

# INDIA'S SATYAM SCANDAL: EVIDENCE THE TOO LARGE TO INDICT MINDSET OF ACCOUNTING REGULATORS IS A GLOBAL PHENOMENON

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## ABSTRACT

*This paper examines the capture of government regulators using the case of Satyam Computer Services Ltd., one of India's largest software and services companies, which disclosed a \$1.47 billion fraud on its balance sheet on January 7, 2009. The firm, which traded on the New York and Bombay Stock Exchanges, was required to file financial reports with the SEC. Price Waterhouse of India, the local member of PricewaterhouseCoopers (PWC), served as its auditor. After news of the scandal hit the airwaves, Price Waterhouse of India issued a press release and stated that its audit was conducted in accordance with applicable auditing standards and was supported by sufficient audit evidence. Because Satyam shares were quoted on Wall Street, SEC rules prohibited auditors from having business relations with their clients. U.S. regulators failed to take action against PWC. Is this lack of enforcement related to PWC's size and the impact that the failure of a Big 4 firm would have on the global financial marketplace? We question whether government regulators have been captured by the key market players in the auditing services market. One outcome of this "capture" is moral hazard, which implies that the Big 4 accounting firms, or their local affiliates, may place less emphasis on quality audits. Such an approach to the audit function places the self-interests of the audit firm above the public interest. We also question whether foreign companies that are listed on US Stock Exchanges fall under the purview of US Laws and if these companies and their auditors face the same regulatory scrutiny as publicly-traded US Corporations. In addition, the paper provides suggestions to protect the public interest while citing lessons learned from this scandal.*

**JEL:** M42, M48, M41

**KEYWORDS:** Auditing, Capture Theory, Accounting Regulation

## INTRODUCTION

Regulation of business has always been a topic of considerable debate. Regulatory proponents call for more regulation of the private sector in order to protect the public good, while regulatory opponents claim that additional regulation further damages a free-market economy by unduly constraining business. The *theory* of regulatory *capture* posits that regulators, including government bureaucrats who oversee the regulatory process and legislators who write the regulations, are routinely and predictably "captured" and manipulated to serve the interests of those who are supposed to be subject to them.

For public choice theorists, regulatory capture occurs because groups or individuals with a high-stakes interest in the outcome of policy or regulatory decisions can be expected to focus their resources and energies to gain their preferential policy. Meanwhile, members of the public, each with an insignificant individual stake in the regulatory outcome, will either ignore or pay scant attention to the regulatory process altogether. Regulatory capture results when this imbalance of focused resources devoted to a particular

policy outcome is successful at “capturing” influence with elected officials or regulatory agency bureaucrats so that the preferred policy outcomes of the special interest(s) are implemented. A captured regulatory agency serving the interests of its invested patrons and wielding the power of the government behind its decisions is often worse than no regulation. Galbraith (1955) posited that captured regulators were part of the problem rather than the solution. He suggested that regulators were vigorous in their youth, moving to complacency in middle age, until they became in old age either senile or arms of the sector they are supposed to regulate.

Ample evidence suggests that regulatory *capture* is indeed widespread and takes a variety of forms. The Big 5 accounting firms were reduced to the Big 4 with the criminal indictment of Arthur Andersen in 2002 and the firm’s ultimate collapse. The vacuum created by the demise of Arthur Andersen and, ironically, the constraints of the Sarbanes-Oxley Act of 2002 (SOX), i.e., the unlinking of audit and consulting services, have contributed to increased market power for the remaining Big 4 firms. One negative aspect of this increased market power is the reluctance of government regulators to indict any of the Big 4 for criminal actions, creating moral hazard. Corporate executives, government regulators and politicians have all expressed concerns about the lack of choices that large public companies have when selecting a public accounting firm. In response to these concerns, the U.S. Congress, as part of the Sarbanes-Oxley Act of 2002, required the General Accounting Office, now the General Accountability Office (GAO), to examine the effects of the consolidation on competitive forces, audit costs and quality, and audit independence in the public accounting industry.

