

Name:

Enrolment No:



UNIVERSITY OF PETROLEUM AND ENERGY STUDIES

End Semester Examination, May 2019

Programme : MBA General/Core

Course: Business Ethics & Corporate Governance

Max. Marks : 100

Course Code : MBC1814

Time: 03 Hours

Instructions: Attempt all sections and questions

SECTION A

Q.1

Multiple choice questions/true and false . choose correct answer with explanation

Marks

CO

a. Meeting the information needs of modern investment community is also paramount in terms of ____ and attracting ____.

- i. accountability and capital
- ii. mergers and takeovers
- iii. profits and customers
- iv. quantity and quality

b. A ____ share price makes the company an attractive takeover target.

- i. High
- ii. Depressed
- iii. Inflated
- iv. premium

c. The importance of corporate governance is it increases the company's ability to _____, _____, respond to _____. (Select any three)

- i. identify and mitigate risks
- ii. changing market trends
- iii. Adapt, surge ahead and global cues.
- iv. manage crisis

d. What an effective corporate governance system could do?

- i. To ensure that directors act in the best interests of the company in its broad sense.
- ii. Both the given options.
- iii. Restrain director's from abusing their powers

1X20=
20

CO1,2

e. Corporate governance relates to _____ that determine company's ability to take improved managerial decisions from the social point of view.

- i. Laws
- ii. Procedures
- iii. practices and implicit rules
- iv. All the given options

f. SEBI issues public interest advertisements to enlighten _____ on the basic features of various instruments and minimum precautions they should take before choosing an investment.

- i. Companies
- ii. Governments
- iii. Investors
- iv. Directors

g. The primary securities law in our country is the _____.

- i. Sales of Goods Act
- ii. Defence policy
- iii. SEBI Act
- iv. FDI policy

h. Who formed (SECURITIES AND EXCHANGE BOARD OF INDIA) SEBI Act 1992.

- i. The investors of India
- ii. The British Government of India.
- iii. The Indian Companies
- iv. The Government of India

i. But legal rules alone cannot ensure good corporate governance. What is needed is _____ on the part of directors, besides, of course, the mandatory provisions.

- i. self-regulation
- ii. egoism
- iii. de-regulation
- iv. bragging

j. Who are the conscious-keepers of shareholders, lenders and others who have financial stakes in companies.

- i. Chairmen
- ii. Directors
- iii. Owners
- iv. Auditors

k. In which market the minority shareholders can play effectively?

- i. Regional Market

- ii. Economy Market
- iii. Capital Market
- iv. Local Market
- v. What does and Ethical Foundation for an organisation embody?

l. The extent to which managers should attempt to change the underlying beliefs and values of individual followers

- i. What we do next
- ii. Who does what
- iii. None of the above
- iv. All of the above

m. Who are organisational stakeholders?

- i. Government
- ii. Providers of finance
- iii. Customers
- iv. Community
- v. Employees
- vi. All of the above

n. What is Ethics to do with?

- i. The wider community
- ii. Business
- iii. Right and wrong
- iv. Nothing
- v. None of the above

o. which of the following is an example of an area where business ethics apply?

- i. Conduct of international operations
- ii. Nowhere
- iii. In the personal life of staff
- iv. None of the above

p. One key to successful ethics training is to eliminate the belief that unethical behaviour is ever justifiable.

- i. True
- ii. False

q. Ethical issues may arise in global business because different nations have different beliefs about what business activities are acceptable or unethical, and these beliefs stem from differences in their cultures.

- i. True
- ii. False

	<p>r. interpretation and respect of human rights is consistent across countries.</p> <p>i. True ii. False</p> <p>s. Foreign investment has often been seen to have a positive influence on human rights in developing countries.</p> <p>i. True ii. False</p> <p>t. Although most industries have been associated with some human rights concerns, extractive and labour intensive industries have been at the centre of the debate on business and human rights.</p> <p>1. True 2. False</p>		
SECTION B			
	Short Notes / Subjective/ long type questions	Marks	CO
Q2.	<p>Write short notes on following</p> <p>1. Deontology and Teleology 2. Stewardship Theory 3. Cultural issues in Merger and Acquisition 4. Theory of Carvak and Hedonism</p>	20	CO3
SECTION-C			
	Case/ application based questions	Marks	CO
	<p>In the spring of 2002, Leslie Milne, manager of Mearl Oil Company's Support System, Environmental, visited a Mearl plant in Indonesia. She couldn't help but notice that many industrial facilities in the area were discharging wastewater into open ditches, which could present a serious environmental and health hazard. Many Australian industrial plants had been accused of moving to Indonesia in order to take advantage of the lower environmental standards. Because Mearl wanted to ensure that its plants located in Indonesia were not accused of this, the company</p>		CO4

issued a Water Effluent Management memo. This memorandum required all Mearl plants in Indonesia to discharge wastewaters to a specific baseline performance level that protected human health and the environment.

