SEVEN YEARS AFTER THE SATYAM COMPUTER FRAUD

KEY DEVELOPMENTS IMPACTING FINANCIAL CRIME IN INDIA

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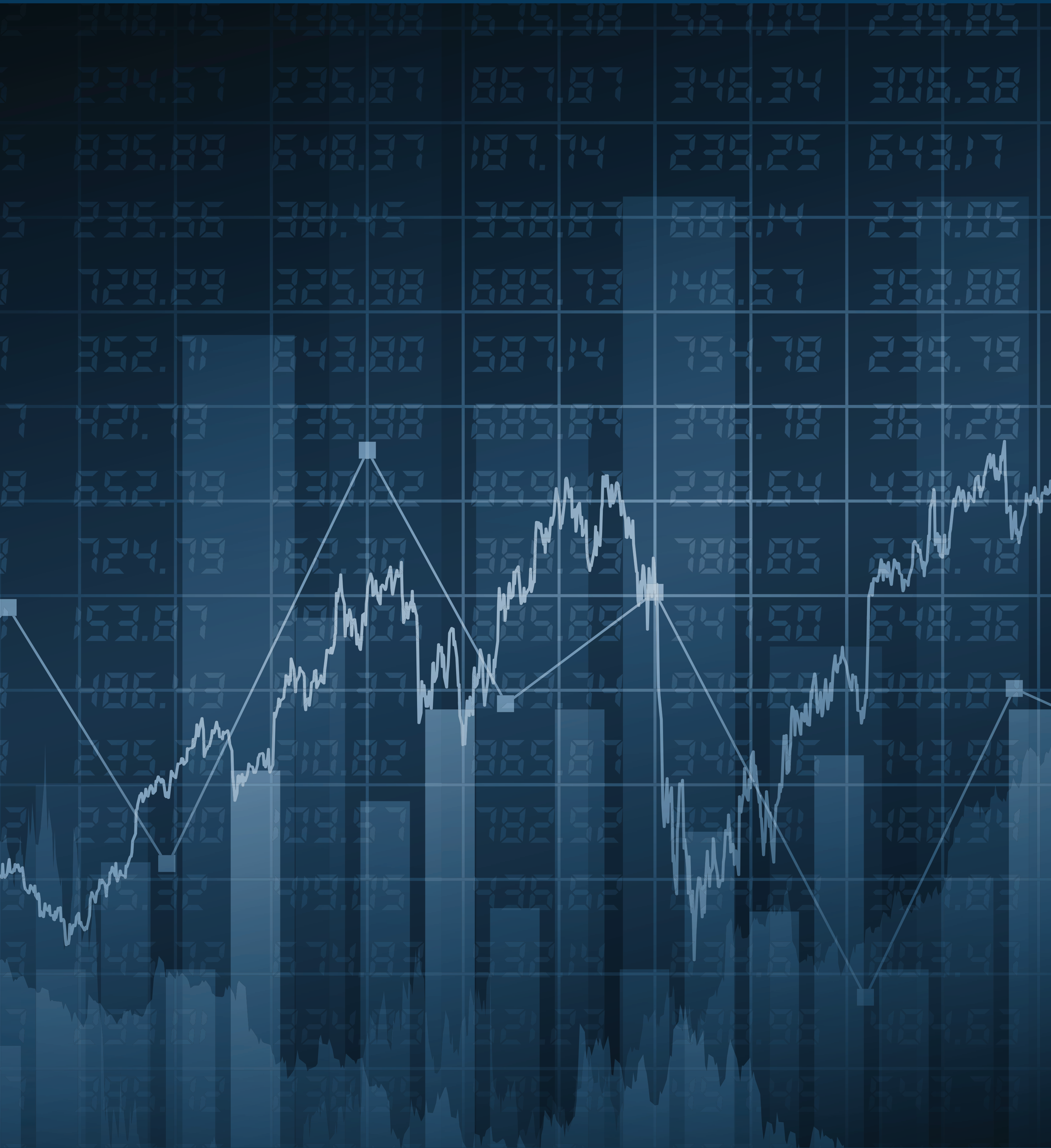


