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**CORPORATE GOVERNANCE IN  
THE INDONESIAN STATE-OWNED ENTERPRISES**

A Thesis presented in fulfilment of the  
requirements for the degree of Doctor Philosophy in  
Development Studies at Massey University,  
Palmerston North, New Zealand

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\*\*\*\* This work is dedicated to my parents who through their everlasting love, devotion and prayers have made my world a better place to live in \*\*\*\*

## **Abstract**

Concern regarding corporate governance is a new phenomenon in Indonesia. It became apparent in the business community when the economic crisis hit the country in 1997. Due to its recent recognition, it appears that very little is known about corporate governance in Indonesia and there has been no academic study conducted on corporate governance in the Indonesian State-owned Enterprises (ISOEs) despite the fact that their performance is closely linked to the development of the country.

The main objectives of this study are two-fold: first is to examine corporate governance systems and the roles of the Boards of ISOEs; and second is to assess the effectiveness of government initiatives in improving corporate governance practices in ISOEs. This study employed both qualitative and quantitative methods. The quantitative analysis was derived from numerical data obtained from government reports and other public documents. The qualitative analysis was based on the results of in-depth interviews with key individuals and other sources such as public opinions published in the mass media.

Several key findings were obtained from the results of this study. Firstly, the study found that using agency theory to explain the relationships between the agents and the principals was more problematic in ISOEs than those in private enterprises. This is because an ISOE is a loose coalition of various agents with no real owner. Consequently, agency theory, if it is used to redefine the relationships among parties in ISOEs, should be approached at two different levels. At the micro level the agency theory examines the agent-principal relationships among the ISOE management, the Boards and the government—the corporate governance tripod. At the macro level it examines the agent-principal relationships between the corporate governance tripod and the ISOEs stakeholders (the public, labour unions, politicians in the People's Representative Assembly and others).

Secondly, the results of this study confirm the results of previous studies which found that Boards in SOEs were largely ineffective. To enhance Boards' effectiveness, this study suggests that as a quasi-owner the government needs to reduce its intervention in ISOEs' operations and empower the Boards by establishing employee representation on the Board. In addition, Board training and assessment should be a mandatory in the ISOEs.

Thirdly, this study found that the initiatives on corporate governance carried out by the Indonesian government had been ineffective due to the lack of incentives, lack of commitment and consistency, lack of understanding of corporate governance and unclear programmes. Here, the key factor required to enhance effectiveness is strong-willed commitment of the government and ISOE management.

Lastly, other factors such as culture, public governance and law enforcement have a great influence in the process of attaining good corporate governance practices. Therefore, there should be joint efforts among parties in the public sector to ensure that good corporate governance is achieved in conjunction with the attainment of good public governance.

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## Glossary

*Aku Cinta Produksi Indonesia* = I love Indonesian products

*Bank Indonesia* = the Indonesian Central Bank

*Bapak Pembangunan Indonesia* = the Father of Indonesian Development

Bappenas (*Badan Perencana Pembangunan Nasional*) = the National Development Planning Agency

BIN (*Badan Investasi Negara*) = the State Investment Board

BPPMA (*Badan Pertimbangan Penanaman Modal Asing*) = the Foreign Capital Investment Advisory Board

*Benteng* = Fortress

BPKP (*Badan Pengawasan Keuangan dan Pembangunan*) = The Financial and Development Supervisory Board

BULOG (*Badan Urusan Logistik*) = The National Logistics Agency

BUMN (*Badan Usaha Milik Negara*) = Indonesian State-owned Enterprises

*Demokrasi Terpimpin* = Democracy Guidelines

*Departmen Industri* = the Ministry of Industry

*Departemen Keuangan* = the Ministry of Finance

*Dewan Direksi* = Board of Management

*Dewan Komisaris* = Board of Directors

*Dewan Pengawas* = Board of Supervisors

DPR (*Dewan Perwakilan Rakyat*) = People's Representative Assembly

EKUIN (*Ekonomi, Keuangan dan Industri*) = Economy, Finance, and Industry

ICW (*Indische Comptabiliteitswet*) = the Accountability Law in the Dutch colonial era

IBW (*Indonesische Bedrijvenwet*) = the Company Law in the Dutch colonial era

*Indonesianisasi* = the indigenisation of economic activity

*Instruksi Presiden* = Presidential Instruction

*Kabinet Persatuan Nasional* = the National Unity Cabinet

*Kebijakan Ekonomi Terpimpin* = Guided Economy Policy

*Keputusan Menteri* = Ministerial Decree

*Keputusan Presiden* = Presidential Decree

KKN (*Korupsi, Kolusi, dan Nepotisme*) = Corruption, Collusion, and Nepotism

Meneg PBMUN (*Kementrian Negara Bidang Pemberdayaan Badan Usaha Milik Negara*) = the State Ministry for the Empowerment of ISOEs

*Menunggu petunjuk* = The state of waiting for instruction

*Orde Baru* = New Order

*Orde Lama* = Old Order

*Peraturan Pemerintah* = Government Regulation

*Perjan (Perusahaan Jawatan)* = Governmental Agency

*Perum (Perusahaan Umum)* = Public Company

*Persero (Perusahaan Perseroan)* = Limited Liability Company whose shares are wholly or partly owned by government

*Perusahaan Negara* = State Company

*Repelita (Rencana Pembangunan Lima Tahun)* = the Five Year Development Plans

*PT (Perusahaan Terbatas)* = limited liability company

*RS (Rumah Sakit)* = Hospital

*Undang-Undang* = Law

*UUD 1945 (Undang-Undang Dasar 1945)* = the Indonesian Constitution



# **Chapter One**

## **Introduction**

The governance of the corporation is now as important to the world economy as the government of countries.

(James D. Wolfensohn, in Simpson, 2003: 11)

### **Research Background**

Large scale corporate scandals occurring around the world have attracted public attention to the failure of corporate governance in many public companies locally and internationally<sup>1</sup>. In the United States, the corporate scandals connected with Enron, WorldCom, Global Crossing and Tyco International, to name a few, were the result of abuses of power by the parties who had been given the responsibility to manage a company on behalf and in the interests of the owners. Enron, for example, was exposed for manipulating its accounts through off-balance sheets and losing billions as its stock price dropped from \$90 (August 2000) to \$1 (December 2001) and bringing down the entire Andersen auditing and consulting organisation (Pye and Camm, 2003: 53).

In the United Kingdom, the major breakdown of many British businesses, such as the collapse of Rolls Royce (Davies, 1999: 19), and Barings Bank, and other related business scandals motivated the public to be more critical regarding the role and performance of parties who run businesses. In Russia, the controlling shareholders of an oil company had misused the company profits that left the company in debt to its creditors, employees and the state (Iskander and Chamlou, 2000: 1).

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<sup>1</sup> The first well-documented failure of governance, according to Iskander and Chamlou (2000: 1), was the South Sea Bubble in the 1700s, which revolutionised business laws and practices in England. Similarly, the stock market crash of 1929 in the USA raised public awareness of the importance of good corporate governance practices.

In Asia, poor corporate governance practices were attributed to 'crony capitalism' where personal connections and political patronage, rather than entrepreneurial abilities, determined who got access to credit and other resources and on what terms (Chang, 2000: 775). This created over-investment and over-borrowing by many large companies, which then ended up creating on large bad debts. Besides crony capitalism, Chang (2000) noted that in Korean business there is also a moral hazard of "too big to fail" syndrome that refutes the possibility of big corporations going bankrupt. Table 1.1 provides a list of poor corporate governance practices in some Asian companies.

**Table 1.1 List of Asian Companies with Poor Corporate Governance**

<b>Company</b>	<b>Country</b>	<b>Date</b>	<b>Alleged incident</b>
Bangkok Bank of Commerce	Thailand	1996-97	Bank managers moved money to offshore companies under their control.
United Engineers (Malaysia) Bhd	Malaysia	1997-98	United Engineers bailed out its financially troubled parent, Renong Bhd, by acquiring a 33% stake at an artificially high price.
Sinar Mas Group	Indonesia	1997-98	Group managers transferred foreign exchange losses from a manufacturing company to a group-controlled bank, effectively expropriating the bank's creditors and minority shareholders
PT Bank Bali	Indonesia	1997-98	Managers diverted funds in order to finance a political party.
Guangdong International	Hong Kong/China	1998-99	Assets that had been pledged as collateral disappeared from the company when it went bankrupt
Siu-Fung Ceramics Co	Hong Kong/China	1998-99	Assets that had been pledged as collateral disappeared from the company when it went bankrupt

Source: Johnson, Boone, Breach, and Friedman (1999)

An important reason for corporate breakdowns, according to Monks and Minow (2003: 1), is the sense that every mechanism sets up to provide checks and balances fails at the same time. Some of the blame is directed toward the Board of Directors because they are perceived as failing to

execute their duties responsibly, both collectively and individually. Jensen and Fuller (2002) in their research paper 'What's a Director to Do?' assert that the recent wave of corporate scandals provides continuing evidence that Boards have failed to fulfil their role as the top-level corporate control mechanism; they have destroyed and ruined the reputations of companies. As a result, a number of reputable business-related publications have initiated to publish a list of the 'worst corporate Boards' mostly in the USA (see *Business Week*, January 24, 2000).

To prevent the occurrence of similar corporate scandals, several initiatives and reforms to improve corporate governance systems and practices have been carried out around the world. Numerous institutions and committees were established in many countries to deal with the issues. In the USA, for example, the initiative included the establishment of the National Commission on Fraudulent Financial Reporting (the Treadway report) and the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report) in 1987 and 1992 respectively (Vinten, 2001). The Treadway Report offered 11 recommendations to enhance the effectiveness of audit committees, which were to be the keystone of corporate financial governance. Recently, following the Enron scandal, the US Congress passed the Sarbanes-Oxley Act 2002, a law that mandated a number of reforms to enhance corporate responsibility and financial disclosures, and to combat corporate and accounting fraud. At the same time, the 'Public Company Accounting Oversight Board' was established to oversee the auditors of public companies in order to protect the interests of investors and the public (PCAOB website, 2005). The term corporate governance was even mentioned for the first time in the US President's annual State of the Union address (Monks and Minow, 2003: 1).

In the UK, several committees such as the Cadbury (Committee on the Financial Aspects of Corporate Governance, 1992), Greenbury (The Study Group on Directors' Remuneration, 1995), Rutteman (Joint Working Party on Internal Control and Financial Reporting, 1994), Hampel (Committee on Corporate Governance, 1998), and Turnbull (Institute of Chartered Accountants Internal Control Working Party, 1999) were

established in response to the need for better corporate governance practices<sup>2</sup>. Other countries have followed a similar line. For example, Australia has the Bosch Report; Canada has the Dey Report; South Africa has the King Committee and New Zealand has the Corporate Governance Code established by the Securities Commission. In the Asian region, the Philippines formed the Presidential Commission on Governance and India established the Bajaj Committee<sup>3</sup>.

In another setting, various shareholder reform actions have taken place in an effort to protect shareholder rights and to instil the concept of corporate governance into businesses. Institutional investors such as CalPERS in the USA have been 'putting pressure on poor management, imposing changes like reduction in pay for managers, reducing the size of board, and teaming up with others to change management' (Vives, 2000: 7). In fact, the largest American institutional investors have produced numerous corporate governance codes for different countries in which they invest, and have created influential associations such as the International Corporate Governance Network (ICGN) which actively co-ordinate and promote their interests across the globe (Learmount, 2002: 2).

Along with the institutional investors' activism, international institutions such as the Organisation for Economic Co-Operation and Development (OECD), and financial agencies such as the World Bank, the Asian Development Bank (ADB) and the International Monetary Fund (IMF) were also involved in the enhancement of good corporate governance practices, particularly in the developing countries. The OECD (2004), for example, stipulates corporate governance principles that have now adopted by many countries. The World Bank considers corporate governance as an essential part of strengthening the international financial architecture, and also a critical part of creating the investment climate which will allow developing countries to broaden and deepen their access to capital. In addition, the Bank notices that corporate governance has other related benefits which are vital to the development agenda. This

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<sup>2</sup> Vinten (2001) labels the Committees established following the establishment of the Cadbury Committee as the Sons of Cadbury.

<sup>3</sup> See Gregory (2000) for a comprehensive review of corporate governance initiatives around the world.

includes eliminating corrupt practices in both the public and private sector. The ADB provided financial and technical aid to several Asian countries including Indonesia to promote good corporate governance practices.

To provide a rapid response mechanism for coordinating and channelling practical technical assistance to specific constituents on a national, regional, and global basis, the World Bank and the OECD joined together and signed a Memorandum of Understanding in June 1999 to sponsor the Global Corporate Governance Forum. The forum brings together other multilateral development banks, bilateral and international organisations, the IMF, the Commonwealth, the Asia Pacific Economic Cooperation, the International Accounting Standards Committee, the International Organisation of Securities Commission, and the private sector (Iskander and Chamlou, 2000: 13).

In the academic setting, a large body of research has been conducted covering many aspects of corporate governance issues. For example, in the area of roles and responsibilities of the Board of Directors, issues such as board composition, independent directors, board size, board ownership, board committees and board compensation were among the issues studied (see the Patterson Report, 2003 for a detailed review). Gompers, Ishi, and Metrick (2001) in their study of 1,500 companies found a striking relationship between corporate governance and stock returns. Russel Reynold Associates (1998) surveyed 374 institutional investors in Australia, France, the UK and the USA and found that 71 per cent had refrained from investing in certain companies because of their reputation for poor corporate governance (cited in Gregg, 2001). McKinsey in conjunction with Institutional Investor, Inc. carried out a survey of over 100 major investors, CEOs, and senior executives. The results suggested that companies with high corporate governance standards were worth significantly more to investors than those with low governance standards—even if the comparison was between companies with identical business and financial profiles (cited in Felton, Hudnut, and van Heeckeren, 1996).

## Research Problem

In Asia, the major incident that caused the intense focus of business, media and academics on the failure of corporate governance was the severe economic crisis<sup>4</sup> that hit the region in 1997 (see, for example, Claessens, Djankov, and Lang, 1998). Amongst the Asian countries, Indonesia was the most severely affected by the crisis and its impact is still evident today. Indonesia suffered an extremely heavy debt burden due to the severe fall in the Indonesian currency against the US dollars. The crisis created a drastic reversal of a long period of high Growth Domestic Product (GDP) growth, from 7-8 percent annually to negative growth of close to 14 percent (Djiwandono, 2000: 50)<sup>5</sup>

A number of factors were claimed as the causes of the crisis in Indonesia including poor corporate governance practices in both private and state-owned enterprises. The ADB asserts that the lack of good corporate governance practices in the Indonesian State-owned Enterprises (ISOEs)<sup>6</sup> is very deep-rooted; therefore, addressing it has to become the top priority. The major causes of such poor practices were government interference in day-to-day operations, lax internal controls, loopholes in accounting practices, poor auditing standards and practices and indiscriminate subsidies and protection that have undermined ISOEs (ADB, 2001)

The ADB assertion was supported by McKinsey and Co.'s Investor Opinion Survey for Asia carried out in 2000. The survey ranked Indonesia as the worst in corporate governance practices out of six Asian countries. Global investors from the United States, Asia, Europe and other countries who participated in the survey gave a score of 1.1 points to Indonesia, on a 1 to 5 scale, with 5 points meaning 'very good' and 1 'very poor.' Malaysia scored 1.5 points, Thailand 1.7, South Korea 2.0, Taiwan 2.5, and Japan 2.6. Almost all the respondents said they are willing to pay more for shares of companies with 'good' governance, and in the case of Indonesia

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<sup>4</sup> The Indonesian term for the crisis is *Krismon*, an acronym for *Krisis Moneter*.

<sup>5</sup> The economic crisis has drawn Indonesia become a poor country, from having \$1,300 level of annual income per capita to US\$350.

<sup>6</sup> The Indonesian term for ISOEs is Badan Usaha Milik Negara (BUMN)

they said a 27% premium, on average, is appropriate for shares in such companies.

Likewise, a survey by Pricewaterhouse Coopers in 1999 using institutional investors in Singapore as respondents showed that Indonesia, among countries in the Asia-Australia region, was ranked very low not only in the perceived standard of disclosure and transparency, but also in other areas such as accountability to shareholders, board processes, auditing and compliance (cited in Kurniawan and Indriantoro, 2000). The results were relatively similar to the Political and Economic Risk Consultancy (PERC) survey in 1998 that ranked Indonesia as the worst in transparency with the highest score of 8.41. The countries surveyed were South Korea, Malaysia, the Philippines, Singapore, Indonesia and Thailand. The survey used a scale from 0 to 10, which 0 as the best and 10 as the worst. This situation, according to PERC, made the Indonesian business environment very vulnerable to corruption. Another survey conducted by Booz-Allen and Hamilton in 1998 showed that the good corporate governance index for Indonesia (2.88) was the lowest in East Asia compared to Malaysia (7.72), Thailand (4.89), Singapore (8.93) and Japan (9.17). The survey used 0 to 10 scales, with 0 as the worst and 10 as the best (*Bisnis Indonesia*, September 11, 2003).

The above claims and findings were not surprising or new. In fact, there was a lack of good corporate governance practices long before the 1997 economic crisis. In the 1970s, for example, Pertamina, an ISOE, had accumulated a \$10.5 billion debt as a result of misgoverned and mismanagement which occurred when the enterprise started borrowing short term loans for long term projects. That debt was more than three times the level of Indonesia's international debt, causing enormous foreign exchange problems and almost making the country bankrupt. The situation occurred because the company executives, chaired by Ibnu Sutowo, ignored government control mechanisms and by passed the authority (Prawiro, 1998). Another case occurred in the late 1980s when Bapindo, a state-owned bank, was discovered to have a large number of non performing loans and corrupt practices. In both situations, regrettably, no sanction was taken by the government toward the Boards

of the ISOEs. If there were sanctions, they stopped at the middle management level.

To improve poor corporate governance practices, numerous initiatives and reforms have been undertaken in Indonesia particularly to improve the transparency and the accountability of the companies and to increase the effectiveness of the Board of Directors<sup>7</sup>. Most of the initiatives were largely imposed by the international financial agencies such as the IMF, the World Bank<sup>8</sup> and the ADB<sup>9</sup>. As such, good corporate governance practices became a condition attached to the receipt of financial aid from the agencies. Examples of initiatives and reforms in the private sector include:

- Developing a national strategy for corporate governance reform
- Reviewing the current approaches to corporate governance issues
- Conducting educational events in corporate governance for the public
- Conducting pilot projects to implement corporate governance principles in the industries
- Carrying out regulatory reform within the capital market.
- Instituting a fit and proper test for directors and commissioners
- Technical assistance from the international community (cited in Kurniawan and Indriantoro, 2000:9)

Meanwhile, a number of institutions were established such as the National Committee on Corporate Governance (NCCG), the Indonesian Institute for Corporate Governance (the IICG), the Forum for Corporate Governance in Indonesia (FCGI), Corporate Leadership Development Indonesia (CLDI), the Indonesian Institute for Corporate Directorship (IICD) and Indonesian Society of Independent Commissioners (ISICOM).

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<sup>7</sup> According to Roche (2005: 45), corporate governance matters for Asian countries for reasons (1) to compete for financial capital and (2) globalisation.

<sup>8</sup> The examples of the World Bank Loan to Indonesia with corporate governance component attached are: (1) BEPEKA Audit Modernisation Project, 1997; (2) Policy Reform Support Loan Project 1998 and 1999; (3) Accountancy Development Project 1988 and 1994 (World Bank, 1999).

<sup>9</sup> In 2001, the ADB provided US\$2.7 million grant to assist Indonesia in developing a system of corporate governance for state-owned enterprises and to identify options for privatization (ADB, 2001).



The NCCG was established as a non-governmental body by the Decree of Coordinating Minister for Economy, Finance, and Industry No. 10/1999 dated 19 August 1999. Its task was to formulate and recommend a National Policy on Good Corporate Governance. The members included prominent respected figures from business and industry, representatives from the investment community, representatives from professional bodies, and academics.

The establishment of the NCCG was part of the Indonesian government's commitment to the International Monetary Fund as outlined in a Letter of Intent signed in January 2000. The NCCG produced the Indonesian Code of Good Corporate Governance, the purpose of which was:

[T]o maximise corporate and shareholder value by enhancing transparency, reliability and accountability and by establishing a managerial system encouraging and promoting creativity and progressive entrepreneurship (NCCG, 2000).

Indeed, to implement sound business practises, companies should develop formal corporate governance guidelines, by which the Board of Directors and management are self-regulated. Such guidelines should be of a standard that is representative of the best corporate governance practices in the business environment. Once the Code of Best Practice is developed, companies should adhere to it and report to shareholders about any deviations. The process of setting guidelines will help focus the minds of directors and management on the importance of good governance.

In addition to the Code for Corporate Governance, the NCCG also proposed a reform in the regulatory environment. The proposal included:

- Amending company law to accommodate corporate governance principles
- Amending company registration law to ensure transparency of corporate information
- Improving accounting standards, including regulations on the formation of audit committees and compliance officers
- Improving regulation on disclosure

- Improving capital market rules, including support of a new Financial Supervisory Agency, which is part of the new Central Bank Law
- Improving articles of association
- Improving banking sector regulations
- Forming an Institute of Commissioners) to train and certify Commissioners (cited in Kurniawan and Indriantoro, 2000)

To disseminate the concept of corporate governance, several educational events were carried out, such as:

- A conference titled 'The Importance of Corporate Governance', jointly conducted by the World Bank, the Jakarta Initiative, the Capital Market Society of Indonesia and the Jakarta Stock Exchange in April 1999.
- A panel discussion on Corporate Governance jointly conducted by Ernst and Young, the Indonesian Institute of Accountant's Management Accountants Compartment (IAI-KAM) and the Indonesian Financial Executives Association (IFEA).
- A seminar on corporate governance conducted by IAI in 2000.

In the public sector, good corporate governance practices became one of the key objectives stated in the State Ministry of ISOEs Master Plans for 2002-2006. To attain this objective, the Ministry launched a number of Ministerial Decrees: (1) Decree No. KEP-178/M-PBUMN/1999, on the establishment of Working Groups in Corporate Governance and Corporate Ethics, (2) Decree No. 23/2000 on the recommendation to implement good corporate governance practices in all ISOES and (3) Decree No. 117/M-MBU/2002 on the mandate to all ISOEs to implement good corporate governance principles: transparency, accountability, fairness, responsibility, and independence. In line with this, the ADB has provided funding to the Indonesian government to improve the corporate governance system in the ISOEs. The new system is expected to give management greater authority and autonomy as well as the incentives for directors and commissioners to improve performance (ADB, 2001).

Despite many initiatives and reforms carried out by the government and other agencies, domestic and international, to improve corporate governance in the public and private sectors, better practices and awareness of the importance of corporate governance seem to be a long way from being achieved. A survey by the Indonesian Institute of Corporate Governance (IICG) found that the number of public companies listed on the Jakarta Stock Exchange interested in participating in the corporate governance survey was decreasing every year. In 2002, only 36 of 321 companies responded to the survey. In 2003, questionnaires were sent to 333 public companies but only 34 companies responded. In 2004, the number of companies participating in the survey was only 22 of 318 companies surveyed (Poeradisastira, *Swa Online*, April 28, 2005).

To some extent, this condition is not surprising and is understandable due to the fact that the corporate governance concept is a relatively new phenomenon in Indonesia. It became a big concern to all parties in the public and private sectors only after the economic crisis occurred and foreign agencies imposed and attached their financial assistance to the implementation of good corporate governance practices. With this regard, Prawiro (1998: 352) said 'It is regrettable though not unexpected that the most significant reforms [in Indonesia] are frequently born of crisis.'

Despite so many public concerns about poor corporate governance practices in the business sector, to date there has been very little empirical research that systematically examines corporate governance in Indonesia, let alone in ISOEs<sup>10</sup>. Therefore, little is known about how corporate governance functions in ISOEs. There have been some studies carried out to examine corporate governance in Indonesia but they were limited to the private sector (banking institutions) and were commonly sponsored by the international financial agencies such as the World Bank and the Asian Development Bank or other institutions such as foreign-owned public accounting offices (see e.g., Patrick, 2001; Nam and Nam, 2004; Kameyama and Alijoyo, 2004). In addition, not all of the results of the studies were released to the public.

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<sup>10</sup> The situation is similar to other developing countries such as in Africa (see e.g., Okeahalam and Akinboade, 2003)

Relevant to this, it is worth noting the contention coming from Ayubi (1995: 3 cited in Younis, 1996: 20) who states that,

Very few developing countries have conducted their own empirical studies on the performance of their own public sectors. On this subject they have, on the whole, been prepared to take the word of 'experts' from the developed countries and their international organizations.

Hence, Indonesia needs empirical evidence about corporate governance practices in ISOEs from the perspective of the Indonesians. As such, 'If poor corporate governance is the culprit, then the more that is known about it the more likely a suitable remedy can be applied to solve the problem and to prevent its recurrence' (Tabalujan, 2002). Herein, the more research on corporate governance the more people will focus the attention on how to create the sound business environment needed to release the country from the economic crisis and to attain sustainable development growth.