Mearl corporate environmental staff had frequently issued environmental memoranda to document and communicate new regulatory requirements, company expectations and required practices. Over time, the number of memos had grown substantially. Therefore, in an effort to globalize corporate expectations and required practices, Mearl established a new policy in May 2003, called Mearl Environmental Impact Targets (EITs). The Mearl EIT was established to support globally consistent implementation of Mearl's Environmental Policy (see Exhibit 1). The EIT applied to all of Mearl global operations.

Milne had just completed a troubling telephone conversation with Maya Stevenson, senior environmental manager for Mearl Canada Limited (MearlCan). MearlCan was concerned with the performance requirements specified in the Mearl EIT for Water Effluent Management. MearlCan argued that while it made sense for Mearl operations in developing countries, the EIT requirements should not be imposed upon operations in countries where extensive regulatory and legislative controls (federal, provincial and municipal) were in place and enforced. MearlCan's concern was that the EIT may impose a heavy capital cost and/or administrative burden on Mearl operations in Canada, which would result in a competitive disadvantage. In addition, the MearlCan operations were already meeting the high environmental standards imposed by the Canadian government. MearlCan intended to bring these concerns to the International Environment Group (IEG) meeting in September 2004 to request relief from the corporate expectation, based on regulatory equivalency. While Milne could sympathize with MearlCan's point of view, she felt strongly that the EIT should be required by all of Mearl's facilities, independent of local laws.

THE OIL AND GAS INDUSTRY

The oil and gas industry was the largest in the world, valued between US\$2 trillion¹ and US\$5 trillion. It consisted of several major players, each vigorously pursuing growth in an environment characterized by mounting public pressure to curb climate change and restricted access to oil and gas reserves. The United Nations' Environment Programme's Intergovernmental Panel on Climate Change reported in 2001 that during the 20th century, the global average surface temperature increased by 0.6°C, and the global average sea level rose between 0.1 and 0.2 metres. Moreover, a Pentagon report published in 2003 "explores how such an abrupt climate change scenario could potentially de-stabilize the geo-political environment, leading to skirmishes, battles, and even war due to resource constraints." The substantial scientific evidence for global warming had oil and gas companies exploring new means to create green energy while carefully managing public opinion around their current fossil fuel operations. Oil and gas companies were increasingly cognizant of the need for a public licence to operate, and they very carefully managed their reputation to preserve and enhance this social licence. While there was much debate on how much oil and gas remained to be extracted from the earth, the U.S. Geological Survey reported in 1994 that oil fields discovery in the world peaked in 1962 and had since been in decline. Leading geologists

estimated that peak production would be reached between 2037 to 2040 Colin Campbell, who had worked for Texaco, AMOCO and FINA, and Jean Laherrère, who had worked for Total, a French oil company, estimated that oil production from non-OPEC sources would peak before 2010, and production from the top five OPEC producers (Saudi Arabia, Kuwait, Iraq, Iran and Abu Dhabi) would peak around 2015. Oil and gas companies faced great pressure to meet rising demand for oil in an environment where production could not go on forever.

ENVIRONMENTAL IMPACTS OF THE OIL AND GAS INDUSTRY

The environmental impacts of the oil and gas industry occurred at oil and gas exploration, mining, refining, distribution and marketing stages. While large spills during the distribution stage would have detrimental environmental impacts, the majority of the industry's direct impacts occurred during the refining stage.

The environmental impacts of the refineries could be divided into three categories based on environmental pathway: air, water, and land and soil.

The environmental impacts on the air of the oil and gas industry could be split into two types: risk of explosions and fires, and emissions. While the risk of explosions was real, emissions had a much greater impact and had been the focus of public and political attention such as through the Kyoto Protocol.

Emissions included sulfur dioxide (SO₂), nitrous oxides (NO_x), hydrogen sulphide, other hydrocarbons (HCs), benzene, carbon monoxide (CO), carbon dioxide (CO₂), particulate matter (such as ash), polycyclic aromatic hydrocarbon (PAHs), mercaptans, toxic organic compounds and odors.¹⁰ These emissions could have damaging effects on the environment, through acid rain (which can raise the acidity of groundwater and kill fish) and global warming (which can increase soil erosion through flooding and droughts). In addition, various emissions could have direct adverse impacts on human health, such as respiratory problems, eye and throat irritation and cancer. The oil and gas industry also affected water quality through the use of cooling water and emissions. The temperature of water used for cooling was increased so dramatically that it often harmed vegetation and marine life. Further, the industry released emissions to water supplies that also had a direct negative effect on the marine ecosystem. Water emissions included hydrocarbons (HCs), mercaptans, caustics, oil, phenols, chromium, and effluent from gas scrubbers. Land and soil impacts included hazardous waste, sludge from effluent treatment, spent catalysts and tars. Other environmental impacts included decommissioning offshore rigs, land use, energy use and general waste. The environmental impacts of the consumption of oil and gas derivatives and the combustion of oil for power generation and transportation are also prevalent and pertinent to the oil and gas industry but are not discussed here.

