

1. Stakeholder, risk mapping, sustainable development and internal controls – Rowlands & Medeleev

Rowlands & Medeleev (R&M), a major listed European civil engineering company, was successful in its bid to become principal (lead) contractor to build the Giant Dam Project in an East Asian country. The board of R&M prided itself in observing the highest standards of corporate governance. R&M's client, the government of the East Asian country, had taken into account several factors in appointing the principal contractor including each bidder's track record in large civil engineering projects, the value of the bid and a statement, required from each bidder, on how it would deal with the 'sensitive issues' and publicity that might arise as a result of the project.

The Giant Dam Project was seen as vital to the East Asian country's economic development as it would provide a large amount of hydroelectric power. This was seen as a 'clean energy' driver of future economic growth. The government was keen to point out that because hydroelectric power did not involve the burning of fossil fuels, the power would be environmentally clean and would contribute to the East Asian country's ability to meet its internationally agreed carbon emission targets. This, in turn, would contribute to the reduction of greenhouse gases in the environment. Critics, such as the environmental pressure group 'Stop-the-dam', however, argued that the project was far too large and the cost to the local environment would be unacceptable. Stop-the-dam was highly organised and, according to press reports in Europe, was capable of disrupting progress on the dam by measures such as creating 'human barriers' to the site and hiding people in tunnels who would have to be physically removed before proceeding. A spokesman for Stop-the-dam said it would definitely be attempting to resist the Giant Dam Project when construction started.

The project was intended to dam one of the region's largest rivers, thus creating a massive lake behind it. The lake would, the critics claimed, not only displace an estimated 100,000 people from their homes, but would also flood productive farmland and destroy several rare plant and animal habitats. A number of important archaeological sites would also be lost. The largest community to be relocated was the indigenous First Nation people who had lived on and farmed the land for an estimated thousand years. A spokesman for the First Nation community said that the 'true price' of hydroelectric power was 'misery and cruelty'. A press report said that whilst the First Nation would be unlikely to disrupt the building of the dam, it was highly likely that they would protest and also attempt to mobilise opinion in other parts of the world against the Giant Dam Project.

The board of R&M was fully aware of the controversy when it submitted its tender to build the dam. The finance director, Sally Grignard, had insisted on putting an amount into the tender for the management of 'local risks'. Sally was also responsible for the financing of the project for R&M. Although the client was expected to release money in several 'interim payments' as the various parts of the project were completed to strict time deadlines, she anticipated a number of working capital challenges for R&M, especially near the beginning where a number of early stage costs would need to be incurred. There would, she explained, also be financing issues in managing the cash flows to R&M's many subcontractors. Although the major banks financed the client through a lending syndicate, R&M's usual bank said it was wary of lending directly to R&M for the Giant Dam Project because of the potential negative publicity that might result. Another bank said it would provide R&M with its early stage working capital needs on the understanding that its involvement in financing R&M to undertake the Giant Dam Project was not disclosed. A press statement from Stop-the-dam said that it would do all it could to discover R&M's financial lenders and publicly expose them. Sally told the R&M board that some debt financing would be essential until the first interim payments from the client became available.

When it was announced that R&M had won the contract to build the Giant Dam Project, some of its institutional shareholders contacted Richard Markovnikoff, the chairman. They wanted reassurance that the company had fully taken the environmental issues and other risks into account. One fund manager asked if Mr Markovnikoff could explain the sustainability implications of the project to assess whether R&M shares were still suitable for his environmentally sensitive clients. Mr Markovnikoff said, through the company's investor relations department, that he intended to give a statement at the next annual general meeting (AGM) that he hoped would address these environmental concerns. He would also, he said, make a statement on the importance of confidentiality in the financing of the early stage working capital needs.

