A Story of a FAILED IT Giant: Case of Silverline Technologies Limited

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Silverline's Fall from Grace

Silverline's Downfall Caused By

External Environment Induced (Recession *plus* M&A Induced)

Systematic Manipulation of Accounting Policies and Practices

Silverline *Ki Kahani*

Year	1997	1998	1999	2000	2001	2002	2004
Sales (Crores)	77	83	110	195	310	175	NA
PAT (Crores)	22	24	41	70	131	34	NA
Equity (Crores)	38	43*	64	64	86**	108***	120
Net worth (Rs Crores	95	119	174	462	1,206	1,123	NA
RoNW	24%	20%	23%	17%	11%	4%	--Ve
Share Price (Rs.)	32	90	250	1300	250	150	5
Market Cap. (Rs. Crores)	122	387	1,600	8,320	2,150	1,620	60
Promoter Stake	60%	73%	73%	31%	23%	15%	0.07%
Auditor	DHS	DHS	DHS	DHS	DHS	Vish.	CGSN
Subsidiaries	1	1	2	1	3	4	-

- STL’s Marketing Company till 1999 (Probable)
- STL Investments of WoS (> Rs 300 Crores)
- STL Loans & Advances … related parties
- STL Debtors / Receivables of WoS
- Contingent Liabilities
- Bank / Corporate Guarantees
- Other Board of Directors … Questionable
- High Figures on 30 Jun. 2002
  - Large number of litigations
  - STL Investments in others (incubators)
- Other Issues – Auditors Payments, Managerial Remuneration, Board Meetings Attended, Commitment of Funds, Resignation of Independent Directors

Why Financial Reporting Procedures and Practices be misused (for self benefits)?

Possibility for Earnings Management

Audits are not Perfect Detectors of Fraud

Flexibility in GAAP Requires Judgment

Degree of Earnings Management

- Employment of conventional GAAP Flexibility
- Employment of Flexibility that strains GAAP
- Behaviour Beyond the Boundaries of GAAP
- Understating liabilities
- Fraudulent Financial Reporting

Part I

The Five

Ploys

The Five Ploys

- Recognizing revenue early
- Recording fictitious revenue
- Overstating assets to defer expenses
- Understating liabilities
- Taking big baths

Ploy 1: Recognize Revenue Early

Firms often recognize revenue before they qualify to do so

Revenue Recognition Criteria

- Substantial Performance
- Confidence In Collections
- Good Handle On Costs

Ploy 2: Record Fictitious Revenue

Firms record fictitious revenue by employing aggressive accounting procedures or by conducting outright fraud. Examples include:

- Recording revenue when the firm ships goods to its own off-site warehouses even though the goods (or services) have not yet been purchased by customers.
- Grossing up revenue, e.g., recording large amounts of revenue along with offsetting cost of sales for swap transactions, etc.
- Selling goods to affiliated parties, which may technically qualify as sales under GAAP (if the affiliates are not consolidated) but which are primarily conducted to increase reported revenue.
- Recording investment income as operating revenue.
- Otherwise recording revenue that lacks economic substance.

Ploy 3: Overstating Assets to Understate Expenses

Examples:

- Capitalizing expenditures as assets rather than recording them as an expense.
- Failing to write down assets which have permanently declined in value (i.e., the PV of expected cash flows is less than book value).
- Failing to properly amortize intangible assets when impairment occurs.
- Otherwise overstating assets, e.g., ending inventory.
- Understate reserves for bad debts, inventory, etc.

Ploy 4: Understate Liabilities to Understate Expenses

Examples:

- Simply ignoring invoices when received.
- Recording revenue when cash is received even though services have not yet been performed (this cash should be recorded as an unearned revenue liability).
- Ignoring lawsuits and other contingent liabilities that are likely to be realized.

Ploy 5: Take Big Baths

Firms sometimes record large special charges in the current period. These charges set up reserve accounts that reduce recorded expenses in later periods.

- Theory: Investors will largely ignore the one-time charge, and by taking the charge today the income statement will look stronger in the future.

Special Charges: Primarily asset write-offs of goodwill, inventory, or PP&E (asset impairments).

Restructuring Charges: Restructuring charges are associated with major changes in an entity's business and/or strategy, such as divestment of business units, termination of employees with severance packages, etc.

Part II

Detecting the

Ploys

Audit Report

Look For:

- A qualified opinion
- Any reservations the auditors may express regarding the financials
- Any changes in accounting methods the auditors highlight

Proxy Statements

Look for:

- Executive stock options, which often provide the incentive for earnings management
- Related-party transactions, which can be used to inflate reported revenue or hide liabilities
- Litigation that is not accrued on the financials
- Changes in auditors which may relate to disputes.

Financial Statement Investigation

Analyze financial statement metrics:

- Across firms in the same industry (e.g., cross-sectional analysis), and
- Over time for the same firm (e.g. cross-time analysis).

Key Point: Note that the indicators listed (herein) often can be interpreted two ways. On the one hand, they could reflect earnings management. On the other hand, they could reflect actual strength or improvement for the firm. Therefore, when an indicator is detected, it simply means that further analysis must be conducted to distinguish between actual strength and feigned strength.

Insights on Silverline Technologies

- Never be part of a company with a very complicated organization *or* business model
- Lack of Financial Transparency
- Huge Related Party Transactions
- Stock Price Manipulations
- Insider Trading
- Stress on Quality of Management

What is Corporate Governance?

- Corporate Governance is *taking into account all stakeholders interests* …
- In other words, not to misuse powers (*given by some others*) is the essence of corporate governance
- Corporate Governance in India is very different from western countries –
  - It starts with differences in the ownership patterns itself.
  - Regulators and institutional intermediaries often succumb to pressures (and also take time to respond … but they do respond) … so implementation of corporate governance norms is slow, stuttered and weak.
  - Most (retail) investors lack capability, have poor awareness.

- Corporate(s) and its managers (specially owner-managers) often tend to do things that are ***legal but questionable***.
- Silverline is an extreme example in that direction. (As pointed by Prof. K R S Murthy), the corporate governance questions are:
  - Why do business leaders do things they know should not be done?
  - What are the pressures or fears that force them to do so?
  - How can they be helped to be more integral to their own beings?
  - How can the board of directors play a more useful role?