Since the initial charge by Congress for the GAO to examine the market structure of audits for large public companies, the GAO has issued two reports, the first *Public Accounting Firms: Mandated Study on Consolidation and Competition* (GAO, 2003) and a second *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* (GAO, 2008). Among other findings, both of these reports stated that the Big 4 audit 97% of all public companies with sales between \$250 million and \$5 billion dollars (GAO, 2003, 2008). Dominance by the Big 4 is global in scope, not just a U.S. phenomenon. Affiliates of the Big 4 are also the largest auditing firms in Turkey, South Korea, India and the Philippines. The Big 4 audit all of the Financial Times Stock Exchange (FTSE) 100 companies in England (Simms & Oram, 2002). They also audit more than 80% of the public companies in Japan and two-thirds of those in Canada. According to the International Accounting Bulletin, they hold over 70% of the European market by fee income (The Economist, 2004). Although the collapse of one of the Big 4 firms could have dire consequences for participants in the financial markets, it appears that the GAO has discounted the impact of not only the current lack of competition facing the Big 4 but also the possible capture by the Big 4 of government regulators charged with the oversight of the accounting profession. We posit that the reluctance of government regulators to punish the Big 4 accounting firms is not just a U.S. phenomenon, rather a global regulatory failure. We use the collapse of India’s Satyam and the questionable audit its auditor, PWC, as an example of accounting regulators being “asleep at the wheel” and giving little more than a slap on the wrist to PWC and its Indian affiliates, in spite of the egregious audit failure at Satyam.

The remainder of the paper is organized into five sections. In Section 2, we provide literature review and a brief background on regulation. In Section 3, we review the Satyam fraud and PWC’s failure to detect Satyam’s accounting shenanigans. In Section 4, we discuss the societal implications associated with a “too big to fail” mentality and the moral hazard of such a mindset. A conclusion is provided in Section 5.

## LITERATURE REVIEW AND BACKGROUND

When the U.S. government deems that a company’s failure would have significant ramifications for the national economy, elected officials make the argument that the company is “too big to fail.” This reasoning is used to justify government bailouts and, in some cases, the loosening or repeal of regulatory policies.

The bailouts of Chrysler in the late 1970s and Long Term Capital Management in the late 1990s provide examples (Cunningham, 2006). More recently, the U.S. Treasury loaned in excess of \$700 billion to several of the nation's largest financial institutions and other large non-banking companies such as American Insurance Group, General Motors and Chrysler (Young, 2013). Once again, government officials argued that the failure of these large corporations, either together or individually, would have a dire negative impact on the economy. Once the "too big to fail" mentality becomes the modus operandi of government, large firms may get a "leg up" on their smaller competitors. In other words, government regulators give the special interests favorable differential treatment.

In July of 2002, the Financial Economists Roundtable met to discuss the crisis in corporate governance, auditing and accounting that followed the scandals at Enron, Adelphia and WorldCom. As part of their deliberations, the attendees asked... "might they [the Big 4] perceive that they were 'too-big-to-fail' and, consequently, have incentives to engage in moral hazard behavior?" (*Journal of Applied Finance*, 2002) Perhaps the engagement in moral hazard behavior came sooner rather than later.

Recently, global financial markets were sent into a tailspin by the subprime mortgage crisis. One of the first investment banks to fail as a result of this crisis was Lehman Brothers. On December 21, 2010, Andrew Cuomo, New York Attorney General, filed a lawsuit accusing Ernst & Young (E&Y) of helping Lehman Brothers hide its declining financial health for several months before its implosion in September 2008. Cuomo's suit against E&Y is a civil suit, not a criminal indictment like the one brought against Arthur Andersen, and may, as many suggest, be settled out of court. E&Y responded by stating that the Lehman bankruptcy resulted from a series of unprecedented adverse events in the financial markets. A spokesman stated that E&Y stood by its December 31, 2007 audit of the company (Frean and Spence, 2010).

A couple of observations are in order. First, the Arthur Andersen (AA) effect appears to be impacting regulators. Once AA was served with a criminal indictment, SEC rules prohibited the firm from auditing SEC registered companies. As a result, most of its large clients and some partners left AA in search of one of the other four international audit firms. Regulators learned their lesson. Repetition of this scenario with E&Y would create turmoil in global financial markets which are just now beginning to show signs of recovery from the subprime mortgage crises. Regulators have decided to bring a civil indictment against E&Y rather than a criminal indictment, allowing the firm to continue auditing its SEC clients. Second, the disintegration of one of the remaining Big 4 firms would result in an audit services market that would be even more concentrated than it is today. An increase of just 50 points in the Herfindahl-Hirschman Index (HHI) would put the accounting industry in violation of antitrust guidelines (Sloan, 2010). Feldman (2010) estimated that the failure of E&Y would add 733 points to the HHI, unacceptable to the Department of Justice's Antitrust Division. Regulators may punish E&Y with significant monetary fines and perhaps suspend them from accepting new clients for a short period of time, but regulators and those clients seeking the services of one of the Big 4 accounting firms want E&Y to survive. Once again, it appears that one of the Big 4 accounting firms is too big for a regulator to protect the public interest, i.e., serve E&Y a criminal indictment.

