

booz&co.



Trusting Your IT Outsourcer *What the CIO Must Know After Satyam*



Contact Information

Beirut

Ramez Shehadi

Partner

+961-1-336433

ramez.shehadi@booz.com

London

Louise Fletcher

Partner

+44-20-7393-3530

louise.fletcher@booz.com

Chicago

Mike Cooke

Partner

+1-312-578-4639

mike.cooke@booz.com

New Delhi

Suvojoy Sengupta

Partner

+44-20-7393-3314

suvojoy.sengupta@booz.com

Vinay Couto

Partner

+1-312-578-4617

vinay.couto@booz.com

New York

Jeffrey Tucker

Partner

+1-212-551-6653

jeffrey.tucker@booz.com

Frankfurt

Stefan Stroh

Partner

+49-69-97167-423

stefan.stroh@booz.com

Olaf Acker

Principal

+49-69-97167-453

olaf.acker@booz.com

EXECUTIVE SUMMARY

Allegations of accounting fraud at Indian IT and business process outsourcer Satyam have raised serious concerns for CIOs who have outsourced large portions of their IT operations, both to Satyam and other firms. For those companies working with Satyam, the most pressing question is whether or not Satyam will survive. While its future status is unclear, the firm will certainly struggle to make the investments necessary to generate new client relationships and for R&D and staff development. Current customers need to determine how this will affect their operations: How much mission-critical work is Satyam engaged in? What are the risks in terms of potential service disruptions in transferring work to other vendors? Who owns the relevant intellectual property? However, any CIO working with outsourcing vendors, not just those working with Satyam, should take this opportunity to gather such detailed information for each of their vendors.

The long-term question raised by this incident is whether Satyam's difficulties will lead to a loss of trust in the Indian outsourcing community as a whole. Foreign corporations already have many more outsourcing options: China, of course, but also Eastern Europe and Brazil. In order to maintain their trust in any potential outsourcing vendor, customers will no doubt expect much higher standards of financial transparency and due diligence. Every company needs to set up a systematic way to analyze its current outsourcing relationships and develop workable risk mitigation against short-term service disruptions.

AN UNPRECEDENTED INCIDENT

The revelations in early January that Indian IT and business process outsourcing (BPO) major Satyam Computer Services had long been falsifying its financial results sent shock waves through the global IT community. The question of the day for CIOs worldwide is whether the Satyam episode is an isolated incident or a watershed in the globalization story of Indian business.

At first glance, Satyam was an instance of deliberate and systematic fabrication of financial results by a single company that, on the surface, had embraced every good governance practice. Such financial scandals are neither unique to emerging economies such as India's nor the sole preserve of companies structured under the family/promoter model. The Indian government is to be commended for moving swiftly and decisively to

control the damage. A new government-appointed board is looking to restate the Satyam accounts, appoint new leadership, and evaluate strategic options for the beleaguered company.

However, for CIOs who have outsourced large portions of their IT portfolios, this incident raises serious concerns about risks of potential knowledge loss and service disruptions should major issues arise with their outsourcing vendors, whether in India or elsewhere. This scenario requires them to answer tough questions from the CEO and board members, sure to focus on two areas: short-term tactical questions regarding the management of their current Indian outsourcing arrangements, and long-term structural questions about using Indian and other outsourcing firms and whether changes to their vendor governance models are necessary.

Is the Satyam episode an isolated incident or a watershed in the globalization of Indian business?

Satyam's Scandal and Its Implications

On January 7, 2009, Satyam announced that it had been cooking the books for almost seven years and it had claimed \$1 billion in cash that did not exist. Founder and chairman B. Ramalinga Raju initially said that he had falsified the profits to avoid losing control of the company. However, recent investigations indicate Raju may have skimmed the money directly from the company. Satyam's NYSE-traded American Depository Receipts fell from a 52-week high of almost \$30 per share to \$1.10. Raju, his brother B. Rama Raju, a managing director of the company, and CFO Vadlamani Srinivas were arrested and held in police custody. And this at a company that just last year had won prestigious international awards for outstanding corporate governance.