REDUCING IMPACTS

There were two motivations for firms to reduce environmental impacts: managing risk and creating opportunity through innovation. Risk management included complying with current regulations and foreseeing legislative changes. Local, regional and national laws regulated environmental impacts of the discharges. International protocols, such as the Kyoto Protocol on greenhouse gas emissions, were often translated into national objectives or regulations. These regulations

differed considerably by region and by country. Failure to comply with the regulations could lead to fines, penalties, legal costs and the costs associated with remediation. These costs motivated firms to reduce their impacts to levels presently regulated by government, as well as to anticipate future regulations that could affect their business. Participation in voluntary initiatives, such as ISO 14001 and the European Eco-management and Audit

Scheme (EMAS), also reduced risk by generating credibility with the public. ISO 14001 and EMAS were international environmental management systems standards that facilitated, not dictated, improved environmental performance. These systems included, for example, identifying environmental aspects, developing a plan to reduce impacts and delegating responsibility. Firms that complied with the standards could either self-declare conformance or be certified through a third-party audit, which would help build their corporate reputation. Many firms, particularly in Europe, required ISO 14001 or EMAS certification of their major suppliers. It is important to note that certification to an environmental management system standard did not necessarily ensure good environmental performance, only good management processes. While risk management motivated most companies to reduce impacts, many firms had gained a competitive advantage by finding innovative ways to reduce their environmental footprint. The most common way of achieving this was through reduced resource consumption, and thus lower costs. For example, the Mearl Eco-Efficiency Program in Canada reported in 1999 that it saved 800 million kilowatts (kWh) of electricity and 1.2 trillion British thermal units (Btu) fuel savings in its first three years.

Furthermore, this program reduced CO₂ emissions by an average of 245,000 metric tons of per year. A challenge for multinationals was that different jurisdictions measured discharges in different ways, which caused difficulties conforming to a baseline global environmental performance standard. For example, the levels of contaminants allowed in a plant's wastewater discharge could be a function of both the municipality's sewage treatment plant technology and the disposal method used for the treatment plant's sludge. Some cities burned this sludge in an incinerator; others processed it and applied it to farmland, while still others sent it to landfill. The method of disposal of the sludge and the efficiency of the applied wastewater treatment technology determined the level of contaminants that were allowed in the water that entered the city's sewer system.

MEARL OIL COMPANY CORPORATE PROFILE

Founded in 1947, Mearl Oil Company had grown into the world's largest oil and gas company with 2003 revenues of \$210 billion. Mearl had more than 200 major subsidiaries, joint ventures and affiliates around the world. Along with exploration for extraction and refining of oil and natural gas, Mearl had substantial interests in power generation and financial services. Mearl employed more than 250,000 people and partnered with over 8,000 supplier companies worldwide. It had operations in 30 countries. In 1994, Mearl created a separate division called Renewable Energy to explore the company's various options for hedging against the end of the fossil fuel era. The division initially started with a modest budget of \$100 million, but flourished as the competition followed suit. In 2003, the division's budget was \$1.4 billion. Mearl's main corporate financial performance

goal was to surpass 20 per cent annual return on average capital employed (ROACE). This goal was first achieved in 2002 when the ROACE was 20.3 per cent. Following this achievement, Mearl's chief executive officer (CEO) wrote in a press release: "This year's ROACE proves that all Mearl team members are pushing together into a greener, more profitable future." (see Exhibit 2).

MEARL'S ENVIRONMENTAL POLICY

Mearl's environmental values were first developed in the late 1970s and were refined in Mearl's Environmental Policy in 1993. The policy applied to all Mearl facilities, products and employees worldwide, and it guided the conduct of daily business practices among Mearl's subsidiaries and operations. However, it was broad in content and scope and permitted considerable latitude in the way it was operationalized. From the corporate office's perspective, more tightly defined standards needed to be imposed on Mearl operations worldwide. Otherwise, the company could be vulnerable to damaged reputation, heavy fines and penalties and a lack of local customer and community support.

ENVIRONMENTAL IMPACT TARGETS

The Mearl Support System, Environmental, was formed in 1995 to provide direction, guidance, service and support to Mearl operations through implementation of the Mearl Environmental Policy. The Mearl Support System organization consisted of staff subject-matter experts and plant environmental engineers supporting U.S. operations. The EITs were developed by a global team of Mearl plant, divisional and staff environmental professionals who specialized in different areas of environmental protection, such as design of new facilities, water, waste, remediation, joint ventures, resource conservation and pollution prevention. In developing the criteria, the team considered such issues as potential risk, current government regulations, emission levels that were believed to protect the environment and human health, and the reliability of the scientific assumptions. Studying the underlying science was important because safety factors were sometimes compounded in the standards-making process, causing government mandates to be excessively conservative. If the performance criteria were too conservative, achieving them would be unnecessarily expensive. The team also identified the typical technology that could be used to achieve the desired environmental performance and the associated costs. All Mearl units were expected to comply with applicable laws and regulations, in accordance with Mearl's Environmental Policy. The Mearl EITs were established in 2003 to supplement legal requirements, and any other local or regional Mearl environmental requirements, by describing baseline performance requirements to protect human health and the environment. Although specific methods to conform to the performance requirements may be identified in the EITs, no performance requirement was intended to preclude the use of any alternative conformance method that resulted in equal or better performance. Each Mearl operation was responsible for selecting conformance methods that best suited its needs, so long as those methods resulted in performance equal to or better than the Mearl EITs. The Water Effluent Management EITs established wastewater discharge requirements that were considered protective of human health and the environment.