### **Research Objectives and Research Questions**

Having discussed the problems and reforms associated with corporate governance practices in Indonesia, the relevant question becomes 'What is the current state of corporate governance practices in ISOEs?'<sup>11</sup> The rationale for selecting ISOEs as the focus of the study is the fact that ISOEs still play an important role in the Indonesian economy. Firstly, they provide a significant contribution to government revenue and the creation of wealth. In 2004, the ISOEs' total assets reached Rp1,177 trillion which was almost 70 percent of Indonesian Product Domestic Bruto (PDB) and generated revenues of Rp495.2 trillion (*Warta Ekonomi*, March 10, 2005). Secondly, ISOEs employ more than 600,000 people and are thus critical in job creation and in reducing unemployment. Thirdly, in 2003 about 30.8

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<sup>11</sup> There was only one study (unpublished) conducted by the Supervisory Board of Finance and Development (*Badan Pengawasan Keuangan dan Pembangunan/BPKP*) in 2000 that examined the effectiveness of the Board in ISOEs. However, it was not based on a corporate governance perspective. Other studies on ISOEs were mostly in the area of privatisation and management control (see e.g., Mardjana, 1993; Djamhari, 1996).

percent or one third of shares traded and exchanged at the Jakarta Stock Exchange were ISOE shares<sup>12</sup>. (*Kompas Online*, December 20, 2003). PT<sup>13</sup> Telekomunikasi Indonesia Tbk, for example, is the largest capitalized telecommunication company in the Jakarta Stock Exchange. In terms of market control, PT Pertamina has a prominent role in the oil and gas industry. Similarly, PT Pelni dominates sea transportation, PT Garuda is the biggest national flag air carrier, PT Krakatau Steel has the largest factory in steel industry, and PT Pusri is the leading player in fertiliser industry. Thus, any improvement in their performance has the potential to make a significant contribution to general economic performance and the government budgetary position. As noted by Patrick (2001: 4) in his study on corporate governance in private listed companies in Indonesia, the implementation of good corporate governance rules and practices for ISOEs is as important as for private listed companies.

At the micro level, good corporate governance will direct companies to conduct business responsibly by not engaging in illegal practices, corruption, and bribery and by not creating externalities<sup>14</sup>. As one Chinese academic argues:

Policy-makers around the world have another important reason to be concerned with corporate governance: low corporate governance standards also breed corruption. Corruption, defined here as the misuse of public office for private gain (Rose-Ackerman, 1978), has both the demand and supply sides to it. While much attention of the global anti-corruption campaign has been directed towards the demand side of corruption, that is, the corrupted government officials, the supply side of corruption is just as important, and the impacts of the governance of corporations—the main contributors of bribe payment—on the level of corruption should not be underestimated. Rules of corporate governance, such as accountability, transparency and fairness, have profound impacts on the motives and constraints for both the corrupted and the corruptors involved in corrupt practices (quoted in Roche, 2005: 17).

<sup>12</sup> This percentage comes from no more than 10 out of 158 ISOEs.

<sup>13</sup> PT is the abbreviation for *Perusahaan Terbatas* (limited liability company).

<sup>14</sup> An externality is a situation in which the full social cost of an action is not borne by the company or individual that takes the action. Examples are cases of air or water pollution in which a company adds pollution to the environment without having to purchase the right to do so from the parties giving up the clean air or water (Jensen, 2001: 303).

At the macro level, sound public governance which has accountability, transparency, openness and rule of law as its basic components will lead to efficient economic decision making, which will improve country's performance. Transparency in corporate governance, for example, may increase local government participation in managing, owning or having shares in ISOEs that operate in their regions. This in turn will be beneficial in the development of the local economy and the success of the decentralisation programme. As noted by Madhav Mehra, the President of the World Council for Corporate Governance, corporations are now being asked to do more than maintain bottom-line profit; they are expected to play a role in the social transformation of the country (cited in Harichandan 2001). This is the reason the OECD, an intergovernmental organisation whose mandate is to advise on public policy matters, is interested in corporate governance (Witherell, 2000). The organisation developed a set of Principles of Corporate Governance that is summarised in four values: equitable treatment, responsibility, transparency and accountability. These values link corporate governance to other important elements of governance in a broader sense: the battle against bribery and corruption; corporate responsibility and ethics; public sector governance and regulatory reform. In the long run, sound public and corporate governance are a must to achieve the three pillars of sustainable development; a balance amongst economic, social and environmental objectives.

Having said the above, this study attempts to approach the issue of corporate governance in ISOEs from the perspective of development studies. Here, there is a significant relationship between corporate governance of ISOEs and the economic and social development of Indonesia. As Leong (2005: xxiii) argued, 'good corporate governance is also a key ingredient to sustained economic growth.' This study aims to link corporate governance with development issues such as privatisation and government reform of ISOEs.

Corporate governance is a new phenomenon to Indonesia. It was only recently introduced to the business community when the economic crisis

hit the country in 1997. Due to this fact, it appears that very little is known about corporate governance and to my knowledge there has been no academic study conducted on corporate governance in the ISOEs. Bearing this circumstance in mind, this study is exploratory in nature in that it is 'Initial research conducted to clarify and define the nature of a problem' (Zikmund, 1997: 102).

The main objectives of this study are to examine corporate governance practices in ISOEs and the roles of the Boards. With regard to corporate governance practices in ISOEs, this study attempts to assess the implementation of Anglo-American corporate governance model prescribed by the financial agencies (the IMF, the World Bank, and the ADB). There are striking differences between corporate governance systems in Asia and those in Western countries. For example, the corporate governance systems in East Asia are relationship-based (Rajan and Zingales, 1998) whereas the Anglo-American corporate governance systems are market-based. Hence, the notion that corporate governance mechanisms applied in the West should be implanted in the Asian business needs to be viewed with caution (Tsui and Gul, 2000: 7). In his review, Park (2001) argues that the East Asian model remains appropriate for the developing economies whenever the negative features subsisted in the model are corrected. Keeping this in mind, SOEs can be used as a 'testing ground' for the universality of Western-generated theory (Lin and Germain, 2003: 1131).

With regard to the roles of the Boards, many have argued that one of the many causes of poor corporate governance practices in Indonesia is the under-performance of the Boards in carrying out their duties both in the private companies and in the ISOEs. In the private companies, the criticism is that the Boards is lacking the required competence and is failing to maintain its independence due to close relationships with the major shareholders (including family ties). Very often the existence of the Boards in a company is a matter of formality, in order to adhere to regulations. Hence, their functions are limited to being 'watchdogs' or 'fire-fighters'. They are seldom involved in decision making processes. As noted by Blair (2001: 78), the Board of Directors are seen to be just 'rubber

stamps' for the CEO. Dahya, Karbhari, Xiao, and Yang (2003) in their study within the Chinese context identify four types of the Supervisory Board members: (1) an honored guest; (2) a friendly advisor, (3) a censored watchdog and (4) an independent watchdog. Most of them tend to be of the first three types.

A number of factors have been recognised as reasons for selecting Board members and some of them are unacceptable. For example, the appointment was made because they were friends of the Chairman; owned of a large number of shares; added prestige to the company (previously they had high position in the bureaucracy), were insiders, major customers or investors, patrons, or granted or repaid political favours (Nash, 1991 cited in Gay 2002: 43).

In ISOEs it is not uncommon for the board members to have multiple roles. On the one hand, they are government officials, whose function is to regulate the ISOEs. On the other hand, they are members of the Boards which should act in accordance with the guidelines established by the lawmakers. The dual roles open the door to conflicts of interest because they may create a situation where the board members, as regulators, issue certain policies which only benefit the ISOEs under their supervision. Hence, it prevents them from acting fairly to the business community as a whole.

Despite the argument that the Board of Directors is 'the single most important corporate governance mechanism' and 'the crucial part of the corporate structure' (Blair, 2001: 77; Gugler, 2001: 4; Monks and Minow, 2003: 195), international comparative research on board structure is a neglected area (Fox, 1996: 1). Thus, '... much remains to be done to understand the function and effectiveness of international boards, and to provide comparison across nations' (Boyd et al., 1996 quoted in Fox, 1996: 1).

In line with the objectives stated above, there are two additional objectives which this study attempts to examine. Firstly, this study aims to examine the initiatives carried out by the Indonesian government to enhance good corporate governance practices in the ISOEs. As observed, the government, under the supervision of the international financial



agencies, has launched several programmes to enhance corporate governance practices. However, the reality shows that many Board members and managers of ISOEs are still involved in wrongdoing and misconduct. Therefore, there is a question as to the effectiveness of government initiatives to improve corporate governance practices in ISOEs. Secondly, this study seeks to examine factors (if any) that may have affected the effectiveness of corporate governance initiatives in ISOEs.

### **Research Questions**

To systematically address the research objectives, this study develops the following research questions:

- What are the current practices of ISOEs?
- What are the corporate governance systems in the ISOEs?
- What are the roles of the Boards in the ISOEs and are the roles effectively carried out in practice?
- What corporate governance initiatives are there in ISOEs and have these initiatives been effectively carried out to increase the performance of ISOEs?
- What factors (if any) may deter the implementation of good corporate governance in ISOEs?

To answer all the above research questions, both qualitative and quantitative methods were employed. The quantitative analysis was derived from numerical data obtained from government reports and other public documents. The qualitative analysis was based on the results of in-depth interviews with key individuals and other sources such as public opinions published in the mass media. The in-depth interview method is seldom used by researchers in corporate governance research in Indonesia. More detailed discussion of the research methodology employed in this study is presented in Chapter Five.

As stated previously, this study is exploratory in nature and having this nature, this study is not intended to confirm or refute any particular theory. As Learmount (2002: 16) says:

Given the incipient state of theoretical and empirical research on corporate governance, it seems prudent to address the issue of corporate governance without accepting or rejecting a priori any definition of the 'the governance problem' (emphasis is in original).

### **Importance of the Research**

The importance of this study is four-fold. Firstly, this study contributes to the literature by filling the gap in the body of knowledge of corporate governance in developing countries, particularly in SOEs. As corporate governance attracts the attention of practitioners and scholars from various disciplines, many studies have concentrated on the private sector but very few on corporate governance in the public sector. Secondly, this study highlights the roles of the Boards in ISOEs which are under-studied despite many claims of this ineffectiveness. The results of this study reveal the likely causes and consequences of the ineffectiveness. Thirdly, several issues that are of general concern for ISOE management and policymakers are highlighted that may lead to the creation of policies on the future direction of corporate governance reform in ISOEs. The successful launch and effectiveness of government initiatives on corporate governance in the ISOEs may require more substantial research. Too often government initiatives failed because people involved in them lacked an understanding of the issues and the need to solve the issues based on empirical data. Finally, this study provides a basis for the academia, practitioners, and regulators to carry out future research on the subject in the ISOEs.

### **Research Outline**

This study consists of ten chapters. Chapter One provides the background of this study. It briefly describes the state of corporate governance practices and inherent issues across countries. In addition, this chapter explains the rationale, objectives and research questions of the study.

Chapter Two discusses the theoretical background and issues of corporate governance documented in the literature. The discussion includes a review of agency theory, concepts, definitions and basic

principles of corporate governance, and the debates between shareholder and stakeholder value. The discussion in this chapter reveals that there is not a universal definition of corporate governance. It means different things to different people. This chapter highlights the differences between market-based corporate governance and group-based corporate governance and between governance and management.

Chapter Three provides an overview of the Board of Directors, which includes a discussion of its structure, composition, role and duties, and independence. The discussion of board structure highlights the differences between the one-tier board structure adopted in the Anglo-American countries such as in the USA and in the UK and the two-tier board structure practiced in the European countries such as Germany and the Netherlands. To provide a comparison, a discussion of several board structures adopted in the developing countries such as in Malaysia, India, and China is presented. Furthermore, this chapter highlights the debates of board independence and board leadership prevalent in the one-tier board structure.

Chapter Four is a literature review of SOEs. As such, this chapter discusses the theory and empirical practice of SOEs documented in the literature. It includes discussions of the definitions, origins, objectives and performance of SOEs. In addition, this chapter explores several issues related to privatisation including its pros and the cons. This chapter is important as a backdrop to the empirical portion of this study.

Chapter Five explains the research methodology employed in this study. This includes explanations of the sampling techniques chosen to select the interviewees, data collection and analysis methods used, and a brief reflection of the fieldwork. In-depth interviews were used to capture the opinions and views of key individuals interviewed in this study. The results of the interviews and data from other sources such as public opinions published in the mass media are used as the basis of my arguments in this study.

Chapter Six aims to answer the first question of this study 'What is the current practice of ISOEs'? In doing so, this chapter provides an in-depth review of the origin, development, performance and privatisation of

ISOEs. In addition, this chapter discusses briefly the related debates concerning government participation in business and the necessity of privatisation to improve the performance of the ISOEs.

Chapter Seven aims to answer the second and third questions developed in this study: 'What are the corporate governance systems in the ISOEs?' and 'What are the roles of the Boards in the ISOEs and are the roles effectively carried out in practice?' In doing so, this chapter presents the results of in-depth interviews with the key individuals on corporate governance practices in ISOEs. The results of in-depth interviews highlight issues important to improving the effectiveness of corporate governance systems and the role of the Boards in ISOEs.

Chapter Eight aims to answer the last two research questions developed in Chapter One: 'What corporate governance initiatives are there in ISOEs and have these initiatives been effectively carried out to increase the performance of ISOEs' and 'What factors (if any) may deter the implementation of good corporate governance in ISOEs? In this chapter, I examine the effectiveness of government initiatives aim at enhancing corporate governance practices in ISOEs. In doing so, I attempt to explore factors that may have impact on the success of the initiatives.

Chapter Nine discusses some of the key findings of this study gained from the empirical results taking into account the literature review presented in Chapter Two, Chapter Three and Four. In doing so, some key issues that relate to the performance of ISOEs, corporate governance systems, and the roles of the Board are presented. In addition, some key issues in relation to the effectiveness of governance initiatives to improve corporate governance practices in ISOEs and factors such as culture, law enforcement and public governance which may have impact on the effectiveness are presented.

Chapter Ten is the conclusion of this study. It summarises the content of all chapters. In addition, this chapter outlines a summary of key findings policy implications, suggestions for further research.

## **Chapter Two**

### **Corporate Governance: A Review of the Literature**

Corporate governance deals with the checks and balances that need to be put in place to deal with the problem resulting from the separation of management and ownership in corporations. Checks and balances are necessary to ensure accountability, since people are likely to manage their own affairs more carefully than those of others (Fremond and Capaul, 2002)

#### **Introduction**

Corporate governance theory evolved following the development of the modern company characterised by the separation of ownership and control and the notion of owners (a group of people who provide the capital for the company operations) and agents (a group of people who run the day-to-day operations of a company on behalf on the owners).

Theoretically, the corporate governance concept can be viewed from four models of corporate control: 1. the simple finance model; 2. the stewardship model; 3. the stakeholder model; and 4. the political model (Turnbull, 1997: 187). In the simple finance model or known as the agency theory, the central problem in corporate governance is to construct rules and incentives to effectively align the behaviour of agents with the interests of the principles. This theory assumes that the agents (the managers) are not trustworthy people; they consist of rational, self-interested people with opportunistic behaviour. The agents, as argued by agency theorists (e.g. Jensen and Meckling, 1976; Tricker, 1994), will not make decisions that attempt to maximise the long-term value of the company, but rather will make decisions out of self-interests to benefit themselves at the expense of the principal. Hence there is a need for corporate governance mechanisms, which can protect the principal's interests and control the agents' self-interested behaviour.

In the stewardship model, the basic assumption is that managers are good stewards of the companies and they will manage a company for the best interests of the owners. Here, there is no conflict of interests between manager and owners (for a review see e.g. Donaldson and Davis 1991). The stakeholder model assumes that a company is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the company's activities. The political model recognises that the allocation of corporate power, privileges and profit between owners, managers and other stakeholders is determined by how governments favour their various constituencies<sup>15</sup>.

This study draws upon the agency theory argued to be the dominant framework for the study of corporate governance because so much research on corporate governance had been based on this theory, the agent-principal relationship. As such, the literature on corporate governance is extensive and thus, no attempt has been made to review it all. The following criteria were used for the selection of the literature that has been examined: (1) the relevance of these writings to the scope of this study and (2) the availability of the literature.

This chapter is divided into seven sections. The first section discusses agency theory, the underlying theory of corporate governance, which explains the impact of the separation of ownership and control on corporate governance. A brief discussion of the nature of companies is given in this section to provide a better understanding of the concept of ownership and control in companies. The section goes on to discuss corporate governance concepts. The third section discusses different corporate governance systems which have largely been applied in developed countries. Section four presents a discussion on good corporate governance principles prescribed by the international community on corporate governance, including the OECD. Section five provides an overview of differences between management and governance. The sixth section examines the pros and cons between shareholder and stakeholder value. The final section provides a summary of this chapter.

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<sup>15</sup> See Turnbull (1997) for a detailed analysis of the four concepts discussed above.

## Agency Theory

A first step in understanding corporate governance is to note the characteristics of a 'company'. In practice, there are at least three forms of companies <sup>16</sup> : sole proprietorship, partnership, and limited liability company. A sole proprietorship is a type of company that is owned by one person. Some examples are a restaurant and a coffee shop. The characteristics of a sole proprietorship are that the company has a limited lifespan, limited ability to obtain capital, and the owner has unlimited liability that means the owner is personally liable for all the debts of the company. The advantage of sole proprietorship is it is easy to establish, i.e., it exists as soon as one starts doing business.

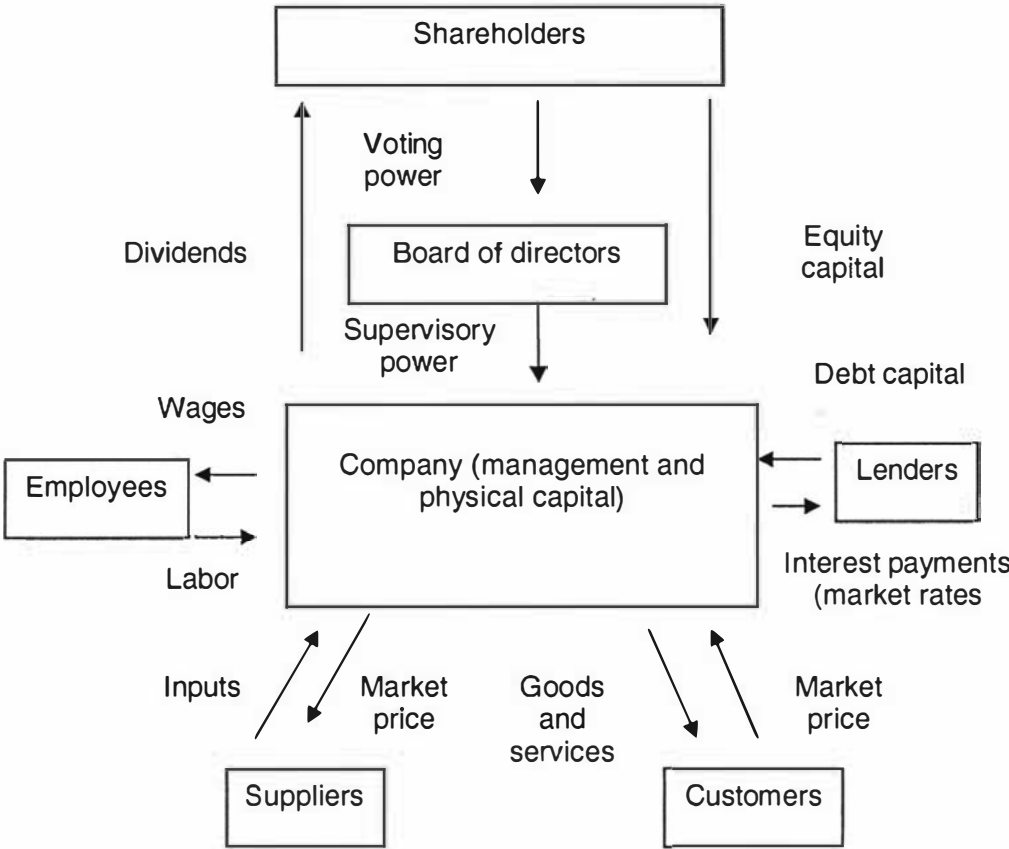
A partnership is a company that is owned by at least two people. The owners are known as partners and they can include individuals and groups of individuals. Some examples are accounting firms, law firms, investment banks, and advertising firms. Similar to a sole proprietorship, a partnership has unlimited liability and a limited life span. The advantage of a partnership is that it is easy to obtain capital (through partnership) and to bring together expertise in the company.

The third form of a company is the limited liability company; a legal entity that is separate and distinct from its owners and managers. The law permits a limited liability company to have its own rights, privileges, and liabilities, as if it were a person. In that respect, it can establish its own legal name for conducting its business activities. The advantages of a limited liability company are that it has an infinite life and a limited liability which means that the owners are not personally liable for the debts or any other legal obligations of the company. In addition, a limited liability company is able to pull together a wide range of professional skills and highly specialised knowledge and the transfer of ownership is easy. Korten (1995) considers the limited liability company to be an important institutional innovation. Figure 2.1 illustrates the basic model of a limited liability company.

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<sup>16</sup> The terms 'company' and 'enterprise' are used throughout this study interchangeably.

**Figure 2.1 Basic Black Box Model of the Limited Liability Company**



Source adapted from Blair (1995: 21) – Basic ‘Black Box’ Model of the Corporation

The owners of a limited liability company are called ‘shareholders’, given that they provide equity capital known as ‘shares’. A shareholder can be an individual, institution, company or other entity that owns shares in a company. If the business is profitable, shareholders may receive dividends or capital gain (the difference between stated share price and its market price) if they decide to sell the shares. However, the shareholders may get nothing if the revenues of the business are not sufficient to pay lenders, suppliers, and employees. Because payments to shareholders are paid last, shareholders are said to have a ‘residual’ claim. In day-to-day operation, a limited liability company (henceforth company) is organised and run by a team of management on behalf of the owners. Their responsibility is to increase the corporate value in a sound business



environment. The existence of owners on the one hand and management on the other, creates a 'separation of ownership and control' which leads to 'property without power' for the owners and to 'power without property' for the incumbent management (Bicksler, 2003: 69). To protect their interests, shareholders are entitled by law to elect a Board of Directors who are responsible to direct and control the company on behalf of the owners.

Lenders are groups of people who also provide funds to the company in the form of debt capital. Lenders receive interest in exchange for the use of their funds. Employees contribute human capital to the company and they receive salaries or wages in return for their contribution. Suppliers provide input in the form of goods or services to the company and in return they receive product prices, fees or commission. Customers are groups of people who buy company goods or services and they pay for those products based on the market price.

As a company becomes larger and ownership becomes dispersed<sup>17</sup>, the shareholders can no longer be active in controlling and monitoring the company activities. The role of the owners, then, changes from an active participant to a passive observer. The control is shifted to the agents, commonly known as the management, who are hired by the shareholders to run the day-to-day business activities. Nowadays, the shareholders have begun to think and act more like investors than owners and have left the power of nomination of directors, and even the election of directors, to management (Hansell, 2003: iv).

This change of roles brought about by the separation of ownership by shareholders and control by management has the potential to cause conflict between the owners and the agents. This is because there is a natural human tendency for the agent to act in his or her own interest, particularly when the interests of the owners conflict with the interests of the agents, i.e., while owners seek to maximise their welfare, the agents may want to maximise their own interests. The agents self-interests, for example, can be in the form of pure theft, enjoying private benefits of

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<sup>17</sup> This particularly occurs when a company goes public and trades its shares in the capital market. In this case, the owners are not a homogeneous group. They can comprise of individuals, private and public institutional investors, employees and managers of the company.

control (perks, pet projects, empire building, and favouring friends and family), entrenchment (to protect the private benefits of control), exerting insufficient effort and making biased decisions (too much or too little risk taking) (Vives, 2002: 4-5). A recent example was the misconduct of two Tyco executives, Dennis Kozlowski and Mark Swartz, who were found guilty for stock fraud, unauthorised bonuses, and falsified expense accounts. They extracted \$600 million, that among other things, was used for apartments in New York City, homes in Florida, jewellery, and a birthday party for Kozlowski's wife (Tosi, Shen, and Gentry 2003: 180).

Recently, Joel Bakan, in his book entitled *The Corporation: The Pathological Pursuit of Profit and Power* (2004), views a corporation in terms of an individual who has the personality and characteristics of a psychopath. The reason is, he argued, due to the fact that a corporation is,

- Irresponsible - it puts others at risk in pursuit of its own goals.
- Manipulative - it manipulates people and opinion in pursuit of its goals
- Grandiose - it always insists that it is the best
- Reckless - it refuses to accept responsibility for its actions
- Remorseless - it cannot feel remorse
- Superficial - it relates to others always in a way that does not reflect their true selves

According to Bakan (2004), all the above characteristics have resulted from the fact that the ultimate goal of a corporation is to create profit and to increase shareholder value at almost any cost. Hence, other matters including social responsibility to its stakeholders are not important.

An example that Bakan uses is the story of Anita Roddick, founder of the Body Shop. In the beginning, Roddick managed her business to be a kinder and gentler corporation. However, after the company went public in 1982 and new managers were brought into the company to overcome the financial difficulty, the values of the business were changed and no longer supported Roddick's value of a company being socially responsible to its community. Now, Roddick looks at the initial stock offering as a 'pact with the Devil.' (Bakan, 2004: 52).

More than two hundreds years ago Adam Smith raised his concern about self-interested managers when he, in his seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations*, stated:

The directors of [join stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.... They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one (1976: 741).

In 1932, Adolf A. Berle, Jr., a lawyer born in 1895, and Gardiner C. Means, an economist born in 1896, published their seminal book *The Modern Corporation and Private Property* that challenged the view that shareholders controlled the modern company. They examined the 200 largest US companies in the early 1920s and found that stockholdings in those companies under study were so dispersed that it reduced the ability of owners to control the companies. The evidence, as they claimed, marked the transformation of American business from family-controlled to a market-controlled company. This has given rise to what Berle and Means described as the 'separation of ownership and control' that gave way to a situation where the shareholders were no longer able to monitor the business activities in a company where they had invested capital<sup>18</sup>.