### **GLOBAL PHENOMENON: THE SATYAM CASE**

The Satyam scandal highlights the importance of securities laws and accounting regulation in emerging markets. It provides insight into the problems that emerging markets face when they transition from locally controlled corporations to globally traded corporations. There is wide consensus that emerging markets must strive to create a regulatory environment in their securities markets that fosters effective corporate governance. India has managed its transition into a global economy well, and although it suffers from corporate governance issues, it is not alone as both developed countries and emerging countries experience accounting and corporate governance scandals (Winkler, 2010).

In October 2009, the World Bank accused Satyam of installing spy systems on its computers and stealing assets and issued an eight-year ban against the company. In December 2008, Ramalinga Raju, the Chairman of Satyam, announced that Satyam would spend \$1.6 billion to purchase Maytas Properties and Maytas Infrastructure, two companies unrelated to the information technology field. Efforts in this direction were withdrawn under pressure from shareholders who viewed the transactions as an attempt to siphon money out of Satyam into the hands of the Raju family since the Raju family held a larger stake in Maytas Properties and Maytas Infrastructure than it did in Satyam. On December 30, analysts with Forrester Research advised clients to stop doing business with Satyam because of the fear of widespread fraud. Satyam hired Merrill Lynch to advise it on ways to increase shareholder value. On January 7, just hours before Mr. Raju disclosed the fraud, Merrill Lynch sent a letter to the stock exchange indicating that it was withdrawing from its engagement with Satyam because during the course of its representation it learned of material accounting irregularities (Winkler, 2010).

Mr. Raju claimed that he overstated assets on Satyam's balance sheet by \$1.47 billion. Nearly \$1.04 billion in bank loans and cash that the company claimed to own was nonexistent. Satyam also underreported liabilities on its balance sheet. Satyam overstated income nearly every quarter over the course of several years in order to meet analyst expectations. The results announced on October 17, 2009 overstated quarterly revenues by 75 percent and profits by 97 percent (Winkler, 2010). For the third quarter, Satyam reported 50.4 billion rupees (\$1.03 billion) of cash and 3.76 billion rupees of earned interest that were fictitious. Receivables were overstated and liabilities were understated by 4.9 billion rupees and 12.3 billion rupees, respectively (The Economist 2009).

Numerous bank statements were created to advance the fraud, and bank accounts were falsified to inflate the balance sheet with balances that did not exist. The income statement was inflated by claiming interest income from the fake bank accounts. Fake salary accounts were created, and the money in them was appropriated after the company deposited the salaries. The company's global head of internal audit created fake customer identities, generated fake invoices against their names to inflate revenue, forged board resolutions and illegally obtained loans for the company. It also appeared that the cash that the company raised through American Depository Receipts (ADRs) in the United States never made it to the balance sheets (Kahn, 2009).

Global auditing firm PWC audited Satyam's books from June 2000 until the discovery of the fraud. PWC signed Satyam's financial statements and was responsible for the numbers under Indian law. Cash is one of the easiest accounts to audit. The question of how the audit of a cash account failed to disclose a shortage of \$1.03 billion dollars remains unanswered. The auditors also did not independently verify with the banks in which Satyam claimed to have deposits (Winkler, 2010). Suspiciously, Satyam also paid PWC twice what other firms would charge for the audit, which raises questions about whether PWC was complicit in the fraud. Furthermore, PWC audited the company for nearly 9 years and did not uncover the fraud, whereas Merrill Lynch discovered the fraud as part of its due diligence in merely 10 days. Missing these red flags implied either that the auditors were grossly inept or in collusion with the company in committing the fraud. PWC initially asserted that it performed all of the company's audits in accordance with applicable auditing standards (Winkler, 2010).

Immediately following the news of the fraud, Merrill Lynch terminated its engagement with Satyam, Credit Suisse suspended its coverage of Satyam, and PWC came under intense scrutiny and its license to operate was revoked. Coveted awards won by Satyam and its executive management were stripped from the company (Agarwal and Sharma, 2009). Satyam's shares fell to 11.50 rupees on January 10, 2009, their lowest level since March 1998, compared to a high of 544 rupees in 2008. In the New York Stock Exchange, Satyam shares peaked in 2008 at US\$ 29.10; by March 2009 they were trading around US \$1.80. Thus, investors lost \$2.82 billion in Satyam (Bhasin, 2012). Criminal charges were brought against Mr. Raju, including: criminal conspiracy, breach of trust, and forgery.