Required:

- (a) Any large project such as the Giant Dam Project has a number of stakeholders.
- (i) Define the terms 'stakeholder' and 'stakeholder claim', and identify from the case FOUR of R&M's external stakeholders as it carries out the Giant Dam Project; - (6 marks)
- (ii) Describe the claim of each of the four identified stakeholders. (4 marks)
- (b) Describe a framework to assess the risks to the progress of the Giant Dam Project. Your answer should include a diagram to represent the framework. (6 marks)
- (c) Using information from the case, assess THREE risks to the Giant Dam Project. (9 marks)
- (d) Prepare the statement for Mr Markovnikoff to read out at the AGM. The statement you construct should contain the following:
- (i) A definition and brief explanation of 'sustainable development'; (3 marks)
- (ii) An evaluation of the environmental and sustainability implications of the Giant Dam Project; (8 marks)
- (iii) A statement on the importance of confidentiality in the financing of the early stage working capital needs and an explanation of how this conflicts with the duty of transparency in matters of corporate governance. (6 marks)
- Professional marks for layout, logical flow and persuasiveness of the statement. (4 marks)
- (e) Internal controls are very important in a complex civil engineering project such as the Giant Dam Project.

Required:

Describe the difficulties of maintaining sound internal controls in the Giant Dam Project created by working through sub-contractors.

(4 marks)
(50 marks)
(June 2008)

2. Corporate governance, risk and environmental reporting – PP and Redco

Peter Paints Plc (PP) is a UK based listed company with a strong European presence. The company manufactures paints and produces chemicals used in the paints and coatings industries.

PP sells its products to retailers and also to a wide range of industrial companies including global businesses. The board, as part of a strategic review some two years ago decided upon a more global strategy to extend the reach of the company, to increase market share and to service the requirements of global customers.

Recently PP selected Redco Inc as an acquisition target to increase its global reach. Redco is located outside Europe in a rapidly growing developing country. Redco recently floated shares on its local stock market and has a track record of success. Analyst's reports locally and in the UK describe Redco in terms that make it an ideal target for PP.

PP operates a unitary board and at a recent meeting Jim Jones the PP chief executive set out acquisition plans. PP intends to acquire the whole share capital of Redco and will make a public bid following valuation processes. Jim is pushing the project forward and asks the board for their approval following his presentation of the rationale. Jim argues that the combined companies will generate economies of scale and the takeover provides a route to increased global presence and market share.

Redco was until recently a family owned and controlled private company and in order to raise capital, and to provide an eventual exit strategy for the family, listed 75% of its shares. The flotation took place two years ago but the family still play an active role in managing the business.

The developing country in which Redco operates has few corporate governance requirements at present, although it will move to an OECD framework approach in the near future.

Redco operates an unusual board structure with a managing board consisting of the original family members and a secondary board consisting of senior managers. There are no non-executive directors. Strategic issues are dealt with solely by the managing board and the views of the secondary board are not heard by the managing board since they are treated as senior managers rather than executive directors.

A local press report has indicated that the annual general meeting is a formal affair with little opportunity for shareholders to express views, the proceedings being dominated by the managing board members.

At an informal board team meeting the finance director of PP expressed his views 'I would advise some caution regarding the acquisition. Such acquisitions inevitably involve risks particularly in foreign markets. I can see change issues in the integration of such a business at a corporate governance level.'

The operations director of PP also expressed his views 'I agree that risk is a key issue and suggest that we look into this before progressing too far. There are risks for the company and risks within the new business that we acquire.'

The finance director of PP turned his laptop into view where he had downloaded the published financial statements of Redco. The financial statements contained a note to the accounts disclosing an incident giving rise to negative local environmental impact. The disclosure was in narrative form only without an indication of a provision having been made.

The chairman of PP commented 'Redco does not produce any sustainability or environmental reports and I have no knowledge regarding the environmental footprint of Redco'.

The company secretary and lawyer responded surprisingly 'I am not sure what environmental reporting and environmental footprints are about I guess someone can explain them to me'.

Required:

- (a) Critically evaluate the quality of corporate governance at Redco commenting on any issues that would concern the board of PP. (10 marks)
- (b) The operations director was concerned about risk. Explain the risks that may arise upon the acquisition of Redco and describe how risks can be assessed. (15 marks)
- (c) Explain the arguments for changing the two tier board system at Redco describing the advantages of unitary boards in general and for Redco in particular after the acquisition. Note: 2 professional marks for the argument and explanation (10 marks)
- (d) Describe the generally recognised four key roles of non-executive directors explaining how these would improve the corporate governance at Redco. (7 marks)
- (e) Write a memo to the company secretary of PP, Sue Innocent, defining and explaining the meaning of the two terms describing the importance of environmental reporting to Redco. Note: 2 professional marks for structure and content (8 marks)
- (50 marks)**

3. Corporate governance and ethics – Oil Explorers Plc

Oil Explorers Plc is a global oil exploration company listed in the UK that undertakes exploration, processing and selling of crude and refined oil.