Jensen and Meckling (1976) further explored the issue of the separation of ownership and control from the agency theory perspective. Under this theory, the company is not treated as a 'black box'<sup>19</sup> but as a

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<sup>18</sup> The study of Berle and Means on the separation of ownership and control is largely applicable to the US and the UK because in many other countries the ownership of companies is not dispersed.

<sup>19</sup> In traditional neo-classical theory, a company is treated as a single homogenous entity, a simple production function, whose objective is to maximise the company's value by maximising profits. Hence, no distinction is made between the owners and the agents.

legal entity serving as a nexus for a set of contracting relationships among individuals. They define an agency relationship<sup>20</sup>:

[A] contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe the agent will not always act in the best interests of the principal (Jensen and Meckling, 1976: 308).

In relation to this, Jensen and Meckling (1976) argue that the higher the managerial ownership, the lower the total agency costs, hence the better the firm's performance. This means that when a manager owns 100% of the firm there are no agency costs, but if the manager's ownership decreases from 100%, the agency costs will increase. The agency costs are defined to be 'the sum of the costs of designing, implementing, and maintaining appropriate incentives and control systems and the residual loss resulting from not solving these problems completely' (Jensen and Mecklings, 1976).

### **Conceptual Approaches to Corporate Governance**

The word 'governance' comes from the old French word 'governance', which means control and the state of being governed (Farrar, 2001: 3). In the public sector, the World Bank (1992: 1) describes governance as 'the manner in which power is exercised in the management of a country's economic and social resources for development'. Kaufmann, Kraay, and Zoido-Lobatón (1999) define governance 'as the tradition and institutions by which authority in a country is exercised.' It implies structures and processes for determining use of available resources for public goods (Tandon, 1999). It involves monitoring and overseeing strategic direction, socio-economic and cultural contexts, externalities, and the constituencies of the institution (Mehra, 2002).

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<sup>20</sup> It is worth to note that the agency relationship between principals and the agents can cover various relationships, such as the company and its managers, the company and its creditor, the company and its employees, and the company's owners and its company's directors.

Good governance is about both achieving desired results and achieving them in the right way (Institute on Governance, 2005). It equals 'sound development management' (World Bank, 1992: 1). The United Nations (1997) published a list of characteristics of good governance. They include:

- Participation: providing all men and women with a voice in decision making
- Transparency: built on the free flow of information
- Responsiveness: of institutions and processes to stakeholders
- Consensus orientation: differing interests are mediated to reach a broad consensus on what is in the general interest
- Equity: all men and women have opportunities to become involved
- Effectiveness and efficiency: processes and institutions produce results that meet needs while making the best use of resources
- Accountability: of decision-makers to stakeholders
- Strategic vision: leaders and the public have a broad and long-term perspective on good governance and human development, along with a sense of what is needed for such development. There is also an understanding of the historical, cultural and social complexities in which that perspective is grounded. [Source: 'Governance and Sustainable Human Development', United Nations Development Programme, 1997.]

In the business setting, the term of 'corporate governance', according to Farrar (2001: 3), was used for the first time in 1962 by Richard Eells of Columbia Business School in his book *The Government of Corporations*. To date, the term has become a popular term amongst various groups from academics, mass media, and politicians to the general public, as they endeavour to deal with so many corporate failures. The debate covers many aspects of corporate governance from the board structure, the market or network-based models to the value of shareholders or stakeholders.

As a concept, corporate governance has only recently emerged as a body of knowledge (Iskander and Chamlou, 2000: 3) and become a subject

for serious academic and professional study and writing (Tricker, 1994: xi). This has essentially taken place since the world witnessed the incidence of so many corporate breakdowns. Since the concept is new, it is not surprising if there appears to be no universally accepted definition of corporate governance; 'It means different things to different people (Kendall and Kendal, 1998: 18). It can be referred to as 'a system' (Cadbury Committee, 1992), 'a set of provisions' (Scott, 1998), 'a set of methods' (Shleifer and Vishny, 1997), 'control of corporations and systems of accountability' (Farrar, 2001: 3), or simply 'the rules of the game' (Gan, Lee and Hoon, 2001: 3). In addition, some think that corporate governance is an 'end' of organizational operation (Kilmister, 1989), while others assert that it is a 'means' rather than an 'end' (The Hampel Committee cited in Smerdon, 1998: 3).

The agency theory of corporate governance, in a narrow meaning, attempts to solve or alleviate the agency problem, commonly referred to as the principal-agent problem. As Iskander and Chamblou (2000: 3) stated:

The problem ... grows out of the separation of ownership and control and of corporate outsiders and insiders. In the absence of the protections that good governance supplies, asymmetries of information and difficulties of monitoring means that capital providers who lack control over corporation will find it risky and costly to protect themselves from the opportunistic behavior of managers or controlling shareholders.

In line with this, it is essential to ensure that corporate actions, assets and agents are directed to achieving the corporate objectives established by the company's shareholders (Elaine Sternberg, 1998: 20 cited in Gregg, 2001: 14). Shleifer and Vishny (1997:737) state:

[C]orporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?

From the stakeholders view, Blair (1995: 3) says:

[T]he central problem in any corporate governance system is how to make corporate executives accountable to the other contributors to the enterprise whose investment are at risk, while still giving those executives the freedom, the incentives, and the control over resources they need to create and seize investment opportunities and to be tough competitors.

According to Hart (1995: 678), corporate governance issues arise whenever two conditions are present. Firstly, there has to be an agency problem, or conflict of interest, involving members of the organisation: the owners, managers, workers or consumers. Secondly, transaction costs are such that this agency problem cannot be dealt with through a contract. Transaction costs are 'the costs of formulating, monitoring and enforcing of relationships based on written or unwritten contracts within markets and hierarchies' (Gay, 2002: 41). Good corporate governance is concerned with '... correctly motivating managerial behaviour towards improving the business and directly controlling the behaviour of managers' (Keasey and Wright, 1997: 2).

The Cadbury Committee put an emphasis on the financial aspects of corporate governance and provided a definition that stressed the importance of the internal control mechanism of company corporate governance, the Board of Directors. The Committee's objectives are to strengthen the unitary board system and to increase its effectiveness (Cadbury Committee, 1992). According to the Cadbury Committee:

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.

There are many others who share a similar view with the OECD and the Cadbury Committee which focus on the micro perspective of corporate governance, that is the relationship between the three major participants in a company, shareholders, directors and management, that constitute 'the governance tripod'. Monks and Minow (2001:1) depict this relationship in their definition of corporate governance. They define corporate governance '... is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the Board of Directors.'

Others, who approach corporate governance with a much broader perspective, consider other factors such as legal, culture and environment in their definition on corporate governance system. Blair (1995: 3), for example, defines corporate governance as:

[T]he whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risk and returns from the activities they undertake are allocated.

In this respect, Blair (1995) suggests that it is useful to approach corporate governance issues with an understanding of a whole range of aspects which come from various subjects such as company law, corporate finance, and organisational theory rather than treating each subject separately. Weimer and Pape (1997:152), who studied corporate governance at the level of countries, define corporate governance as 'a more-or-less country-specific framework of legal, institutional and cultural factors shaping the patterns of influence that stakeholders ... exert on managerial decision making'. They argue that their definition allows them to approach of governance issues from different theoretical angles (e.g. economic, sociological and psychological). Lipton and Rosenblum (1991: 197 cited in Gregg, 2001: 14) use the term corporate governance to describe 'the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy.



The OECD definition is probably the one which provides a synthesis of all these views on corporate governance. The OECD recognises the other parties interested in the affairs of the company, the stakeholders. The OECD (1999) defines corporate governance as:

[T]he system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

The various perspectives on corporate governance somewhat show that, 'no one in the real world knows exactly what it means, or how if at all, it should be incorporated into a company's strategy' (Kendall and Kendall, 1998: xv). As argued by Turnbull (2001: 4), 'there are no agreed definitions or boundaries for defining or investigating corporate governance'. This is evidently associated with the complexity of corporate governance issues and the various approaches that can be chosen. Kakabadse and Kakabadse (2001) observed that the literature is fragmented due to the different disciplinary backgrounds—sociology, finance/ economics, organisational theory, law—leading to different terminology and operationalisation of similar concepts. Moreover, according to Kakabadse and Kakabadse (2001), most empirical research is not theory driven and, of those that are, most are focused on structural dimensions of the board, with only speculative inference of board behaviour. Likewise, the impact of interconnected aspects that contribute to the differences in the corporate governance systems around the world—like the economic and political environment, history, culture, and legal systems that differ from country to country—has been considerably ignored. For example, in the USA, financial institutions such as banks and insurance companies have a very limited power, thus they have not played a significant role in corporate governance. In contrast, in Germany and

Japan, a different political climate has allowed financial institutions to become involved in corporate governance (see Allen and Gale, 2000).

The various approaches to corporate governance, according to Colley Jr. *et al.* (2003: ix), show that there is a general lack of understanding of the principles of effective corporate governance that result from an absence of knowledge and/or experience. This '... can lead to poor policy decisions by boards and regulators alike and ... in extreme cases, complex issues become political, and passions overwhelm reason' (*ibid.*). The lack of a broad defining paradigm, in Pound's (1993) view, 'has created a sense of intellectual vertigo in the increasingly intense debate over corporate governance reforms' (quoted in Turnbull, 2001: 4).

The agency theory approach to corporate governance itself is not without criticism. The criticism is centred on its limited ability to explain complex sociological and psychological mechanisms inherent to the principal-agent interactions (see Davis *et al.*, 1997). In practice, as argued by Budnitz (1990 cited in Johnson, Daily and Ellstrand, 1996: 414), most courts which use legal perspective have rejected the agency perspectives used as a foundation for addressing directors' legal obligations. For example, in the case of bankruptcy, directors' duties shift from protecting shareholders interests to protecting the interests of the company's creditors.

Allen and Gale (2000) argue on the effectiveness of the agency theory approach based on the following reasons:

- The agency approach to corporate governance is somewhat narrow in its focus. In many instances, managers are responsible to other stakeholders, including employees, who may be legally entitled to exert control on the firm's policies.
- The separation of ownership and control is a much less frequent phenomenon than a reading of the academic literature suggests.
- Shareholders may not have better knowledge than the manager does about the optimal course of action for the firm. Hence, interference by shareholders may end up reducing the shareholders' value, in contrast with one of the main tenets of the agency approach.

In Allen and Gale's (2000) view, the main factor that ensures efficient resource allocation is competition in product and input markets. The reason is that firms run by opportunistic, or plainly incompetent, managers will not be able to survive in a competitive environment. In the absence of good information about the optimal management strategy, where standard governance mechanisms are ineffective almost by definition, a Darwinian process of competition may serve to select best management teams. To date, debate on governance concepts is still taking place in both academic and business settings.

### **Corporate Governance Systems**

The literature documents two main corporate governance systems: the market-based and the group-based<sup>21</sup> governance systems. Both of these have evolved in different regulatory, institutional and political environments. As indicated by the term, in the market-based system, also known as the Anglo-American governance system, markets (financial and capital market) play a major role. In the market-based system, a company and its managers are to act in the best interest of shareholders. Hence, the role of the government is to create a strong competitive environment in which companies operate. In the group-based system, largely practiced in European countries and in Japan, banks play an important role. A company and its managers are to act in the best interest of stakeholders. The role of the government is to direct the economy through regulations and policies.

Weimer and Pape (1999: 152), in their study entitled 'A taxonomy of systems of corporate governance', identify four groups of relatively rich industrialised countries<sup>22</sup> which have more or less similar corporate governance systems: (1) Anglo-American countries (the USA, the UK, Canada and Australia); (2) Germanic countries (Germany, the Netherlands,

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<sup>21</sup> Some scholars use the term bank-based system which implies that banks, not the market, play a key role in the corporate governance system. This is applied in the Japanese corporate governance system. Other scholars name the two different systems as the outsider and the insider model (see Rosser 2003, for example).

<sup>22</sup> Determined by their relative size of Gross Domestic Product (GDP),

Switzerland, Sweden, Austria, Denmark, Norway and Finland); (3) Latin Countries (France, Italy, Spain and Belgium) and (4) Japan (which is considered an isolate). Table 2.1 presents the Weimer and Pape's (1999) taxonomy of systems corporate governance. The explanation for the table is mostly taken from Weimer and Pape's (1999) study, other references cited are provided.

**Table 2.1 A Taxonomy of Corporate Governance Systems**

Market/Network-oriented system of corporate governance	Market-oriented	Network-oriented		
Country class	Anglo-American	Germanic	Latin	Japan
Concept of the firm	Instrumental, shareholder-oriented	Institutional	Institutional	Institutional
Board system	One-tier (executive and non-executive board)	Two-tier (executive and supervisory board)	Optional (France), in general one-tier	Board of directors; office of representative directors; office of auditors; <i>de facto</i> one-tier
Salient stakeholder(s)	Shareholders	Industrial banks (Germany), employees, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group.	City banks, other financial institutions, employees, in general oligarchic group
Importance of stock market in the national economy	High	Moderate/High	Moderate	High
Active external market for corporate control	Yes	No	No	No
Ownership concentration	Low	Low	Moderate	Low/Moderate
Performance-dependent, executive compensation	High	Low	Moderate	Low
Time horizon of economic relationships	Short term	Long term	Long term	Long term

Source adapted from Weimer and Pape (1999: 154). The GDP comparison is omitted in the table.

From the groupings, they further identify and examine eight characteristics of corporate governance systems prevalence in those four groups of countries. All characteristics have legal, institutional and cultural dimensions. The characteristics are:

1. the prevailing concept of the firm;
2. the board system;
3. the salient stakeholders' ability to exert influence on managerial decision making;
4. the importance of stock markets in the national economy;
5. the presence or absence of an external market for corporate control<sup>23</sup>;
6. the ownership structure;
7. the extent to which executive compensation was dependent on corporate performance; and
8. the time horizon of economic relationships.

Their examination of the eight characteristics listed above results in two distinct corporate governance systems: the 'market-oriented' and the 'network oriented' (or group-based) systems.

The main characteristic of the market-oriented systems is an active external market for corporate control, which serves as a mechanism for independent shareholders to influence managerial decision making. The market-oriented systems prevail in the Anglo-American countries where the shareholder's interests are central in the corporate governance systems. The company and its Board of Directors are conceived as instruments for the creation of shareholder wealth. The governing body adopts a one-tier board that comprises the executive (the insiders) and non-executive directors (the outsiders). The responsibilities of the Board of Directors are determined by law and self-regulation. Both executive and non-executive directors are appointed and dismissed by shareholder resolution. Stock markets play a more important role in the Anglo-

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<sup>23</sup> The basic theory of the market for corporate control states that there is take-over mechanism that can penalize management if it is not efficient. The indicator is the fall of share price that opens an opportunity for another company to take-over for a reason that it can manage the targeted company more efficiently (see Scharfstein, 1988).

American countries than those in the other groups of countries. Consequently, there is an active market for corporate control in the form of market takeover. The ownership structure is characterised by a low concentration of ownership. Shares in the companies, in general, are relatively widely held. Executive compensation is related to the company performance. Finally, economic relationships are short-term and the managers prefer short-term goal at the expense of long term profits.

In network-oriented systems managerial decision making can be substantially swayed by oligarchic groups via networks of relatively stable relationships. These systems are common in Germanic countries (e.g., Germany, where banks and employees are influential), Latin countries (e.g., France and Italy, where family control is relatively important), and Japan (where banks serve as the nucleus of mutually related, vertically and horizontally integrated groups of companies).

In Germanic countries, the creation of shareholder wealth is not a central point. A company is conceived as a means to serve various parties' interests from shareholders, management, employees, suppliers of goods and services, lenders to customers (Moerland, 1995). Thus, corporate governance mechanisms are needed for selecting directors, who have enough independence to ensure that they will properly monitor the managers' performance (Iskander and Chamlou, 2000: 4).

In a closely held or family-owned company where the controlling and minority shareholders exist side by side, and where the managers' actions are dictated by the controlling shareholders, the primary governance issue is how to ensure outside shareholders can prevent the controlling shareholders from taking benefits through self-dealing or disregarding the rights of minority shareholders. Large banks play a very important role in companies. Apart from their role as suppliers of debt, they can have other roles as shareholders and as such, the members of the Supervisory Board. German banks can own a large number of shares in the non-financial companies and become influential shareholders in the decision making process. In SOEs where the stakeholders' value is the main objective, the emphasis of corporate governance is to safeguard the interests of diverse groups such as employees, customers, and the community at large.

Germanic countries adopt a two-tier board structure. In Germany, for example, the board comprises a management board called *Vorstand* and a supervisory board called *Aufsichtsrat*. The *Aufsichtsrat* has the duty of managers. Both the shareholders and the employees are represented on the *Aufsichtsrat*. In addition, it is common to have a bank representative as the chairman of the Supervisory Board who is appointed and dismissed by the general assembly of shareholders (*Hauptversammlung*). The right of employees to participate in decision making is known as 'co-determination'. The *Vorstand* is appointed and dismissed by the *Aufsichtsrat*.

In Germanic countries, stock markets play a less important role in the economy than they do in Anglo-American countries. An active external market for corporate control is almost non-existent. Although hostile takeovers are legally permissible, they are very rare (Allen and Gale, 2000: 24). The use of performance-related compensation for executives is rather limited. The institutional environment favours the establishment of long-term relationships.

In Latin countries, the French legal system allows companies to choose between a one-tier and a two-tier board system. The vast majority of listed companies (98%) have chosen the unitary system. French corporate law does not distinguish between executive and non-executive directors; however, de facto, at least two thirds of the board can be qualified as non-executives, usually being representatives of major shareholders. Shareholders sovereignty is an important concept but it is not as central as in the Anglo-American countries. Members of the Board of Directors can be removed by the shareholders at will. However, as in Germanic countries and in contrast to the Anglo-American countries, the 'one share, one vote' principle does not apply in general.

As in Germanic countries, capital markets play a less important role in Latin countries than they do in Anglo-American countries and there is no active market for corporate control. However, the number of hostile takeovers is higher than in the Germanic countries (Moerland, 1995 cited in Weimer and Pape, 1999: 159). Ownership concentration is relatively high in France, Italy, and Spain. The influence of shareholders is

characterised by financial holdings and cross holdings, government control and family control (De Jong, 1989 cited in Weimer and Pape 1999: 159). In France, the government has a strong control over companies while in Italy, family or industrial groups are the influential shareholders. They hold controlling interests in virtually all of the 200 listed companies (Zingales, 1994). Performance-related executive compensation is not common in Latin countries. The only exception is France, where percentages of executive remuneration are similar to those in the UK and Canada (Abowd and Bognanno, 1995 cited in Weimer and Pape, 1999: 159). The institutional environment favours long-term economic relationship.

In Japan, the cultural dimension is prevalent in the systems of corporate governance, particularly the sense of 'family values' and the importance of 'achieving' consensus. The Japanese board comprises three different groups that have different responsibilities: a Board of Directors, an office of representative directors and an office of auditors. *De facto*, the Japanese board resembles the one-tier board in which it has inside and outside directors.

As in Germany, employees, shareholders, and banks are important stakeholders in Japan and they have strong influences on managerial decision making. Employees have a say in company policies such as wage determination, the way in which work is organised, and the way in which managerial choices are made that would affect the lives of the employees (Aoki, 1984 cited in Weimer and Pape, 1999). The expressed goal of managers in Japan is to pursue employment stability for workers rather than dividends for shareholders (Allen and Gale, 2000: 24). Banks influence managerial decision making by transferring their own staff members as both executive and non-executive directors. Stock markets play an important role in the economy; however, market for corporate control is not active. Japanese culture favours consensus to hostile takeover. The cross shareholdings are relatively small. Ownership is more widely dispersed than in Germany but the concentration is not as low as in the USA. Performance-related executive compensation is not prevalent in Japan. The Japanese are in favour of long-term and stable economic commitment. A company is considered as a family member, thus,



companies are expected to treat stakeholders as extended family members by promoting their long-term interests (Allen and Gale, 2000).

In most other countries, including in Asia, a substantial part of the companies are still family-owned. The founder/family of the companies plays a central role in governance. In these companies ownership is not dispersed. In their study, La Porta et al. (1999) found that the most common form of ownership around the world is family-owned or state-owned which do have controlling power over the company.

### **Which Corporate Governance Model Is The Best?**

As discussed above, the corporate governance concept is influenced by many aspects including legal, culture, ownership and political environment which differ from country to country. Therefore, some concepts may be more appropriate and relevant to some countries than others, or more relevant to one country at different times depending on the development stage experienced by that country.

To date, despite the claim of increasing convergence in the nature of corporate governance systems across countries, people are mostly aware that there is no such corporate governance system that fits all companies's circumstances. It depends on the legal structure and what governance problems need to be addressed. On the one side, the Anglo-American governance system has the Board of Directors, consisting of independent board members and strong institutional investor activists which, in principle, can be important monitoring and disciplinary mechanisms (Bicksler, 2003). Therefore, most American business community, including many economists, seem to be of the opinion that the Anglo-American governance system is preferable. However, the Enron scandal is evidence that the Anglo-American corporate governance systems characterised by strong market controls are not inherently superior to monitor the management board. On the other side, the Board of Directors in the European and Japanese governance system representing the inter-locking interests of various groups, which may have informational advantages and serve as important monitoring and disciplinary mechanisms (Ibid). Table

2.2 illustrates the key difference in characteristics between the market-based and the group-based corporate governance system.

**Table 2.2 Stylized Characteristics of Alternative Models of Corporate Governance**

'Anglo-American'/'market-based'/'transaction based'/'network-based'/'arm's length'/'outsider' system	'Japanese_German'/'bank-centered'/'relationship-based'/'control-oriented'/'insider' system
<b>A. Instruments chosen at the firm level</b>	
1. dispersed stock ownership, primarily by households and institutional investors	concentrated stock ownership or proxy control by banks
2. little cross-shareholdings between firms and little bank ownership of firms	substantial cross-ownership between firms, substantial direct and indirect bank ownership
3. active market for corporate control	no significant market for control
4. little bank involvement in firm's operations	substantial direct involvement of banks in firm operations (monitoring, decision making, restructuring)
5. high-powered management incentives (through pay-performance link at the firm and through market for managers)	low-powered management incentives
6. high ratio of bonds to loans in firm liabilities	Low ratio of bonds to loans in firm liabilities
<b>B. Instruments chosen at the policy level</b>	
1. far-reaching disclosure and accounting requirements in stock market, substantial minority shareholders protection, barriers to large shareholders activity	Limited disclosure and accounting requirements, limited minority shareholder protection, few barriers to large shareholder activity
2. rules favourable to or at least not actively hostile to corporate bond market	may have legal obstacles limiting the size of the corporate bond market
3. bankruptcy legislation tends to emphasize protection from creditors	bankruptcy legislation tends to emphasize protection of creditor claims.

Source: Heinrich (1999: 15)

Within a country, corporate governance mechanisms can also vary. In a public company, for example, where the shareholders are dispersed and managers have strong controls over the company, the corporate governance challenge is for outside shareholders to control the performance of management. In a family-owned company, the owner is the manager. This situation offers the controlling family the best of both worlds: it can run the business as it sees fit and gamble, at least partly,

with other people's money, but may threaten minority shareholders with exploitation (Zafft, 2003). In France, a company may choose between three different board structures, depending on which one enables it 'to carry out its mission in the best possible manner.' The single-tier board (*conseil d'administration*) is the most common and has two manifestations: one with a combined Chairman/Chief Executive and one where the roles are separated. In addition, some companies adopt a two-tier structure with a supervisory board (*conseil de surveillance*) and a management board (*directoire*).

In developing countries, H. Miller, a Nobel Laureate Economics recipient in 1990, argues that *per se* none of the corporate governance models dominate and none are intrinsically superior to the others (cited in Bicksler, 2003). Despite this fact, financial agencies such as the World Bank and the ADB tend to prescribe the Anglo-American corporate governance models, characterised by the importance of the roles of independent directors and board committees, as a condition to receive financial loans.

### **Corporate Governance Basic Principles**

There are some basic principles which good corporate governance must have. They can be based on a 'principles-based' or a 'rules-based' approach. The 'principles based' approach means companies are asked to adopt a set of principles and preferred practices which as they see most appropriate to their particular circumstances. It allows companies some freedom to determine for themselves the appropriateness of otherwise of their corporate governance practices. Companies would then disclose their governance practices and explain where and why they have deviated from the principles and/or preferred practices. The principles-based approach is adopted, for example, by the Cadbury Committee and the OECD, among others. The 'rules-based' approach tends to be more prescriptive and mandatory such as the requirements laid out in the Sarbanes-Oxley Act (2002) in the USA. ICANZ (2003)<sup>24</sup> describe these approaches as a 'comply

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<sup>24</sup> The Institute of Chartered Accountants of New Zealand.

or explain based' approach. Table 2.3 presents the OECD Principles of Corporate Governance.

**Table 2.3 The OECD Principles of Corporate Governance**

Principle	Narrative
I. Ensuring the basis for an effective corporate governance framework	The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
II. The rights of shareholders and key ownership functions	The corporate governance framework should protect and facilitate the exercise of shareholders' right.
III. The equitable treatment of shareholders	The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
IV. The role of stakeholders in corporate governance	The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
V. Disclosure and transparency	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
VI. The responsibilities of the board	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Source: OECD Principles of Corporate Governance (2004)

The importance of corporate governance principles to a company is similar to that of a road map for a driver, in that the adoption of corporate

governance principles can assist management and directors in outlining the best practices by which they intend to operate (Daily and Dalton, 2003: 42). In addition, well-articulated corporate governance principles have three additional benefits (Ibid: 42). The first benefit is that they serve as a strong signal to shareholders and the investment community that the enterprise is committed to operating in line with current best practices. The second benefit is that they can be used as guidelines in recruiting new directors. The third benefit is to provide the additional element of comfort that a director candidate needs in deciding whether to accept or reject a board membership, given the pressures directors face in the current governance environment.