Although Mr. Raju initially asserted that he acted alone in perpetrating the fraud, the Indian authorities also charged Mr. Raju's brother, the company's CFO, the company's global head of internal audit and one of the company's managing directors. Indian officials acted quickly to try to save Satyam from the same fate that met Enron and WorldCom, when they experienced large accounting scandals. The Indian government appointed a new board of directors for Satyam to try to save the company. The Board worked diligently to bring stability and confidence back to the company to ensure the sale of the company within the 100-day time frame assigned by the Indian Government. The Securities and Exchange Board of India (SEBI) appointed a retired Supreme Court Justice, Justice Bharucha, to oversee the process of an auction for Satyam and instill confidence in the transaction. Several companies bid on Satyam on April 13, 2009. The winning bidder, Tech Mahindra, bought Satyam for \$1.13 per share—less than a third of its stock market value before Mr. Raju revealed the fraud—and salvaged its operations (Dagar, 2009).

There were also several civil charges filed in the U.S. against Satyam by the holders of its ADRs. Both civil and criminal litigation cases continue in India and civil litigation continues in the United States. The SEC and the Public Company Accounting Oversight Board (PCAOB) fined the affiliate, PW India, \$7.5 million in what was described as the largest American penalty ever against a foreign accounting firm (Norris, 2011). According to President of the Institute of Chartered Accountants of India (ICAI), “The Satyam scam was not an accounting or auditing failure, but one of corporate governance. This apex body had found the two PWC auditors prima-facie guilty of professional misconduct.” (The Economic Times, 2009). The Central Bureau of Investigation (CBI – India), which investigated the Satyam fraud case, also charged the two auditors with “complicity in the commission of the fraud by consciously overlooking the accounting irregularities” (Business Standard, 2011). The Registrar of Companies report in India, stated that the directors and senior officials at Satyam, sold shares ahead of the fraud revelation by Mr. Raju (IBNLive, 2009).

The firm, which trades on the New York and Bombay Stock Exchanges, is required to file financial reports with the SEC. After news of the scandal hit the airwaves, PW India issued a press release and stated that its audit was conducted in accordance with applicable auditing standards and was supported by sufficient audit evidence. In 2008, the PCAOB had inspected selected audits of PW India, but the PCAOB’s findings were not released (Bloomberg, 2009)

The Big Four – Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP – have long distinguished themselves from second- and third-tier assurance services firms by marketing themselves as global entities with specific-industry skills that international companies need in highly competitive markets. The Big Four boast of their numerous global affiliates and tout the efficiency and responsiveness of these affiliate offices to current and potential clients. These global professional services firms state that their affiliate offices provide a global network with tens of thousands of employees who can meet the accounting, auditing and consulting needs of the world’s largest companies. In essence, the Big Four sell the idea of a global affiliate network as “we are family,” with each affiliate office working together to take care of the needs of their international clients.

Ironically, the Big Four quickly disavow this “we are family” concept when a problem surfaces in one of their affiliate offices. When an audit failure occurs, the international offices of the Big Four issue public statements reminding accounting regulators that the numerous firms which comprise their affiliate networks are legally independent. In Satyam’s case, the PWC affiliate was PW of India. When news of the Satyam scandal broke, PWC’s international headquarters office in London quickly distanced itself from PW of India and stated that local Indian affiliate offices had conducted the Satyam audit. These PW India affiliates were Lovelock & Lewes, Price Waterhouse Bangalore, Price Waterhouse & Co. Bangalore, Price Waterhouse Calcutta and Price Waterhouse & Co. Calcutta. The US Securities and Stock Exchange Commission (SEC) eventually sanctioned these five PWC affiliates and fined them \$10 million, the largest fine the SEC has ever issued to a foreign-based accounting firm (The Indian Express, 2011). Upon payment

of the fine, PW India stated that it neither admitted nor denied wrongdoing in the Satyam case. The PWC affiliate emphasized that no American accounting regulator “found that PW India or any of its professionals engaged in any intentional wrongdoing or was otherwise involved in the fraud perpetrated by Satyam management.” The PCAOB barred two PW India accountants from taking part in audits of American companies but said it did so because they had refused to cooperate with its investigation (The Firm, 2013).

The \$10 million fine, however, pales in comparison to the losses suffered by Satyam investors and creditors. PWC’s affiliate gladly paid the fine. PWC still has its Indian affiliates in spite of the fact that “PW India failed to conduct even the most fundamental audit procedures” (The Indian Express, 2011). PWC still advertises the expertise and skill set of its global affiliates found in 159 countries and 776 cities. Given the “slap on the wrist” that PWC received from accounting regulators, a skeptic might ask if PWC and its global affiliate network, which comprise the world’s largest professional services firm, have become too big of an international player to indict for its audit of India’s Enron.

