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Corporate Governance and Corporate Failure in the Oil Industry: Historical Analysis of Anglo Iranian Oil Company (AIOC) 1908-1951

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Abstract

There has been much written about the nationalization of the AIOC in 1951. Many accounts have, perhaps unfairly, painted the directors of the AIOC as Imperialist stooges seeking to plunder the natural resources of another sovereign state to cement the United Kingdom's geo-political position in the Middle East. The main aim of this research is to employ historical analysis to address and scrutinize the corporate governance and corporate failure of AIOC, which led to the company's nationalization. Analysis of archival material illustrates that the AIOC had not honored their commitments to various agreements for over 30 years preceding nationalization. Furthermore, from a range of evidence arising from the AIOC annual reports and historical sources including the British press, it can be clearly seen that the management regarded the shareholders' interests to be superior and taking preference over the interests of Iranian and other stakeholder groups. Historical analysis should feature prominently in empirical accounting research, which is a major motivation behind this analysis. Longitudinal analysis of confidential documents and internal memos illustrates that the company was aware of various Iranians concerns as early as the 1910s, but through various strategies, management was able to deflect these concerns, the scale of which was often not well understood, ultimately leading to nationalization in 1951.

Keywords: Oil Industry, Anglo Iranian Oil Company (AIOC), Corporate Governance

1. Introduction

The expanding use of petroleum products in the twentieth century increased the significance of such areas as the Middle East and also led to the rise of the international oil companies. Oil has, therefore, been an important determinant of relations between the great powers on the one hand, and countries like Iran on the other. Access to oil became crucial for both economic and strategic reasons. No modern state could do without oil and the oil industry was vital to the British Empire after the Great War. By the 1950s, no single raw material was as important to the global economy as oil. Britain was extremely conscious of its limited oil resources and was dependent on finding it in remote parts of the world. Jones (1981) argued that from the time of the Navy's first experiments with oil, Admiralty planners were concerned about securing oil reserves and maintaining foreign control of oil supplies. Therefore, the British government's willingness to maintain control became more necessary and British firms were looking overseas and in particular to the Middle East.

Persia (renamed as Iran in 1935) was one of the countries in which Britain gained enormous power and influence and increased government involvement in oil affairs as well as by closer co-operation between government and big business, through the Anglo Iranian Oil Company (AIOC)[1] . The AIOC was considered a suitable company upon which Britain could rely because it had significant political, strategic and economic power in Iran in the 20th century. The expansion of AIOC was influenced by the British government's desire to use oil in its vessels instead of coal. More so than coal, the oil industry had been associated with government intervention, due to its importance in providing intermediate inputs to the modern economy. Millward (2007) and Chandler (1990) explained that in 1914, British interests influenced the Iranian deposits according to its own requirements, where the British government-controlled oil for its navy and acquired a majority shareholding (51%) stake in the AIOC.

Oil refinery in Abadan and the company continued to expand its oil production from this major oil installation. Iran, via the AIOC's activities consequently became the second largest exporter of crude petroleum in the world, having the third largest oil reserves during that period. Iranian oil supplies were a major source of soft currency generation and tax revenue for the British government. Iranian oil was essential to Britain's balance of payments. Marsh (2003) emphasized that Iran was not militarily strong, but its geo-strategic location made it invaluable Iran was the oldest oil producing country in the Middle East region accounting for 74.2 per cent of the net income of the oil industry in the period 1913-47 (Issawi and Yeganeh, 1962). There was cooperation and joint decision making between the company and the British authorities at home and abroad through the government's shareholding in the company. In fact, the government accepted because they were keen on having control and maintain disciplinary actions undertaken by the Iranian government. The overseas operations of the British oil companies actually produce a net credit in the British balance of payment current accounts, which in turn reduced the overall deficit when account is taken of oil imports.

The overarching concern of this article is to examine the relationship between changes in corporate governance and the exploitation of scale and scope economies by the British government. It is then applied to examine changes in the AIOC in the period 1908-1951 where contrasts are drawn between the public view of the crisis and the actual events as documented in the literature, official papers, and financial records. Furthermore, the role of Sir William M. Fraser (1888-1970), the AIOC's chairperson (1941-1956) is examined in detail. In these respects, consideration is also given to how AIOC's management attempted to influence the British government and lobbying process.