January 2016 marks the seventh anniversary of India's largest financial statement fraud at Satyam Computer Services Limited. At the center of the fraud was the well-known entrepreneur and chairman of Satyam, B. Ramalinga Raju. Corporate India was shocked when Raju resigned on 7 January 2009 and confessed that he had manipulated Satyam's financial statements in excess of INR 7,000 crore (USD 1.4 billion).[1,2] In April 2015, Raju was sentenced to seven years in jail.[3]

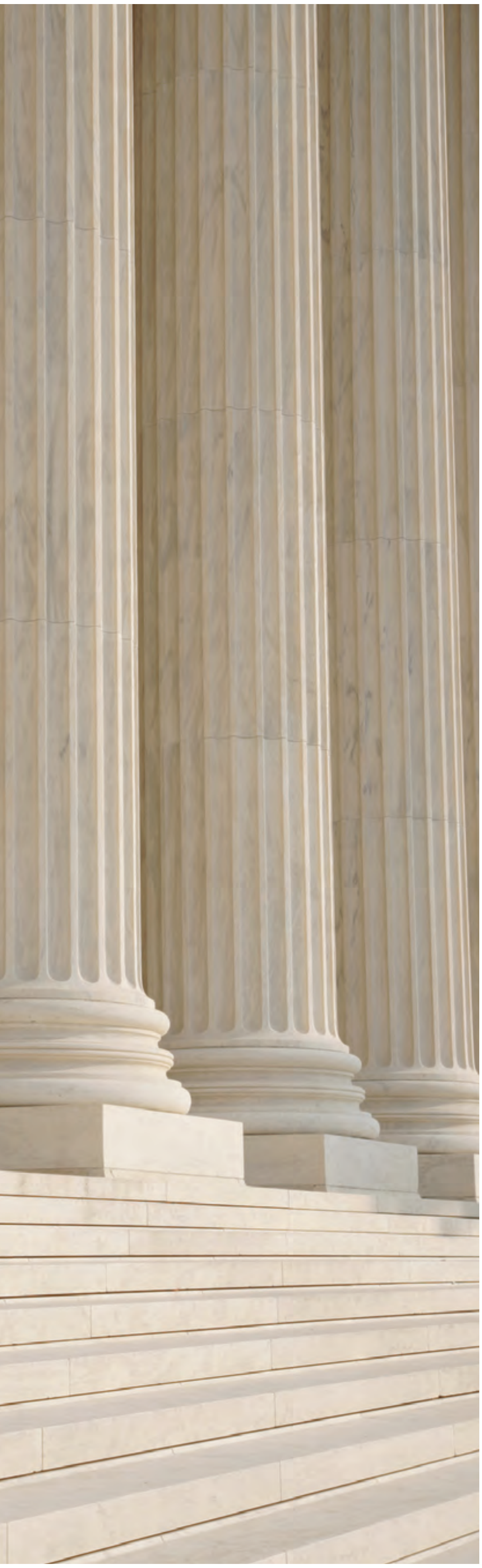
Raju had attempted to hide Satyam's poor financial performance by making it appear as if both the top and bottom lines were growing.[4] As a result of a complex web of financial transactions, Satyam had fictitious cash and bank balances of over INR 5,040 crore.[5] The trigger point that exposed the fraud was Raju's failed attempt to acquire equity interests in Maytas ("Satyam" spelt backwards) companies that were founded by Raju's family members.[6] Acquiring assets (whose existence was disputed) from the books of Maytas against the fictitious cash and bank balances in Satyam's books was the plan for regularizing Satyam's forged numbers.[7] However, pressure from institutional investors forced the Satyam board to shelve the Maytas deal[8] and Raju subsequently confessed.