Self-evaluations and corporate audits were used to ensure conformance to the EITs. If the audits identified potential non-conformance situations, the plant was required to develop corrective action plans, including implementation costs and timelines and a process to prevent recurrences. In this way, the EITs ensured that all facilities operated to an environmental baseline acceptable to the corporation. Mearl had an environmental management system in place and was moving its facilities to the ISO 14001 standard. An environmental management system required the organization to monitor its environmental aspects and environmental regulations. The system also put in place management processes that would address applicable legal requirements and manage environmental impacts. In May 2003, the EITs were finalized and communicated throughout Mearl. Existing facilities were expected to be in conformance with the EITs or implement corrective action plans. New facilities were expected to implement the EITs at startup. In 2003, Mearl placed a greater emphasis on globalization of its operations, focusing on the integration of the organization and evaluating its global initiatives and public commitments. The EITs sent out that year were one of the initiatives evaluated.

INTERNATIONAL ENVIRONMENT GROUP

To further commonize Mearl operations, the Mearl International Environment Group (IEG) was established in January 2004. The IEG was formed with the objective to address common facility environmental issues that affect Mearl operations worldwide and to develop common global strategies and recommendations consistent with Mearl's Environmental Policy. The IEG consisted of representatives of Mearl operations from around the globe: North America, South America, Europe, Asia and Africa, as well as representatives of global corporate groups such as audit, legal, public policy, research and development, and the Mearl Support System. Each regional member was responsible for communicating, following up on and monitoring IEG mandates within their region or unit. Depending on the nature and number of issues, IEG meetings were held at least twice a year. In addition to other matters, they would consider divisional or plant concerns associated with the EIT.

MEARL CANADA LIMITED

Mearl Canada Limited (MearlCan) was Canada's largest producer of crude oil and natural gas. MearlCan had 27 extracting facilities, as well as five refineries and many marketing offices. MearlCan employed approximately 15,000 people and had the capacity to extract 60 million barrels of oil per year, of which 75 per cent was shipped to the United States. While the largest concentration of MearlCan's operations were in Alberta, it also had facilities in Saint John's (Newfoundland), Sarnia (Ontario) and Halifax (Nova Scotia). The provinces of Alberta and Ontario, where the majority of production took place, had a regulatory environment dominated by the responsible party doctrine, which meant the MearlCan board of directors had direct liability and responsibility for environmental performance.

THE PATH FORWARD

Leslie Milne was reflecting on the conversation she had with the representative of MearlCan. MearlCan had argued that its operations were regulated by a government in a developed country and thereby should not be required to conform

to the EITs. MearlCan's specific concern was associated with one of its manufacturing operations that did not conform to the effluent requirements in the Water Effluent Management EITs. The plant in question had recently installed a modern wastewater treatment system, including biological treatment, for process-related wastewaters that it discharged to a city sanitary sewer. The effluent quality of the process wastewater met all sewer use bylaw limits. The EITs, however, required that the plant's sanitary wastewater (e.g. restroom and cafeteria wastewaters) receive at least secondary biological treatment prior to discharge to surface waters. Since the plant was located in a city with no such facility, the Mearl plant would have to install its own biological treatment plant for sanitary waste. The plant required an activated sludge membrane process and sequencing batch reactor in combination with ultraviolet disinfection system. The total cost of the installation would be approximately \$2 million, which would materially affect MearlCan's income statement. MearlCan implied that the capital and operating costs associated with the biological sanitary treatment plant would make it difficult for the plant to reach its business goals. MearlCan believed that this EIT requirement was overly protective and that they would be seeking relief from the corporate requirements, based on regulatory equivalency at the next IEG meeting. Milne, citing consistency with the Mearl Environmental Policy to protect human health and the environment, strongly supported the performance requirements in the Water Effluent Management EITs, and believed that its applicability should include MearlCan operations. She could only speculate on how the IEG would address MearlCan's concerns. Milne would have to carefully prepare her case for the application of the uniform, global Environmental Impact Targets before the IEG meeting in September.

Exhibit 1

ENVIRONMENTAL POLICY

Mearl Oil Company is committed to protecting the environment. Through continuous improvement, we will constantly strive to increase awareness of environmental issues within the Company, with our suppliers, with our customers, as well as in the communities in which we operate. This commitment extends beyond regulatory compliance to incorporate responsible environmental practices into our daily operations.

