

# Management discussion of risks and concerns

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Any Group needs to ensure that it has a proper continuous risk identification and management process. This process will generally involve the following steps:

- Identifying, ranking and sourcing risks inherent in the Group's strategy (including its overall goals and appetite for risk);
- Selecting the appropriate risk management approaches and transferring or avoiding those risks that the business is not competent or willing to manage;
- Implementing controls to manage the remaining risks;
- Monitoring the effectiveness of risk management approaches and controls;
- Learning from experience and making improvements.

Since June 2006, the Group has become a subsidiary of Electronic Data Systems Corporation (EDS). In terms of a merger agreement executed between Electronic Data Systems Corporation, Hewlett-Packard Company ('HP') and Hawk Merger Corporation, the last named company merged into Electronic Data Systems Corporation on 26 August 2008. As a result of this merger, Electronic Data Systems Corporation became a 100% subsidiary of HP and was renamed as Electronic Data Systems LLC. Further, HP became the ultimate holding company of Mphasis.

Hewlett Packard is a technology company that operates in more than 170 countries around the world with a revenue totalling \$118.4 billion for the fiscal ended 31 October 2008. HP was founded in 1939 and has its Corporate headquarters in Palo Alto, California, USA. This acquisition of EDS by HP has significantly altered the risk profile of the Group as also given it greater access to international markets combined with a strong governance process.

Management has identified certain areas of risk where the Group is vulnerable, listing them below along with actions to deal with the same and thereby mitigate, if not eliminate such risks. Management strives to ensure a policy of strong corporate ethics driven by correct organisation culture rather than by legal requirements. Thus, healthy internal systems and practices are based on best practices rather than on legal compliance.

## **Business Risks**

### ***Economic crisis***

The Group derived 88% of its revenues for the period 31 October 2008 from the US and Europe. The economic crisis that these regions are currently going through as well as their spill over effect on India and the Asia Pacific region are likely to affect the Group's revenues and profitability.

### ***Client concentration risk***

The Group derived 12% of its total revenues during the year ended 31 October 2008 from a single client. The Group's profitability and revenues would be affected in case of loss of this client or a significant downsizing of projects given to the Group by this client. The overall trend is a declining client concentration and the Group is confident that this will continue. Increasing volume of the group's business will be sourced through HP and any significant changes in HP or in its relationships with the clients it seconds to the Group could also affect revenues. 40% of the total revenues are currently sourced through HP under the Master Service Agreement.

### ***Business concentration risk by vertical***

The Group derived 42% of its revenues for the year ended 31 October 2008 from the Financial Services vertical, which include banks, brokerages, insurance companies and financial institutions. A downturn in the fortunes of clients in this group or a reduction in their IT spending / budgets, would adversely affect the Group's own profitability. Due to the association with HP, the Group has successfully broadened its base into technology, Manufacturing and telecom verticals. The shares of revenue from financial services vertical have not grown during the year. There has been an increase in the area of technology, manufacturing & telecom vertical creating a better balance in the revenue portfolio.

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## ***Competition risk***

New competitors may enter the markets the Group operates in or current competitors could decide to focus more on these markets, and thereby intensify the highly competitive conditions that already exist. These new entrants and existing competitors could offer or introduce new technologies, offer a different service model, or could treat the services to be provided by one of our businesses as a component of a larger service offering. Such developments would enable these new and existing competitors to offer similar services at reduced prices. Such developments could harm the Group's business and results of operations.

The market for software development services is highly competitive and subject to rapid technological change, regulatory developments and emerging industry standards that the Group expects will continue. This could result in lower margins in future for the Group and could also result in increased pricing pressures. Certain of the Group's competitors have substantially greater financial, technical, marketing and other resources than the Group, and competitors of the Group have made and continue to make significant investments in the construction of new facilities. To the extent the Group is unable to compete effectively against its competitors, its financial condition and results of operations would be materially and adversely affected.

Management expects competition to persist and increase in the future. Management continuously monitors competition and modifies the business model to adequately compete but it cannot assure that the Group will be able to compete successfully against these or future competitors.

