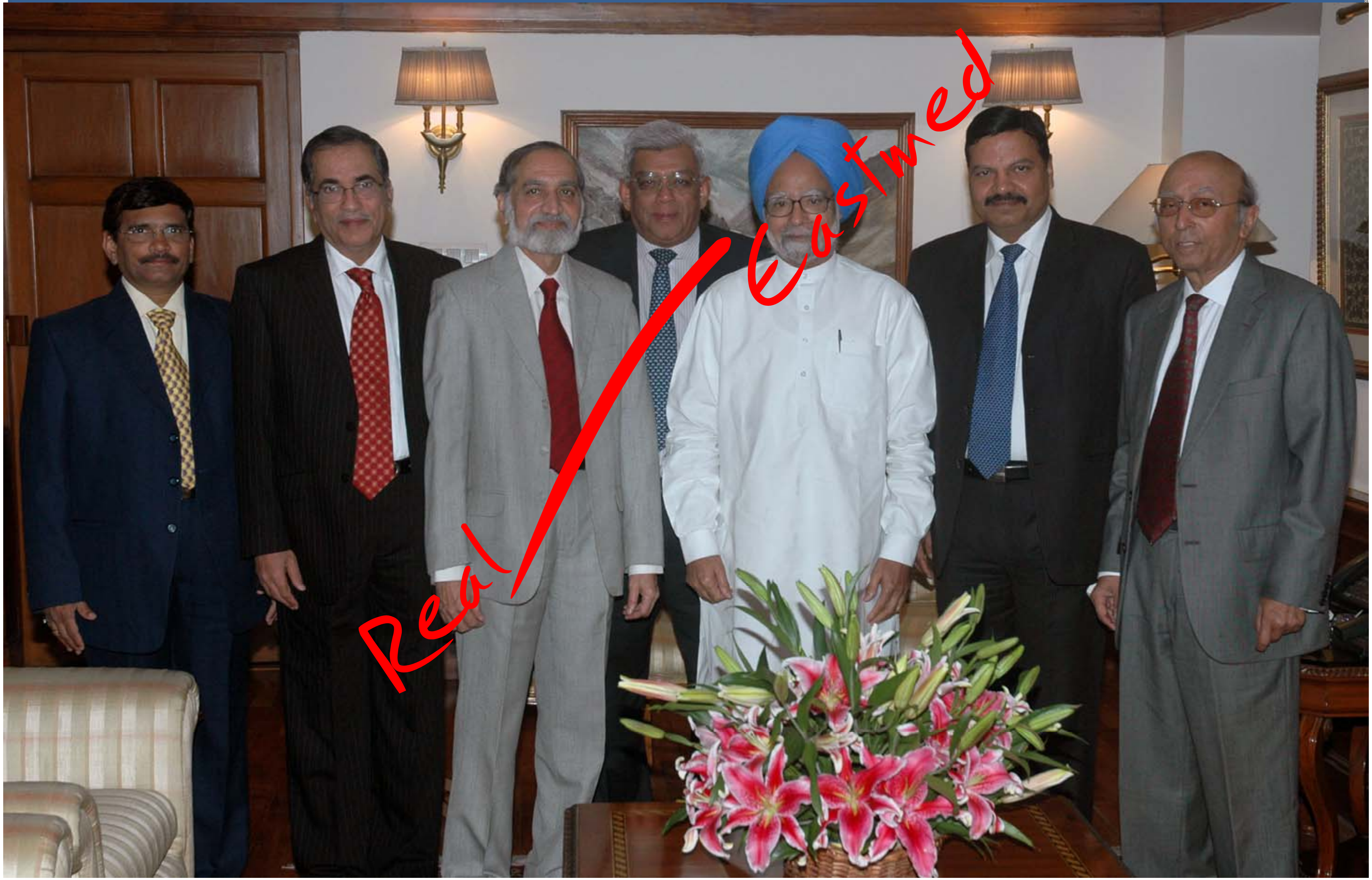
Prime Minister’s Appreciation



Factors that contribute to Fraud

- Greed-Ethical values given a go by
- Executive incentives
- Stock market expectations
- Nature of accounting rules
- Audit failures- Internal & External
- Aggressiveness of investment banks, commercial banks, Rating agencies & investors
- Weak Independent directors and Audit committee
- Whistle blower policy not being effective

How did Satyam scam happen?

- Ambitious growth drive
- Audit failure- example., External confirmations of Bank balances not properly done
- Deceptive reporting practices—lack of transparency
- ESOPs issued to those who prepared fake bills
- Excessive interest in maintaining stock prices
- High risk deals that went sour
- Above all, greed and lack of ethical values.

ROAD AHEAD
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Corporate Lessons to be learnt

- Rotation of audit firm vs rotation of audit partner
- Strengthening of Quality review (Peer review)
- Joint Auditors to audit companies beyond a size
- Internal audit of Financials by an external firm with undiminished scope
- Composition of Board and quality & qualification of Independent Directors

Reaffirmed

Corporate Lessons to be …

- Audit Committee meetings-adequacy of notice and adequacy of duration
- Criteria for remuneration to Key Personnel
- Effective 'whistle blower policy' in place
- Focus on 'Intangibles' & 'Tangibles' follow
- Education on Ethical values

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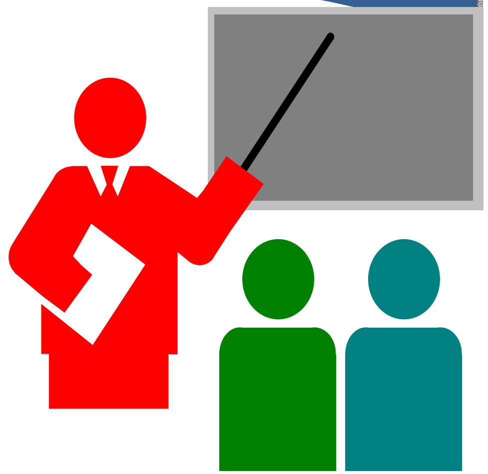
Moral Lessons for recapitulation



- Humility helps while Ego hurts
- Think of a Rainy day, always
- Distinguish between opportunities and temptations
- Build quality teams and enable succession
- Adapt with technology/knowledge changes but stay static on fundamentals
- Listen to your head in complying with law and to your heart in dealing with people

Moral Lessons for …

- Many good things done get washed away in one bad conduct
- To live beyond your age - Love people and use wealth
- Ability may take you to the top

  but it takes Character to stay there

- Nothing is impossible, if attempted with nobility


Thank you
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