Royal Dutch Shell: Putting at Risk Reputation as a Resource

At the beginning of February 2004 the Royal Dutch Shell Group announced that it had recategorised some 20 per cent of its total proven reserves base. Whilst oil and gas companies regularly review their reserves, the sheer magnitude of this recategorisation took the equity markets by surprise. At the time of the announcement, Shell also disclosed that it would conduct its own audit of the facts and circumstances surrounding the revision. An executive summary of the Audit Report was made public at the end of March. Meanwhile, the Chief Executive, Finance Director and Head of Exploration and Production had all been dismissed. The Audit Report provides a fascinating insight into the problems that surrounded the reserves recategorisation with specific focus on the conduct of Shell's management and whether further changes are necessary to both personnel and internal controls.

The events at Shell have opened up the whole debate on the role of reserves reports in general, which is likely to continue for some time to come. However, one needs to distinguish between the issue of corporate governance and control from the issue of what purpose a reserves statement serves. The aim of the Audit report was to focus on the governance and control issues and in this respect it highlights the way in which a company can keep from following strict guidelines.

The report highlights the fact that the reserves issue had been brewing for some time. In fact from the moment that Mr van de Vijver succeeded Sir Philip Watts as the Chief Executive Officer of Shell's EP unit 'I (he) observed that the health of the EP business was not as robust as the Company-determined performance targets set under the form EP CEO' (p.4). Such was the extent of the mismatch between what was stated to the outside world and the internal reality that the EP management hoped to 'play for time' (p.6) and wait for over-booked reserves. In an extraordinary e-mail Mr Van de Vijver even said that he had become 'sick and tired about lying about the extent of our reserves issues' (p.8).

The report concludes that the 'aggressive' (p.12) booking of reserves was only possible because of certain deficiencies in the Company's controls, not least the fact that 'the internal reserves audit function was both understaffed and under trained' (p.12). In addition it was made clear that such was the pressure from operating unit management to follow Shell Group practises and not follow SEC guidelines that company staff felt that their very jobs were at risk.

This report is important as it highlights how aggressive corporate targets come into conflict with governance and control. The oil and gas industry during the 1990's struggled to balance profitability and growth. In the case of Shell, the strategy of targeting higher returns led to a significant underinvestment in the EP business at the very time that its main competitors were gearing up for growth through a series of mergers and acquisitions. The resultant pressure to deliver targets set by senior management was in direct conflict with the amount of capital they were prepared to release to local managers to deliver that growth. As a result it was inevitable that over aggressive reserves booking could result in the absence of strict auditing and governance.

The report also highlights the extent to which corporate culture can sometimes get in the way of good governance. In the case of Shell, the culture even prevented senior management from following the fiduciary rules by which they were bound when they were appointed as directors. It is quite frankly astonishing that a senior director of a major company should admit that 'because of the unspoken rule within the Company you are not to go directly to individual Board members' and not appreciate the fiduciary implications of not doing so. Radical changes have taken place in the relationship between shareholders and companies over the past decade, in particular financial and operational transparency. Unfortunately, the report illustrates the extent to these changes had not been fully incorporated by Shell in its internal audits and controls.

Whilst fairly short, the Audit Report is available on the Shell website: www.shell.com. Shell is to be congratulated on its transparency of the issue and the report is a salutary lesson for managers who might think that corporate culture can be more important than local exchange listing rules. The fact that Shell was caught out by this is all the more surprising given the 'you can be sure of Shell' slogan for external consumption as well an internal guideline which highlights 'reputation as a resource'. The fall out of the recategorisation will carry on for some time and there may even be repercussions with respect to reserves reporting in the wider industry. However, the clear message to come out of the report is that companies must make sure that there is appropriate governance and control, for without it a century's reputation can be ruined in a month.

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