Management expects that a portion of the Group's anticipated future revenue growth in the various business segments will be derived from:

- The continued selling of services to our existing customers;
- The planned introduction of new or enhanced services;
- The selling of services to new customers;

How successful the Group will be in these efforts will depend on a variety of factors, including the Group's:

- Service offerings;
- Effective sales and marketing efforts;
- Ability to attract new as well as retention of new and existing customers;
- Market acceptance and the avoidance of difficulties or delays in development or Introduction of new services.

The alignment with HP has significantly reduced this risk and the Group plans to leverage HP's existing client relationships to broaden its client base.

## ***International operations risk***

The Group has international operations in many countries like Australia, Belgium, China, Germany, Japan, Mexico, The Netherlands, Singapore, UK, and the US. International operations are subject to various risks which could adversely affect those operations or the business as a whole, including:

- Costs of customizing products and services for foreign customers;
- Difficulties in managing and staffing international operations;
- Reduced protection for intellectual property rights in some countries;
- Longer sales and payment cycles;
- The burdens of complying with a wide variety of foreign laws; and
- Exposure to local economic conditions.

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HP has operations in 170 countries and Mphasis is expecting to partner with HP in several of these geographies where it currently may not have a presence. This may increase the risk of international operations within the Group. However, the Group plans to leverage the HP experience & expertise in operating in these geographies to mitigate these risks to a large extent.

### ***Overseas tax obligation risk***

The Group is also required to comply with various state level legislation / statutes in the US which is the largest market for the Group. Based on legal opinion, the Group provides for the Income / Sales taxes in the various states in the US, where it has operations. In the event that there is a dispute with the state authorities, the actual tax liability may be higher than that recognised hitherto by the Group. The tax calculation and provision are suitably verified by the Group's tax consultants and legal advisors in the US so as to mitigate these risks.

As a large part of the growth in the Group's business is expected to come from and through HP, a larger proportion of the revenues of the Group would be subject to transfer pricing regulations. This would also necessitate having more rigour around Transfer Pricing mechanisms to ensure that an arm's length is maintained in all transactions.

### ***Fixed price contract risk***

The Group derived 4% of its total revenues from Fixed Price contracts during the year ended 31 October 2008. Such projects require continuous monitoring and as well as accurate estimation of overall efforts, which directly affects the profitability of the group. If constant and adequate control is not exercised, it will result in cost overruns and eventual losses for the Group besides loss in client goodwill on account of delayed delivery, quality and failure to meet contractual obligations. It also results in revenue variability as it depends on new project wins once an existing project is complete. During the year the share of fixed price contracts has reduced with corresponding increase in the time and material contracts.

Management minimises this risk through a process of periodic monitoring of the profitability of fixed price contracts, including reviewing the estimate of efforts to complete and appropriate corrective action being undertaken by the concerned client management teams. These actions ensure that the estimated profitability of these contracts is maintained.

### ***Termination of contracts by clients***

A significant portion of the Group's contracts with its clients is on a non-exclusive, project-by-project basis. The clients, with or without cause, may terminate the contracts, including fixed-price contracts, by providing an advance notice varying between zero to 90 days. Further, these contracts do not carry a commitment of future volume of business. The Group's business is therefore dependant on the decisions and actions of the client, which are outside the Group's control, and could result in the termination of the said contracts. These actions could include:

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- Financial difficulties for the client;
- A change in strategic priorities;
- A demand for reduction in prices; and
- A change in outsourcing strategy by shifting work to in-house IT departments or to the Group's competitors.

The Group may also potentially lose out on the prospects and revenue because such prospects and clients may perceive themselves to be in conflict with HP or may not have had a good relationship with HP in the past. Also after the HP transaction, the Group is viewed as part of a bigger company & hence may be perceived as unwilling to take on small contracts. This may adversely impact the business, particularly in the domestic market. However, any such loss is likely to be more than offset by the new business that would flow to the Group because of its association with HP.

### ***Delivery Disputes***

Where for competitive reasons the Group needs to accept a project it may do so even where the specifications may not have been completely defined at inception. This could lead to differences in opinion with the client at the time of delivery of the project. The Group's client relationships are sufficiently strong whereby such disputes can be resolved to the mutual satisfaction of the client and the Group. But in future if such disputes are not resolved, they could have an impact on the operating results of the Group. These risks are heightened in cases where clients face budgetary constraints or have internal management issues. The Group also maintains adequate insurance for professional indemnity and errors and omissions to cover such cases.