Further compounding PWC’s troubles, was the business relationship between PWC and Satyam in the U.S. Both firms worked on a major IT contract for Idearc, a spinoff of telecom firm Verizon. Because Satyam shares are quoted on Wall Street, SEC rules prohibit auditors from having business relations with their clients. U.S. regulators have yet to take action against PWC. Once again, is this lack of enforcement related to PWC’s size and the impact that the failure of a Big 4 firm would have on the global financial marketplace?

### **MORAL HAZARD BEHAVIOR: SOCIETAL IMPLICATIONS**

One form of moral hazard behavior may be less quality audits. The absence of quality audits increases the probability of audit failures. Auditor silence in the face of inordinate corporate risk taking may also imply moral hazard behavior on the part of auditors. Such actions by auditors are more than a social issue such as the environment or sustainability. The failure of one large, publicly traded bank or brokerage house may set up a chain reaction that brings global financial markets to the brink of ruin (Roth, 2008). The collapse of The Bank of Credit and Commerce International in 1991, Barings Bank in 1995, and Bear Stearns and Lehman Brothers both in 2008 provide examples. Each of these collapses rattled the financial markets and spurred global anxiety. Governments and financial regulators around the world coordinated their efforts to prevent panic and to resolve the financial crisis (Nanto, 2009).

The attitude of the Big 4 toward their social responsibility for quality audits or alerting a board of directors to an unhealthy level of financial management risk is more than just about the reputational capital of the Big 4. It has implications for world-wide financial stability. Writing on the great financial crash of 1929 in the United States, J.K. Galbraith saw the crash as a symptom of a wider problem. Galbraith believed that the world of finance was incapable of expressing even the most basic and necessary self-criticism. “The sense of responsibility in the financial community for the community as a whole is not small,” he observed, “it is nearly nil” (Galbraith, 1955). Turner (2006) noted the fact that Big 4 firm-on-firm peer reviews never resulted in a negative or qualified report on one of the major international accounting firms, and had engrained a culture in which one firm had agreed not to tell on the other. When Galbraith’s observation is combined with Turner’s statement, marketplace stakeholders could question if the Big 4 view audit quality with a critical eye.

Neither the global community nor government regulators can afford for the Big 4 to disregard legal, regulatory and ethical standards. Galbraith (1955) also posited that regulators were part of the problem rather than the solution. They were, he thought, vigorous in their youth, moving to complacency in middle age, until they became in old age either senile, or arms of the sector they are supposed to regulate.

A major concern in the marketplace is over the possible demise of one of the remaining Big 4 firms, especially if one of the firms faces a criminal indictment. Friedland (2004) noted that the break-up of Arthur Andersen unfolded in a relatively smooth manner. With this in mind, the authors posit that rather than forming the mentality of “too concentrated to indict,” government agencies, particularly the SEC, should inform the Big 4 and large corporations that the agency has formed a mentality of “here is the plan” in case one or more of the Big 4 are brought to court on criminal charges.

## CONCLUSION

The purpose of this study is to use the tepid reaction of accounting regulators to PWC’s audit failure at Satyam as evidence that the “too big to fail” mindset is a global phenomenon, not isolated only to the U.S. The facts associated with PWC’s audit at Satyam are troubling for the investing public. From June of 2000 until January 2010, PWC audited Satyam. During this time period, Satyam overstated its earnings in almost every quarter. PWC never voiced any concerns about these revenue overstatements. In year 10 of PWC’s audit work for Satyam, PWC missed a cash shortage of \$1.03 billion. Merrill Lynch, a non-audit firm that Satyam hired late December 2009 to help the company find ways to increase shareholder value, notified the New York Stock on January 7 that it was withdrawing from its Satyam engagement because of accounting irregularities. Merrill Lynch uncovered evidence of fraud in less than 10 days. PWC either failed to uncover or ignored the same fraud symptoms for ten years.

Accounting regulators fined PWC’s five Indian affiliates a paltry \$10 million while Satyam investors lost \$2.82 billion. The PCAOB banned two accountants at the PWC Indian affiliates from working on the audits of any American company. The ban was the result of those individuals refusing to cooperate in the regulators’ investigation, not because of reckless audit work. This slight slap on the wrist by accounting regulators reinforces the idea that the regulated have captured the regulator. Such a condition creates a moral hazard environment for audit quality, which, in turn, has negative consequences for global investors and efficient capital markets.

One limitation of our paper is the number of Big 4 audit failures that we examine at the global level. Future research could extend the number of Big 4 audit failures associated with firms in mature or emerging markets and determine if regulatory actions were consistent with a “slap on the wrist” or if they resulted in more serious consequences.

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