



Shell Games at Royal Dutch/Shell: Will They Affect Corporate Governance in Europe?

Published : April 07, 2004 in [Knowledge@Wharton](#)

On January 9, Royal Dutch/Shell, the third largest oil company in the world, announced that its reserves — the measure of oil still in the Earth that it controlled — was overstated by 20%. Mild as that statement might sound to the uninitiated, to financial markets it came as an earthquake -- and the reverberations have not yet ended. In February, chairman Sir Philip Watts apologized to investors in a lengthy analysts' meeting. In March, Watts and heir apparent Walter van de Vijver were sacked and further adjustments to the reserve accounts were made. The Securities and Exchange Commission and the U.S. Department of Justice and various European entities have confirmed ongoing investigations.



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

When the brouhaha broke out, the international financial press was quick to label it "Europe's Enron", much as it did when accounting scandals surfaced at Parmalat, the Italian conglomerate. As the media hubbub over alleged corporate wrongdoing grows louder, is it likely that Europe might see its own version of corporate governance reform, comparable to the Sarbanes-Oxley legislation in the U.S.? Two Wharton experts -- Christian Leuz and Robert E. Mittelstaedt Jr. -- have different perspectives on the situation.

First, some background: Oil reserve accounting is an arcane subject, but vital for investors. Obviously, investors buy a company's shares to get a stake in current and future earnings. For energy companies - or any firm that has its product sales capped by limited supply versus potential market demand - investors have to take into account how long resources to generate future earnings will last in calculating their expected return. Thus, the stock price of an energy company is intimately tied to the amount of oil or gas reserves it claims. When Royal Dutch/Shell, considered one of the stodgiest of the large energy companies, lopped off 20% of its declared oil and gas reserves, investors and analysts were stunned. The lost reserves were equivalent to 3.9 billion barrels of oil or at least \$70 billion in future revenues.

Moreover, as information from internal investigations and investigative reporting has leaked out, it has become clear that the reserve restatement was done without the research, process and discussion that investors would like to see in a trusted and presumably well-managed company. The board was notified of emergency meetings to approve the changes over the Christmas holidays. As memos coursed through the senior executive ranks of Royal Dutch/Shell over the prior two years, routine briefings of independent board members required to sign off on reserve estimates were boilerplate and devoid of any hint of concern. Most of the inflated estimates were made while the now deposed CEO was head of exploration and development. Perhaps most damning, during this period of the 1990s Royal Dutch/Shell was falling behind its biggest rivals who were making bigger resource discoveries and acquiring other energy companies and their reserves.

This period coincided with increased concern on the part of the SEC about oil reserve accounting. Over the last decade or more, energy companies have engaged in partnerships with a range of new countries, such as parts of the former Soviet Union, or new governments in Africa and the Middle East, that may involve high legal or diplomatic risk. In addition, improvements in exploration technology have opened up the potential for discovering and exploiting reserves in the deep ocean such as that of the Gulf of Mexico, under the polar ice caps or within difficult rock formations. There is little history of reliable estimation of these finds or their development.

While both these situations represented serious potential for global energy companies, they also represented potential hazard as these same firms were under pressure to compete for investor attention with dot.com wunderkinds and other riveting "story stocks". Enforcement agencies and smart investors worried that the oil companies were motivated to exaggerate their hopes in terms of their reserve claims. This would be hard to track as reserve estimation allows a lot of management discretion. The SEC has the most stringent requirements in the world; however even it requires only "reasonable certainty" on the part of management and no third party confirmation.

Revised Estimates

The increased level of scrutiny has prompted several oil companies to revise their reserve estimates but none anywhere near the magnitude of Royal Dutch/Shell's. (One exception is the troubled and much smaller El Paso Corp., which has restated natural gas reserves by almost 35% and is now dealing with numerous investigations.) Furthermore, Royal Dutch/Shell's restatement makes clear how much it is lagging fellow giants ExxonMobil and BP. Even before the restatement, Royal Dutch/Shell had five-year annual returns of 0.5%, the second lowest of publicly traded energy companies, according to *Forbes* magazine. With the revised reserve estimates, there is no hiding the fact that Royal Dutch/Shell's replacement cost for oil reserves, a commonly followed number in the industry, is strikingly above that of its peers.