### ***Onsite - Offshore proportion***

Some clients insist on onsite efforts to exercise better control and to monitor progress of the project. The Group is moving towards offshore efforts over a period of time once clients are convinced of the Group's ability to deliver and execute projects as per plan or even ahead of such plans. However, requirements by the customers to maintain a specified number of resources onsite could significantly impact the results of operations of the Group.

### ***Operational Results / Issues***

The Group's ability to improve profit margins will depend on factors that include the degree to which and the speed with which the Group will be able to increase operational efficiencies and reduce operating costs. Delays or difficulties in implementing and consolidating process improvements, such as those designed to reduce travel, telecommunication and customer service costs, or installing new products and services and in consolidating various functions, including administrative functions, eliminating duplicate operations and consolidating facilities could adversely affect the timing or effectiveness of cost reduction and margin improvement efforts. The Group has an effective system of forecasting and budgeting for costs so as to ensure optimum utilisation of resources. It is continuously in the process of reviewing its systems and procedures to implement tighter controls.

Customer retention is an important factor in the amount and predictability of revenue and profits in the Group's businesses. The Group's ability to retain existing customers depends on a number of factors, including:

- Customer satisfaction;
- Service offerings by competitors;
- Customer service levels; and
- Price.

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In providing services, the Group would incur installation and conversion costs in connection with new customers that will need to be recovered before the contractual relationship will provide incremental profit. Longer customer relationships are likely to be more profitable.

As discussed under the 'Competition risk', a significant portion of the Group's revenues is generated from existing clients and the Group has also been successful in adding new clients every year. However, there can be no assurance that the Group would be able to retain all/significant proportion of its existing clients.

### ***Mergers & Acquisitions***

While the focus of the Group is currently more on the organic growth, it would not be averse to inorganic growth opportunities especially if these significantly increase the delivery capabilities from India or other offshore/ near shore locations.

### ***Telecommunication infrastructure risk***

The use of strategically located software development centres provides the Group with cost advantages, ability to attract and retain highly skilled personnel and consequently the ability to provide the clients with services 24 hours a day and 7 days a week. This delivery model involves the maintenance of active voice and data communication links between the Group's call centres, its software development centres and clients. Although the Group maintains redundancy facilities and satellite communication links, any loss in its ability to transmit voice and data through satellite and telephone communication links could adversely affect the Group's ability to complete client projects on a timely basis thereby affecting its revenues and operational performance. The delivery centres of the Group have moved on to a state of the art, global secured network put in place by HP with built in redundancies and fall back options. This network is widely recognised as the only one of its kind in the world and is a source of significant competitive advantage.

### **Financial Risks**

#### ***Foreign exchange fluctuation risk***

As a predominant part of the Group's billings are in foreign currency, which is 91% for the year ended 31 October 2008, it is exposed to currency fluctuations and volatility against the Indian rupee. Principal currencies dealt with by the Group include the US Dollar, British Pound, Euro, Singapore Dollar, Japanese Yen and the Australian Dollar. To the extent that there is a significant appreciation of the rupee, it would affect our earnings negatively. Such volatility would also affect our assets located at various locations worldwide in terms of their carrying value. Rupee depreciation would affect the Group's import policy especially covering capital items thereby increasing our liability and cost. The expected increase in offshore work may heighten the risk of rupee appreciation. To mitigate this the Group is moving towards acquiring domestic business which is immune to currency fluctuations as also working with HP in several geographies to increase its onsite presence to provide a natural hedge in the business model. Currently the Group has a policy of hedging the balance sheet and is actively considering putting in place cash flow hedges on future earnings as well.

#### ***Credit risk***

The Group's ability to recover dues from a client is dependent on the credit terms given to the client. With clients and operations all across the world, effective procedures and recovery mechanism have to be in place to avoid excessive bad debts. The Group constantly reviews credibility of existing customers and follows rigorous credit checks on prospective clients before fixing credit limits and credit periods. With the increased size of operations and the marquee clients that the Group has access to through HP, the credit checks will become more stringent leading to a reduction in the credit risk.