Oil Explorers publishes quarterly data on its oil reserves and it is this data that according to analysts drives its share price. Analysts see the oil reserves as a predictor of future earnings and cash flow and keenly await publication of results to see the results of new exploration success and utilisation in production.

Oil Explorers recently made a massive investment in an oil field in a developing country on the basis of local geological reports. Subsequently following visits and surveys by their own team of experts Oil Explorers found that the original reserves estimates were overstated and that productive reserves were only half of the original estimate of 200 billion barrelettes.

Oil Explorers has a reputation for accurate reporting and has invested in its own team of geologists. The company has regularly claimed that its geological survey team are the best in the industry and underpin the accuracy of their estimates.

At the time of acquisition of the new oil field Oil Explorers had announced the original estimate and analysts and investors are looking to see this figure and explanations of production plans confirmed in its annual report that is due out very soon.

Petra Permian, chief geologist has admitted to the board that the reserves are overstated and that the publication of a lower figure would not only seriously affect the share price but would damage the reputation of the geological survey department the quality of which was a critical success factor in the strategy of the company. Petra admitted that due diligence processes had been rushed due to competitive pressures and that the error was not identified when contracts were signed. The disclosure of the misstatement would also cast doubt on these processes.

The board of Oil Explorers met to discuss the disclosure problems and to consider the annual report and financial statements for the year. Chairman Colin Cambrian, a Chartered Certified Accountant opened the meeting with a brief statement: 'I am very worried about the reserves problems presented at our last board meeting and invite all members to give their views on solutions in a free and frank way.'

The first to speak was operations director Martin Mesozoic: 'we cannot afford to disclose the misstatement of our reserves since it would precipitate the collapse of our share price and damage our reputation. We have a good reputation with investors and with luck we will locate new reserves and investors will never know the truth'.

Trinny Triassic the finance director and Chartered Certified Accountant responded: 'we are bound under the listing requirements to standards of truthfulness and transparency and the board must not forget this. We would technically be in contravention of codes of corporate governance and ethics by not disclosing'.

Jim Jurassic the human resource director took a different view 'I am not a technical expert but if I were to put myself in the position of an investor then I would expect the misstatement to be disclosed whatever the interpretation of rules might say and whatever the damage to the company'.

Following brief comments from three non-executive directors Colin closed the meeting with a statement: 'Thank you for your comments we will consider what is the right approach when Tony (CEO) and I meet next week'.

Following this meeting the company went ahead with the publication of its preliminary profit announcement without disclosing the misstatement. At a briefing meeting to present the results Doris Dolerite an industry analyst asked a probing question: 'I am aware that there have been problems regarding proven reserves at the new oil field, does the board have confidence in its internal audit and control systems?'

Colin Cambrian answered her question: 'I will be writing to the shareholders in the light of problems at the new oil field and will address the issues you have raised'.

Required:

- (a) With reference to the scenario, explain what is meant by the term 'transparency' and evaluate the importance of transparency as a principle of good corporate governance for listed companies. (10 marks)
- (b) Identify and explain what is meant by Kohlberg's three levels of moral development and with reference to the scenario relate these levels to the views of Martin Mesozoic, Trinny Triassic and Jim Jurassic. (12 marks)
- (c) Critically discuss four key roles of non-executive directors on the board of a listed company setting out with reference to the scenario the possible tensions between these roles that the three non-executive directors of Oil Explorers may experience in advising and challenging regarding the disclosure of the misstatement of oil reserves. (12 marks)
- (d) Write a letter in draft form, suitable for the chairman to send to shareholders regarding the matters raised at the preliminary results meeting. Your letter should include the following:
 - (i) Why you believe that robust internal controls are important in the circumstances?
 - (ii) Information regarding changes to internal systems that may be appropriate in the light of the problems with the new oil field.

You may make assumptions as necessary regarding the actions that may be taken by the board following the preliminary results meeting. You can earn up to 4 professional marks for the structure, content, style and layout of your letter.

(16 marks)
(50 marks)