

Control mechanisms  
and performance  
measurement  
standards of pgb  
essay sample



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## Control mechanisms and performance measurement standards

### a) Control mechanisms

Control mechanisms can be defined as optical, mechanical, or electronic systems that are used in order to manage and control variables in a desirable way. The functions of control mechanisms generally can be categorized into planning, leading, organizing and controlling. Control mechanisms play an important role in every organization especially in enhancing the predictability of an organization. In PGB, adoption of Corporate Financial Policy (CFP) has been approved by Board with the main purpose of managing financial risk exposures of PGB which includes liquidity risk, foreign exchange risk, and counterparty risk.

The diagram above is showing that the in PGB, Risk Management Department (RMD) is required to report updates regularly to the PGB Management Committee (MC) and it will be further transferred to Board Audit Committee (BAC) in the form of the quarterly Enterprise Risk Report (ERR). In ERR, it mainly includes the overall PGB's risk profile and status of risk mitigation implementation. Moreover, PGB INTERISK system will record all the updates such as risk mitigation actions, unexpected risk events and risk rating from its business. During this long process, we do find many clues in internal control statement of PGB annual report 2011 that PGB relies on many control mechanisms in its risk management to mitigate its financial risk.

As the gas processing and gas transmission are the core business of PGB, PGB is dealing with many long term projects such as Kimanis power plant project which is expected to be completed in the end of this year or early of

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next year and development of the LNG regasification plant in Melaka. Hence, sophisticated and proper control mechanisms for PGB are very important in ensuring that the projects are on track as expected without any liquidity problems.

Project Risk Management (PrisMa) system can be considered as a critical control mechanism in PGB to ensure efficient reporting and monitoring. It recorded all the useful information regarding to the project risk management like lessons learnt, independent reviews and risk assessments. In this PrisMa, project managers are needed to update the status of their projects implemented and report them to their respective head of division. After that, all the reports updated will be transferred to General Manager of the Technical and Facilities Development Division (GM, TFDD) every month. By doing this, PGB able to assess the progress of its projects and take immediate actions in order to reduce the risk exposures involved. Project risk management of PGB is closely related to its liquidity risk management because adequate cash and cash equivalents are needed to cover the regular expenses of the projects in long term. However, PGB is less likely to face any liquidity problems in its project risk management as it is holding sufficient cash and liquid marketable assets with assistance from Project Risk Management (PrisMa) system.

Furthermore, PGB's risk management department (RMD) has also developed in-house Growth Risk Matrix in supporting the decision making in new business ventures. In this Growth Risk Matrix, the risk assessments of new business ventures will be listed in table in order to estimate the potential adverse consequences will be incurred. Besides, control mechanisms also

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have been found in the credit management of PGB which is called as Petronas's Credit Risk Rating System. The objectives and functions of this system are to examine the credit worthiness of all the PGB's external customers and assign credit rating for them. Besides, information in the system will be updated every year based on the latest financial position of its external customers. Thus, PGB can discover the signs of financial distress of its external customers at earlier stage and having preparation on such situation and hence reduce its credit risk involved. Besides, credit risk report will be generated by PGB RMD on a monthly basis and it is totally independent analysis with the Petronas's Credit Risk Rating System.

In the report, Credit Value at Risk (CVaR), a measurement of potential loss from customers's overdue balances, will be compared with Credit Risk Tolerance limit (CRTL) in order to ensure that CVaR is greater than CRTL. Unfortunately, PGB is till inefficient in its debtor management with the increasing total receivables past due more than 90 days from March 2011 to December 2012 as discussed earlier. Hence, PGB should develop a more specific control mechanism in debtor collection management in order to reduce its credit risk. In managing counterparty risk, Contractor Risk Assessment (CoRA) is an inevitable process to assess and evaluate the qualification of the contractor. PGB's Project Supply Chain Management (PSCM) Department and PETRONAS Group Shared Material and Services Organization (SMSO) will conduct technical and evaluation assessment before award the contract to the contractor. As mentioned earlier, derivatives have been used by PGB in managing its foreign exchange risk. PGB is entering into Currency Exchange Agreement (CEA), which is an

embedded derivative contract with its parent company in order to hedge against the foreign exchange risk between Yen and Ringgit Malaysia. In order to determine how efficiency is PGB in managing its financial risk, its competitor, Shell Refining Company (Shell) will be used again for comparison purpose.