All Mearl employees and contractors must abide by the following principles and integrate them into their daily business activities. We will:

1. Demonstrate our commitment to the environment through the actions of our employees — from the CEO to the frontline workers.
2. Use proven environmental management systems to monitor and evaluate our waste reduction, energy and resources conservation, and materials recycling programs.
3. Listen to and educate the public and our other stakeholders concerning our environmental impacts, strategies and programs.
4. Develop, implement and share technologies for minimizing emissions of harmful pollutants.
5. Comply with all legal regulations and work with government to create environmentally and financially responsible laws.

Exhibit 2
FINANCIAL HIGHLIGHTS
(for years ending December 31)
(in Cdn\$ millions)

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Sales and other operating revenue			
Upstream	\$ 20,583	\$ 19,385	\$ 19,585
Downstream	150,573	138,867	136,557
Chemicals	21,495	18,584	18,573
Other	18,394	19,575	15,056
Mean income	\$ 22,634	\$ 18,589	\$ 11,337
Total financing costs	2,032	503	1,020
Income after financing costs	20,602	18,086	10,317
Average capital employed	101,354	89,094	71,152
ROACE	20.3%	20.3%	14.5%

Q3.	As Leslie Milne, please provide a compelling case as to why global uniform environmental impact targets must be applied.	15	CO4
Q4.	As Maya Stevenson, please provide a compelling case for a deviation to present to the International Environment Group. •.	15	CO4
Q5.	You must assume that the IEG has no prior information about your request or your situation	15	CO4
Q6	As IEG, please prepare a list of questions for Stevenson and Milne that will help you decide whether a deviation should be permitted	15	CO4

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SECTION A

Q.1.	I. Multiple choice questions. choose correct answer with explanation	Marks	CO
	<p>1. The primary stakeholders are:</p> <ul style="list-style-type: none">a. Customers.b. Suppliers.c. Shareholders.d. Creditors. <p>2. The goal of corporate governance and business ethics education is to:</p> <ul style="list-style-type: none">a. Teach students their professional accountability and to uphold their personal Integrity to society.b. Change the way in which ethics is taught to students.c. Create more ethics standards by which corporate professionals must operate.d. Increase the workload for accounting students. <p>3. The corporate governance structure of a company reflects the individual companies':</p> <ul style="list-style-type: none">a. Cultural and economic system.b. Legal and business system.c. Social and regulatory system.d. All of the above. <p>4. The internal audit function is least effective when the department:</p> <ul style="list-style-type: none">a. Is non-independent.b. Is competent.c. Is objective.d. Exhibits integrity <p>5. Under the _____, both internal and external corporate governance mechanisms are intended to induce managerial actions that maximize profit and shareholder value.</p> <ul style="list-style-type: none">a. Shareholder theory.	<p>1X10= 10</p>	<p>CO1,2</p>

	<p>b. Agency theory. c. Stakeholder theory. d. Corporate governance theory.</p> <p>6. Which of the following is a problem presented by ethics audits?</p> <p>a. They may be used to reallocate resources. b. They identify practices that need improvement. c. Selecting auditors may be difficult. d. They may pinpoint problems with stakeholder relationships.</p> <p>7. An organization’s appropriate tone at the top promoting ethical conduct is an example of:</p> <p>a. Ethics sensitivity. b. Ethics incentives. c. Ethical behavior. d. Consequentialist.</p> <p>8. An independent director is one who:</p> <p>a. Did not attend a school supported by the company. b. Does not have outside relationships with other directors. c. Does not have any other relationships with the company other than his or her directorship. d. All of the above.</p> <p>9. The chairperson of the board of directors and CEO should be leaders with:</p> <p>a. Vision and problem solving skills. b. The ability to motivate. c. Business acumen. d. All of the above.</p> <p>10. The social economy partnership philosophy emphasizes:</p> <p>a. cooperation and assistance. b. profit maximization. c. competition. d. restricting resources and support.</p>		
	<p>II. Examine the veracity (True and False) of the statement with explanation (1X10=10)</p> <p>a. Minimal social responsibility focuses on contractual stakeholders and mainly takes economic and legal considerations into account. b. Ethical issues may arise in global business because different nations have different beliefs about what business activities are acceptable or unethical, and these beliefs stem from differences in their cultures.</p>	<p>(1X10=10)</p>	<p>C01,2</p>

	<ul style="list-style-type: none"> c. The process of assessing and reporting a business's performance in fulfilling the economic, legal, ethical, and philanthropic responsibilities expected of it by its stakeholders is called a social audit. d. An ethical climate can be defined as a set of values, beliefs, goals, norms, and ways of solving problems shared by the members (employees) on an organization of any size, for profit or nonprofit. e. Centralized organizations tend to be more ethical when compared with decentralized organizations. f. Ecology refers to the science of the interrelationships among organisms and their environments. g. In recent years, business has played a significant role in adapting, using, and maintaining the quality of sustainability. h. The Global Compact invites companies to consider how they can take account of human rights instead of setting out specific provisions for companies. i. Minimal social responsibility focuses on contractual stakeholders and mainly takes economic and legal considerations into account. j. Employee turnover is a useful indicator for assessing employee issues. 		
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SECTION B