The study is of significant interest to academics and the business community alike, since historical studies offer an opportunity to consider the contextualization of the development of accounting by reference to major key points and periods of crisis assist in the search for the origins of a debacle and try to arrive at conclusions which generate historical evidence. This paper makes a contribution by addressing the political impact of AIOC operations in Iran by identifying the relations among different governmental British authorities with the local communities to ascertain the policies of corporate governance.

Our argument proceeds as follows. Section 2 presents the historiography of AIOC. Following that, Section 3 highlights the nationalization of AIOC, which have dominated the historiography of the AIOC and are therefore worthy of further investigation. Section 4 discusses the corporate governance and the framing of the Iranian nationalization case study. Section 5 outlines the corporate governance in the AIOC 1909 – 1951. Finally, Section 6 draws conclusions and summarizes the findings.

[1] Originally the Anglo-Persian Oil Company, in deference to the Shah it became the Anglo-Iranian Oil Company in 1935 and in 1954 took on the name of its former marketing subsidiary, British Petroleum.

2. Historiography of AIOC

In 1901, William Knox D'Arcy, the son of an Irish solicitor and a millionaire London socialite was the real founder of the AIOC (Sampson, 1975). He used his fortune to finance oil exploration in Iran (Penrose, 1968). On 28th of May 1901, an exclusive concession was granted to D'Arcy for 60 years for the exploration of natural gas and petroleum throughout Iran, which covered 500,000 square miles of territory (Issawi and Yeganeh, 1962). Later in 1905, D'Arcy ran into financial difficulties before oil in commercial quantities was discovered and the Burmah Oil Company was brought in to come to D'Arcy's assistance by taking shares in the company to explore for oil in Burmah and India (Penrose, 1968). Fortunately, in 1908, a great oil field had been discovered by D'Arcy and Burmah Oil, which partly financed the Anglo Iranian Oil Company (AIOC), allowing it to become a leading contender in international oil markets (Penrose, 1968).

In 1908, D'Arcy finally discovered a huge oil field and his company Anglo Persian Oil Company (which was now partly owned by BOC) became a leading contender on the international oil markets (Penrose, 1968). After the discovery, a pipeline was built from the oilfields to the coast and a refinery was constructed at Abadan (Penrose, 1968). This discovery was to alter radically the face of the world oil industry (Jones, 2010). In 1914, the first Lord of the Admiralty, Winston Churchill, was keen to see the Navy change its ships from coal to oil power. As a result, after prolonged negotiations, Churchill, on behalf of the British government, bought 51% of Anglo Persian Oil Company with the aim of establishing a new kind of organization (Jones, 2010). Anglo Persian changed its name to AIOC in 1935.

In 1914, the first Lord of the Admiralty, Winston Churchill, was keen to see the Navy change its ships from coal to oil power. He had an interest in the oil reserves of Iran to guarantee a continuous oil supply and to ease the strain on Britain's hard-pressed coal supplies at a time of economic reconstruction. In fact, Churchill viewed the AIOC with increasing interest, as it had a promising future with its various oilfields in the Middle East (Jones, 2010). As a result, after prolonged negotiations, Churchill bought 51% of the AIOC with the aim of establishing a new kind of industrial animal (Jones, 2010). The British navy converted from coal to oil, which was an attraction in the emergence of the British oil industry and was the main reason for the growth of the British government's interest in the affairs of the oil companies (Jones, 1981). Churchill's interest in the Iranian oil reserves reflected increasing British dependence on Iranian oil and the reorientation of the peacetime economy away from coal. In summary, more than coal, the oil industry has been associated with government intervention due to its importance in providing intermediate inputs to the British economy.

In 1923-24, for instance, Persia received £411,000, and although royalties amounted to £1.4 million in 1926-27, the total fell the following year to £502,000.3. The problem became more acute in the early thirties when the general onset of depression led to a decline in oil sales, to falling profits and to talk of a restriction of oil output (Jones, 1981).