This article examines some key developments that have affected the overall financial crime environment in India in the seven years after the Satyam fraud.

FINANCIAL CRIMES – WHAT HAS CHANGED IN THE PAST SEVEN YEARS?

In the past seven years, we have witnessed a number of innovative frauds and scams affecting a host of stakeholders, including management, workers, retail and institutional investors, banks and government. They cover a diverse range of issues such as financial misstatements, corruption, money laundering, Ponzi schemes, loan frauds and cybercrime. Regulators are now trying to match the pace at which fraudsters innovate. The Indian government has responded by strengthening regulations (e.g., Companies Act, 2013), improving transparency and increasing collaborative efforts and sharing of information between government and law enforcement agencies. Companies have strengthened their internal control framework and have adopted enhanced policies and procedures to fulfill the requirements of new regulations and meet global standards. The Reserve Bank of India (RBI) has provided specific guidelines to banks for curbing loan frauds.[9] Law enforcement agencies are developing cyber cells to be able to quickly respond to cybercrime.

On the following pages are seven key developments in the financial crime environment since the Satyam fraud.



CORPORATE GOVERNANCE

1 Before the fraud came to light, Satyam was the beneficiary of a plethora of corporate governance awards.[10] It was among the first Indian companies to report its financial statements in accordance with the International Financial Reporting Standards (IFRS).[11] The Satyam Board had initially approved the Maytas deal. It was only after the pressure from the institutional investors that some independent directors resigned in protest.[12]

India Inc. has seen a flush of new regulations and laws since the Satyam scam, of which the most prominent and discussed is the Indian Companies Act, 2013. The Securities Exchange Board of India (SEBI) has also issued some critical guidelines[13] — prohibition on insider trading; shareholders' approval for related party transactions; a whistleblower mechanism; elaborate disclosures on pay packages and the requirement to have at least one female director on corporate boards.[14] Corporates have also seen other regulations that impact the way they manage and run their businesses, including corporate social responsibility becoming mandatory for certain companies.[15]

The Companies Act, 2013 has substantially raised the bar on governance. Greater emphasis on responsibility of management has been envisioned by incorporating the definition of what constitutes fraud, and the Act also makes extensive provisions for penalizing fraudulent activities. In areas of compliance, comments are required in directors' reports for any qualification, observation or other remarks made by the company secretary in its report to the company.[16] Self evaluation of the board, its committees and directors, which is globally seen as a good practice, has now been included in India.[17]

The Companies Act, 2013 has also imposed stringent responsibility and accountability on independent directors, who are required to possess an appropriate balance of skills, experience and knowledge in one or more fields of finance, law, management, sales, marketing, administration, research, corporate governance, technical operations or other disciplines related to the company's business.[18]

The Serious Fraud Investigation Office (SFIO) has been empowered to investigate frauds relating to companies.[19] Additionally, the nomenclature and role of the National Advisory Committee on Accounting Standards (NACAS) has been changed to the National Financial Reporting Authority (NFRA). NFRA is not merely an advisory body, but a regulatory body itself, and it may investigate companies either suo motu or on a reference made to it by the Central Government.[20]

TECHNOLOGY — BOTH AN ENABLER AND DETERRENT OF FRAUD

2 At Satyam, Raju leveraged technology to facilitate the fraud by creating different software programs and using "super user" IDs to record fictitious accounting entries.[21]

Continuously evolving technologies have raised the danger of misuse and manipulation of information. Fraud schemes are becoming more technology-centric and ironically most of this technology is deployed by companies to improve efficiencies.

Technology is a double-edged sword. While the fraudsters are leveraging it to carry out elaborate fraud schemes, professionals are leveraging it to catch them. With the advent of advanced data analytics and mining of unstructured data, preempting early warning signs for identifying potential fraud is becoming a strong tool to combat fraud. However, only a few industries, such as banking, insurance and e-commerce, are using analytics as a tool to identify fraud.