	Write short notes on following	Marks	CO
Q2.	<ul style="list-style-type: none"> 1. Ethical issues in Hostile takeover 2. Positive and negative externalities 3. Trusteeship and Agency theories 4. Cultural Ethics 5. Moral reasoning and Cognitive barrier 	5x4=20	CO3

SECTION-C

	Case/ application based questions	Marks	CO
	NORTHERN MINES LIMITED (A)		CO4
	Sitting back in his chair, Andrew Fisher, a director and member of the audit committee of Northern Mines Limited, suddenly realized that this July 23 audit		

committee meeting was going to go on later than anyone expected. Andrew had been reviewing an April 8 letter from the external auditor to management, which had been sent to all committee members as part of the pre-meeting information package, and he had come across an item of concern that the audit committee had not previously discussed.

In one section of the letter, a reference was made to the tailings disposal plan associated with the closure of two of Northern Mines' Ontario uranium mines (Exhibit 1). The plan recommended by management involved the conventional flooded tailings approach, at an estimated cost to the company of \$22.5 million. The letter, however, also mentioned two alternative methods, each with an estimated cost of about \$300 million, that had been examined (but not recommended) in an independent consultant's report. Andrew was both surprised and concerned. This was the first time that he, and he presumed the other members of the audit committee, had heard of these alternative tailings disposal suggestions. Although Northern Mines had provided \$22.5 million for waste management associated with the tailings disposal for the two mine closures, an additional liability of about \$280 million could apparently exist if the company was forced by regulatory agencies to adopt one of the two alternative cleanup methods described in the letter. The \$280 million represented about 55 per cent of the company's current retained earnings. Ultimately, the audit committee would have to decide if a potential additional liability existed, and if so, how the company would account for it. Andrew was already starting to think about how the audit committee should proceed: first, they would have to decide if an investigation of this matter was warranted, and then if necessary, what information they would need in order to decide whether and how to account for and disclose it in their financial statements.

Northern Mines was a leading diversified Canadian mining company. Headquartered in Toronto, the company had major interests throughout Canada, the United States, the Far East, and Latin America. Mining operations encompassed all activities related to exploring for and producing ores and metals ready to sell on the world commodity markets. Northern Mines' mining interests included underground uranium mines in Ontario and the United States and wholly or partly-owned mining ventures in a variety of other metals in other parts of the world. The company had originally been founded to develop a number of uranium deposits near Runsum, Ontario, which at one time became known as the "uranium capital" of the world. However, as the Ontario ore bodies began to run out, and richer deposits were discovered elsewhere, management had diversified in anticipation of withdrawing production at Runsum.

URANIUM MINING

The Northern Mines' Ontario uranium mines were underground mines. The ore was mined and initially crushed underground and then hoisted to the surface for milling. Because the uranium deposit was low grade, the ore had to be finely ground and then processed by a sulphuric acid treatment to extract the uranium. In 1990, 2.7 million tons of ore were processed from three mines at a recovery rate of 93 per cent to yield 4.3 million pounds of uranium. The mining and milling operations

resulted in a large quantity of waste rock and tailings, which contained mildly radioactive elements and pyrites that generated acid when exposed to oxygen and water. If the tailings were released into the environment, through groundwater seepage or runoff, contamination of the groundwater could occur. Consequently, the tailings had to be disposed of in a manner that would control releases and prevent contamination of the groundwater.

A NEW STRATEGIC FOCUS

In 1990, the board of Northern Mines made a decision to refine the strategic focus of the company: Northern Mines would build on its distinctive competencies in the mineral resource sector. As part of the effort to concentrate on profitable mineral resource mining, Northern Mines closed two of its three uranium mines in August 1990: the Lakeview and Martin mines. As the spot price of uranium had declined from a high of US\$43.40 per pound in 1978 to under US\$10 per pound in the 1990s, production at the company's three high-cost mines had been dependent on long-term contracts that ensured a reasonable profit margin. When further profitable contracts could not be secured, because of depressed uranium market prices and the comparatively low grade and high operating costs of the Ontario mines, the company decided to close the Lakeview and Martin mines. An existing long-term contract with Ontario Hydro guaranteed a high enough price to keep the more modern and efficient Sorrel mine operating at a profit.

FINANCIAL POSITION

Northern Mines was a major competitor in the mining industry in Canada. When 17 publicly traded mining companies in Canada were evaluated based on total assets, revenues and profitability, Northern Mines placed in the top six in each category. At the time of the audit committee meeting, the North American economy, especially the Canadian economy, had been in a deep recession for over a year. The recession had put downward pressure on the commodity price of metals around the world. The profitability of Northern Mines' mining segment was dependent on the quantity produced, the cost of production and the price received. Both the quantity and the costs were variables under Northern Mines' control, but prices were largely determined by world markets. Consequently, production decisions were largely determined by prevailing prices; the effect was to make mining a cyclical industry (Exhibit 2).