In 1933, a new concession was ratified by the Majlis (Iranian parliament), which extended the life of the original D'Arcy concession by thirty-two years. The key features of the 1933 Agreement between Iran and the AIOC were an increase in the royalty paid to Iran (Esfahani and Pesaran, 2008) comprising a fixed sum of 4s per ton, a guaranteed 20 per cent of worldwide profits above a fixed level and a minimum annual payment of £750,000 (Yergin, 1991). At the same time, it was agreed that Iranianization should be implemented. Literally, the 1933 Agreement offered Iran a share in AIOC's overall profits around the world equivalent to 20 percent of dividends distributed among holders of common stock in excess of £671,250). However, this was not the case because the company used to increase its taxes to decrease its net profits and thus decreasing Iran's 20 percent share in dividends and general reserves (Elm, 1992). Obviously, Iran was receiving crumbs from its resources because it was left at the mercy of the British government. But, Britain was claiming that they built and operated in Iran a flourishing company (AIOC), which they hoped to hand over intact to the Iranian nation at the end of the concession.

The Iranian government proclaimed the 1933 Agreement to be null and void and announced that "no concession would be granted to any foreigner whatsoever to regain the

Iranian national rights in respect of the country's natural resources whether underground or otherwise and necessary steps should be taken in order to restore Iranian national rights" (Issawi and Yeganeh, 1962, p. 133). The Iranian government believed that the previous concession was ratified by the Majlis (the Iranian Parliament) during a despotic regime and the deputies at the time possessed no powers of free debate or of expressing the public will and the benefits granted to the company were sold too cheaply (Issawi and Yeganeh, 1962).

These factors gave momentum to nationalist demands for increased shares of the profits. In October 1947, the Majlis reconsidered the way oil should be exploited by Britain and started negotiations with the British government to re-examine the oil concession granted to the AIOC in 1933 (Marsh, 2007). The Iranian government's dissatisfaction was to some extent the result of the British Government's insistence on dividend limitations, since Iranian royalties depended in part on the level of profit distribution. Furthermore, there was "sharp inflation experienced by the Middle East during the war, which resulted in an increase in the price of petroleum between 1939 and 1948 (Abdelrehim *et al.* 2011). This in turn greatly reduced the real value of payments to the Iranian government since payments to the government continued to be made on a fixed royalty basis" (Issawi and Yeganeh, 1962, p. 132).

3. Nationalization of AIOC

Throughout the first half of the twentieth century, the AIOC had been heavily implicated in the political economy of the Middle East, and in particular, Iran. The company's operations in Iran had a significant impact on the Iranian economy developing important consequences for British and U.S foreign policy in the 1950s. Nationalism and democracy had become new features of the Iranian political landscape. At the top of the agenda for nationalist politicians was the renegotiation of previous concessions made by the Shah on better terms for Iran. The Iranians felt that the company's wealth had been amassed on their soil, but they had no share in its wider advantages. There were, in addition, many interests in Iran itself, more especially the property of the AIOC of which is great imperial importance. The assertion of Iranian nationalism had made it more difficult to solve Anglo-Iranian differences, since Iran, like Turkey, was engaged in a process of modernization and state-building, a transition which was accompanied by an attempt to emphasize national characteristics and to reduce her dependence upon the great powers (Beck, 1974).