In FYE 2011, both companies did not incur any critical losses resulted from weaknesses of internal control. For Shell, all the updates of company risk profile, risk reaction and actions taken, assurances are all documented in the Risk Register and Assurance Plan. However, specific control mechanisms cannot be found in internal control statement of Shell, Shell is adopting a more traditional method in managing its financial and other risk. On the other hand, PGB is obviously better in its risk management by having different specific control mechanism to manage different financial risk involved. For instance, Petronas's Credit Risk Rating System is specially designed information system to manage its credit risk. It indicates that the control mechanisms or information system of PGB in risk management is stronger and more efficient than Shell. Hence, it allows PGB to be more decisive and faster in making a right decision when dealing with financial risk.

b) Performance measurement standards

Key Performance Indicators (KPI) or Key Success Indicators (KSI) helps an organization to define and measure progress toward organizational goals. Besides, a KPI is also can reflect the critical success factors of an organization.

PGB's governance procedure has been introduced the governance of Health, Safety and Environment (HSE) as Key Performance Indicators (KPIs). They will be assessed based on the performance of their respective businesses' Fatal Accident Rate (FAR), Lost Time Injury Frequency (LTIF), Major Loss of Primary Containment (LOPC) incidents and major fires. The inclusion of these KPIs will help drive improvements in PETRONAS' process safety and capability performance. For PGB, safety plays a very important role as a key forces area for the oil and gas industry since the accident happened in 2010 - Gulf of Mexico.

They are committed to the highest safety and health standards through the restructuring of Group Health, Safety and Environment Division (GHSED) to enable their Business Units to have greater accountability. They try to tightening and reviewing the processes and procedures in order to ensure the risks posed to people and the environment are minimized, and mitigating measures can be swiftly employed in the event of an incident. As well, the main purpose of GHSED is to enhancing HSE performance in sequence to eliminate business risks and exposure and maintain consistency in the implementation of HSE standards and requirements. As the specific KPI in PGB is limited, we decided to use other performance measurement standards such as share price, cash flow and financial ratios to measure the performance of PGB. Share Price

As mentioned in the annual report, PGB is particularly care about the shareholders' interest. Shareholders' objective definitely is increasing their wealth. In order to achieve this objective, financial performance of the company is definitely being the critical part. This indicates that the PGB's <https://assignbuster.com/control-mechanisms-and-performance-measurement-standards-of-pgb-essay-sample/>

shares price is the reflection of the company's financial performance in the perception of the shareholders. Hence, the absolute standard of performance measurement is the share price. PGB used KLCI as the benchmark for this indicator. We could see this clue from the page 81 in annual report. A better shares price performance than KLCI would indicate a better financial performance of the company. The ability to outperform KLCI is the testimony of investor confidence in PGB's financial strength, operational performance and growth potential. Hence, share price could provide some measures on how is the company's financial performance. During the period 1st Apr 2011 to 31st Dec 2011, PGB's share price appreciated by 32% while KLCI decreased by 1% in the same period. Why share price increased? There are many answers, but most of the answers related to the PGB's financial performance and future prospect.

As the fundamental analyst would use financial records of PGB to evaluate the PGB's shares, the financial performance definitely reflected in the share price. That's why share price is the main indicator. Cash Flow from Operating, Investing, and Financing Activities In annual report page 168, it's showing the PGB's management made their segments' performance assessment based on operating profit or loss in consolidated financial statement. This shows that PGB values their operating profit and uses it as performance indicator. However, operating profit might not reflect the liquidity performance such as debtor management; it would not be a good performance indicator. Cash flow would be a better indicator compared to net profit.

The cash flow derived from the net profit and takes into account the liquidity management result. The variation of cash flow from year to year definitely is the result of the company's financial performance especially in the liquidity performance. It also reflects the result of PGB's capital structure and working capital approach. Therefore, comparing every year cash flow could provide the financial performance of PGB. For instance, the year to year cash flow from financing activities could reflect how the change in financing cost was. This related to the PGB's capital structure and provides indication on the capital structure performance. Thus, cash flow from these 3 activities can be the financial performance indicator. Financial Ratio

In order to achieve a better performance measurement standard, we will use the average ROE, ROTA and P/E ratio within the industry. The table below is showing the financial performance of all companies in the industry of oil and gas-refining and distribution.

company	Market capital (RM in millions)	ROE (%)	ROTA (%)	P/E (times)
PETGAS	20,961.879	12.769	10.286	32.970
SHELL	2760.000	NIL	NIL	NIL
GASMSIA	3299.880	11.539	5.634	NIL
PETDAG	20961.879	13.750	7.770	31.780
ESSO	893.700	17.377	6.056	5.830
PENERGY	315.315	1.023	0.435	91.880
Average	13.859	7.437	23.53	