Although earnings from operations were down for the third consecutive year, Northern Mines had not posted a loss in over 30 years. Management expected that earnings for the current year would again be lower, yet still positive. Earnings estimates were down due to continued low commodity prices for metals and the expected necessary writeoffs because of the accelerated closure of the two uranium mines. A special one-time provision of \$85 million against pre-tax earnings had been recently allocated to cover the estimated costs of the shutdown of the Lakeview and Martin mines. Together with provisions made in previous years, a total of \$125 million had been accrued to cover all costs associated with closure of the two mines. The \$125 million provision included employee costs, shutdown and demolition costs, ongoing

care and maintenance, the writeoff of the remaining assets, and environmental and regulatory costs associated with tailings disposal. The closure of the two uranium mines also required the approval of a comprehensive waste management plan by a government regulatory agency, the Atomic Energy Control Board. Northern Mines had submitted for approval what management believed was the most ecologically sound and economically feasible proposal for waste management. Based on management's submitted proposal, \$22.5 million of the total provision of \$125 million had been estimated for environmental and regulatory costs associated with waste management.

THE AUDIT COMMITTEE

The Northern Mines audit committee met quarterly to review the financial statements and related notes before their presentation to the board for approval. In addition, the audit committee had to review and approve the Management Discussion and Analysis (M, D &A) section of the annual report to ensure that it was complete and accurate (refer to Appendix 1: Note on Audit Committees). Other responsibilities of the audit committee included

(1) systematically reviewing the corporation's accounting and financial controls and reporting procedures, and reporting its findings to the board of directors; and (2) reviewing the work of the external auditors, recommending to the board their annual fees, and nominating the auditors to be approved by the shareholders at the annual meeting.

The Northern Mines audit committee was composed of five members, all of whom were outside directors of the company and who had been members of the board for at least three years. Each of the members of the audit committee had previously held a senior management position in a large corporation and had a sophisticated knowledge of business. Richard Young, the chairman of the audit committee, had professional accounting experience and had been chief executive officer of a major Canadian company for many years. Although none of the members of the audit committee had expert knowledge of the environmental science of mine closures or the regulatory process for the approval of the waste management plan, they all could recognize when a particular issue needed further investigation. Andrew believed that current communications between the audit committee and Northern Mines' management were very good.

Several business journals had recently published articles about the increasing demands and expectations that were being placed on directors and audit committees. Although all of the members of the audit committee were aware that they could be personally liable for any financial damages related to improper financial reporting through their fiduciary responsibility as directors, they were concerned about the possibility that as members of the audit committee, they could face even greater legal liability. Andrew had read much of the recent literature on what was being asked of audit committees and wondered if any director could adequately perform the increasingly stringent duties of a member of an audit committee.

THE AUDITOR'S LETTER

When Andrew brought up his concerns about the reference to the additional cost of the two alternative waste management methods mentioned in the auditor's letter, it was evident that the other members of the committee were equally surprised and concerned. The current provisions for mine closure costs and waste management had been made based on management's best estimates and had been accepted by the board. The letter did not disagree with the chosen alternative, but simply mentioned that Northern Mines might be forced at some point in the lengthy regulatory process to adopt an alternative method of cleanup, which could result in a potential liability of up to \$300 million. The audit committee was responsible for ensuring full disclosure of any material liability they knew about to the shareholders. However, it was not clear from the auditor's letter to management whether or not a disclosable potential liability existed. Andrew had several unanswered questions: Why hadn't management mentioned the alternative waste management methods before? Was there a potential liability, or were the auditors being too cautious? If no liability existed, why had the auditors mentioned it in their letter? If a potential liability existed, why hadn't the auditors asked for a note? How would the liability be accounted for if it existed?

Andrew knew the audit committee would have to decide whether it believed that an additional potential liability existed, and if so, whether it would be necessary to include it in the financial statements or notes. No one in the room wanted to think about how much time it would take to investigate the issue, but it was obvious they needed to develop a plan of attack.

An example illustrating the increased liability of directors is the 1992 judgment in which two officers/ directors of Bata Industries were found guilty of violating the Province of Ontario's Environmental Protection and Water Resources Act. The president and vice-president/general manager were found to be responsible for failing to take adequate measures to prevent leakage of storage drums at a shoe plant. They were personally fined \$12,000 each.