Satyam was estimated to have about 631 clients as of June 2008, with about 60 percent of its revenue coming from companies based in the U.S. However, fewer than 250 of those accounts were worth more than \$1 million per year to the company, and the smaller contracts could be easily absorbed by rivals. Of the larger, long-term strategic relationships, which include Unilever, Nestlé, DuPont, Cisco Systems, General Electric, General Motors, Nissan, Sony, and Applied Materials, such clients will no doubt look to other incumbent and new suppliers as an immediate fallback position. Satyam also supposedly has \$200 million in contracts currently up for renewal, and many competitors are gearing up to take significant business as part of the renewal recompetete process. Competitors are also discussing strategies for taking more client business in accounts where they have a dual prime role with Satyam.

The Satyam fraud appears to have occurred due to the simultaneous failure of several internal and external controls, including reputed independent directors, an audit committee, and statutory auditors of international renown. In other words, the Satyam scandal is really a breakdown in the execution of governance practices, not a lack of governance mechanisms. Therefore, the extent of the fraud at Satyam may run well over \$1 billion, and no one knows yet how much working capital and cash on hand remains.

So far, it is unclear whether the Indian government will step in to solidify the company's financial position or whether the company will be sold, either as a whole or in pieces. We believe a sale of Satyam in its current form seems unlikely. Who would buy a company with so much financial uncertainty—especially at a time of economic stress? Competitors are much more likely to simply poach its customers and employees than to buy it outright and assume all the potential liability.

OUTSOURCING ALTERNATIVES

CIOs whose companies continue to maintain long-term relationships with Satyam have one primary concern: Satyam's very survival. Satyam could indeed crumble quickly, and its operations could be greatly hampered soon. Clearly, it will not be in a position to invest significantly in client engagements, staff development, or research and development, all critical elements for an IT services company. Satyam must also spend a great deal of time and resources working through its accounting issues and dealing with extensive external regulatory investigations in both India and the U.S.

Most Indian IT and BPO companies have publicly said that they will not poach Satyam clients or employees. However, we have observed several companies that are indeed opportunistically trying to wean away Satyam clients. Although major clients have

not deserted Satyam yet, this situation may well change on short notice.

One the positive side for Satyam's clients, most of the work in India is done out of centers in Hyderabad, Bangalore, and Chennai, home to outsourcing operations of many of Satyam's competitors (including Wipro, Infosys, Tata Consultancy Services, IBM, and Accenture). We expect to see plans for the absorption of staff and clients drawn up by competitors within days, and a lot of shifting taking place within weeks. Every provider will give top priority to providing services to support day-to-day operational computing systems. Project-based work will wait. For CIOs, the possibility of all this upheaval has caused a great deal of concern regarding the operational resilience of these new relationships.

Booz & Company recommends that Satyam's clients move quickly to assess the damage and put in place contingency plans for service continuity. They must first determine their exposure to and reliance on Satyam, including conducting a comprehensive inventory of the systems and projects Satyam was working on. Next, they must identify the most mission-critical systems being developed or main-

tained by Satyam and put together a plan for bringing those systems back in-house or migrating them to another vendor. At the same time, they should review every contract covering work with Satyam, paying particular attention to the exit clauses governing the transfer of work and ownership of any intellectual property.

CIOs need to consider their options, assessing which vendors might be able to take over from Satyam. Now would also be a good time to review the governance and accounting oversight of all offshore suppliers and to catalog and capture all the intellectual property and domain expertise residing with Satyam, including all of the potential business knowledge possessed by the vendor's employees. Consider offering jobs or incentives to Satyam staff as part of transferring that knowledge back in-house or to competitors. We recognize the challenges of undertaking such a significant project, especially given all the other demands CIOs are facing in this challenging business environment. However, this exercise can not only help mitigate against short-term service disruptions but also give the IT organization a greater understanding of its current outsourcers' activities, which can be leveraged in the future to negotiate more favorable contract terms.