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## ***Liquidity risk***

The Corporate Finance Department of the Group is responsible for ensuring that the Group's liquidity position is satisfactory at all times. The Group's cash flow is dependent to a large extent on the credit terms extended to clients and the effective recovery of dues from them. Delays in recovery of dues, has a direct impact on the Groups liquidity position. Investment of surplus cash resources of the Group is also an area of risk in terms of safety and liquidity and balancing this with returns. The Group also has expansion plans for its delivery infrastructure which may strain its liquidity position to a certain extent. However, given the financial strength of the Group and its access to a much larger parent company, the access to funds is not expected to be a hindrance to the business or growth.

## ***Employee Benefits***

Employee benefits consists of contribution to provident and gratuity funds.

Contributions to provident fund is as per defined contribution plan wherein both employee and the Company make monthly contributions that is equal to a specified percentage of the employee's salary to the Regional Provident Fund Office. The Company has no further obligations beyond its monthly contributions.

Contributions to gratuity and compensated absences under defined benefits are based on actuarial valuation and the contribution is made to the fund. Actuarial liability is ascertained as per the guidance issued by the Actuarial Society of India with assumptions on salary escalation, withdrawal rate, rate of discount and mortality rates. Though the assumptions are in line with the industry, a change in any of these assumptions could affect our earnings. Similarly, if the earnings of the fund is inadequate, the Company has an obligation to make good the shortfall, which would affect our earnings.

## ***Capital expenditure risk***

Significant resources are required towards acquisition of capital equipment. The Group is currently able to meet this requirement through internal accruals and has not resorted to borrowings from external lending agencies. However, this may not be the case in future wherein the Group could have to borrow from external financial agencies to tide over short term gap which are not significant.

## ***Investment in property***

The Group does not generally invest in property in the form of land and buildings. However, the Group owns certain properties purchased earlier which are held for use and future expansion. These properties are valued at cost. Due to fluctuations in the real estate market, the market value of these properties may fall below the cost at which they were originally purchased. Should these properties be sold there is a risk that the sale price may be lower than the value at which such properties are recorded in the books.

## ***Indian Taxation risk***

Currently, the Group's Indian operations enjoy several significant tax concessions provided by the laws in India. These benefits include, a tax holiday from profits generated from the export of computer software and the exemption from import customs duties on assets purchased that are to be used in export revenue generating activities.

Any amendment to the Indian taxation statutes could adversely affect the Group's financial results and competitive advantage vis a vis other countries across the world. With the Software Technology Park (STP) scheme in a sunset phase, the Group is moving towards Special Economic Zone (SEZ) schemes where it would continue to enjoy tax holidays.

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## Legal & Other Contractual Risks

### *Regulatory risks*

As the Group operates in various countries round the world, it requires legal compliances of all rules, regulations and laws in these countries. Non-compliance exposes the whole Group to penal and or monetary repercussions besides generating negative publicity for the Group. The Group has appointed legal counsel and consultants in the various countries where it operates to ensure compliance with their respective regulations.

HP also has a robust governance process & has legal counsels around the world whom the Group can consult

Further, any regulatory pronouncements by any government putting restriction on outsourcing work outside recipient country can significantly affect group's operations.

### **Directors, Managers, Officers and other employees' liability risk**

These are the legal risks of the above individuals towards third parties. If such cases are decided against such individuals, the liability could fall on the Group to make good any losses. The Group is sufficiently insured to cover such risks and also there are adequate controls in place to mitigate this.

### *Contractual risks*

This risk pertains to liquidated damages and other penalties associated with the non-fulfilment of contractual obligations either with clients or with other parties. In addition to providing performance guarantees, the Group also makes sufficient provision for warranties and post contract customer support to cover such eventualities wherever required. The Group also has insurance cover for 'errors and omissions'.

### **Changes in visa / work permit / immigration rules and terrorism**

Onsite efforts of the Group would be affected on account of difficulties in obtaining work permits and business visa's especially to the US. With increased focus on offshoring & more stringent norms for visa coming in, it may become challenging to deliver & come upto clients' expectation.

Some of the recently publicised events involving people from Bangalore have given the city and the country unwanted publicity and undeserved scrutiny. The fact that one of these people was apparently employed by a reputed IT company in Bangalore has not helped either.

### *Insider Trading*

The risk of insider trading and its consequences has become a matter of concern for any organisation. To mitigate this risk detailed insider trading guidelines are in place and these are rigorously implemented and monitored.