SHELL| 2760. 000| NIL| NIL| NIL|

GASMSIA| 3299. 880| 11. 539| 5. 634| NIL|

PETDAG| 20961. 879| 13. 750| 7. 770| 31. 780|

ESSO| 893. 700| 17. 377| 6. 056| 5. 830|

PENERGY| 315. 315| 1. 023| 0. 435| 91. 880|

Average| | 13. 859| 7. 437| 23. 53|

Source: OSK database based on the latest financial statements of the respective companies Note

1) SHELL will be excluded in calculating all average figures because the



information is not available due the loss made in last FYE. 2) The ROE and ROTA of PENERGY which are extremely low and P/E which is extremely high in the industry will not be included to prevent the industry average figures mislead by only one company. 3) GASMSIA will be excluded in calculating average P/E ratio because the earnings of its first FYE is still unknown since it has just listed in the Bursa Malaysia. Return on Equity (ROE)

Return on Equity = Net Income / Total Equity

Return on equity (ROE) measures a company's profitability by revealing how well the company generated income by using shareholders contribution. As company's main objective is to maximize shareholders equity, ROE provides an insight towards company's earnings derived from each dollar of investor equity. In the industry, ROE of PGB, 12. 769% is slightly lower than the average ROE which is 13. 859%.

The main reason is due to PGB rely heavily in equity financing rather than debt financing which explained earlier in its funding management. Hence, all the earnings will be distributed out for a huge amount of equity which will lead to a lower ROE of PGB. Hence, if the PGB able to raise funds from external borrowings which is lower cost in nature rather than equity, it would lead to a lower cost of capital of PGB and hence enhance the financial performance of PGB. Return on Total Assets (ROTA)

Return on total asset = Net Income / Total Net Asset

ROTA can be treated as an indicator of how effectively a company is utilizing its total net assets to generate returns before it pays its contractual obligations. In industry, ROTA of PGB which is 10. 286% is higher than the

average ROTA which is 7.437% and it is also the highest within its industry. It indicates that PGB is the most efficient company in generating returns based on its total net assets within the industry. The main reason probably is due to its all time high turnover of RM3,525 million in FYE 2011. Price per Earnings Ratio (P/E)

$P/E \text{ Ratio} = \text{Price per Share} / \text{Earnings per Share}$

P/E ratio is the most common method in valuing a company used by the investors and financial analyst. P/E is also referred as the "price multiple", as it indicating by how much investors are willing to pay per dollar of earnings. Basically, the higher the P/E, the higher growth of return investor expected from the company for each dollar they invested.

The P/E ratio of PGB which is 32.970 times is higher than the average industry P/E ratio which is 23.53 times. It simply means that investors willing to pay 32.97 times for every RM earned by PGB. Besides, a higher than average P/E ratio also indicates that investors are expecting PGB able to perform better than other companies in the future. Earnings per Share (EPS)

$EPS = (\text{Net income} - \text{Preferred Dividend}) / \text{No. of Share Outstanding}$  The comparison of EPS within the oil and gas-refining and distribution industry is not available in OSK database. However, EPS is one of the important indicators in measuring a company's financial performance. Hence, we will compare the EPS of PGB with the Shell from FYE 2009 to 2011. PGB | SHELL |

2011 | 2011 | 2010 | 2009 | 2011 | 2010 | 2009 |

54.6 cents | 72.7 cents | 47.6 cents | 46.9 cents | -41.9 cents | 35.5 cents |

96.6 cents |

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Generally, the higher the EPS ratio, the better company performance compared to previous period. From the table above showed that EPS of PGB has increased year-on-year from FYE 2009 to FYE 2011. This could be mostly due to the better management of their operating costs, decreased by 15. 0% from RM2, 043. 5 million in FYE 2010 to RM1, 737. 8 million in FYE 2011. The decreased of RM305. 7 million was due to reduce of 23. 7% for operating cost incurred for the throughput services. On the other hand, SHELL's EPS has decrease year-on-year and generate 41. 9 loss per RM1 unit of share (sen) in FYE 2011. This may mainly due to increases in the global crude prices following supply limitation as a result of the Japan energy crisis and middle-east geopolitical tensions, caused an increased in cost of sales by 11% year-on-year from RM10. 2 billion in FYE 2010 to RM11. 3 billion in FYE 2011.

[ 2 ]. Kamarul Yunus, N2012, ' Petronas Gas fired up on power plants' potential', Business Times, May 16, viewed on 20th 2012,