The AIOC was seen as a symbol of informal British Empire that remained mostly resistant to change and unwilling to improve the Iranian concessions. Therefore, resentment against the AIOC grew because of its British sovereignty. More than this, Iranians felt desperate about the company's exploitation of their oil resources claiming that the company was not safeguarding Iranian rights and that the Iranian government should nationalize the oil industry. Bucheli (2008) described companies investing in mining or oil as targets of political violence pointing out that they are more vulnerable to nationalist policies than those operating in the manufacturing or service sector. This is due to their vertically integrated structure, which affects local polities. In similar vein, White (2000, p. 551) asserted that "nationalization appeared a distinct possibility in a number of Britain's decolonizing territories because many of the anti-colonial movements taking shape by the 1950s espoused some form of socialism". More to the point, Bostock and Jones (1989, p. 66) stated that the virulent Iranian economic nationalism "cannot be treated solely as an endogenous factor to British business. Iranian policies were a reaction to the close relations between British business in Iran and the British government". Ferrier (1988, p. 170) was more explicit in his statement that the Iranian nationalists were aware that "AIOC was acting as an agent of the British government in depriving the Iranian government of the revenues to which it was entitled". However, in contradiction, AIOC executives blamed the Treasury in London for being inflexible in royalty and dividend payments to Iran, which was the main trigger for the company's nationalization. From a broader perspective, the dependency theory explains that the world consists of a "core" of dominant nations and a "periphery" of dependent ones (Seers, 1981). Friedmann and Wayne (1977) argued that the main relationship between societies has been an exploitative one because wealth is created at one of its poles and poverty is created at the other. Thus, this may explain how rich and powerful countries have monopolistic power and how they are allowed to exploit weak and poor countries through economic and political methods, resulting in unfairness in income distribution, discrimination and political repression. Given this hypothesis, it was predictable that major British businesses were founded on the basis of monopoly concessions, secured at a time when British political power was strong and Iranian political power weak (Bostock and Jones, 1989). Within this context, Iranian nationalists were well aware of the fact that the AIOC's strategy was shaped not only by the policies of the company, but also by the prevailing political economy of the British government. The AIOC was "acting as an agent of the British government in depriving the Iranian government of the revenues to which it was entitled" (Ferrier, 1980). Accordingly, the AIOC was seen as a prime example of domination in its economic power over Iran, resulting in unfairness in income distribution, as well as discrimination and political repression.

Notwithstanding the economic and military importance of Iran, British politicians and the senior management of AIOC have been accused of arrogance in their dealings with successive Iranian governments (Elm, 1992; Heiss, 1997). A serious dispute arose in 1951 when AIOC was nationalized. The British government refused to recognize the nationalization decree and claimed that the existing concession agreement could not be renounced unilaterally. The repercussions were serious, not just for the company, which lost a significant proportion of its assets, but for wider regional and indeed global geopolitics. The nationalization therefore had major consequences for Anglo-Iranian relations and represented a blow to British imperial power which did not fully recover even after the Central Intelligence Agency (CIA) sponsored coup to remove Musaddiq in 1953. Different phases and aspects of the dispute have been researched extensively, including Anglo-American relations, British and American foreign policies international law, covert operations, Iranian nationalism, the development of the Iranian oil industry, and the impact on international oil companies, including the AIOC.

Whilst the Iranian Prime Minister Mohamed Musaddiq[2] was conscious of the strategic importance of Iranian oil to the AIOC and the British government, his political priorities were to address the poverty of the people by securing control over their natural resources and the right to greater revenues. The nationalization crisis brought the British government and the AIOC management (Fraser) into sharp focus. As argued by Jones, (2006), the AIOC faced a number of difficult and interrelated problems. First, it was overwhelmingly dependent on Iran for nearly all of its oil production. This was potentially hazardous because of growing Iranian nationalism and resentment at Anglo-Iranian's privileged position. An obvious strategic response would have been geographical diversification, but such a strategy risked intensifying Iranian criticism for failing to maintain Iran's relative position in world oil production. A second problem for the company was its weak position in world markets, in part because of its late entry behind the US oil companies and Shell. A third set of problems arose from the fact that its majority shareholder was the British government. A fourth problem was the personality of William Fraser, the managing director between 1923 and 1956 and chairman 1941-56, who was an abrasive and undiplomatic oilman. Fraser had no flexibility at all and did not like to be told what to do by the government. He alone wished to determine both the AIOC's and Britain's policies with regard to Iranian oil. "He had contempt for civil servants and on occasion tried to intimidate them into doing what he wanted" (Elm, 1992, p. 66). Fraser's chief asset was his commercial insight, and his chief weakness was his lack of political insight (Elm, 1992*).* According to Sir Edward Bridges, Permanent Secretary to the Treasury, Fraser was narrow-minded, lacked political insight and should be removed (Bamberg, 1994). People within the AIOC considered Fraser "a silent, craggy Scotsman, with an intimidating Glasgow accent and a bleak sense of humor" (Sampson, 1975, p. 113). Fraser "did not think politics concerned him at all and had all the contempt of a Glasgow accountant for anything [which] could not be shown on a balance sheet" (Sampson, 1975, p. 120). Both Fraser's stubbornness and Anglo Iranian's ageing and conservative directors are heavily criticized. Yet their position was extremely delicate. Fraser's stubbornness kept the company's interests in play, and it was finally able to return to Iran with a

[2] Mohamed Musaddiq (1882-1967), led the National Front coalition from its formation in 1949 and became Prime Minister in April 1951.