In practice, many countries and companies adopt the OECD Principles of Corporate Governance as general guidelines for practicing good corporate governance. The OECD Principles are primarily concerned with listed companies. They are organized into six sections: (I) Ensuring the basis for an effective corporate governance framework, (II) The rights of shareholders and key ownership functions, (III) The equitable treatment of shareholders, (IV) The role of stakeholders in corporate governance, (V) Disclosure and transparency, and (VI) The responsibilities of the board. The following section will discuss three main principles of corporate governance.

### ***Transparency***

The relationship between managers and owners is asymmetrical, i.e., the managers have more knowledge and information about the enterprise and, consequently, more power to influence outcomes. In practice, the owners have virtually no first-hand information with which to judge the actions of the governing group that they have elected to represent them – no speeches, no reports, no votes – until the firm's financial performance is disclosed a year later (Useem, 2003: 242). To avoid the problem, a company needs to be transparent; it must provide the information needed by all relevant parties that are affected by the companies' operations through providing adequate disclosure. Implementing transparency can be in the form of providing the company's financial accounting statements in

plain language so that the manager-on-the-street can understand them (Bicksler, 2003).

Transparency means openness. That is 'letting the public know' and allowing various parties to make informed investment decisions (Victor Wee, 1999 cited in OECD, 1999). The essence of transparency is 'financial disclosure which reflects economic reality' (Henry Paulson, 2002 cited in Bicksler, 2003). A free, efficient, and globally competitive market depends on openness. Investors must have confidence in the market and in the information provided by and about the companies in which they invest. If a company does not provide that level of confidence, investors will cease to participate in it. Examples of this openness are disclosing publicly (1) details of operations and financial conditions, (2) how the board makes key decisions, including those affecting executive compensation, strategic planning, the nomination of directors, the appointment and assessment of management and (3) the backgrounds of director nominees, including any economic links to the company. In addition, companies must inform the public or relevant parties as to whether they comply with the Codes of Best Practice and explain the reasoning for any variations. In line with this, Boards should have the ability to effectively monitor management performance, and investors should have the ability to effectively monitor the Boards.

The results of the OECD study in 1998 showed that transparency and good corporate governance practices were considered as the major factors in attracting the support needed to prosper in conditions of increasing uncertainty (cited in Davies, 1999:113). Similarly, Mitton's study (2002) showed that in a sample of companies from five Asian countries, those adhering to more stringent standards of corporate transparency significantly outperformed low-transparency enterprises during the crisis

Having said the above, it is important to note that practicing transparency *per se* is not a guarantee that the interests of shareholders are well protected. An example can be drawn from the recent Enron corporate misdeed. Enron published its audited annual report to the public transparently so that it could be examined and evaluated by the

public. However, at the same time, Enron provided false and misleading financial statements which lead the shareholders (and the public) to undertake misinformed decision making. Therefore, it is essential that transparency is acted upon with honesty and integrity. Perfect transparency, according to Bicksler (2003), 'is the absence of any important corporate financial informational asymmetries between the security owners and the corporate executive management.'

### **Accountability**

Accountability provides a way of measuring performance in any and all segments of society, from political organizations and government institutions to social and business communities (Bavly, 1999). It represents an obligation to answer to the execution of one's assigned responsibilities (Alberta Legislature, 1994:1 cited in Burger, Bolender, Keates, and Townsend, 2000). It implies acceptance of responsibility, without which there is no basis upon which an injured party can initiate a tort of action to redress grievances (Branscomb, 1995). It is to ensure that the behaviour of the Board of Directors is consistent with the interest of shareholders. Pitkin and Farrelly (1999: 253) argue that accountability is imperative to increase efficiency and competitiveness, for without adequate external accountability there is no incentive for efficiency and effective management practices. In addition, they assert that where accountability is absent, corruption and fraud can flourish.

Within the corporate governance context, accountability means holding the Board of Directors responsible to provide good quality information to the shareholders (Cadbury Committee Report, 1992, par. 3.4). In addition, a system of accountability mandates full reporting of the results of responsibilities (Bavly, 1999: 15). The OECD Principles state that board members are accountable to shareholders and to the company. Accountability to shareholders means equal treatment of majority and minority shareholders. Accountability to the company means that directors must ensure that the company complies with existing laws and regulations, such as tax, labour, health and safety laws, equal opportunity, environmental legislation and competition law.

Paul C. Light (1993, cited in Bavly, 1999: 15) distinguishes between two forms of accountability: one relating to performance and the other to compliance. Performance accountability has to do with the evaluation of effectiveness and bench marking; compliance accountability demands detection of violations and enforcement of sanctions. One of the most effective forms of Board of Directors' accountability is to align the interests of management with the interests of shareholders. In doing so, the Board of Directors and the management should be open and accessible to inquiry by shareholders and stakeholders about the condition of the company and their performances by producing and publishing annual reports. Thus, effective accountability is highly dependent on the supply of information. As Bird (1973: 55) states:

The duty of accountability arises throughout the private and public sectors wherever resources are entrusted to stewards by their owners. This duty is discharged by the provision to the owners of statements of account and an audit report. The objective of both of these is to give information to owners. They will succeed in doing this only if they communicate effectively to the owners their intended message, and that message is relevant to decisions that owners must take in relation to the resources they own, especially the decision whether to allow the steward to retain his position (quoted in Spira 2001) .

Despite the importance of accountability in corporate governance, it is interesting to note that the parallel corporate governance debate in the USA has placed more emphasis on enhancing performance over accountability (Keasey, Thompson and Wright, 1997: 2).

### ***Fairness***

Fairness means providing equitable treatment to all parties related to the company including foreign investors and minority shareholders. It also means that shareholders and stakeholders can have access to the same information. The company cannot take actions which significantly advantage one party and disadvantage the others. Hence, the Board of Directors is essential to balancing the interests of company, shareholders and stakeholders.



### ***The Implementation of Principles in Practice***

It is worth noting that practising the principles is not an end of corporate governance. The New Zealand Institute of Chartered Accountants (2003) stresses the importance of focusing on the objectives as well. This means that:

- It would not be enough for the companies to merely disclose that they comply with the principles. Rather, they would need to identify how it is that they achieve the corporate governance objectives.
- If there is a 'principle' for the company to comply with, there is a risk that investor will gain a false and unsafe impression that the regulator is providing an assurance to investors (the moral hazard problem).
- 'One size fits all' is avoided. That is alternative and better ways of achieving good governance and meeting investor preferences are easily accommodated.
- Developments in corporate governance are driven by what works, and by what investors want, in preference to what might otherwise be the product of regulatory compromise.
- The continuing development of better corporate governance practices is facilitated through competition to demonstrate practices that best meet the preferences of investors.

In addition, implementing corporate governance principles can be problematic and not without costs because as one Australian company, MIM Holdings, stated it would cost it more than A\$1 million a year to comply with international accounting standards and yet shareholders' interests would not necessarily be served by making commercially valuable information public knowledge (McLeod, 2003). Box 2.1 provides an example of difficulties in enforcing fairness to shareholders.

### **Box 2.1 Difficulties in Enforcing Equitable Treatment of Shareholders**

A recent case illustrating the lack of equitable treatment in the market for corporate control was the acquisition of the Moroccan bank Banque Marocaine de l' Afrique Occidentale (BMAO) by a listed state-owned bank called Banque Nationale pour le Développement Economique (BNDE) in 2000. BNDE commissioned one of the big five consulting firms to do the valuation. BMAO's minority shareholders representing ten percent of capital objected to the buyout price and requested a second valuation. A press campaign was initiated against the dissenting shareholders, arguing the law should not allow just any shareholder to bring a transaction to a standstill. The minority stakeholders lost their case.

This example illustrates the conflicts that prevail in countries where the rights of minority shareholders are not well understood and where a shareholder culture does not exist. BMAO was widely known to have a balance sheet with serious problems.

In consequence, the valuation might well have been favourable to minority shareholders.

Nevertheless, this is not the point. The minority shareholders were not able to go through with their motion of a second valuation. It was not deemed acceptable that minority shareholders would question a decision of management/controlling shareholders.

Source adapted from Fremond and Capaul (2002)

## **Governance and Management**

Governance is not the same as management. Governance focuses on the company's outcomes or results of the organisation's activities rather than the ways in which these are achieved. It is concerned with the 'large picture' rather than the details (Kilmister, 1989) and is best seen as existing outside the phenomenon of management and inside the phenomenon of ownership (Carver and Oliver, 2002, p. xxi). Management, on the other hand, is concerned with the day-to-day operation of a company. It focuses on the ways or the means by which the company's objectives are achieved. Management is a 'hands-on' operation and

governance is a 'hands-off' (Kilmister, 1989). Governance relates to 'where the company is going' and management relates to 'getting the company there' (Tricker, 1994: 10).

Mueller (1981: 38) explained the contrast between 'governance' and 'management' as follows:

Governance normally implies a keeping on a straight course under proper guidance and the smooth conduct for the good of the whole. Governance is concerned with the intrinsic nature, purpose, and identity of the institution, its relevance, continuity, and fiduciary aspects. It is also concerned with strategic direction, socio-economic and cultural context, resources, externalities, and constituencies.

Management is more of a hands-on activity. Conventionally management is a conducting or supervising action with the judicious use of means to accomplish an end. Management is primarily focused on specific goal attainment and the functions of organizations, planning, staffing, administration and direction, measurement control, innovation, representation, decision making, and operation.

The three central ideas which emanate from the above definitions are:

(1) governance has an external focus, whereas management has an internal focus, (2) governance assumes an open system, whereas management assumes a closed system, and (3) governance is strategy-oriented, whereas management is task-oriented (Tricker, 1994: 10).

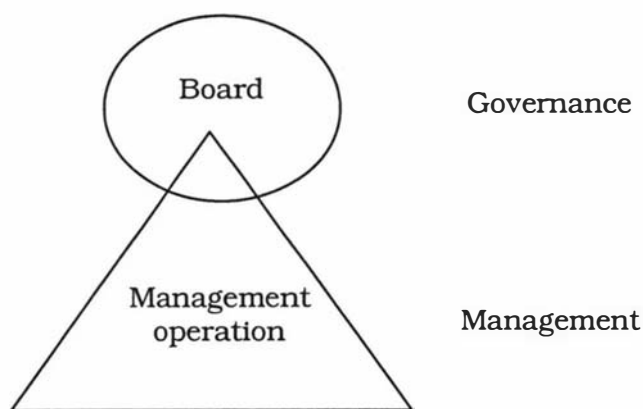
Dayton (1984: 34) provides another explanation on the difference between government and management:

By *corporate governance*, I mean the process, structures, and relationship through which the board of directors oversees what its executives do. By *corporate management*, I mean what the executives do to define and achieve the objectives of the company (emphasis is in original)

In practice, the relationship between the Board of Directors and management is problematic. The Board of Directors is dependent on management in terms of obtaining necessary, accurate and timely information, therefore, many times 'they know too little too late' (Monks and Minow, 2001: 171). In addition, although the Board of Directors bears

the ultimate responsibility for the company, in reality, the management has the expertise, infrastructure, and time to run and control the company. Thus, it has a greater degree of domination on the Board of Directors (Ibid: 174). Figure 2.2 illustrates the difference between governance and management in a one-tier board structure.

**Figure 2.2 Governance and Management**



Source adapted from Tricker (1994)

### **The Objectives of Corporate Governance: Shareholder or Stakeholder Value?**

Just as definitions of corporate governance differ, so are opinions on the objective of corporate governance. The debate is centred on the shareholder value and the stakeholder value<sup>25</sup>, influenced by a different perspective of the company's objectives. Each perspective provides a different style of corporate governance. Shareholder and stakeholder value are *normative* in that they entail what the company 'ought or ought-not' to do.

According to the proponents of shareholder value, managers who focus on shareholder value are more likely to create healthier companies than those who do not. Healthier companies will have the ability to attract potential investors to invest their capital in the company. This capital is

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<sup>25</sup> Davies (1999) uses the term inclusive and exclusive instead of shareholders and stakeholders corporate governance.

significant to company growth. If the company grows, it will provide benefits to its stakeholders, such as the government, through paying higher taxes, and to workers, through paying higher wages and salaries. The positive impact of this situation will lead to the economic development of the country as a whole. In the USA and the UK legal systems, managers have a strong legal requirement to act in the interests of shareholders (Allen and Gale, 2000: 26). In this respect, Milton Friedman (1962: 133), one of the most articulate defenders of shareholder value says,

[T]here is one and only one social responsibility of business—to use its resources and engage in activity designed to increase its profits so long it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud. ... the very foundation of our free society [is] to make as much for their [managers] stockholders as possible. (1962: 133).

As such, a problem of *moral hazard* occurs; 'How can shareholders ensure that managers pursue their interests?' The answer to this question results in corporate governance to largely focus on the work of the board of directors and its relationship to shareholders (Davies, 1999: 20).

Nonetheless, the opponents of shareholder value question whether or not maximising company value for shareholders is consistent with the interests of society at large. They argue that the shareholder value view has failed to recognise the needs of customers, suppliers, employees, and the community at large whose welfare must be taken into account. Consequently, the ever-increasing adoption of the shareholder value philosophy has led, and will continue to lead, to ever greater social inequalities, which will ultimately foster unwelcome social and political repercussions (Aghion and Williamson, 1998).

Stakeholders are generally defined as all those who have a material relationship with the company that is not based on share ownership (Fremond and Capaul, 2002: 16). These include shareholders, employees, creditors, customers, suppliers, local communities and even society at large. The basic assumption of stakeholder theory is that the company exists for the purpose of serving its stakeholders; 'those groups without whose support the organisation would cease to exist' (Freeman 1984: 31-2

cited in Gregg, 2001: 21). As stated by Liebig (1990: 217), 'Every citizen is a stakeholder in business whether he or she holds a share of stock or not, is employed in business or not, or buys the products and services of business or not. Davies (1999: 23) simply defines stakeholders as 'all parties who have an interest in a particular enterprise whether that interest is legitimate or not'.

The term 'stakeholder' is claimed to have been originated by Robert K. Merton in the 1950s (Kakabadse and Kakabadse, 2001: 24) and first appeared with reference to business in a 1963 internal memorandum at the Stanford Research Institute (Gregg, 2001: 21). Since then, it has become a popular term among consumers, social activists and environmentalists, and has been used by some corporate executives as an argument in support of policies that would inhibit takeovers or give companies more defence against them (Blair, 1995: 203).

The objective of stakeholder value is to empower the roles of all relevant parties (stakeholders) rather than just the shareholders. By pursuing this objective, a company will be more effective and responsible to the various interests in society which it serves. One CEO, Heidi Kunz says 'It is hard for me to imagine that a company can deliver superior shareholder returns over the long term without very positive relationships with other stakeholders, particularly its employees and suppliers' (quoted in the OECD proceeding, 1998). This means that all persons with legitimate interests in a company have a right to be heard, and to have their views considered (Kant, 1965 cited in Kakabadse and Kakabadse, 2001: 24).

Corporate governance from a stakeholder value view is seen as 'a way to maximise wealth creation in a manner that does not impose inappropriate costs on third parties or on society as a whole' (Monks and Minow, 1995: 162). According to Blair (1995: 322),

[T]he goal of directors and management should be maximising total wealth creation by the firm. The key to achieving this is to enhance the voice of and provide ownership-like incentives to those participants in the firm who contribute or control critical, specialised inputs (firm specific human capital) and to align the interests of these

critical stakeholders with the interests of outside, passive shareholders (emphasis is in original).

Here, stakeholder value emphasises 'the relationship amongst various participants in determining the direction and preference of the corporation' (Monks and Minow, 1995: 1). Better relationships between shareholders and companies are not an end in themselves; they are just a means to an end (Kakabadse and Kakabadse, 2001: 24).

The Hampel Report (1998), while it supports the shareholders approach in its view of governance, also recognises the various interests of stakeholders. The Report 1.16 states:

A company must develop relationships relevant to its success. These will depend on the nature of the company's business, that they will include those with the employees, customers, suppliers, credit providers, local communities and governments. It is management's responsibility to develop policies which address these matters; in doing so they must have regard to the overriding objective of preserving and enhancing the shareholders' investment over time (quoted in Smerdon, 1998:11).

In the USA, Porter (1992:11 cited in Turnbull 1997) recommended that US policymakers, institutional investors, and companies increase the involvement of employees, customers, suppliers and community representatives in their ownership and control structure to make US firms competitive with those in Japan and Germany<sup>26</sup>. The reason is because no business can exist without its employees, customers, suppliers and host community; the 'strategic stakeholders' as considered by Turnbull (1997: 14). In Asia, the Chairman of the Hong Kong Securities and Futures Commission Andrew Sheng (2004) states 'It is important that one major element of corporate governance is not just about having an appropriate board structure and culture, and internal control processes, but also about managing a company's relationship with its stakeholders and

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<sup>26</sup> In the USA, in at least 38 states, there are now 'stakeholder' laws that permit (or even require) directors to consider the impact of their actions on constituencies other than shareholders (Monks and Minow, 1995: 38).

providing transparency about how it goes about delivering performance through conformance.'

Here, it is worth noting what one German chief executive officer stated 30 years ago. He said 'Why should I care about the shareholders, who I see once a year at the general meeting? It is much more important that I care about the employees; I see them everyday' (quoted in Goergen, 1999: 2).

Bain and Band (1996 quoted in Berghe and Ridder, 1999: 22) point out that shareholder's interests can only be protected in the long run if attention is also devoted to the interests of the other stakeholders. They say:

We believe that the essence of good governance is found in the relationship between the various participants in determining the direction and performance of organisations. The primary groups involved are the shareholders, the board of directors, and the management. However, there are other players too. These include the customers, employees, suppliers, creditors and the community. We believe that the central concern of governance is to add value to as many organisational stakeholders as is practicable....Any business that looks solely to the very short-run selfish maximisation of return will destroy value in the medium to longer term.

Nonetheless, for its opponents, the use of the stakeholder theory can lead companies to believe that they have moral responsibilities to any number of 'interested' parties simply because the latter have an interest in company activities whereas an 'interest', even if legitimate, is not necessarily a stake (Gregg, 2001: 23). This is to say that even people affected by a company's activities do not necessarily have a stake in them. Thus, being offended by a company practice, for example, is hardly sufficient to make an individual group, or even society qualify as a stakeholder. In this respect, Gregg (2001: 15) strongly argues that:

[I]t would be *immoral* (given that it would represent a betrayal of the trust that shareholders place in directors) for a business corporation to place other objectives on the same level as the end of maximising shareholders wealth without consulting and obtaining the consent of shareholders [emphasis in original].



In his opinion, the adoption of stakeholder theory would turn boardrooms into something resembling parliamentary assemblies, with each of them becoming battlegrounds for warring groups. Thus, it is not a coincidence that many stakeholder theorists refer to such groups as 'constituencies'. Another strong view comes from Sternberg (1997: 8-9) who says that stakeholder theory is for those who would like to be offered a free lunch, and enjoy the benefits of business without the discipline of business.

In practice, the implementation of stakeholder theory is a confusing and inconclusive exercise (Gregg, 2001). One of the reasons, as stated by Jensen (2001: 304), is that stakeholder theory does not explain how to choose among multiple competing and inconsistent constituent interests. For example, shareholders would simply like to maximise profit and are not concerned with the company's debt. The management and employees prefer high salaries irrespective of company performance. Lenders require the company to pay its debt in full, regardless of poor company performance. Communities want high charitable contributions, social expenditure by companies to benefit the community at large, stable employment, increased investment, and so on. Without having common objectives among these stakeholders, managers may be left unaccountable for their action. Gregg (2001: 24) argues that intellectually, it is impossible to 'balance' stakeholder's interests.

Today, there appear to be more trends of convergence between the shareholder and the stakeholder approaches. A significant indicator of the shift in approach, as Gillibrand (2004) notes, came in 2002 when the Association of British Insurers, which collectively accounts for over 50% of the value of the London Stock Exchange, called for the companies they invest in to draw up charters of social responsibility (Gillibrand, 2004). Another example was GES Investment Services, a Swedish corporate social responsibility group advising institutional investors with over \$ 70 billion in assets, which recommended the exclusion of Nomura Securities from investment on grounds of allegations of sex discrimination in employment, and of BASF due to a finding of the US Environmental Protection Agency of sales of illegal pesticides (Ibid).

Hence, even though stakeholder value can be problematic, a well-run board will have to deal with these interests in order to ensure long term corporate health (Smerdon, 1998: 3). Without looking after suppliers, customers, members of the staff and the environment, shareholders are likely to suffer. According to Davies (1999), if stakeholder theory is used properly, it will help companies to compete in the future by maximising their effectiveness in understanding and meeting customer needs, utilising the skills and support of employees, suppliers, distributors, and other partners. (Ibid: 114). In addition, he argues that stakeholder theory has the potential to become the major instrument for global development and for fulfilling the destiny of companies and of all who work with them.

Taking into consideration both the shareholder and stakeholder value, the important features of corporate governance can be outlined as follows:

- It helps to ensure that an adequate and appropriate system of controls operates within a company and hence assets are safeguarded;
- It also prevents any single individual having too powerful an influence;
- It is concerned with the relationship between a company's management, the board of directors, shareholders, and other stakeholders;
- It aims to ensure that the company is managed in the best interests of shareholders and other stakeholders;
- It tries to encourage both transparency and accountability which investors are increasingly looking for in both corporate management and corporate performance (Mallin, 2004: 4)

## **Summary**

This chapter discussed corporate governance concepts in a company characterised by the separation of ownership and control. From the agency theory perspective, the separation of ownership and control brings with it the potential for conflict among the principals (the group of people who provide the capital to the company) and the agent (the group of people who

are hired to run the company's day-to-day operations). The reason is because the interests of the principals (the owners) may not be the same as those of the agents (management). Here, corporate governance systems are needed to ensure that the shareholders interests are secured.

To date, there is no single theory on corporate governance; it can be approached from different models such as the simple finance model, the stewardship model, the stakeholder model and the political model. This study focuses on the simple finance model based on the agency theory approach which concerns itself with shareholder value.

Corporate governance systems are complex affected by many aspects coming from the inside of a company such as the Board of Directors, management and outside such as corporate laws, politics and culture.

Debates on the objectives of corporate governance are still taking place between the proponents of shareholder value and those of stakeholder value. Each side has its own logical explanations to support its argument. On the implementation of corporate governance systems, people agree that 'no size fits all'.

Governance and management are corporate mechanisms to ensure that shareholder' interests are protected. However, one must consider that they have different emphases. Governance focuses on accountability to outsiders, not only the shareholders, while management is concerned with the responsibility of running company efficiently and effectively in the best interests of the owners. The next chapter will discuss the Board of Directors, an internal corporate governance mechanism, in a great detail.

## **Chapter Three**

### **The Board of Directors**

There is a standard joke in corporate governance circles that there are only three jobs for which no educational, technical or professional qualifications are required, nor open competition, nor any training provided: board directors, cabinet ministers, and parents. There is also the Parkinson-type law that 'the principles, skills and knowledge required for getting to the top are in equal but inverse proportions to the knowledge and skills required for being at the top' – the guiding principle of 'what's in it for me' rather than 'what is in the best interests of the organisation', the skills of destroying rivals for first place rather than building teams, the knowledge of the internal micro-politics of the organisation rather than of the global business environment (Michael Gillibrand, 2004)

#### **Introduction**

The underlying assumption of the agency theory of corporate governance is that the agents or the managers will not always act in the best interests of the owners because they are rational but rather self-interested and opportunistic individuals. Sinha (1996: 14) describes the difference between self-interest and opportunistic behaviour as follows:

The assumption of self-interest visualises individual behaviour motivated by their preferences. However, the individual will candidly disclose all pertinent information on enquiry and meet all obligations expected of him or her from the transaction. Opportunism is described as pursuit of self-interest with guile.

To ensure that agents will not pursue their own interests, owners need corporate governance mechanisms that can discipline managers' conduct. In practice, there are a number of corporate governance mechanisms that operate inside and outside the company. Inside a company, corporate governance mechanisms are the Board of Directors and executive compensation. On the outside, corporate governance mechanisms operate in the forms of (1) the market for corporate control, (2) monitoring by large shareholders or financial institutions acting as institutional investors, (3) creditors, (4) the legal and regulatory

requirement and (5) competition (see Allen and Gale, 2000 for a further discussion).

The purpose of this chapter is to discuss the Board of Directors which is argued to be the most important corporate governance mechanism (see Rechner, 1989)<sup>27</sup>. The reason for this is because they serve as a link through which shareholders exercise control of company affairs. As such, they are 'the first line of defence for shareholders against incompetent or lazy management (Prowse, 1994: 13). The Board of Directors is believed to be of significance in improving company performance and investors' perceptions as they provide expert advice, acts as safeguards and brings skills, knowledge, and experience (Carver and Oliver, 2002: 1-2). The discussions of the Board of Directors in this chapter serve as the backdrop for the empirical portion of this study.