Exhibit 1

**EXCERPT FROM THE AUDITOR'S APRIL 8 LETTER TO MANAGEMENT
Management Letter for the Year ended December 31**

Observation	Implication	Recommendations	Management Comment
5. CONTINGENCY — ENVIRONMENTAL RESTORATION			
<p>The Approved Budget for the Martin and Lakeview Curtailment Program allocates a total of \$28.7 million to environmental costs. This amount includes \$22.5 million in respect of ongoing waste management in a "wetlands" tailing containment area. The Division proposes to flood the tailings area and establish vegetation as a means of controlling the generation of radiation and acid-bearing solutions. An independent report has been commissioned to attempt to convince the Atomic Energy Control Board (AECB) that the wetlands concept is a preferable approach to site restoration in environmental terms, as well as being the only economically viable solution. The consultants have indicated that the principal alternatives are:</p> <p>(a) deep disposal in an existing lake (which may be unacceptable), and</p> <p>(b) backfilling the tailings into the disused mine workings.</p> <p>The cost of each of these alternatives is estimated at \$300 million.</p>	<p>The Corporation appears to have a potential contingent liability of up to \$300 million.</p>	<p>This contingent liability should be reviewed by senior management on a regular basis until the issue has been resolved with the AECB, to ensure that the Corporation has adequately provided for these costs.</p>	<p>The principles of deep disposal and our flood tailings concept are essentially the same and would not be acceptable for the Company to transfer tailings to another site when we can flood tailings in place.</p> <p>Backfilling mine workings is not a solution. Only 50 per cent of the tailings could be returned underground. Backfilling therefore, solves less than half the problem.</p> <p>Senior management will continually review the by-step progress with the AECB. The management will be in a position to recognize any additional liabilities.</p>
<p>Exhibit -2 Financial Highlights</p>			

	Year	Year -1	Year -2	Year -3
Earnings (millions of dollars)				
Revenue	\$ 1,343.1	1,711.9	1,979.1	1,532.6
Investment & other income	57.7	41.6	32.1	36.3
	<u>1,400.8</u>	<u>1,753.5</u>	<u>2,011.2</u>	<u>1,568.9</u>
Cost of mine production and metal sales	969.4	1,311.1	1,482.5	1,167.0
S,G & A	160.3	161.8	170.2	144.2
Interest expense	35.3	33.9	33.9	37.2
Depreciation	62.6	67.1	68.2	64.8
Exploration	14.9	11.1	7.4	3.7
Writeoff of capital assets & provision for mine closure	39.9	-	-	-
	<u>(1,282.4)</u>	<u>(1,585.0)</u>	<u>(1,762.2)</u>	<u>(1,416.9)</u>
Earnings before tax, minority interests, and gain on sale of discontinued operations	118.4	168.5	249.0	152.0
Income and mining taxes	(42.1)	(60.5)	(105.2)	(45.4)
Earnings from continuing operations, before minority interests in subsidiaries	76.3	108.0	143.8	106.6
Minority interests in net earnings of subsidiaries	(0.9)	(3.4)	(29.1)	(13.5)
Earnings from continuing operations	75.4	104.6	114.7	93.1
Gain on sale of discontinued operations, net of inc. tax	11.9	-	-	-
Earnings b/extra. items	87.3	104.6	114.7	93.1
Extraordinary items, net	-	(31.5)	19.7	-
Net earnings	<u>\$ 87.3</u>	<u>73.1</u>	<u>134.4</u>	<u>93.1</u>

Appendix 1

NOTE ON AUDIT COMMITTEES

An audit committee is a committee of the board of directors to which the board delegates its responsibility for oversight of the financial reporting process. The Canadian Business Corporation Act and the corporation acts of many provinces contain provisions requiring the creation of audit committees and rules governing their composition and responsibility in public companies.

The objectives of an audit committee, as stated in a research study published by the Canadian Institute of Chartered Accountants, are as follows:

- (a) To help directors meet their responsibilities, especially for accountability;
- (b) To provide better communication between directors and external auditors;
- (c) To enhance the external auditor's independence;
- (d) To increase the credibility and objectivity of financial reports; and
- (e) To strengthen the role of the outside directors by facilitating in-depth discussions between directors on the committee, management and external auditors.

	<p>Audit committees are generally comprised of a minimum of three directors who are elected by the full board. To enhance the independence of the audit committee, the majority of the directors are usually outside directors. Although committee members with a knowledge of accounting or law can be advantageous, it is also desirable that members have a broad general management background and experience as senior managers so that they can relate to the pressures of top management. In the past, audit committees have met annually or semi-annually. However, with mounting pressure from regulatory authorities to require audit committees to also review interim and quarterly financial statements, some audit committees are meeting at least once each quarter.</p> <p>Several studies and guidelines were published in the early 1990s by large accounting firms, the Canadian Securities Administrators, and other regulatory bodies concerning the role of audit committees. Many of these studies focused on how audit committees could work to reduce the risk of inadequate financial reporting, and explored the continually evolving role of audit committees. As directors have been faced with growing expectations from shareholders, the government and the public, pressure has mounted for greater accountability. As mentioned in several studies, audit committees have been targeted as one route for increasing director accountability and ensuring the integrity of financial reporting.</p>		
Q3.	Identify and specify what financial reporting problem might exist. How and why might it exist?	(20)	CO4
Q4.	As a member of the audit committee, what factors would influence your decision about whether to investigate the issue?	(10)	CO4
Q5.	Should the audit committee conduct further investigation? If so, formulate a plan of action outlining the steps the audit committee would take to investigate the concerns raised by the auditor.	(10)	CO4
Q6.	What information would the audit committee need? If not, why did the auditors mention their concern in the letter to management?	(10)	CO4
Q7.	What are the implications of your decision?	(10)	CO4