THE EROSION OF TRUST

It would be irresponsible to trivialize the broader implications of Satyam's issues for India's IT services and business process outsourcing sector, which hitherto had won accolades from U.S. companies for setting high standards of quality, client service, reliability, and cost competitiveness. Even before news of the scandal broke, the sector had been feeling the impact of major recessions in developed economies as well as concerns around the likely stance of the Obama administration toward offshoring. Meanwhile, companies have been significantly evaluating both near-shore alternatives and offshore destinations other than India, including Brazil and Poland. While this has been driven mainly by Indian political and security concerns, hyperinflation in Indian technical salaries, and soaring real estate prices, the Satyam debacle may accelerate the pursuit of such alternatives.

Now another critical component of successful outsourcing has been lost: trust. When overseas clients choose offshore providers, they must, first and foremost, be able to trust their providers with the sensitive data, proprietary systems, and complex processes that are instrumental to their businesses. Our recent discussions with a variety of companies clearly indicate that the Satyam experience has shaken that trust. CIOs must demand much higher standards of transparency and conduct even more due diligence, especially during the current climate of financial crisis. Well-governed providers of outsourcing services with established disclosure norms and robust accounting practices will clearly be favored, while the weaker, smaller players will likely suffer.

GOVERNANCE IN CORPORATE INDIA

The long-term question raised by Satyam's downfall centers on whether foreign investors will grow skeptical about corporate governance standards throughout the Indian business community. Does the Satyam saga warrant an extensive overhaul of corporate governance and regulatory frameworks for Indian outsourcing providers? No regulatory regime is either perfect in design or perfectly enforceable, and it is certainly not possible to legislate morality. Instances of financial malfeasance have cropped up with depressing regularity, in spite of tightening regula-

tory regimes, in India and elsewhere. By and large, existing market and legal mechanisms should be able to deal with isolated incidents and discipline the wrongdoers. It is premature, and even dangerous, to conclude that a fundamental breakdown in corporate governance has indeed taken place in India.

It is quite possible that if companies continue to pull back their spending and if the liquidity crunch continues much longer, more outsourcing companies could run into difficulties. Given that potential, every company needs to set up a systematic way to analyze its current outsourcing relationships—not just with Satyam and other Indian providers but with all of its outsourcing vendors—and develop workable risk mitigation strategies. In the words of Barack Obama's new chief of staff, Rahm Emanuel, "You never want a serious crisis to go to waste."

The most recent list of our office addresses and telephone numbers can be found on our website, www.booz.com

Worldwide Offices

Asia

Beijing
Hong Kong
Mumbai
Seoul
Shanghai
Taipei
Tokyo

**Australia,
New Zealand &
Southeast Asia**
Adelaide
Auckland

Bangkok
Brisbane
Canberra
Jakarta
Kuala Lumpur
Melbourne
Sydney

Europe

Amsterdam
Berlin
Copenhagen
Dublin
Düsseldorf
Frankfurt
Helsinki
London

Madrid
Milan
Moscow
Munich
Oslo
Paris
Rome
Stockholm
Stuttgart
Vienna
Warsaw
Zurich

Middle East

Abu Dhabi
Beirut
Cairo

Dubai
Riyadh

North America

Atlanta
Chicago
Cleveland
Dallas
Detroit
Florham Park
Houston
Los Angeles
McLean
Mexico City
New York City
Parsippany
San Francisco

South America

Buenos Aires
Rio de Janeiro
Santiago
São Paulo

Booz & Company is a leading global management consulting firm, helping the world's top businesses, governments, and organizations.

Our founder, Edwin Booz, defined the profession when he established the first management consulting firm in 1914.

Today, with more than 3,300 people in 58 offices around the world, we bring foresight and knowledge, deep functional expertise, and a practical approach to building capabilities and delivering real impact. We work closely with our clients to create and deliver essential advantage.

For our management magazine *strategy+business*, visit www.strategy-business.com.

Visit www.booz.com to learn more about Booz & Company.