As in corporate governance, the literature on the Board of Directors is extensive. It covers a wide range of board attributes: structure, composition, characteristics, and process (see Zahra and Pearce, 1989). Board structure covers board organisation; the role of subsidiary boards in holding companies; board committees; the formal independence of one-tier and two-tier boards; the leadership of boards and the flow of information between board structures (Maassen, 1999). Board composition refers to the size of the Board and the mix of different directors' demographics (insiders/outside, male/female, foreign/local) and the degree of affiliation the directors have with the corporation (Zahra and Pearce, 1989). Board characteristics encompass director's backgrounds, such as director's experience; tenure; functional background; independence; stock ownership and other variables that influence the directors' interests and their performance (see Muth and Dalton, 1998; Zahra and Pearce, 1989; Kesner 1988). Board process refers to decision making activities; styles of Board; the frequency and the length of Board meetings; the formality of

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<sup>27</sup> There are other scholars who suggest differently. Hart (1995) argues that takeovers are the most powerful mechanism in disciplining managers. Allen and Gale (2002) believe competition is the most effective control mechanism. Stiglitz (1985) emphasises the importance of large equity shareholdings. Prowse (1994) promotes a reliance on the legal and regulatory environment. Empirical evidence, however, shows that each of the mechanisms is not effective enough as a disciplining mechanism; they have some degree of complementarity and substitutability.

Board proceedings and Board culture on evaluation of the director's performance (Pettigrew, 1992).

A discussion of the vast literature of Board attributes is beyond the scope of this study<sup>28</sup>. Hence, the discussion in this chapter is limited to the literature that has its relevance to the objectives of this study. Having said this, the discussions in this chapter are divided into nine sections. The first section starts with a discussion of the meaning of the Board of Directors. The second section reviews the two types of board structures: one-tier and two-tier Boards. Next, the discussion is followed by a review of the much debated issues relating to board composition and dual leadership in the one-tier board structure. The fourth section reviews Board Committees. The fifth section discusses the roles of the Board of Directors. The sixth section describes the duties of the Board of Directors. Section seven discusses Board activities. Section eight looks at some issues relating to the Board. Finally, section nine, provides a summary of this chapter.

### **What is a Board of Directors?**

The term 'the board', according to Monks and Minow (1995: 165), originally came from the United Kingdom. It referred to a group of people who had the responsibility of overseeing company. They would meet regularly and assemble around a long board laid across two sawhorses. The leader of the board was called the 'Chairman', distinguished by being seated on a chair, compared to the stools available for the others.

The Chairman plays a very important role in the company Board of Directors. He or she must have a clear view of where they want to go, both for the company and for the role of the board within it, and at the same time he or she must provide leadership and create and maintain a positive image of the organisation (Kendall and Kendall, 1998: 102-103). Louden (1982: 55-56) provides a definition of the Board of Directors as follows:

The board of directors is the legal and accountable group responsible for all the corporation's actions and the results of those actions. It is elected by the shareholders and

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<sup>28</sup> See Zahra and Pearce (1989) and Johnson et al (1996) for a comprehensive discussion on the board of directors.

serves as trustee of the shareholder's interest...more and more publicly held companies do not have one dominant shareholder. This being so, board of directors must, accordingly, act in essence as the owners of the business.

The members of the Board of Directors are appointed by the shareholders. They are accountable to the shareholders and charged with the responsibility for representing the shareholders' interests. Board members do not have individual power or authority instead it is shared with the full board as a group. The Board of Directors then appoints a chief executive officer (CEO), who, in turn, hires other executive officers and managers, and so on down the line to non management employees. The executives and managers manage the company on behalf of the shareholders and write contracts with other parties based on each individual power and authority. Hence, the Board of Directors does not get involved in the day-to-day operations of a company but rather ensures the interests of shareholders are protected. A board that is overly active in day-to-day management can reduce the effectiveness of the organisation (Sison and Kleiner, 2001: 157). Box 3.1 provides a discussion of the five categories of Board members and their related issues.

### **BOX 3.1 Five Categories of Members of the Board**

#### *Company executives*

These persons take an active stance on issues of concern to them, and their position as board members is the same as the one they take as managers. In certain cases, an individual at odds with management on an issue can swing the majority of the board towards his position and thus force management to alter its plans. Yet, these are rare instances: most often a board member who is also a company executive will have fought for his position before the issue comes before the board: only, when he has not been successful will he try again at the board level. What does happen somewhat more commonly is that an executive is instrumental in bringing a hesitant board to take a positive stand on proposal. While a board usually does not actually turn down a plan presented by management, it can challenge particular aspects. A Board member can then try and convince the board to go along with management's original plan.

#### *Government people*

Many corporate issues are of little relevance for such individuals and they have limited influence on them in practice. The main concern lies in

decisions with a bearing on macro issues—particularly those directly relevant to their special field of interest within government. Thus, a person responsible for regional development will become active in decisions concerning, say, new plant investments. In such instances, his influences can be sizeable especially if the establish of the Board does not feel strongly one way or the other. Yet, a person does not usually wait until an issue reaches the Board level to make his position known. He often can exert more influence as a government official than as a Board member.

#### *Executives of other companies*

The primary characteristics of such a group are their interest in corporate affairs as they relate to their own company's activity. For example, an executive of a steel company sitting on the Board of a car manufacturer may be concerned that the company buy from his own firm. Or the president of shipyard may try to exert influence on an oil company to cause it order ships from his yard. And one company reported that it decided to locate a plant in a particular country because the enterprise of one of its Board members was already there and needed the company's orders to reach a profitable level of sales.

#### *Worker Representatives*

In several countries, company employees elect members of the Board (e.g., Germany). They are of course primarily concerned with issues having a bearing on workers' lives—salaries and other forms of compensation, fringe benefits, working conditions, vacations, etc. And they can influence investment decisions. Thus, worker representatives may fight against foreign plants for fear this might reduce the domestic job offerings.

#### *Other Outsiders*

Such people do not *a priori* have special interests as far as strategic and policy behaviour as a result of their outside position. They therefore tend to be more objective albeit less determined to defend their stances. Thus, a Board member is rarely concerned by all strategy and policy issues confronted by the firm. Except perhaps for outsiders, Board members' interests tend to be limited. For any decision, few, if any, Board members usually get involved and even then focus on certain aspects only. Since other Board members often do not feel strongly about the issue, an individual member taking a strong stance frequently can convince others to back his position were it only by default—by not opposing his view. Yet, it is worth repeating that in practice the real influence of the board *per se* is usually rather limited, individual typically exerting power via channels related to their roles beyond that of board members.

Source adapted from Mazzolini (1979: 287-288)



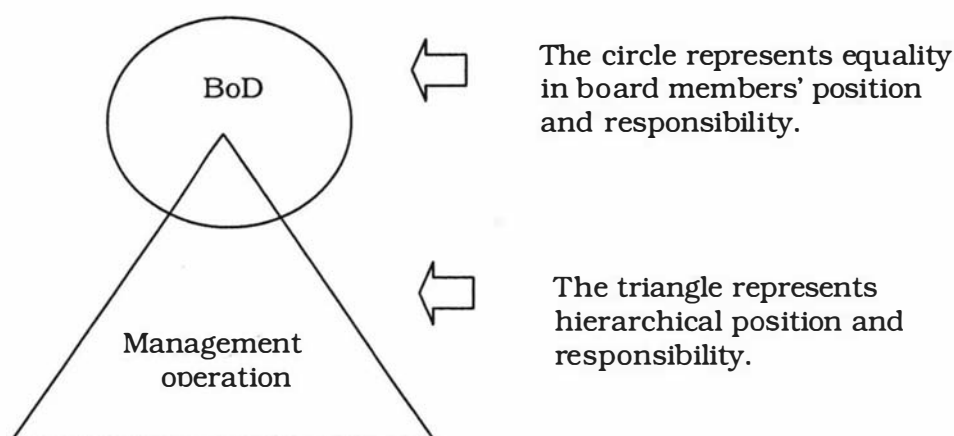
## Board Structures: The One-tier versus Two-tier Board

Within corporate governance systems, there are two types of board structure that are commonly known: (1) The *one-tier board* and (2) The *two-tier board*. The one-tier board serves the owner of the company whereas the two-tier board aims to serve the interests of a wide range of stakeholders including shareholders, employees, creditors and the communities in which the companies operate. The following section discusses each of the two board structures.

### One-tier Board Structure

The one-tier board is characterised by a single board comprising of both the executive and non-executive directors. It is practiced in countries which adopt the Anglo-American laws such as the US and the UK. Figure 3.1 illustrates the one-tier board structure.

**Figure 3.1 The One-Tier Board Structure**



Source adapted from Tricker (1994: 45)

Within the one-tier board structure, there are other variations: (1) the *all-executive board*, (2) the *majority executive board*, and (3) the *majority outside board* (Tricker, 1994: 45). Under the *all-executive board* structure, the Board is composed entirely of full-time directors who are also the executives of the company. Generally, they include the chief financial officer, the chief operating officer, the chief personnel officer, the chief

marketing officer, and the chief executive officer. The later commonly holds the post of chairman. The advantage of this board structure is that it ensures professional competence, establishes a direct linkage between authority and responsibility and provides for participative management. Further it provides an atmosphere of incentive, involvement and motivation. In terms of management development and career planning it opens up opportunities for the managers to reach the top. It creates a pool of top capability from which the chief executive officers of SOEs can be drawn (Fernandes, 1986: 123). The main drawback of this board structure is that it is too 'inbred'. It does not provide exposure to a second opinion. It makes no room for representation of relevant interests. It precludes the participation of concerned government agencies. This board structure is seldom applied in the SOEs. It may not be desirable, in the long run, to encourage its emergence (Fernandes, 1986: 124). It is commonly practiced in many small private and family firms (Tricker, 1994: 45).

In the *majority executive board* and the *majority outside board* structures, the Board of Directors consists of a mix of outside directors, commonly referred to as non-executive directors (NEDs) and inside directors commonly referred to as the executive directors (EDs)<sup>29</sup>. The inside directors are mostly the top executives of the company (e.g., chief executive officer, chief operating officer, chief financial officer) and the Chief Executive Officer is commonly the Chairman of the Board. The term 'majority' shows that outside directors have more members on the board.

### ***Two-Tier Board Structure***

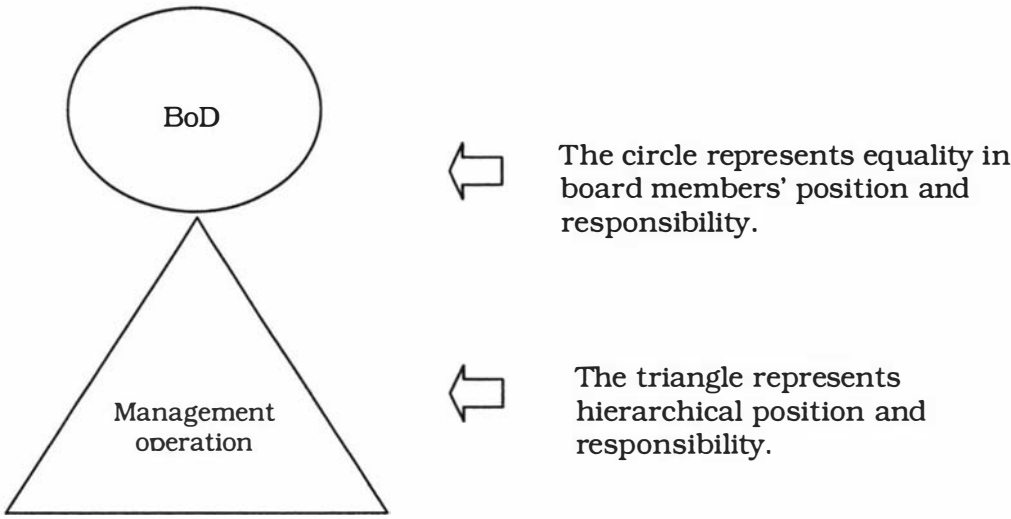
The two-tier board is characterised by two layers. One layer, at the top, is comprised of non-executive directors or outside directors. They are commonly referred to as the *Supervisory Board* or council. The other layer of the board is comprised of the executive members of the company and referred to as the *management board*. Hence, there are no common members between the Boards. The *two-tier* board is largely practised in

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<sup>29</sup> Fernandes (1986: 125) use the term a 'composite' board to describe the *majority executive* and the *majority outside* board structures.

countries which adopt Civil Law such as Germany and the Netherlands. Figure 3.2 illustrates the two-tier board structure.

**Figure 3.2 The Two-Tier Board Structure**



Source adapted from Tricker (1994: 45)

This board structure is often argued to better secure the outside shareholders interests<sup>30</sup> and to ensure management takes account of the shareholders' views (Allen and Gale, 2000: 29). Fernandes (1986: 124), for example, states that this structure provides a balance between participative management and the rigours of external control and is of pertinent in the case of SOEs servicing the general public such as public transportation, electricity and water supply systems. The drawback of this structure pertains to the boundary of the authority and responsibility between the Supervisory Board and the management board specifically in SOEs. The decision makings through two levels might also create bureaucratic delays. In practice there is likelihood that one of the boards will 'seize' the power of decision makings and the other board becomes merely a nominal body. The chances are that the management board will

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<sup>30</sup> Company shares can be owned by inside shareholders such as management and the employees and by the outside shareholders such as individuals or institutions.

run the enterprise; converting the Supervisory Board into a sort of advisory or auditing council (Fernandes, 1986: 125).

The discussion of the many variations of the two-tier board structure practices across countries and companies is beyond the scope of this study. Hence, the discussion provides examples of the two-tier board structure practiced in two European countries, Germany and the Netherlands, and several Asian countries. Germanic board structure has its distinctiveness from other board structures wherein the employees have their representation on the board. The Netherlands board structure is chosen given the historical connection with the Indonesian board structure. The discussion on board structure and practices in Germany and the Netherlands is largely drawn upon Maw (1994) while that of Asian countries is taken from the *Handbook of International Corporate Governance* (2005) by the Institute of Directors.

### **Germany**

In Germany, there are two types of company, a simple limited liability (*GmbH*) and a public company (*Aktiengesellschaft* or AG). In *GmbH*, the appointment and removal of directors is solely decided by shareholders in a shareholders' meeting. This means shareholders themselves ultimately retain the power. In an AG company, the Supervisory Board is called *Aufsichtsrat*. Its members are elected by ordinary resolution of the shareholders' meeting, for a maximum period of five years (Goergen, 1998: 40). After the membership expires, re-appointment is not automatic and they must be formally re-elected by the Supervisory Board. Members of the Supervisory Board can be dismissed by the shareholders' meeting before the end of their term. In serious cases, the Supervisory Board itself may apply to the court to remove a Supervisory Board member (Terlau, 2003: 16). A removal of all or a number of members of the Supervisory Board commonly occurs in a takeover situation (Ibid: 16).

Supervisory Board members in AG are a mixed-group of people who represent different shareholders' interests. They can be representatives of banks, local communities, and employees; executives of other companies; independent lawyers or accountants; and the local 'great and good' (Maw,

1994: 121). The representative of employees cannot be dismissed by the shareholders' meeting (Goergen, 1998: 40). The right of employees to be kept informed about the company's activities and to participate in decision making that may affect the employees is known as 'co-determination' (Mallin, 2004: 126).

The Supervisory Board is independent of shareholders in that it owes its fiduciary duty, loyalty and care to the company instead of to the shareholders (Terlau, 2003: 15). Its main functions are to appoint the members of the management board, to supervise the company's management and to report to shareholders' meetings on issues such as the development of the company and the performance of management. Hence, the Supervisory Board members can not be members of the company's management board in order to avoid conflict of interests and functions.

The Management Board is called *Vorstand*. The Management Board can consist of one or more members depending on the type of the company, the size of its nominal share capital, and the number of its employees. The appointment and dismissal of Management Board members does not require shareholders' approval. The Management Board is responsible for the day-to-day business of the company, and for financial accountability. Members of the management can be removed by the Supervisory Board on various grounds, for example, from a violation of their fiduciary duties, incompetence, significant disputes between the management and the Supervisory Board about future company strategy, to a vote of no confidence from shareholders (Terlau, 2003: 16).

### ***The Netherlands***

In the Netherlands, the Supervisory Board is called *raad van commissarissen* and the Management Board is called *raad van bestuur*. Both Boards are autonomous and operate independently from each other. Shareholders do not hold the ultimate power over companies, particularly in 'large' corporations. In addition, the size of a company determines the responsibility of the Supervisory Board. In smaller companies, the duties of the Supervisory Board are to oversee the policy of the Management Board and its general business activities, and to advise the Management

Board. In the performance of its duties, the Supervisory Board has to act in the general interest of the company, but does not have to report to the shareholders meeting. It provides checks and balances on management activities, rather than supervising them. Supervisory Board members will normally be independent experts (commercial, legal, tax etc), representatives of family shareholders or of joint venture partners, or representatives of the government or of banks.

In large companies, the Supervisory Board should have a labour representative especially where the sole shareholder is a foreign company and the majority of the Board consists only of representatives who are not familiar with the Dutch social and economic situation. The labour representative has to act in accordance with the general interests of the company, and not only the interests of the labour force. Besides appointing and dismissing the members of the Management Board, the Supervisory Board has other functions. These include approving specified important decisions, for examples, issuing shares, acquisitions and major investments, and applying for a Stock Exchange listing. The Supervisory Board must consist of at least three individuals and they cannot also serve on the Management Board. They are usually appointed for a four year term by the existing Supervisory Board themselves, albeit by following a procedure which involves notifying shareholders, the Management Board and the works council of an anticipated vacancy. Subject to that procedure, however, the Supervisory Board can be seen as self-perpetuating.

The Management Board is responsible for the management of the company with collective powers and responsibilities. Managing directors are elected by the Supervisory Board in large companies, usually for an indefinite period—but otherwise by the shareholders. The Management Board is responsible for preparing the annual accounts and an annual report. Its role is an independent one, and it is not subordinated to either the shareholders or to the Supervisory Board, although the Supervisory Board's approval must be obtained in large companies prior to the company undertaking major changes (e.g., stock issues), major acquisitions, or joint ventures.

**Malaysia**

The Malaysian legal system is based upon UK common law principles requiring directors to act bona fide in the interests of the company and with diligence. Directors have the fiduciary duty not to place themselves in a position where interest and duty conflict. Directors also have common law duties of care and skill.

The Malaysian board structure is one-tier or unitary with a combination of executive and non-executive directors in balance so that no individual or groups of individuals may dominate the board. At least one-third of the Board should be non-executives who are independent. The Kuala Lumpur Stock Exchange Listing Requirements define independence as:

[A] director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interest of an application or a listed issuer.

Independent directors have the right to retain experts to advise them on problem arising at the company's expense provided that they reasonably believe that the retention is required for the proper performance of their functions and powers and that the amount involved is reasonable.

Board meetings should occur on a regular basis, with due notice of the issues to be discussed, and should record its conclusions in discharging its duties and responsibilities. Boards should disclose the number of meetings each year and the details of attendance at the meetings.

**Philippines**

The Philippines Corporation Code (2002) follows the US. It has a one-tier board structure. The Board of Directors is defined as a collegial body that has the responsibility to conduct all business and controls or holds all the property and assets of the corporation. The Board consists of at least 5 but no more than 15 members elected by shareholders in the annual shareholders' meeting. In practice, large public companies typically have a

Board composed between 7 and 11 members representing the largest shareholders of the company. The Corporation Code (2002) mandates that every members of the Board must own at least one share of the capital stock of the corporation where he or she is a Director. A majority of the directors must be residents of the Philippines. A director is normally appointed for one year and there no limit to re-election. Board meeting are normally held each month. Outside directors are not common and not mandatory. Outside directors, if present, are brought in by controlling shareholders. Legal entities may not serve as directorss.

The Code of Corporate Governance (2002) suggests that the roles of the chairman and the CEO be separated to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making. The responsibilities of the chairman may include:

- to schedule meetings to enable the board to perform its duties responsibly while not interfering with the flow of the company's operations;
- to prepare the agenda of the board meeting in consultation with the CEO;
- to assist in ensuring the corporation's compliance with the generally accepted guidelines on corporate governance.

### **India**

India applies a common law system. The Companies Act is administered by the Department of Company Affairs and enforces the powers, roles, and responsibilities of directors and shareholders as well as operations and duties of companies.

The Board structure is one-tier and it must comprise of at least three directors. Most of the top listed companies already have a majority of independent directors and have an audit committee comprised of at least three independent directors. Regardless, non-executives directors are often family members, retired chief executives, or lawyers. The Kumar Mangalam Birla Committee on Corporate Governance Report (2000) mandated that the Board of a company shall have an optimum



combination of executive and non-executive directors with no less than 50 percent of the Board comprising of non-executives directors. The number of independent directors would depend on the nature of the chairman of the Board. If a company has a non-executive chairman, at least one-third of the Board should comprise of independent directors. Where a company has an executive chairman, at least half the Board should be independent.

### **China**

China's legal system stipulates a single-tier Board of Directors and a Supervisory Board that monitors its activities. Independent directors have also started to play a positive role in expressing their independent opinion on issues such as whether a particular related-party transaction would cause damage to minority shareholders, and on the nomination of directors, as well as accounting and disclosure issues. These independent opinions have been widely publicized by the media and welcomed by investors.

To ensure that there are enough qualified independent director candidates for companies to choose from, the China Securities Regulatory Commission (CSRC), in partnership with some of the top management schools in China, runs regular monthly training sessions for those who are interested in becoming independent directors. The background of the directors is varied from academic institutions, law and accounting firms, executives of other companies, to retired government officials and other professions.

### **Issues in the One-Tier Board Structure**

In recent years, various issues have been discussed in efforts to improve the Board of Directors' independence, particularly in the one-tier board structure practiced in countries such as the USA and the UK. These include discussions on the board composition and board leadership structure. The following presents a review of the two issues.

### ***Board Composition***

Board composition deals with how many seats are in the boardroom and who represents the Board members<sup>31</sup>. It is an important issue in the corporate governance literature, particularly in the one-tier board structure, due to its significant impact on the effectiveness of the Board (see Fama and Jensen, 1983; Useem, 2003: 243). Therefore, Board composition is argued to be the most widely studied issue in governance research (Judge and Zeithaml, 1992). As Koontz (1967 cited in Cochran and Wartick, 1994:14) states:

Central to the effectiveness of any board of directors is the composition of its membership. This problem has many facets—size, the number of inside and outside directors, the age and retirement of members, individual qualifications, compensation and other incentives. All these elements of board composition present difficult problems in practice.

The earliest research on Board composition focused primarily on the distinction between inside and outside directors (Johnson et al, 1996). Hence, the central discussion of this section is centred on this issue. Inside directors have generally been defined as those directors who serve as executive officers while outside directors are being classified as all non-executive members of the board. To some corporate governance theorists, a higher representation of outside directors on the Board is essential<sup>32</sup>. These directors are believed to be vital in ensuring an effective and impartial governance system within the company because they have more independence from management (Fama, 1980). The independence is achieved because board members do not have any personal or professional relationship with the company, the company's subsidiaries or affiliates, or company management (Daily and Dalton, 2003: 41). Board independence, according to Daily and Dalton (2003: 41) is,

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<sup>31</sup> The members of the board of directors may come from various backgrounds such as (1) company executives, (2) government people, (3) executives of other companies, (4) worker representatives, and (5) other outsiders (see Mazzolini, 1979 for a discussion).

<sup>32</sup> Christopher Stone (1975) in Cochran and Wartick (1994: 15) even suggested that all inside directors should be eliminated from the company boards.

... like a lighthouse on a dark and stormy night. It serves as the beacon of hope for corporate governance reform activists who embrace the perspective that more independent boards will result in greater oversight of corporate management and that this, in turn, will lead to improved firm performance.

An ideal corporate governance structure, as argued by Rechner (1989), is one in which the Board is composed of a majority of outside directors and a Chairman who is an outside director. The weakest corporate governance, on the other hand, is one where the Board is dominated by inside directors and the CEO holds the chairmanship of the board. In this situation, the role of independent outside directors is likely to function as a rubber stamp board given the total control of the CEO (Rechner, 1989).

Besides independence, there are other factors which are believed to be advantages of having more outside directors than inside directors on the board. Firstly, outside directors are able to acquire necessary resources from the external environment otherwise unavailable from the management (Pfeffer, 1981). They may fulfil this role by enhancing the reputation and credibility of the organisation (Hambrick and D'Aveni, 1992; Daily and Schwenk, 1996: 7). Secondly, they have the ability to provide a quality of advice and counsel to the CEO unavailable from inside directors<sup>33</sup>. That is why outside directors are more likely to join the board when the corporation initiates major strategic changes and needs to re-establish external contacts (Hermalin and Weisbach, 1988). Thirdly, when experiencing poor performance, a company that has a Board dominated by outside directors may be more sensitive to the need to adopt bold policies, which may lead to significant change including entry into international markets (Johnson et al, 1996). Agency theorists suggest that Boards

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<sup>33</sup> The practice showed that this expectation might not be easy to achieve. In the Enron scandal, for example, three of the audit committee members resided abroad. This created an environment in which providing advice was ineffective. John Wakeham lived in London, and Paulo Ferraz Pereira, an investment banker and former president of the State Bank of Rio de Janeiro, resided in Brazil. Ronnie Chan, a real estate developer based in Hong Kong, had missed more than a quarter of the board and committee meetings in 1996, 1997, and 2000 (Useem, 2003: 247).

dominated by inside directors may be less vigilant monitors of management as these directors may intentionally provide self-serving accounts of managerial actions to enhance their status with the company's chief executive officer (Fama, 1980; Eisenhardt, 1989).

However, there is some disagreement regarding the level or quality of monitoring from outside directors when they hold ownership in the companies they serve. The argument is that the independence of outside directors who own substantial amounts of company shares may be limited. Daily and Dalton (1992: 109) state this concern as follows:

If, in fact, board members did have an increased financial interest in the firm, it might be reasonably expected that their interests and those of the shareholders—the groups they presumably represent—might converge. At the same time, however, the notion of 'outside' direction would be lost. In general, one could hardly expect a director with a large equity stake in the firm to be a dispassionate observer. It might also be difficult to anticipate that a director would be independent of the very management which provided this largesse.