40 per cent share in a consortium of international oil companies (Sampson, 1975). Bamberg (1994) sums up Fraser as a competent practical oilman but poor diplomat. To sum up, the combination of these problems meant that AIOC was more fragile and struggling to survive in a sea of political and economic uncertainties.

Bamberg (1994) argues that although the state shareholding had been indispensable in preserving the company's independence, it became a liability "on balance", he concludes, it was not in the company's interest to be closely associated with a declining imperial power in an age of rising nationalism. Anglo Iranian came to be regarded as an arm of the British government. The state shareholding resulted in its exclusion from certain countries, especially in Latin America. At times, it was made to follow damaging commercial policies to suit wider government aims. Above all, the relationship worked badly because Fraser was widely disliked- to put it mildly- within the British government. He was regarded as unfit to run the company, while the company itself was regarded as second rate, especially because of its weak marketing organization.

4. Corporate governance

Corporate governance is an important determinant of the distribution of economic power, and thus a key plank of reform in many political ideologies. One can think of corporate governance in two contexts. The first of these is as describing the set of institutions that determine how a corporation is governed – shareholder rights, the rules determining how members of the board of directors are selected, their powers, and so on. A major concern of this strand of the literature is how corporate governance institutions can be designed to align management's incentives with those of the owners of the firm, and the consequences when they are misaligned. Second, one can think of the state's role in governing the corporation – regulations regarding the information corporations must reveal, laws forbidding insider trading, self-dealing and the like, laws concerning mergers and hostile takeovers, and most recently regulations in some countries with regard to managerial compensation. Here, the concern is often to ensure that corporations contribute to the advancement of social welfare, broadly defined (Mueller, 2018). There is a large theoretical literature analyzing the determinants of firm strategy and structure, part of which is concerned with the range of corporate activity. As Chandler (1990) suggests, differences in the technologies of production, distribution and market size and location explain differences in scale and scope economies in different time periods, countries and industries (Toms and Wright, 2002). Nonetheless, recent research has increasingly acknowledged the importance of governance processes as a determinant of managerial strategy. Specifically, governance mechanisms might mediate the extent to which management optimizes scale and scope economies and the speed with which they might seek to adjust to apparent optima. Governance processes are concerned with accountability to shareholders. The elements of these processes, 'voice' versus 'exit' and managerial incentives, can be substitutes or complements (Toms and Wright, 2002). Alternatively, institutional block-holders may provide the concentration of ownership to put pressure on management through using their voting powers to elect their own nominees to boards of directors and through the threat to fight proxy votes more aggressively. In a corporate governance system based on strong voice, managers may give greatest credence to stakeholders with the deepest commitment and the weakest threat of exit. In this case, exit and voice are substitutes. Similarly, family or entrepreneurial ownership may affect managerial strategies via voice-based policy direction but at the same time inhibit growth and the development of professional managerial hierarchies. Also, in adverse economic conditions, effective corporate governance in the form of voice, exit or both may be an important determinant of managerial ability and willingness to undertake restructuring actions. These scenarios and responses are clearly related to the process of resource acquisition or threats of reductions in the resource base. Voice and exit are thus useful governance parameters that may explain the historical development of business (Toms and Wright, 2002).

Ownership structure is considered to be one of the most dominant factors that shape the corporate governance system of a firm (Gursoy, 2005). Ownership structure is one of the major determinants of any corporate governance system. The literature on ownership structure provides us with significant evidence on the international differences in country ownership structures. Thus, the literature suggests that ownership structure is highly dependent on regulation, macroeconomic conditions, corporate history and culture, dominance of prevailing institutions, maturity level of financial system, and politics (Gursoy, 2005). The controlling shareholders typically have control over firms considerably in excess of their cash flow rights. This is so, in part, because they often control large firms through pyramidal structures, and in part because they manage the firms they control. As a consequence, large firms have a problem of separation of ownership and control. These firms are run not by professional managers without equity ownership who are unaccountable to shareholders, but by controlling shareholders. These controlling shareholders are ideally placed to monitor the management, and in fact, the top management is usually part of the controlling family, but at the same time they have the power to expropriate the minority shareholders as well as the interest in so doing (LaPorta *et al.* 1999).