CYBERCRIME

3 Today, more than ever, Indian companies are exposed to a number of cyber security threats including distributed denial-of-service (DDoS) attacks, cyber breaches, malware and email spoofing scams. Indian companies are not fully prepared for, nor completely understand, cyber attacks; generally, it takes a long time before companies realize that they have been attacked.

The biggest challenge facing corporate India, with the exception of a few technology-intensive industries, is the lack of awareness, training and adequate implementation of a comprehensive cyber security program. India's unique cultural and business environment makes the cyber fraud landscape distinct from the challenges faced in other more developed markets. Concepts such as information security and data privacy are not contextualized as seriously in India as they are in Europe and the U.S.

Both companies and law enforcement agencies have started working towards investment, training and information sharing to meet the increasing cyber fraud challenges.

INTELLECTUAL PROPERTY THEFT

4 Intellectual property (IP) provides companies a distinct competitive advantage. While companies in certain sectors such as life sciences, technology, telecommunications, media and entertainment, business process outsourcing (BPO), e-commerce, manufacturing and consumer products have developed extensive proactive and reactive IP management strategies, they continue to be exposed to risks involving counterfeits, piracy and data theft.

Counterfeits remain a major problem in India. The Federation of Indian Chambers of Commerce and Industry (FICCI) estimated that the loss to certain manufacturing sectors increased by 44.4 percent in just two years, from INR 72,969 crore in 2011 to 2012 to INR 105,381 crore in 2013 to 2014. The largest increases were seen in the alcoholic beverages and mobile phones industries, where losses had risen by 151 percent and 111 percent, respectively. The total loss of tax revenue to the government for manufacturing industries estimated for 2014 on account of the illicit markets was INR 39,239 crore, up from INR 26,190 crore in 2012.[22] The FICCI also estimated that over a fifth of fast moving consumer goods (FMCG) products in India are fake or smuggled.[23]

Software piracy is another area that is quite prevalent. Not only does it result in financial losses, it also exposes the users to risks of viruses and malware. Finally, corporate India is also exposed to a wide range of other IP thefts such as theft of confidential and sensitive information, designs and other IP assets.

In addition to developing a proactive IP strategy, companies can use a combination of technology solutions, including data analytics and market intelligence, to identify and combat IP theft.

GREATER AUDITOR INDEPENDENCE AND ACCOUNTABILITY

5 The U.S. Securities and Exchange Commission (SEC) sanctioned the independent auditors of Satyam for repeatedly conducting deficient audits of the company's financial statements and enabling a massive accounting fraud to go undetected for several years. The auditors agreed to settle the SEC's charges and pay a $6 million penalty.[24]

In another case, a U.S. based private equity firm alleged accounting fraud by a children's clothing retailer in India. The retailer's auditor was sued for "fraud, aiding and abetting fraud, negligent misrepresentation, and unfair and deceptive trade practices…"[25] According to one of the private equity firms, the auditor's dual roles as the portfolio company's advisor as well as the retailer's auditor represented "a clear conflict of interest."[26]

The Companies Act, 2013 has laid increased emphasis on the independence and accountability of auditors, adding significantly to the role auditors play in their audit of financial statements. The Act emphasizes the responsibility of auditors to report offences involving fraud to the Central Government.[27] In order to ensure independence, the Act also prohibits auditors from providing other specific services to the auditee company directly or indirectly through its holding or subsidiary company[28] and provides for periodic rotation of audit firms.[29]

BANKING SECTOR'S INCREASED MONITORING WILL BECOME A DETERRENT FOR CORPORATE FRAUDS

6 Non-performing assets (NPAs) in the banking industry rose 23 percent between fiscal years 2013 and 2014 and between 2014 and 2015, and bank frauds increased by a 100 percent during the same period.[30] In response, the RBI has issued circulars and alerted the banking sector to take quick corrective action to combat the problem of defaults and loan frauds. These guidelines require banks to conduct ongoing due diligence on the borrower and to monitor account activity with an objective to compress the total time taken to identify a fraud and aid in effective action by the law enforcement agencies.