On the other hand, other agency theorists support a higher representation of inside directors on the board (Johnson et al, 1996). Baysinger and Hoskisson (1990), for example, argue that inside directors, being involved in the company's decision making processes, are able to provide higher quality information concerning the executives' performance. Consequently, in terms of information gathering, inside directors may be preferred to outside directors. In addition, inside directors are an important source of firm-specific information, and their inclusion on the board can lead to a more effective decision making process (Fama and Jensen, 1983 in Rosenstein and Wyatt, 1997: 230). This argument is challenged by Heracleous and Luh Luh (2002: 19). They say:

Many believe that non-executive directors are of limited usefulness because they do not know the details of the business. But they miss the point that the board is there to lead, not to manage. The best consultants command extremely high premiums for their time, and it is not because they know the details of each client's business, or because they are necessarily smarter than their clients; it is because they contribute such things as knowledge of best practice methodologies and independence of

judgement unimpeded by company politics or culture. These are the same qualities that can make non-executive directors valuable to the board.

Another argument for more inside directors on the board is that the board dominated by outside directors does not ensure better protection of the shareholder interests. The reason is because CEOs, using some relatively powerful but subtle political tactics, may be able to influence the director selection process in ways that create an image of board independence which can please investors (Tosi et al, 2003). One way of using the tactic is that a CEO nominate outside candidates who have similar backgrounds and experiences as the CEO, especially candidates who are CEOs themselves elsewhere. Because of their similar backgrounds and experiences, these outside directors are likely to associate themselves with the company's management, especially the CEO and, as a result, they will seldom challenge the CEO decisions.

Indeed, evidence shows that some of the most notorious corporate misdeeds occurred in companies that havd a majority of outside directors, such as Enron (80% outside directors), and Disney (60% outside directors). These outside directors, as Tosi et al (2003) put it, often act like they are members of the emperor's court, either approving the CEOs' actions or not being terribly interested in what the CEOs do, so long as they are able to hold on to their board status. Simply 'Just saying a company's board is independent doesn't make it so' (Daily and Dalton, 2003)

In practice there is little consensus relating to the proportion of inside and outside directors. Some studies found that a higher proportion of outside board members were associated with a company's poorer performance (see Vance, 1978 for a review). Bavly (1999: 81) noted that in large, older companies, with a greater equity spread and a strong finance and audit department, there were less use and respect for the role of outside directors. The perception was that outside directors rarely contributed original or helpful ideas to the company or to the proceedings of the board. The only situation where there was a relatively higher regard and greater use for director was where the founding entrepreneur still held

a major stake and had structured a small board of trusted acquaintances, all specialists complementing his talents and creativity (ibid: 82).

In contrast, other research concluded that Boards with greater outsider representation were associated with higher financial performance (Baysinger and Butler, 1985). In between, some studies provide no evidence of systematic relationships between board composition and corporate financial performance (Dalton and Daily, 1999:30). They state:

The problem...is that there is barely a shred of evidence to support a relationship between board composition and financial performance. Despite several decades of research designed to establish such a connection, the results have been described as 'vexing, 'contradictory', 'mixed', and inconsistent'.

Despite the fact that there is no consistent empirical evidence that supports to one view over another, an insistence on having a majority of outsiders serve on Boards of Directors has continued to be one of the most extensively discussed board reforms (Zahra and Pearce, 1989; Daily and Schwenk, 1996:6).

### ***Board Leadership: Duality or Separation of Roles?***

Another issue that is widely discussed and debated in the literature is the duality of leadership. This is a condition where the chairman of the board is also the CEO<sup>34</sup>. The key issue here is that if the two roles are combined in one person, it represents a considerable concentration of power (Cadbury Report, 1992: par. 4.9). This concentration of power may lead to the abuse of power which is damaging to shareholders and may encourage opportunistic behaviours on the part of some executives. Jensen (1993) in his Presidential Address to the American Finance Association recommends that companies separate the two functions. In this speech, Jensen articulates the potential benefits of separation:

The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and

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<sup>34</sup> Among the 30 firms that are included in the Dow Jones Industrial Average, which consists of the United States' major corporations, only eight firms have a separate CEO and board chair. For the *Fortune*-listed firms, only 10 percent have a non-executive chairperson (Kim and Nofsinger, 2003: 36).

compensating the CEO. Clearly the CEO cannot perform this function apart from his or her personal interests. Without the direction of an independent leader, it is much more difficult for the board to perform its critical function. Therefore for the board to be effective, it is important to separate the CEO and Chairman positions. The independent chairman should, at a minimum, be given the rights to initiate board appointments, board committee assignments, and (joint with the CEO) the setting of the board's agenda (quoted in Brickley et al. 1997: 193)

The Cadbury Report (1992, par. 4.9) also recommends that '... there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no individual has unfettered powers of decision.'

The CEO and the chairman of the board have different focuses. The CEO is in charge of managing the business while the chairman is in charge of monitoring and controlling the management. Since the board is there to monitor management, having the CEO as both the leader of the board and the leader of management may lead to a conflict of interests because there is no assurance that the CEO would be able to monitor his or her own performance objectively. As stated by Rechner and Dalton (1989: 141)

There are those who argue that this dual role represents a prima facie case of conflict of interests. Given that one the board's prime charter is to monitor the performance of management, there is some question as to whether a CEO/chairman can exercise the necessary independence of judgment for such self-evaluation (cited in Daily and Schwenk, 1996)

Another consideration related to separate board leadership structure is the need for a Chairman who is independent of management. The separate structure is believed to maintain the independence of the chairman which in turn, is expected to benefit shareholders by enhancing the effectiveness of board monitoring (see Kesner and Dalton, 1986; Dayton, 1984; Monks and Minow, 2003)<sup>35</sup>.

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<sup>35</sup> In Morocco, the business community supported the separation of CEO and chair for the wrong reason, namely because it diminished the personal legal liability of the chairperson.

When the CEO, as the Chairman of the Board, formally dominates the board, managers may be able to influence the other board members, whose responsibility is to protect the shareholders' interests (Daily and Dalton, 1997). In addition, Jensen and Fuller (2002: 10) assert that the Board Chairman cannot be the CEO because a Chairman's main job is to set the agenda of the board and to oversee the hiring, firing, and evaluation of the top management team—and no CEO can effectively run a process that evaluates him.

When the Chairman is also the CEO, oversight may be compromised as directors may feel unable to ask the right questions, raise the right issues, or make the right judgments' (Dobrzyński, 1991: 124; Dayton, 1984; Daily and Dalton, 1997). Moreover, the dual leadership structure places inside directors in an untenable position since they are obligated to report any criticism of the CEO to the Chairman, who is the same person (Kesner and Johnson, 1990). Managers who might otherwise be vigilant in reporting executive abuses are unlikely to do so when their direct superior, the CEO, is the abuser (Daily and Dalton, 1997: 127). Another logical reason is related to the heavy workload that demands considerable attention from a Chairman (Daily and Schwenk, 1996).

In Asia the separation of the Chairman and the CEO is now accepted as best practice. As J.J. Irani (in Roche, 2005: 80) states:

The Chairman of the Board should be separate from and independent of the CEO. This would ensure an appropriate balance of power and greater capacity of the Board for independent decision making. This separation of roles provides the needed checks and balances to preserve the integrity in the decision making process.

In contrast, the proponents of dual leadership provide some rationale for the advantages of a dual role. As stated by Anderson and Anthony (1986: 54)

The reason that the positions of chairman and CEO are usually combined is that this provides a single focal point for company leadership. There is never any question about who is boss or who is responsible. This is an important issue ...[otherwise]... this is guaranteed to produce chaos both within the organisation and in relationships with the board.



The separation of the Chairman and the CEO would weaken their power to provide effective leadership, create the potential for rivalry between them, and having two public spokespersons could lead to confusion and even to opportunistic behaviour by outsiders (Lorsch and Lipton 1993 in Brickley et al. 1997). Hence, the dual leadership provides clarity of purpose and unity of command not found with the separation of these positions. Other benefits are: (1) it may enhance relations with external constituents who interpret this centralised structure as a signal that the firm has a strong leadership and a clear sense of direction (Salancik and Meindl, 1984) and (2) it is the more efficient, and therefore sensible, form of governance (e.g. Williamson, 1985).

Bavly (1999: 101) identifies two disadvantages coming from the separation of the position of CEO from that of Chairman of the Board. Firstly, it is likely that the Chairman will lack the extensive knowledge and sensitive understanding necessary to lead the company. Secondly, separation would require extra management time and lead to delays in the corporate decision making process. The greater levels of knowledge and information possessed by the joint CEO/Chairman may enable him or her to better direct the board's agenda and discussions (Lorsch and MacIver, 1989).

Further, it would not be easy for the other directors to choose between divergent positions taken by the Chairman and the CEO (Bavly, 1999: 101). To some extent, the presence of dual leadership may create difficulty in determining who is responsible for poor corporate performance and raise possible confusion about who is really in charge, which could harm the company. These arguments are backed up by research in the social choice theory which demonstrates that significant inconsistencies can arise in decision making when authority is divided among more than one person (see Arrow 1963).

Fama and Jensen (1983) argue that the disadvantages of dual leadership can be counter-balanced by effective independent outside directors who 'have incentives to carry out their tasks and do not collude with managers to expropriate residual claims'.

In reality empirical findings do not uniformly support the performance advantages of either the separate or joint board leadership structure. Brickley et al. (1997: 197) state:

In conclusion, it is not theoretically obvious whether dual or unitary leadership is optimal. Rather both forms of leadership involve potential costs, as well as benefits. Separating the titles is efficient for shareholders only if the reduced agency costs of controlling the CEO's behaviour are not outweighed by the sum of the agency, information, and other associated with the change. Also, since the costs and benefits of different leadership structures can vary across firms, it is possible that the optimal structure will vary across firms.

Nevertheless, many academics and the vast majority of practitioners continue to not support CEO duality. Dobrzynski (1991: 124), for example, notes that many corporate governance experts feel that splitting the jobs of Chairman of the Board and CEO would prevent mismanagement by the CEO and make the position more accountable to the the Board, and consequently the shareholders. Bavly (1999: 102) says care should be taken in generalising the argument for or against dual leadership because that there may be a situation where duality is preferable, for example in companies where business is stable and policies focused and conservative, such as in public utilities. In contrast, an independent Chairman can contribute and be valuable in a company where the CEO is pursuing bold, somewhat risky strategies or when the company is facing turbulent times.

### **Board Committees**

It is a common practice of Boards (particularly public company Boards) to delegate many of their responsibilities to committees. The reasons are three fold. Firstly, it is often more effective for a smaller group of directors to focus their minds and diligence in certain key areas (Hansell, 2003). With the committee reporting directly to the Board, directors can perform better in overseeing how the company is managed. Secondly, the Board cannot be thought of as knowing everything (Pomeranz, 1997: 281). Thus, a reasonable expectation must be set for Board members. Thirdly, Board

Committee ensures the independence of the Board of Directors in carrying out their duties.

Board Committees can make decisions based on the authority delegated to them by the Board. However, it is more common for committees to make recommendations to the Board and for the Board to make the final decisions, based on the recommendations of the committee. If the Board does delegate authority to a committee, it does not mean that the board releases its responsibility on the matters within the committee's mandate; the board must continue to exercise the same oversight that it does when it delegates authority to management. If the committee makes recommendations to the board, the board must review the reports and recommendations of the committee as it would any other input it receives. This includes asking the pertinent questions and pursuing any further inquiries necessary to make an informed business judgement (Hansell, 2003: 82). Hence, 'communications between committees and the full board are critical' (Diplock, 2004)

Depending on the size of the company and the industry in which it operates its board may have what is referred to as 'standing committees' of the board to deal with specific issues. For example, if a company faces a crisis, such as serious litigation, it is advisable for the Board to establish a special committee of directors to devote the additional time necessary to focus on that issue. Other specific issues may relate to environmental matters, occupational health and safety, risk management and finance (Hansell, 2003).

In practice, a company can have more than one committee. For example, it is not uncommon for public companies to have committees such as an audit committee, compensation or remuneration committee and a nominating committee. The audit committee represents a standing committee of the Board of Directors which is charged with dealing with audit-related concerns to assist the fiduciary duty of the board. Pomeranz (1997: 46) argued that 'audit committees have become the guardians of corporate morality within the existing organisation framework.' They discuss, for example, the scope of the audit, explore matter that the auditors raise about management systems and controls, and are involved

in resolving any disagreements that might occur on the form and content of the published financial reports (Tricker, 1994: 248). As a best practice rule, such committees are generally limited to the independent directors on the board.

In some cases, the audit committee is expected not only to be involved with the audit of the company's finance and connection transactions, but also to perform 'compliance audit' to make sure that decisions made by the Board of Directors are properly carried out by the management. Thus, the audit committee has become one of the main ingredients of the board to ensure the 'best interest of the company', which often refers to the bottom line of the company's income statement. However, Tricker (1994) warns about a possible danger lies in the over-enthusiastic audit committee that may interfere the management process, rather than acting as a bridge between auditors and Board. In many countries public companies are required by corporate law to have an audit committee.

### **The Roles of the Board of Directors**

There is no simple answer to questions on what the Board of Directors' roles are. The prevalence of Board of Directors research has not yet resulted in convergence around a specified role set for directors (Johnson, et al, 1996: 409). In the past, directors had to focus their attention only on ensuring the company's compliance with procedural rules to protect themselves (Jensen and Fuller, 2002: 6). That is, they had to act with reasonable care to protect what they believed to be the company's best interests, and they had to ensure that management did not commit fraud, act in bad faith, or conceal personal conflicts of interest (Ibid).

In theory, there are many assumed roles of the Board of Directors prescribed by scholars, practitioners, and corporate governance institutions. Tricker (1994) separates the roles of the Board of Directors into two distinct categories: (1) the performance roles and (2) the conformance roles. The performance and conformance roles can be further broken down into different sub-categories in Table 3.1.

**Table 3.1 Board Roles**

<b>Performance Role</b>	<b>Conformance Role</b>
<i>Knowledge and Expertise</i>	The Watchdog
The Wise men	The Judge
The Catalyst	The Confidante
The Specialist	The Safety-Valve
Window-on-the-World	
<i>Networking and Status</i>	
The Contact Person	
Figure Head	
Status Provider	

Source: Tricker (1994), International Corporate Governance

The performance role of the Boards can be further broken down into two sub-categories of roles: (1) contributing to know-how, expertise and external information and (2) providing networking, representing the company and adding status. These roles are oriented towards improving the company performance through better strategic thinking and policy making. In the first sub category, directors perform as the 'wise men' mean that they are expected to bring knowledge and experience in the company. As the 'specialist', directors are expected to contribute their expertise, skill and knowledge based on their professionalism, for example, in the areas of accountancy, engineering, law and so forth. In 'the window-on-the-world' role, directors are being used as a source of information on issues relevant to board discussion.

In the second sub-category, one important role of the Board of Directors in this sub category is the 'contact-person'. Here a director, through his/her personal contact, is able to connect the board and top management into networks of potentially useful people and organisations. Another role is to act as the 'figure-head' in which a director, usually the Chairman, is called to represent the company in the external arena, for example, meetings with investors or financial analysts. Another related role of the Board of Directors is to be the 'status provider'. This role is commonly held by eminent public figures who were invited to joint the Boards because of their reputations rather than any specific contribution

as discussed above. Tricker (1994) argued that in some cases, for example, when the company experiences financial and product difficulties and needs to rebuild confidence with the financial markets and customers, the bringing of reputation, status, even credibility to a board is important.

The second category, the conformance role, can be further broken down into five sub-distinct roles: (1) judge, (2) catalyst, (3) watchdog, (4) confidante, and (5) safety-valve. As the 'judge', the role of directors is to judge, question and supervise executive management. Here, a director is required to provide an objective assessment of a situation and a clear evaluation of alternatives. In addition, a director is also required to provide an independent assessment of top management performance and to see board issues from various perspectives. As the 'catalyst', a director can question the board's assumptions and stimulate board meetings with new, alternative ideas and insights. In the 'watchdog role', a director places him or herself as the protector of the owners or, more often, specific interest groups for example, minority shareholders, consumers, employees and the like. A role as the 'confidante' requires a director to be a trusted and reliable counsellor in times of uncertainty and stress. As the 'safety-valve', a director's role is to act at time of crisis as a person who is able to release the pressure, prevent further damage and save the situation.

Stiles and Taylor (2001) provide a useful summary of six different theoretical perspectives on this issue: (1) agency theory and (2) transaction cost theory, both of which highlight the role of Boards as a monitor of management activities and assume that managers will potentially act in their own interests rather than those of shareholders; (3) *stewardship theory*, where managers are to be regarded as wanting to do a good job and to be good stewards of company assets; (4) *resource dependency theory*, where it is claimed that Boards link the company to the environment in order to secure resources and potentially to protect itself; (5) *class hegemony*, which adopts the view that organisations are the agent of individuals, hence the role of the board will emphasise recruiting the 'right' individuals in terms of social status and influence; and (6) *managerial hegemony*, which is based on the theory that the real running of the

organisation is assumed by corporate management (cited in Pye and Camm, 2003: 56).

In practice, there is no consensus on what the role of the Board of Directors is. Kakabadse and Kakabadse (2001) in their review of the literature state that theoretically there are three critical board roles that have been identified and studied: service roles, control roles, and strategic roles.

Some researchers contend that the importance of the Board of Directors lies not in their monitoring function for the shareholders or their advisory role for the top management. Instead, it is a function of the socio-political status of its members (Cochran and Wartick, 1997: 18). The board in this category is labelled as the 'pantheonic' board<sup>36</sup>. Hence, it is not unusual to have members of the Board chosen more for 'name recognition' than for management skills (Ibid). Mitnick (1986: i quoted in Cochran and Wartick, 1997: 18) contends that:

A peculiar feature of all or most human collective settings is the presence of a group of distinguished people in the peak position. Many such boards appear to do little or nothing substance.

However, he (1986: 49) argues that:

Organisations without pantheonic directorates are less likely to survive than those that do have such directorates. The more appropriate the pantheonic directorate, the more likely the survival.

Despite the belief that the role of the Board of Directors has changed since the mid-1980s, Bavly (1999: 82) argues that it is difficult to prove that the power of the board as compared with that of the CEO has become stronger. A certain thing that changes is the requirement that directors be

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<sup>36</sup> An example of a pantheonic board is Henry Kissinger, former US president Richard Nixon's national security advisor, who sat as a director of New Orleans-based Freeport-McMoRan Copper and Gold, which operates the world's biggest gold mine in Papua province, Indonesia. He reportedly received well over \$500,000 a year just for sitting on the Freeport board of directors from 1995-2001. He remains on the board to this day, now holding the position of 'director emeritus'. He has also been a major stockholder in Freeport and his 'consulting' firm Kissinger & Associates reportedly makes \$300,000-\$500,000 a year for acting as the company's advisor (various sources).

'financially literate'. They are expected to be able to read financial statements, to understand how to use financial ratios, and to evaluate company performance.

### **The Duties of the Board of Directors**

The duties of the Board of Directors are dictated by regulatory requirements and given that these regulations differ from country to country or state to state, such as in the US, the duties of Board of Directors may also vary<sup>37</sup>. Since it is impossible to list all of the company laws regarding the duties of the Board of Directors, this section discusses some major duties which are generally stated in the company laws. Those are:

- The fiduciary duty
- The duty of loyalty and the duty of fair dealing
- The duty of care
- The duty of supervision

#### ***The Fiduciary Duty***

The fiduciary duty is central to the role of a director. A fiduciary is someone who has legal responsibility to care for something held in trust for someone else (Blair, 1995: 56). To fulfil a fiduciary duty, directors must make decisions on an informed basis, in good faith, with the best interests of the company in mind and importantly be disinterested and independent (Jonhson et al, 1996: 412). Hence, directors must consider that the objective of the corporation is to enhance shareholders interests. According to Maw (1994: 16), a director's fiduciary duties to the company require him or her to not:

- place him/her self in a position where his/her duties as a director might conflict with his/her or his/her family's private interests;

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<sup>37</sup> The regulatory requirements can be in the form of company laws, Stock Exchange rules and regulations (for the public company whose shares are traded in the capital market) and any other regulations such as the investor protection legislations



- act in bad faith or contrary to what he/she honestly believes is in the best interests of the company; or
- exercise the powers conferred upon him/her as a director otherwise than for the particular ('proper') purpose for which those powers were conferred.

In addition, he or she must not exercise such powers for any extraneous purpose, even though he/she may honestly believe that he/she is doing so in the best interests of the company.

### ***The Duty of Loyalty and the Duty of Fair Dealing***

The basic principle of the duty of loyalty is that the director should not use his or her corporate position to make a personal profit or to gain other personal advantages; this duty 'prohibits self-dealing and the usurpation of corporate opportunities' (Johnson et al., 1996: 412-413). The duty of loyalty addresses the issues of conflict of interest, corporate opportunity and confidentiality (Sison and Kleiner, 2001: 158). With respect to conflict of interest, a director is required to acknowledge that the best interests of the company and its shareholders must prevail over any personal or individual interest. If an opportunity arises, for example to acquire property or to market new products, the director must first present it to the company. Thus, whenever a conflict of interest exists, a director must favour the company. Likewise, the director may pursue the opportunity for self-interest only if the company, after being informed of such an opportunity, decides not to pursue it (Ibid). A commonly noted conflict of interest documented in the literature is in a takeover situation (e.g., see Bebchuk, 1992). Directors of targeted company, for instance, may reject a takeover bid which is beneficial to shareholders for fear of losing their position with the firm. An example was a case between North Fork Bancorp. and Dime Bancorp Inc. where Dime's directors were accused of ignoring shareholders' interests by rejecting to North Fork's bid takeover that could increase the wealth of Dime's shareholders (see Engen, 2000 for a detail review). Last but not least, the duty of loyalty requires that directors must keep all matters involving the corporation confidential until

there has been a general public disclosure or until the information becomes public knowledge (Sison and Kleiner, 2001: 158). Breach of confidentiality may result in exposure to improper use of 'inside information' for personal gain or may jeopardise the company in terms of competitive advantage (e.g., Martha Stewart's insider trading practice).

The duty of fair dealing can be viewed as a component of the duty of loyalty, requiring that all transactions with the corporation be handled in a forthright and open manner that is fair to the interests of the corporation (Colley Jr. et al, 2003: 24).

### ***The Duty of Care***

In general, the duty of care requires a director to act in the best interests of the corporation and with the care reasonably expected of 'an ordinary prudent person.' (Colley Jr. et al, 2003: 23, Johnson et al, 1996: 412). In performing this duty, the director also has the duty to be informed and to make necessary inquiries to make him or her well-informed. One of the key skills of an effective director is to understand what is relevant and to persistently seek that information, particularly when he or she has or should have a feeling of discomfort with the situation. This duty, however, allows the Board to delegate functions to and rely on others, including other directors, officers, employees, experts, and Board committees. Hence, a director has to be able to choose competent and trustworthy managers and advisers (Colley Jr. et al, 2003: 24).

### ***The Duty of Supervision***

The duty of supervision is an element of the duty of care; it deals with the effectiveness with which directors exercise their oversight responsibilities. The duty of supervision requires directors to know about the operations of management (Colley Jr. et al, 2003: 25). As an initial step in fulfilling this duty, the Board must establish policies of ethics and disclosure that set the standards for behaviour of directors and senior executives. The Board also must ensure that there are internal controls in place to provide accurate reporting of what is going on in the corporation. This control function is generally the responsibility of the Audit Committee of the

Board. The Board also must establish policies addressing which decisions require Board approval and what information the Board should regularly receive about the performance of the corporation and its various entities (Ibid: 25)

As described by Colley Jr. et al. (2003: 25), the most important task associated with the duty of supervision is the regular meeting of the Board to discuss the performance of the organisation. One of the critical skills for a director is the intuitive sense of what needs to be questioned and the willingness to be persistent in pressing for access to relevant information. Directors must know what they need to know and insist that it be provided

### **Board Activities**

Tricker (1994) provides a simple matrix that classifies Board activities in four dimensions: inward, outward, past/present and future. According to Tricker (1994), the Board of Directors needs to focus internally on the operations of the businesses within the company and externally on the environment in which the company exists. In addition, the Board of Directors must have the ability to look forward while at the same time, to review the company's past and present performance. Central to this matrix is the fact that the Board of Directors has to work with and through the CEO.

The activities of the Board can also be viewed from three philosophical perspectives: strategic, policy making or operational which produces different outcome and benefits (Sison and Kleiner, 2001: 158). The outcome of a strategic board is an organisation with strong core values and a clear mission, understood and championed by the Board members. A Board with a strategic philosophy is concerned with what matters to their profession, industry or cause. A policy-making Board defines limitations for the staff and addresses the short-term and long-term financial needs of the organisation. This Board tends to review reports and ratify the recommendations of the executive management. An operational Board tends to take a more hands-on approach to managing the activities and programmes of the organisation. An operational Board should pay attention to the fact that an overly active Board in day-to-day management

can reduce the effectiveness of the organisation. Figure 3.3 presents a framework for Board Activities.

**Figure 3.3 A Framework for Board Activities**

Outward looking	Providing Accountability	Strategy formulation
Inward Looking	Approve and work with and through CEO	Policy making
	Monitoring and supervising	
	Past and present oriented	Future oriented

Source: Tricker (1994: 149)

**Some Boards Issues**

While the Board’s role in the company is to represent the interests of the shareholders, there are some potentially serious problems with how the Board of Directors exercises its roles and responsibilities. Hence, the failure of Board roles arguably has been at the heart of all the concerns about corporate governance.

Among the issues are directors who lack of independence from the CEO, directors who do not have the time or expertise to fulfil their roles adequately, and directors who do not have a vested interest in the firm (Kim and Nofsinger, 2003: 31). The independence of directors is hard to maintain if they have a close relationship with the company or with the management either because they are nominated by the CEO or their remuneration is dependent on the CEO’s discretion.