5. Corporate governance in the AIOC 1909 – 1951

It was not until 1922 that the public offered shares in the AIOC. As a result of these offerings, the register states that in 1923 the public controlled 17.6% of the company, with HM Government retaining a majority 55.87 shareholding (Ferrier, 1988). It was hoped that in selling shares to the public, the company's reliance on the government could be reduced.

In this context, the role of non-executive directors at the AIOC bears no resemblance to the role that Higgs (2003) recently defined. As a result of their majority shareholding, HM government appointed their own non-executive government director to the board, to ensure their interests were heard. In 1927, Sir George Barstow, a former senior treasury official was appointed to this role. He remained in post until 1946. Sir John Cadman spent a similarly long time in office. He educated at Armstrong College, a forerunner of Newcastle University and a distinguished career in the petroleum industry. He was appointed as chairperson in 1923, remaining in post until his death in 1941. Cadman is said to have dominated the board (Bamberg, 1994) and power is said to have rested solely with him, William Fraser (who ultimately succeeded Cadman as Chairman in 1941) and JB Lloyd, the finance director who was appointed in 1919. They are said to have had an "extremely close rapport" (Ferrier 1988).

It was impossible to draw a hard and fast line as to what their responsibilities would be and they would have to settle between themselves with due regard for efficiency and mutual convenience" (British Petroleum, 1950).

In 1923, in a letter to Murray, Packe comments, "our financial position is not as strong as it should be and I began to sit up and take notice" (British Petroleum, 1948). Subsequently, an omission was made to the board that the company has a deficit of £2,134,076 or £127,301,006 in today's money. Cadman made significant improvements in the late 1920's and organized the business into four operating divisions: technical operations, production and refining; distribution and marketing; finance; and general services.

By 1926, the businesses cash position had improved to such an extent that they paid a dividend yield of 12.5% (failing to 7.5% in 1928). The composition of the board of directors in 1927 was overwhelming composed of directors with 1st hand experience in the British Empire, for example, Sir Hugh Barnes was a former Chief Commissioner of Baluchistan in British India, whilst Sir Trevredyn Wynne was Managing Director of the Bengal-Nagpur Railway Company. Sir John Cargill of the Burmah oil company, likewise, had experience of British imperial conquest. There seemed to be a general feeling that over many years the directors, particularly the NED component failed to understand the unique situation that was developing in Iran. In the context of the issue of Iranianization, "I feel that some of our senior staff do not fully realize the importance of this subject" (British Petroleum, 1949)

6. Conclusion

We highlight how, notwithstanding the problematic political dynamic of the AIOC, management strategically evaded agreements made with the Iranian government over a number of years.

Nationalization eventually occurred as a result of management's inability to substantively address the Iranians ever deepening concerns over many years. Therefore, in many ways the AIOC were actively pursuing a formal CSR agenda, but rarely did the company actually deliver on its commitments. One level nationalization was a legitimate reaction to the perceived unfair plunder of Iran's natural resources, but on the other, it could be considered a symptom of management failure and that principals who had risked private capital in the business had been severely let down by their agents.

The dispute offers an interesting example of the interaction between government and big business, and such a link was most likely to occur in the case of the oil industry in view of the concessions held by oil companies in various parts of the world.

Governance practices at the AIOC would have certainly been frowned upon by today's standards. Various Companies Acts were approved in the 20th century, which were aimed at protecting the public interest. The actors of 1908 consolidated the 17 company statues that had been passed wince the first in 1962. The most important of these was the creation of the public company form, which legally created a company limited by shares. However, disclosure requirement where flexible and companies were only required to file now more than an annual balance sheet, which was not required to be disclosed publicly until the subsequent act of 1948. The UK system strongly mirrored the corporate revolution that took place in the United States between 1880 and 1930 (Cheffins, 2001), when the company was incorporated on the 14th of April 1909 as the Anglo Persian Oil company.

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