Such conditions encourage corporate malfeasance, says [Christian Leuz](#), a professor of accounting at Wharton. "Initially there is simply a business problem. Then people start messing with the numbers to cover it up." Leuz has done research which incorporates information from some 8,000 companies in 31 countries to support his contention that insiders use discretion in financial reporting to boost reported earnings and conceal losses, thus smoothing earnings. Logically, he sees no reason why European countries would be any less likely to do so than American companies, the home of such scandals as Enron, Global Crossing and Tyco, despite a common gut reaction that European companies are more conservative than their American counterparts.

Confirming his intuition, Leuz's research has shown a striking difference in the level of earnings manipulation between the U.S. and other countries with extensive shareholder protections and those without, many of them in continental Europe. "The fundamental [motivation] is the same, but the mechanisms for getting the money out of the firm are different," he says. "If you want to get to the root cause of the problem, it is governance; I don't mean just the board but the right of investors to discipline management and have their interests protected," he asserts.

Unique Structure

Leuz observes that Royal Dutch/Shell is a very specific case. The company has a unique corporate structure descended from more than a century of its existence. In 1833, Marcus Samuel, a London merchant, set up shop to sell seashells to natural history enthusiasts, a fashionable pastime in the period that ended up leading to many invaluable discoveries. Over time, Samuel's trade evolved into a thriving

import-export business. Meanwhile, the Royal Dutch Company for the Exploitation of Petroleum Wells in the Netherlands East Indies was registered in The Hague in 1890. In 1907, the two merged.

From then until now, Royal Dutch has controlled 60% of the combined companies and the same percentage of earnings, while Shell Transport and Trading controls the remaining 40%. This largely unconsolidated structure continues today with separate headquarters and boards in the two countries and two separate share listings, one for Royal Dutch and one for Shell Transport and Trading. This structure makes acquisitions difficult, as any non-cash offer must include the valuations of two different stocks, among other problems. It also includes a legacy of far-flung and decentralized operations and a sloppy system for combining information from both companies in financial disclosures. All this, no doubt, contributed to the current problems at Royal Dutch/Shell.

Still, warns [Robert E. Mittelstaedt, Jr.](#), “Let’s not attribute causality to the governance structure.” Mittelstaedt is vice dean for Executive Education at Wharton and is actively involved in the Directors’ Institute, which provides training for members of boards of directors in the U.S. and Britain. He points out that Royal Dutch/Shell’s structure is unique, and while it may be involved in some of the company’s problems, it is not representative of all European companies. “There are many different structures used by different countries that are effective,” he says. “Good governance comes down to the competence or ethics of the management team.”

Mittelstaedt cautions that “governance is a check-and-balance mechanism. The board does not run the company; it is not involved in day-to-day management. It looks at things after the fact.”

While Mittelstaedt and Leuz differ in their perspectives, both agree that the specific laws, mechanisms or the enforcement agencies of a corporate governance regime are almost impossible to isolate as to their particular effects. While Leuz would argue that the likelihood of scrutiny deters would-be transgressors, Mittelstaedt feels that those committed to deceive will figure out a way, and it is extremely difficult to create a corporate governance structure that will prevent it.

They both agree that the correct implications of the situation at Royal Dutch/Dutch are fairly limited. An uncommonly limiting corporate structure combined with an opaque accounting and reporting regime among energy companies led to a serious problem. Royal Dutch/Shell's new Chairman, Jeroen van der Veer, has said that the company is studying its corporate structure to see if revisions are necessary but that the process will take at least a few years. Yet these various “exceptions to the rules” still have important lessons for other companies.

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.