Some directors, especially those who are potentially good in that role, may serve on multiple Boards. According to a 1997 *Business Week* article,

several people held directorships in ten or more firms. Coca-Cola has five directors (out of 13) who serve on at least five Boards (cited in Kim and Nofsinger, 2003: 37). In addition, most directors also have their own highly demanding full-time jobs especially when they are company executives themselves.

With regard to the disinterest of Board members to company success, Kim and Nofsinger (2003: 32) quoted one director, who boasted in 1962:

If you have five directorships, it is total heaven, like having a permanent hot bath. No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company, you look grave and sage, and on two occasions say, 'I agree'.

Finally, some Boards are simply 'too big' (Ibid : 38). When there are many directors, it is more unlikely that all directors will be actively involved in Board activities. Anyone may conveniently believe that others are doing the monitoring job, and they, therefore, may feel they do not have to work as hard. In a small company, each director knows that he or she must do more work.

## **Summary**

This chapter addressed several aspects related to the roles of the Board of Directors. As the corporate governance theorists suggest, the Board of Directors is an important control mechanism to discipline managers because it links shareholders with management inside a company.

In general, there are two types of Board structure practised around the world: one-tier and two-tier. The one-tier Board structure is practiced in Anglo-American countries such as the US and the UK, characterised by having both inside directors and outside directors as members. The two-tier Board structure is largely practiced in European countries such as Germany and the Netherlands. The structure of the latter has two layers. The first layer is called the Supervisory Board and the second layer is called the Management Board. Although the structure of the Boards is so

different across countries, the limited empirical evidence available suggests that they are equally effective or ineffective at disciplining management.

In a one-tier Board structure, where the Board comprises of both executive and non-executive members, board composition and board leadership are the central issues and are widely discussed and debated in the literature. Corporate governance theorists argue that non-executive directors are more independent than executive directors. Therefore, they suggest that the Board should have more outside directors. This argument is rejected by other scholars who believe that inside directors, although considered not so independent, can provide more skills and knowledge of business to the company.

The issue of board leadership addresses the dual roles of the CEO where the CEO also holds the chairmanship of the Board. The concern is centred on the independence and the objectivity of the CEO in maintaining shareholder interests. However, the proponents of CEO duality argues that the decision making process is more effective if it is performed by one person.

Board roles can be classified into three categories: the performance, conformance, and 'pantheonic' roles. The performance role of the Board is oriented towards improving company performance through better strategic thinking and policy making and Board members are expected to bring knowledge and experience into the company. The conformance role requires the Board members to supervise management using an independent assessment. In addition, the Board members should place themselves as the protector of the owners. The pantheonic role relies on the socio-political status of the Board members to represent the company to the external parties.

In performing their roles, the Board of Directors can ask for and establish Board Committees. There are different types of Board Committees depending upon the company's needs. The most common Board Committee found in practice is the Audit Committee. This Committee, in some countries, is mandatory and required by regulations. Other committees commonly established are the Nomination and Remuneration committees.

Some issues of the Board are that they are criticised for failing to protect shareholders interests. The reasons are vary from the size which is too big, being too busy, lack of independence, to not having enough interest in carrying out his or her duty.

The next chapter will discuss the theoretical background and empirical practices of SOEs. This includes a review of the definitions and roles of SOEs, privatisation and corporate governance.

## **Chapter Four**

### **State-owned Enterprises: A Literature Review**

As long as SOEs remain in public ownership there will be continued political pressure from interest groups for special treatment (NZ Business Roundtable, 1988: 11)

#### **Introduction**

The previous chapters addressed the theoretical background of corporate governance and the Board of Directors documented in the literature. This chapter focuses its discussion on SOEs to gain better understanding on the issue under study, and serves as a basis to answer the question of 'What are the current practices of ISOEs?'

This chapter is divided into eight interrelated sections and organised as follows. Section one, two, and three of this chapter discuss the definitions, origins and rationales, and motives of SOEs. Section four and five provide reviews on the objectives and performance of SOEs. Section six discusses the concepts, debates, and methods of privatisation. Section seven focuses its discussion on corporate governance in SOEs including the Board of Directors and basic principles. The final section provides a summary of this chapter.

#### **What is a State-Owned Enterprise?**

There is no universally accepted definition of the term SOE. Mazzolini (1979) defines an SOE as a company for which the ultimate formal authority rests in the hands of the state. Aharoni (1986: 6) describes an SOE as an enterprise with a corporate identity, whose capital is wholly or substantially provided by the government<sup>38</sup>. According to Aharoni (1986), an SOE has three distinguishing characteristics. Firstly, an SOE is part of the public sector therefore, it must be owned by the government. Secondly,

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<sup>38</sup> It can be the central or local government.



an SOE is an enterprise therefore it must be engaged in the production and sale of goods and services. Thirdly, the sales revenues of an SOE should bear some relation to cost. In view of that, SOEs are 'the hybrid parts of the state' (Birkinshaw *et al.*, 1990 quoted in Thynne, 1998). As such, they have two features of both private and public sector organisations. Ramanadham (1984) uses the term 'public' and 'enterprise' for these two features. The 'enterprise' feature of SOEs is characterised by: (1) it is expected to be financially viable and (2) the price setting is related to cost. The 'publicness' of an SOE is characterised by: (1) the government leads the decision making process (2) the net benefit from the operation belongs to the public; and (3) the enterprise is accountable to society (Ramanadham, 1984). This means that they are required to execute government policies, often in the form of delivering non-commercial services (or 'community service obligations').

In practice, the two features, the 'publicness' and the 'enterprise' exist in varying mixtures in different types of SOEs. In terms of business orientation, some SOEs are profit oriented and may have characteristics similar to those of in private enterprises; for example, they operate in a competitive environment, they are regulated under limited liability company law, they are expected to produce profits and pay taxes and dividends, and they are given some independence from government control. Other SOEs are semi profit oriented<sup>39</sup> and not-for-profit oriented. They are assigned to achieve social goals or government policy objectives. Their operations are largely dependent on government funding.

From a legal perspective, SOEs can be divided into three groups (Aharoni, 1986: 14). The first group are SOEs that remain as a government department such as the post office in many countries. They receive funds from the government as part of the general budget. The employees are civil servants. The second group are SOEs established under a special law. Finally, the third group are SOEs regulated under the general company law of the country. The decision to create an SOE in either of those forms will be the outcome of many factors. Today, the SOEs legal structure can be understood within the context of policies which promote the

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<sup>39</sup> Semi profit oriented SOEs are SOEs that have to gain profit but in the same time have the obligation to provide social services.

commercialisation, corporatisation and, in some instances, privatisation of government services (Bottomley, 2000).

In their study of Canadian SOEs, Trebilcock and Pritchard (1983: 16 cited in Bottomley, 2000) point out that a policy maker deals with a three-step choice in determining the legal form of an SOE: (1) should goods or services be produced publicly or should the government rely on regulation or subsidization of, or contractual arrangements with, private sector firms?; (2) if goods or services are to be publicly produced, should production be undertaken through the departmental or corporate form?; (3) if goods or services are to be produced through the corporate form, what should be the extent of the government's ownership interest, the method of creation, the management and accountability regimes, etc?

### **The Origin of SOEs**

Fernandes (1986) identifies five reasons responsible for the impetus of SOEs:

- **By inheritance.** In many developing countries<sup>40</sup>, a substantial number of public enterprises already existed on the date of independence. They were a legacy from the colonial era. These were mainly in infrastructure and public utilities<sup>41</sup>.
- **By historical accident.** There were some extraordinary cases where public enterprises came into being, not through conscious public policy, but through historical circumstances.<sup>42</sup>
- **By nationalisation.** This is a conscious decision to take private sector investments into public hands. Nationalisation is typically driven by the desire to control the economy (Vogelgang, 1990) and it seems to be mostly governed by forces and situational demands

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<sup>40</sup> Mainly in Asia and in Africa

<sup>41</sup> In New Zealand, for example, government became involved with SOEs because of the historical fact of a colonial background and the pressure on the government to provide much of the infrastructure of the colonial economy (NZ Business Roundtable, 1988: 5).

<sup>42</sup> For example, in Indonesia the government had to take over the assets left behind by the British and the Chinese entrepreneurs who fled the country after Indonesia gained its independence.

in each country (Mascarenhas, 1982). Often the assets taken over belong to foreign companies.

- **By state entrepreneurship.** When the State emerges as an investor and entrepreneur it creates fresh capital assets and additional productive capacity. There is a significant difference between the growth of public sector by a process of nationalisation and by a process of entrepreneurship. In the first case there is only a transfer of ownership with no addition to the country's productive apparatus. In the latter case, the State is positively contributing to the creation of new productive assets.
- **By the take-over of 'sick' private enterprises.** In many developing countries, a growing percentage of SOEs are previously poorly performed private enterprises which have gone bankrupt or are on the verge of bankruptcy. For the protection of employment and maintenance of production, governments are under pressure to take over these units. This is not nationalisation in the commonly understood sense of the word. If the state had not acted the entrepreneur would have gone out of existence.<sup>43</sup>

### **The Rationales and Motives of SOEs**

One of the arguments as to why many governments establish SOEs is because SOEs can be used by governments to fulfil their expanded roles by controlling certain key sectors, filling gaps left open by the private sector, rescue operations, or dogmatic motives (Mazzolini, 1979: 12-14). In Canada, the geographic enormity, sparse population, inhospitable climate, and mercantilist capital base, commercially-oriented gave the rise to the need for SOEs as a natural means by which government could intervene in the economy 'to bind the nation (together), to develop and market its resources, and to retain some measure of the profits and rents' (Kierens, 1984 cited in Taylor and Warrack, 1998: 524). Economists traditionally view SOEs as curing market failures [Atkinson and Stiglitz 1980]. SOEs

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<sup>43</sup> This holds true to Indonesia. When crisis severely hit the Indonesian economy in 1997, many conglomerates went bankrupt and government had to bail out their businesses to prevent civil unrest caused by massive laid off.

are controlled by governments to maximise social welfare and improve on the decisions of private enterprises when monopoly power or externalities introduce divergence between private and social objectives (Shleifer and Vishny, 1994). SOEs are also claimed to be productively efficient, and charge prices that more accurately reflect social marginal costs (Ibid). Herein, SOEs are believed to have superiority over private enterprises, particularly in their capability to boost the economy and to better serve the public interest. As reported by the Australian National Commission of Audit in 1996 (cited in Bottomley, 2000),

Governments became involved in [commercial] areas for several reasons: the private sector was seen as incapable of delivering the required products or services; the community considered it appropriate that government should own a firm that operated as a natural monopoly; or the government wanted to fulfil a community service obligation (emphasis is in original).

Fernandes (1986: 220-221) identifies five motives for the establishment of SOEs. The first is the national strategy of a country. The argument is that there are certain critical areas of the economy that are too important to be left in the hands of the private sector, particularly in the area of national defence that should be in public hands. The second is the concept of 'natural' monopolies. If certain activities can be performed on a monopoly basis then the government should exercise the monopoly rights and plough back the surplus to national development. The third is the concept of 'commanding heights'<sup>44</sup>—the belief that the State can 'mastermind' the economy and promote development by control over certain infrastructural and basic economic sectors more effectively. The fourth is the facts that there are 'unattractive' investments—areas of investment which do not attract private capital—particularly in areas characterised by slow growth, high risk, low profitability and calling for massive investments for which adequate private capital is not available. As stated by Aharoni (1986: 4), the government is willing to invest in industries that have little attraction to the private sector, that is, industries that would be characterised by small profits and heavy burdens,

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<sup>44</sup> The expression used by the British Labour Party (Mazzolini, 1979: 12).

or whose investment could not be split out. Relevant to this, Kaunda (1968, cited in Ramanadham, 1984: 80) states that:

The place of government investment is where the risks were too great for private capital, or too much capital was needed and private enterprise was unable or unwilling to provide it, or the returns appeared too low for private enterprise, but the project was nevertheless necessary in the national interest.

Finally, the absence of an organised domestic private sector—in many countries this has been the prime motive of public investment. This is particularly relevant in countries where the existing private sector is foreign-owned.

Indeed, the roles of SOEs have been debated on various grounds such as ideology, political power, on economic reasoning. From the ideological point of view, socialists regard SOEs as a means for achieving social justice in a classless society and eliminating the poverty and exploitation seen as a result of profit maximisation pursuit by private enterprises (Aharoni, 1986: 45). In China, for example, SOEs are seen as the cornerstone of the socialist economic system. Therefore, Hu (1993 cited in Wang, 1994) argues no compromise should be made in this regard. From the political point of view, SOEs are essential in the distribution of power and vote-gathering mechanisms (Aharoni, 1986: 5). Herein, Waterbury (1993) argues that the preference of keeping SOEs under public ownership tends to be on a political rather than economic basis (cited in Djamhari 1996).

The economic motive for the establishment of SOEs is a pragmatic response to economic problems and stems from two standpoints (Aharoni, 1986: 2). In developed countries, governments create SOEs to promote high-technology industries<sup>45</sup> or to develop certain regions of the country in which private sector cannot provide. In developing countries, particularly in 1950s and 1960s, many governments create SOEs as part of their national programs of import-substitution industrialisation, to achieve

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<sup>45</sup> In Indonesia, the government established PT. Dirgantara Indonesia whose main task is to manufacture CN235, a type of short range military aircraft using high technology.

control of major industries previously owned by foreign companies, i.e., to preserve economic independence—particularly when these companies were considered symbols of political and social repression and economic domination, and to deliver what the government feels is required in the public interest which can not be provided by the private sector. Last but not least, the special advantages to SOEs come from low debt costs, implicitly subsidised equity finance and taxation regimes which were frequently favourable relative to private sector. The disadvantages resulted from explicit regulatory barriers restraining competition in product market which reduced the competitive discipline imposed on SOE management.

Regardless, there are large numbers of SOEs for which none of the above rationales seem to apply (Powell, 1987: 8). At issue is that many governments are responsible for managing a large number of enterprises that do not contribute significantly to employment or to wealth creation. Many of these enterprises are very small in terms of size and business operations. Such enterprises may not be effective for the implementation of government policies and only become an administrative and financial burden to the state.

### **The Objectives of the SOEs**

According to Aharoni (1986: 123), the objectives of SOEs can be influenced by three different views. The first view considers SOEs as an instrument of government that represents the national interest, therefore, the objectives assigned to SOEs would be to maximise social benefits. The second view stresses that SOEs should maximise efficiency, therefore, performance should also be measured by efficiency. Finally, the third view expects SOEs to serve different interest groups—mainly customers and workers.

The objectives to maximise social benefits may be to create employment<sup>46</sup> or maintain it, to bring in foreign currency, to be a model employer, to promote new technologies or to create employment in undeveloped regions. The objective to maximise efficiency aims at maximising profits for the benefit of the shareholders. The objective to

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<sup>46</sup> At a certain point of time, SOEs in China provide such services for more than 112 million workers and their families (Wang, n.d.)

serve different interest groups may result in the appointment of worker and consumer representatives to the Board of Directors. The last objective may cause SOEs to pursue objectives that benefit special interest groups for political motives. These objectives, according to Aharoni (1986: 4) may lead to advancing the interests of certain groups and frustrating others, or consolidating the political power of the ruling party.

However, not all SOEs establish their goals. Garner (1984: 21), for example, found that in Thailand the SOEs formulate neither aims nor objectives. In addition, the government does not provide clear objectives to the SOEs. Consequently, not having itself established SOEs objectives, the government often has to accept objectives set by others notably the international financial agencies such as the World Bank, the IMF, or the ADB mostly as part of a loan condition (Garner, 1984).

In accomplishing various objectives, SOEs may have benefited one group but injured another. In addition, these objectives would make a contribution in short run but create damages in the long run or vice versa. In New Zealand, for example, Cameron (1992: 2) states that problems of SOEs arise from (1) conflicting objectives [and] lack of monitoring performance measurement and incentive arrangements, (2) lack of authority for managers to make decisions and lack of accountability for results, and (3) performance distorted by special advantages and disadvantages in operating environments.

Cameron (1992: 3) further explains that conflicting objectives result in management having no clear basis upon which to trade-off conflicting objectives; greater difficulty in monitoring performance; and reduced transparency about where the costs and benefits of the non commercial function performed by SOEs were borne and received. In addition, there was the tendency of control departments 'to focus on inputs rather than outputs and on proposals rather than results'. Factor number two hampered managers' ability to respond to opportunities and limited their scope to rearrange their business to respond to competition.

In practice, establishing SOE objectives is not an easy task and not an assurance to the SOE's success. The reasons are varied. Firstly, the social and efficiency purposes as described by Aharoni (1986: 123) may

sometimes be complementary, independent or contradictory. Contradictory objectives, for example, present when the shareholding minister requires the SOEs to pay higher taxes and dividends by increasing the product prices whereas other ministers, whose company buys goods and services from other SOEs, require the SOE to sell their products at low prices. The minister of labour, similarly, may favour more labour-intensive programmes for the SOE regardless of the SOE's employment capacity. Yet, another minister, concerned with reducing dependence on imported technology, may seek an increase in the SOE's capital-intensive programme.

Secondly, many SOE objectives are not easily measured and there is no obvious way of balancing them one against the other. This creates monitoring difficulties. Thirdly, SOEs' objectives are rarely, if ever, stated explicitly, and trade-offs among them are not agreed (Boycko, Shleifer, and Vishny, 1996: 318). Governments, as argued by Aharoni (1986: 124), have strong political motives to keep the objectives fuzzy and ill defined and refuse any quantification of trade-offs. With objectives set out in a vague and generalised manner, different agents may invariably seek different objectives and the management may enjoy wide freedom to define goals as they like that may also lead to conflicts between the management and various stakeholders (Ibid).

As noted by Brumby, Hyndman, and Shepherd (1997), both the management and the shareholders (commonly is represented by the minister whose in charge in supervising SOEs) have limited powers to control or change the use to which a resource is put. They are unable to transfer ownership without Parliamentary consent. Herein, different parties give the enterprise conflicting objectives, which turn SOEs into political arenas. Boycko et al. (1996: 318) argue that the inefficiency of SOEs is attributable to the agency problem with politicians rather than that with managers. It is not uncommon for SOEs to address the objectives of politicians rather than maximise efficiency. For example, SOEs are often required to secure jobs for their voters instead of maximising profits (Boycko et al., 1996: 309). Hence, SOEs are often said to be created to 'pursue whatever national objectives are defined by Parliament' (Canada



Privy Council Office (1977: 22 cited in Aharoni, 1986: 141). Littlechild (cited in NZ Business Roundtable, 1988: 11), in the case of nationalisation in the UK, notes that state ownership makes political intervention inevitable:

Nationalisation was designed to achieve political ends: to redistribute income and power. *The whole purpose of public ownership is to make the allocation of resources subject to political rather than market forces.* A government which has the power to intervene cannot help but exercise it even despite its better judgement, whenever circumstances seem to require it, that is, as and when it is politically expedient (emphasis is in original).

Finally, the multiple and ever changing objectives by which SOE performance is evaluated may result in unaccountable operations of management and the Board, i.e., the accountability is lost.

In China's case, He (1991) and Guo, et al. (1992) argue that SOEs are in financial trouble not because they are inherently inefficient, but because they have borne a disproportionately large share of the social costs of system transition (cited in Wang, 1994). Herein, management and the Board of Directors can always blame the poor performance of their enterprises on the various other objectives they were asked to pursue. Management and the Board of Directors may also choose to pursue additional objectives and this variation from government objectives is hard to detect (Aharoni, 1986). Herein, the ability of the government to be a responsible shareholder is put in questions if political goals rather than profit maximisation or efficiency matters are the priority.

Brumby, Hyndman and Shepherd (1997) suggest that providing greater certainty and clarity to an SOE's Board and management should improve the efficiency of SOE governance arrangements. In particular, it could be expected to facilitate the Board and management of SOEs within clear parameters that are aligned with the preferences of the shareholders.

## **The Performance of SOEs**

The literature has documented that the performance of SOEs is generally unsatisfactory. John Moore, the Financial Secretary to the UK Treasury 1983-1986 (cited in Cameron 1992), argues that 'State-owned industries will always perform poorly and the poor performance will badly affect the economy as a whole.' A number of factors have been recognised as the contributors to the poor performance of SOEs: (1) the lack of clarity in and conflicts among their objectives, (2) the requirement to achieve both commercial and non-commercial objectives without any guidance on how to resolve conflict between the two, (3) the lack of authority of the managers to make decisions and therefore they are not responsible for the performance of SOEs, (4) the absence of incentives to perform because of deficiencies in existing arrangements for monitoring performance (Aharoni 1986), (5) the problems of incompetence or corrupt behaviour of government officers, and (6) the use of SOEs for political purposes, in favour of favoured constituencies (Perotti, 2003: 4).<sup>47</sup>

Last but not least analysts and scholars argue that governments neither have neither the entrepreneurial capability nor the comprehensive strategies to direct SOEs in which they have ownership. In this respect, a study in Russian SOEs by Kuznetsova and Kuznetsov (1999: 442) revealed that on Russia, government officials explained that government reluctanced to supervise its property because it was physically impossible to effectively manage a portfolio of shares that included thousands of different assets.

In China, SOE reform to improve their performance had resulted in several major political economy problems (Wang, n.d). The first problem is corruption of SOE managers and government officials who have rights over the SOE they govern. Managers became rich while the SOEs went into debt. Government officials also request funds from the SOEs, either for their own benefit or for their governmental agenda. The second problem is drainage of SOE assets. The contractual system resulted in the managers'

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<sup>47</sup> In Africa, for example, a number of studies have documented the poor performance of SOEs which resulted from bureaucratic and political interference in their operations (Nellis, 1986 cited in Bienen and Waterbury, 1989: 624).

short-term behaviour, when they try to make as much profit as possible during their contract term, neglecting the maintenance of the assets. The third is that SOEs became more and more in debt to the state-owned banks. The government often orders the banks to give loan to the SOEs, even though they are unable to return even the interest of the loans. Also, SOEs became indebted to each other, a phenomenon known as 'Triangle Debts' (Wang, n.d).

Other problems relating to Chinese SOEs as observed by Steinfeld (1998, cited in Wang, n.d) from 1995 to 1996 are: (1) lack of hard budget constraints. An SOE can keep running even though it is losing money. This is mostly due to political reasons. The government cannot afford to close them, as the unemployment of the work force will cause social instability, (2) lack of legally clear and enforceable property rights. In theory, an SOE is owned by all the people, and the state owns it on behalf of the people. But, in practice, various government agencies will be able to intervene in the SOE, claiming themselves as being the government, (3) lack of incentive (and discipline) structures that induce SOE managers to act in the interests of SOE owners. Since the managers are politically appointed, their career is less linked to the performance of the SOE than their political loyalty and competence, and (4) lack of management accountability also resulted in wealthy managers in money-losing SOEs

In another case, the management, the Board and the government officials 'may collude or tacitly consent to jointly expropriate wealth from the enterprises' (Lee, 1993 quoted in Mar and Young, 2001) at the expense of the public. For example, in Chinese SOEs, the 'insiders'- government officials, management and workers took the good assets of SOEs ('asset stripping') leaving the liabilities with the banks and the government (Smyth, 2000). In addition, there is a practice in which the management uses SOEs assets to fund income-in-kind (secret earning). This practice includes payments for children's tuition, entertainment expenses and travel expenses which were worth around one-third of a worker's total income (Smyth, 2000). In the mid-1990s these were estimated to be larger than the regular part of worker's salaries (Zhang, 1996: 24 cited in Smyth, 2000). Moreover, in a large number of SOEs, irregular income could be

more than twice as large as regular earnings (Smyth, 2000). Premier Zhu Rongji admitted at a conference in late 1997 that the drain on Chinese SOEs' assets was between 150 million yuan and 160 million yuan per day (Ibid).

## **Privatisation**

Privatisation is a 'fuzzy' concept (Starr, 1988) that can have 'different meanings' (Guislain, 1997: 10)<sup>48</sup>. It 'is an ugly word for a beautiful concept' (David Howell, 1970 cited in Veljanovski, 1987: 1). In general terms, privatisation can be defined as 'the withdrawal of the state from the production of goods and services' (Veljanovski, 1987: 1). Martin (1993: 11) sees privatisation as a change in the role, responsibilities, priorities and authority of the state, rather than just a change of ownership. To the public, privatisation is 'simply selling public assets to raise money to finance public expenditure' (Veljanovski, 1987: 1). In the UK, privatisation means the government sells the SOE equity of more than 50 percent (Veljanovski, 1987: 2). As in the UK, privatisation in Indonesia means that a large proportion of ISOEs equity, usually in excess of 50 percent, is sold to the public. In this sense, privatisation is the opposite of nationalisation.

Privatisation is a complex process that takes place both in the commercial and in the political market place (Veljanovski, 1987: xiii). In other words, it is not only a matter of economic process; it is above all a political process that can radically disrupt the situation of various stakeholders (Guislain, 1997: 20). The privatisation debates are influenced by theoretical perspectives on the ownership issue drawn from property rights theory (Alchian, 1965), public choice theory (Tullock, 1965) and principal agent theory (Jensen and Meckling, 1976). Private property rights is rooted on a theory that for individuals to have the rights to use, sell, and transform property they must be free to enter contracts, and these contracts must be enforced. Public choice theory assumes that even though people acting in the political marketplace have some concern for others, their main motive, whether they are voters, politicians, lobbyists, or

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<sup>48</sup> Thiemeyer (1986) identified fifteen different meanings attached to the word privatisation in a number of European countries.

bureaucrats, is self-interest. Agent-principal-theory is based on the assumption that in business sphere the agents are self-interested people who may behave according to their particular wants and needs that are different from the owners.