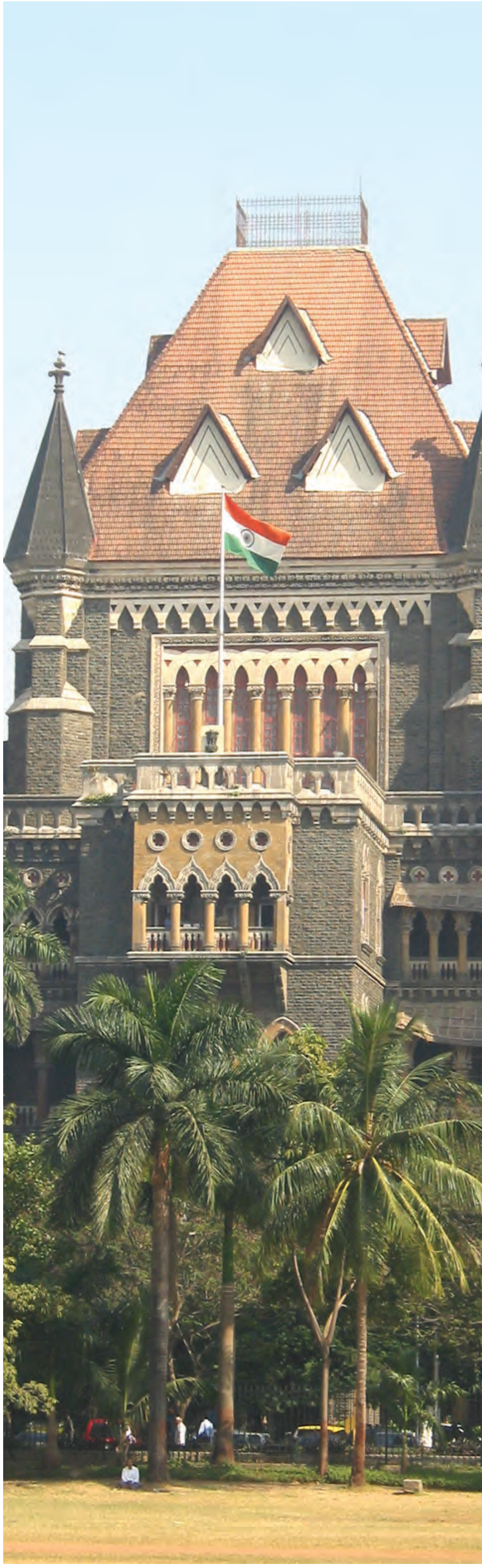
Effective implementation of the RBI's guidelines by banks will aid in taking quick action against defaulters and frauds. This could act as a deterrent and protect both banks and investors from fraudulent activity and/or minimizing the losses resulting from such frauds.

CLASS ACTION SUITS

7 The concept of class action lawsuits was introduced by the Companies Act, 2013 (Section 245). A class action is a type of lawsuit in which one or several persons sue on behalf of a larger group of persons. A class action is often the sole means of enabling persons, even those with serious injuries, to remedy injustices committed by corporations and institutions.

While U.S. stakeholders of Satyam were able to file a class action lawsuit and claim USD 125 million (about INR 700 crore)[31] from the company, Indian investors were not able to take any legal action against Satyam as India's legal framework at the time did not allow for class action suits.

As a result of the Companies Act, 2013, class action suits can provide a beneficial platform for shareholders and depositors to raise their grievances against the management of a company including directors, advisors, consultants and auditors for acts or omissions that are prejudicial, unlawful or wrongful to the interest of the company.[32] Class action suits may be undertaken as a redressal tool by minority shareholders having common interest for promotion of transparent corporate governance.



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