### **Technological risks**

#### *Technology risks*

The Group's ability to remain competitive depends on the ability to adapt to changing technology. As a provider of information technology services, the Group strives to adapt and respond to the technological advances offered by competitors and the technological requirements of clients, in order to maintain and improve the Group's competitive position. However, there can be no assurance that the Group will develop and release new products and services or product and service enhancements within the projected time

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frames and within targeted costs. Significant delays, difficulties or added costs in introducing new services or enhancements, either through internal development, acquisitions or cooperative relationships with other companies, could adversely affect the market acceptance of the Group's services and operating results. The Group has now access to HP technology that it could leverage to its advantage.

### ***Obsolescence risks***

Management continues efforts to transition to new or enhanced data processing systems and/or software, including systems that process customer data and internal management information systems. The successful implementation of these new or enhanced systems will be critical to the effective delivery of products and services and the efficient operation of the Group. Problems or delays with the installation or initial operation of the new or enhanced systems could disrupt or increase costs in connection with delivery of services and with operations planning, financial reporting and management.

### **Human Resources**

#### ***Attracting and retaining professional talent***

The Group's future success will depend in part on continued ability to hire, assimilate and retain qualified personnel. Competition for such personnel is intense, and management may not be successful in attracting or retaining such personnel. The loss of any key employee, the failure of any key employee to perform in his or her current position or the Group's inability to attract and retain skilled employees, particularly technical and management, as needed, could harm the Group's business. The loss of the services of any executive officer or other key technical or management personnel could also harm the Group's business.

The Group strives to provide excellent staff welfare measures to promote employee satisfaction and thereby attract and retain efficient manpower. Further, to ensure that employees grow with technology the Group conducts regular training programmes. The Group has undertaken various initiatives to ensure that succession planning for key employees is put in place. The acquisition of the group by EDS significantly opens up new opportunities for our people and this should mitigate the risk of attrition to a significant degree

#### ***Travel risks & Health Risk***

Due to the nature of the Group's business, the employees are frequently required to travel abroad. In recent times, travel related risks have increased and also employees are subject to health risks in various parts of the world. The Group has a policy of taking mandatory health and travel insurance for all its employees who travel overseas.

### **Others**

#### ***Political risks***

The political establishment in India is sufficiently fragile to warrant this risk in terms of policies and restrictions that could be imposed. India's relationship with its neighbours has been and continues to be a cause of concern although there are reasons to believe that these relationships are gradually improving.

While the software development business is split between offshore and onsite, the call centre operations are largely concentrated in India. This makes it all the more susceptible to risks associated with India. The Indian call centre industry also faces competition from other countries notably Philippines and Ireland. Should clients decide to shift business out of India to other countries, this could adversely affect the Group's business. To counter this, the Group has opened a Spanish language call centre in Mexico and also a software

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development centre in China that will serve as a backup to the existing centres. The Group has facilities in Slough, UK and Phoenix, USA through its acquisitions of Mphasis Consulting and Eldorado Computing respectively.

The Group's Indian operations have enjoyed several tax concessions provided by the laws in India. Should the Indian authorities amend taxation statutes again, this could adversely affect the Group's financial results.

### ***Economic risks***

Trade, monetary and fiscal policies and economic conditions could substantially change. As the Group's business has grown, the Group has become susceptible to changes in general economic conditions, which could result in reductions in capital expenditure by end-user customers, longer sales cycles, deferral or delay of purchase commitments for the Group's services, and increased price competition. Although these factors have not materially impacted the Group in recent years, this would be the case if the current economic slowdown continues or worsens thus adversely affecting the Group's business and operations.

### ***Accidents, natural calamities and safety of employees and assets***

The risk of natural calamities, labour unrest, accidents with peril to employees, assets and other business interruptions could adversely affect the Group's business. The Group's operations are vulnerable to interruption by fire, earthquake, flood, power loss, telecommunications failure and other events beyond management control. Our facilities in India are currently subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations of affected facilities. The Group is sufficiently insured to cover such risks and interruptions to operations and the real estate strategy of the Group requires it to have 2 sites in the same city, to mitigate such risks besides having a disaster recovery and business continuity plan in place.