### ***Why Privatise?***

Privatisation has been a worldwide response to the problems associated with SOEs. It is built on the premise that government is not a good entrepreneur, and therefore ought to concentrate its resources on areas in which it has competence e.g. security, provision of social services, the so-called neo-liberal consensus. As such, it has been regarded as the solution to help reduce government involvement in business and also increase efficiency in the delivery of products and services. Hence, it has been a central component of the Structural Adjustment Programmes (SAPs) mandated by international agencies such as the World Bank and the IMF (Martin, 1993).

Over the last decade a significant proportion of privatisation transactions have been in developing economies (Cook and Uchida, 2003). In the period 1990-1999, the total proceeds around the world were US\$850 billion, growing from \$30 billion in 1990 to \$145 billion in 1999. In non-OECD countries, the proceeds were largely coming from the privatisation of infrastructure mainly in the telecommunications and power industries, followed by mining, agriculture, and forestry (Kikeri and Nellis, 2004: 89-90).

The poor performance of SOEs and the difficulties of assessing SOEs' performance in the absence of external control mechanisms suggest that privatisation is an alternative to ensure the improved performance of SOEs. Privatisation will bring SOEs under market discipline. It can be seen as the steps towards deregulation and the liberalization process that is the reduction of the state role in the economy (Bienen and Waterbury, 1989: 617) and to promote competition within an industry (Kay and Silberston 1984). The Adam Smith Institute (1981: 3 cited in Veljanovski 1987: 2) finds that:

The universal appeal of privatization lies in the fact that it is ...an approach, which recognizes that the regulation which the market imposes on economic activity is superior to any regulation which men can devise and operate by law. It is an approach which recognizes that the market measures, and responds to, the choices and preferences of people more accurately than the political process. A programme performed by the private economy can be done more efficiently, more cheaply, and with greater satisfaction to its beneficiaries than its counterpart can achieve in the public sector.

Suleiman and Waterbury (1990: 3-4) state seven reasons for the government to privatise SOEs:

1. The growing size of the public sector is judged to have reached an excessive level that leads only to inefficiency;
2. Privatised companies will be better managed and better financed through the capital markets than through the state budget<sup>49</sup>;
3. Privatisation contributes to the development of financial markets and hence can finance new and growing enterprises. It leads to increased availability of funds for industry<sup>50</sup>;
4. Privatisation leads to a substantial increase in the state's revenue from the sale of equity;
5. Increase in the state's revenue can lead to the lowering of taxes and to the use of the available funds for specific political purposes;
6. Privatisation can promote broad-based share-holding in society and so be a safeguard against societal disorder; and
7. The state in the 'new participatory capitalist system' may help to detach workers from trade unions; and a weakened trade union movement may help dampen demand, increase investment, and facilitate adjustment.

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<sup>49</sup> The only objective of the British privatization program was to enhance the profitability and efficiency of the SOEs.

<sup>50</sup> The primary purpose of privatization in Czechoslovakia was not to increase the efficiency of SOEs, but to create market structures to encourage private businesses. The market forces would drive the capital markets which in turn enable individual companies to measure their performance through market indicators and improve by increasing efficiency (Jezek, 1997)

Another scholar, John Nellis (1994: 2), states five factors, which different from the above, why privatisation is necessary. Firstly, private ownership establishes 'a market for managers' that lead to higher-quality management. Secondly, 'capital markets put private enterprises to greater scrutiny and discipline than they do public enterprises'. Thirdly, 'private enterprises are subject to exit much more often than public enterprises.' In addition, private enterprises are more subject to bankruptcy, liquidation, hostile takeover, and closure than SOEs. Therefore, the owners and managers will take active actions to avoid such risks. Fourthly, 'politicians interfere less in the affairs of private than public enterprises.' Fifthly, 'private firms are supervised by self-interested Board members and shareholders, rather than by disinterested bureaucrats', and are thus more likely than public enterprises to use capital efficiently and to maintain it.

In the UK, the government claims privatisation enhances individual freedom, encourages and improves efficiency, makes industry more responsive to the demands of the customers, decreases public debt and weakens the power of the trade unions by forcing management to face the realities of the market place (Veljanovski, 1987: 2). In addition, it creates shareholder democracy by giving a large number of small shareholders a stake in industry. In New Zealand, the Treasury office (1987 cited in NZ Business Roundtable, 1988) suggests that '... state ownership is likely to give directors and managers of SOEs inappropriate and inadequate incentives to act strictly commercially.' Likewise, Standard and Poor's Australian Ratings in 1992 made the point in the context of the New Zealand experience relating to privatisation. It says,

The necessary final stage in the process of improving public sector efficiency in New Zealand is therefore seen as privatisation. Only in this way might it be possible to realise ultimate efficiency gains and to ensure that benefits achieved by corporatisation are not reversed in time (quoted in NZ Business Roundtable, 1992: 12).

Meggison, Nash, and van Randenborgh (1994) who conducted a study comparing the pre- and post-privatisation financial and operating performance of 61 companies from eighteen countries in 32 industrial

sectors found that there were strong performance improvements after being privatised in terms of increased real sales, greater profitability, increased investment spending, improved operating efficiency, and increased in work forces. In terms of corporate governance, Megginson et al. (1994) found significant changes in the size and composition of the Board of Directors. Boubakri and Cossett (1998) analysed the performance of 79 newly privatised SOEs in 21 developing countries found significant increases in profitability, operating efficiency, capital investment spending, and employment, and a decline in leverage. Herein, once SOEs become 'small islands in the sea of the private economy,' they will be compelled to behave like other economic agents in the market' (Wang, 1994).

### ***The Privatisation Debate***

Not all people support privatisation. The reasons are varied from (a) the preservation of national sovereignty or independence; (b) the desire to retain control over certain activities or interests perceived to be strategic; (c) the sense that state ownership is needed to safeguard the 'public interest', (d) the fear that wealth might become concentrated in the hands of a few private parties; (e) a distrust of the private sector or certain segments of it, to (f) the protection of bureaucratic or other vested interests (Veljanovski, 1987: 21). Point (a) is particularly true in the Third World where privatization of SOEs often means denationalization—as a transfer of control to foreign investors or managers (Starr, 1988). At issue is that it opens the possibility for the market and private sector to manipulate the market, especially in sectors vital to economic and social development. Martin (1993: 11) asserts that 'Privatisation is not a matter of change ownership but a change in the role of the nation-state.'

In the UK, a country where privatisation programme is considered successful, the government in fact is criticised on several issues (Veljanovski, 1987: 10):

- the government has no single coherent strategy or set of consistent priorities;
- privatisation without competition does not yield obvious benefits;



- the government has not done nearly enough to promote competition;
- the government has sold off public assets cheaply.

The accusation that the government has no coherent strategy is evidence by the fact that government was late in setting out a timetable for privatisation programme and pursues a number of conflicting objectives that are not based on a sophisticated rationale. This resulted in the lack of consistent priorities (Veljanovski, 1987: 11) and lack of any clear analysis of purposes or effects (Kay and Thompson, 1986: 19). Therefore, no objectives are effectively attained.

The empirical evidence shows that private enterprise performs better than SOEs in comparable industries is ambiguous, largely because there are insufficient examples of both operating side by side. Kay and Thompson (1986: 22) provide some aspects that may bias comparisons of efficiency; such as the non-commercial objectives of SOEs and the requirement to purchase more expensive domestically products.

The following are examples of the failures of privatisation programme. Firstly, British Rail has been effectively repossessed by the British government and many similar companies are at risk of having their concession removed on the grounds that they fail to provide adequate services (Wikipedia, 2005). This fact may have contributed to the latest British government policy that will no longer urge poor countries to privatise large swaths of industry or open their markets to foreign trade overnight as a condition for receiving development aid (Seager, *the Guardian* March 2, 2005). In Argentina, privatisation rapidly impoverished of the government. Revenue streams which could previously be directed towards public spending suddenly dried up, resulting in a severe drop in government services. More importantly, the World Bank, historically a supporter of denationalization in developing countries, has also begun to voice concerns over privatization. It no longer believes that privatization should be recommended in all cases (Wikipedia, 2005). To the opponent of privatisation, whether or not privatisation will generate benefits and whether the regulatory system will provide adequate protection for the

consumer remains, at the moment, is an un-provable assertion (Veljanovski, 1987).

### ***Privatisation Methods***

The literature documents several privatisation methods that were commonly chose by governments around the world. Those methods include contracting out a business that is currently publicly provided, sale of a company to a single enterprise or consortium using a competitive bidding process, a placement with a group of investors, a public offering at the stock exchange, gifting the shares to citizens, or a management or employee buyout. Privatisation may include the sale of some or all of an SOE's assets. In Czechoslovakia, the government used a mass-privatization program of distributing vouchers to the public with the objective to transfer a large number of SOEs to the private sector as quickly as possible (Jezek, 1997). In sum, privatisation includes activities that range from selling SOEs to contracting out public services with private contractors. It is the opposite of nationalisation.

According to Fang (1993, cited in Wang, 1994), different methods of privatisation should be used to deal with different types of SOEs. As such,

- SOEs should be allowed to keep their dominant position in areas where natural monopolies are likely to exist or externalities are pervasive.
- The government should gradually 'withdraw' from areas in which SOEs are competing with non-state enterprises by reducing and eventually stopping its investment in those areas.
- Even in the areas where the government is obligated to provide public goods, it should try to contract out such publicly financed services to the private sector, instead of solely relying upon state-owned organizations to perform those functions.

### ***Corporate governance in SOEs***

As discussed above, the government is the sole owner of SOEs on behalf of society and, hence, ownership is not widely dispersed among individual

shareholders. Government is a unique owner because it has the power to make laws affecting both private companies and SOEs. In SOEs, corporate governance rests with the government's discretion, the legal system of the country, and types of SOEs. The need for a Board of Directors depends on the size and organisation of an SOE. A simple and small SOE may not require a Board of Directors. In SOEs, that have complex organisation and have the legal form of limited liability company, the corporate governance structure consists of the Shareholders General Meeting that has the highest power in the decision making, the Board of Directors and the Board committees, and the Board of Management.

Having government as the single owner of SOEs, it may seem that there will be no agency problems because government has the power to control and monitor the managers of the SOEs, i.e., there is no separation of ownership and control. However, the agency problems in the SOEs are much more complicated than those of in private enterprises because an SOE is not only a set of contracts among factors of production but also a loose coalition of various agents which comprise of the managers, the Boards, government ministers, bureaucrats, labour unions, members of Parliament and others (Aharoni, 1986). These agents may have conflicting objectives and self interests that may detriment the performance of the SOEs.

SOEs are not exposed to external control mechanisms such as a market for corporate control which result in takeover, litigations (from debt holders), bankruptcy, competition and a market for managers and directors that can be used to discipline the agents. SOE's shares are not traded in the market; therefore, there is no external mechanism for the public to assess the performance of SOE managers. Hence, the government has to rely heavily on the internal control mechanisms functioning in the SOEs, the Board of Directors.

Market for corporate control exists when an enterprise sells its shares in capital markets. Because shares can be traded, the share price will tend to reflect all available information held by market participants on the performance of an enterprise. This in turn reflects of the value of decision made by its managers. If the shareholders are unhappy with the

performance of the enterprise, they can replace the managers with others who can perform better.

The market for managers and directors is used as a control mechanism to ensure that individual managers and directors will act in accordance with the shareholders' interests. Poor performance of an enterprise (showed by the low profits or loss, low share price) will give a signal to the shareholders and other stakeholders that the managers and directors are underperforming and this will impact to their reputation, remuneration, position and job opportunities if the enterprise is bankrupt or taken over by another enterprise. In terms of ownership control, if it is assumed that the ultimate owners of SOEs are society, they are too dispersed and powerless to exercise monitoring roles. Clarke and Porter (1982, in NZ Business Roundtable, 1988: 23) explain as follows:

First, each citizen is in a free rider situation; the benefits of any individual action intended to increase the value of the firm accrue to all. Unlike private ownership, an individual cannot appropriate returns to his superior ability as an owner by increasing his equity in a state enterprise. His equity, and consequently his gains as an owner from a change in corporate policy, must remain small. Second, in a majority rule system, in which governments are elected on the basis of a package of policies, the voices of individual voters on particular issues carry little weight. To pursue such issues, complex coalitions involving considerable negotiating and enforcement costs often need to be formed. Third, it is very costly for an individual to obtain information about how the enterprise might be better run. There are not always market incentives for the provision of information as there are in private enterprise. Fourth, because the individual cannot sell his equity in the enterprise, management will not receive information on the market's grading of its (relative) performance, which is in the private sector concisely expressed in (relative) share prices. For these reasons, incentives are few for individual 'shareholders' in publicly owned enterprise to attempt to increase the value of the enterprises (emphasis is in original).

The continued role of government involvement as the owner of SOEs sets up a conflict of interest between the government as controlling shareholder and other stakeholders. In using its control for purposes other than value maximisation, the government may exploit minority

shareholders who have no other way to benefit from their investment. The example of this case is provided by one of the interviewees participate in this study. He says:

PT Timah has minority shareholders who reside overseas and so does PT BNI that has minority shareholders in Indonesia. However, when government decided to carry out corporate governance evaluation in ISOEs, it did not inform and ask the minority shareholders whether or not they agreed with the government evaluation programme (P04, September 2003)

Keeping the above in mind, Aharoni (1986: 132) states that the complex relationships between the SOE and its environment cannot be solved by an optimal contract since the optimality characteristics are ill defined.

### ***The Board of Directors in SOEs***

The non-existence of a market for corporate control in SOEs makes the government relies on the internal control mechanisms of SOEs, such as Board of Directors, to maintain and develop SOEs performance. The Board is the most important organ in the SOEs. As argued by Robson (1962: 212):

The governing board occupies a position of crucial importance in the direction and management of a nationalised industry. The success or failure of a nationalisation is, indeed, likely to depend more on the quality and composition of the boards directing the public corporations than any other single factor (quoted in Aharoni, 1986: 308)

However, there are as many opinions on the role of the Board of Directors as there are on the question of the role of SOEs in society. Since the Board is expected to monitor and supervise the enterprise, the points of view on its role depend on the beliefs on the role of the SOEs. According to Aharoni (1986: 307-308) there are two extreme opinions relating to the role of the Board of Directors in SOEs. One of these opinions is that a Board is not needed. The reasons are firstly, if an SOE is believed to be

mainly a policy tool in the hands of the government, it is sensible to claim that a Board is not needed. Secondly, if a Board is legally required, it should be staffed by the minister as chair and representatives of the minister as members.

The 'no-board' in the SOE, as documented by Fernandes (1986: 122), was practiced by the Sri Lankan government when it appointed 'competent authorities' to manage certain SOEs. This arrangement is generally applied in SOEs of a transitional character, pending decisions on the final legal status of the enterprises. The advantage of this arrangement is it allows for speedy decisions, unhindered by often laborious discussions and delays involved in Board meetings. The disadvantages of the no-board are four fold: (1) it places too much authority and responsibility on one person, (2) it leaves the fate of enterprise entirely dependent on a person's competence and integrity, (3) it does not allow for participation of top management, (4) it makes no provision for outside opinion, and (5) it makes the sole controller vulnerable to illegitimate pressure (Fernandes, 1986: 122). In Indonesia, the no-board practice was once practiced in Pertamina before it was hit by a huge debt crisis. Ibnu Sutowo as the CEO of the enterprise at the time reported directly to the President. The crisis in Pertamina forced the government to pass Law No. 8/1971. The important issue of this Law was the establishment of the Board of Directors to monitor the company operations onwards.

The other extreme point of view of the role of the Board stresses the autonomy of the SOE and the need to isolate it from political intervention. Herein, the Board is expected to act as a buffer between the supervisory ministry (and other ministries) and the SOE's top management. The accountability of the Board is to the company, not to its shareholders or the minister. Each director should be a trustee of the company and the Board should be composed of persons with business experience who are not dependent on ministers. In addition, the Board should be allowed to take into consideration other interests only if they are for the good of the company. Neither extreme, Aharoni (1986: 308) argues, takes into account the hybrid nature of the SOE. The first sees the SOE only as a government

instrument. The second sees the SOE only as an enterprise selling its output.

The roles and how the Board is managed will be influenced by a variety of other factors including specific company law requirements, the nature and significance of the company's work, and the extent to which the government sees a need to keep a close watch over what the company is doing (Thynne, 1998). Accordingly, there are some questions which need to be addressed by government both when establishing the Board and when seeking to assess its performance: (1) whether the Board is there to represent various interests within the company, or to concentrate its focus on the commercial aspects of the company, (2) whether the Board does, or ought to, include the chief executive officer (CEO) of the company and maybe one or two other senior managers, so that there is some kind of balance between executive and non-executive members and a corresponding balance between full-time and part-time members, (3) whether the position of chairperson is or should be separate from or fused with the position of CEO and (4) whether or not politicians and/or government officials are, or ought to be, members of the Board (Thynne, 1998); and, if so, what is the significance of their having monitoring responsibilities on behalf of the government or parliament? The response to these questions may vary. According to Peres (1968 in Thynne, 1998), on the one side, people may argue that the presence of politicians and government officials on a Board will significantly reduce the operational autonomy of a company and thus impede its ability to act commercially. However, on the other side, it can be argued that it might actually lock the company into vital networks and sources of information within government that it would otherwise be largely cut off from, and this could well serve to bolster its productivity.

Fernandes (1986: 126) suggests that the government needs to be careful in nominating Board members because this is not only a question of prestige. There is a more significant implication. If these nominees are truly 'representatives' of government, they must have the necessary authority to discharge their functions. They should be in a position to convey clearly to the enterprises the policies of government and to commit

the government when they support Board decisions. Too often one finds that government 'representatives' participate in Board discussions and then reserve the right to obtain 'government approval'.

In most oil-producing countries, the Board includes several ministers and major strategic decisions are made by the Cabinet or by the head of state. The state bureaucracy often perceives the national oil company as a 'state within state' (Grayson, 1981; Philip, 1982; Feigenbaum, 1985 cited in Vernon and Aharoni 1981). In India, about 60 percent of the Board members are government officials, and many listed as non-officials are retired government civil servants, ex-ministers or defeated politicians. These selection criteria create Boards of Directors that are extremely vulnerable to government interference. The same pattern is found in many other countries. (Aharoni, 1986: 310). In describing the Board of parastatals in Africa, Ghai (1977, cited in Aharoni, 1986: 310) writes:

The civil servants who sit on the boards are senior bureaucrats, who can devote only limited time to the affairs of the parastatals.... Decisions are made more by the circulation of the file, which collects marginal comments as it winds its way around the corridors; initiative and aggressive policies are shunned in favour of caution and indecision; and there is undue emphasis on procedure at the expense of substance. The problem is aggravated by the rules whereby success is defined and rewarded, for these too travel over from the department, so that the important consideration becomes the avoidance of risk and possible mistake. Promotion comes in due course if nothing untoward (albeit nothing spectacular either) has happened.

In many countries, as noted by Aharoni (1986: 310), Board members represent some specific constituent group. They do not have time to learn the intricacies of the business and are not interested in devoting the time. These Board members measure their effectiveness in terms of the concessions granted to the group they represent. If they represent the farmers on the Board of an electricity company, lower rates to their constituency are a measure of success as a director.

In practice, a change of government is often followed by a massive change of SOE directors. Phatak (1969) cites a study in fifty-three SOEs



studied, to which 72 percent of the Board members had been replaced in a 3-year period by new members; over a 5-year period, 86 percent had been replaced. The average tenure of Board members is only 14 months, whereas in the private sector the average tenure is more than six years. In one Indian SOE, Hindustan Machine Tools Ltd., eleven board appointments lasted less than a year (cited in Aharoni, 1986: 311)

There are some problems attached to the Board of Directors in SOEs. Firstly, similar to management, the Board of Directors is lack of incentive to monitor management efficient and effectively because they have no wealth invested in the company and no rights to profit sharing. Here, SOEs are controlled by bureaucrats with control rights but with no formal ownership. In addition, they are neither rewarded for good nor penalized for bad performance. In China, for example, the concept of the 'iron rice bowl'<sup>51</sup> ensured that bureaucrats would keep their job even if they failed to adequately fulfil their duties (Andrews & Dowling, 1998 in Mar and Young, 2001).

Secondly, positions on Boards of Directors in SOEs are invariably less well paid and less sought after (Collin, 2004). Hence, to gain benefit from the SOEs, the management, the Board and the government officials who are in charge in managing the SOEs can increase the size of the enterprises or maximize budgets because it means higher salaries, greater power, and more perquisites (Aharoni, 1986; Starr, 1988). This practice will result in higher government spending overall, inefficient allocation among government agencies, and inefficient production within them (Starr, 1988).

Thirdly, members of the Board of Directors are often appointed for political or other reasons, rather than their qualifications for the job and may not be the best persons to manage the company effectively (Mar and Young, 2001). Hence they are subject to political patronage (Collin, 2004). The advantage of having members of the Board with political affiliations and contacts is easy access to government policies and decision making processes.

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<sup>51</sup> The 'iron rice bowl' is a concept used in China whereby workers are guaranteed a job with benefits, housing and free medical care for life (Wang, 1993).

Fourthly, because the Boards of Directors are regarded as representative of ministries and they may have authority in their role as government officials to approve the SOE's budget or to procure its products, management often withhold information from them and try to avoid giving this person too detailed data, fearing the information gained will be used in the negotiations on prices paid by the ministry.

### ***Corporate Governance Principles***

As previously discussed in Chapter 2, there are certain principles to ensure good corporate governance practices. These principles are accountability, transparency, and independence. Being publicly owned, SOEs are expected to be operating in accordance with government policy and accountable to both the government acting as the shareholders and the public as the stakeholders. In addition, SOEs are also expected to disclose publicly details of operations and financial conditions. Mako and Zhang (2004,) in their study on Chinese SOEs, argue that since SOEs are owned by all citizens they should be treated by SOEs in the same way as public limited liability companies treat their shareholders, in terms of information disclosure and transparency. With this respect, the OECD calls on governments to improve transparency by strengthening internal controls, carrying out independent, external audits based on international standards, disclosing any financial assistance from the government and producing aggregate performance reports.

However, implementing such principles in practice can be problematic. Accountability, for example, can be judged by different criteria (Bottomley, 2000). Firstly, an SOE might be said to be accountable if it provides accurate information about its financial activities (and possibly its performance) when it is required to do so. However, the demands of accountability and transparency may conflict with commercialisation because an SOE may want to keep commercially sensitive information confidential rather than disclosing it to the public or in a Parliamentary forum. This problem is worsened if, on a stronger view of accountability, an SOE is required to explain or justify its business

plans to Parliament. Secondly, privatised SOEs have an obligation to fulfil the varying requirements of different accountability audiences even if the people involved are the same. For example, if the shareholder of the SOE is a Minister and the Board of Directors and the executives of the SOE are government officials; their accountability to the Minister may be similar to that of other government officials to the Minister. It means that no separate accountability obligations should be applied. However, the fact remains that the director occupies dual roles with each role attracting different accountability issues. Thirdly, there is an issue as to when the accountability requirements should apply. Different accountability timeframes will apply depending upon who the accountability audience is, and on the method by which that accountability is conveyed. For example, accountability of SOEs to the public will be after the event, while accountability to the portfolio Minister will require disclosures of policies before they are implemented by SOEs.

According to Bottomley (2000), one of the principal methods for ensuring the accountability of SOEs has been to place them within the general structure of ministerial responsibility to Parliament. In simple terms, this means that staff of a SOE is accountable to management who are in turn accountable to the Board of Directors. The directors are accountable to the relevant portfolio minister who, in turn, is accountable to Parliament for the performance of SOEs in that portfolio. Problems can arise at different points along this accountability chain. For example, if a director is appointed from the Minister's department, conflicts may arise between the director's autonomous duty to the company and his or her obligations to the department.

## **Summary**

This chapter discussed several aspects of SOEs including the concepts, objectives, roles, performance, and corporate governance systems. As discussed above, an SOE has two features, the 'publicness' and the 'enterprise'. The 'publicness' demands SOEs to pursue social objectives while the 'enterprise' requires SOEs to operate like private enterprises, i.e., in an efficient manner so that they are able to gain profits for the benefit of

the shareholders. These two features in practice can create problems especially if the government does not provide clear objectives to SOEs. The Board and management can always find ways to get away from bad performance, for example, by blaming the unclear objectives.

The literature documents that the performance of SOEs is mostly poor. The reasons are varied from having to pursue multiple and conflicting objectives without clear performance measurement, to lack of authority and accountability. To overcome these problems, many governments privatise SOEs. Privatisation is selling public assets to the private sector. There are pros and cons of privatisation. People who support privatisation argue that privatised SOEs will be better managed and financed and will result in a substantial increase in government revenue. Consequently, it will increase public wealth. Therefore, some argue that privatisation should be the only solution to overcome problems in the SOEs. For those who are against privatisation, they argue that privatisation will lead to foreign and multinational companies dominating the country's economic development, which may not be beneficial to the society at large. In addition, the findings of studies that show private companies to have better performance than SOEs are inconclusive.

The enterprise nature of SOEs results in governance structures similar to that of private enterprises. The governing bodies of SOEs can consist of the Board of Directors and the Board of Management. Since the government is the only owner of the SOs, it may be perceived that there are no corporate governance problems in SOEs or if there are, the problems are very little. The fact is corporate governance systems in SOEs are more complex because SOEs are loose coalitions of different groups who have different interests. A political party may see SOEs as its source of cash to finance their political campaigns. Boards of Directors and management may use SOEs for their own benefits, to become richer. The government needs SOEs for their taxes and dividends to support government budgets. The public needs SOEs to provide quality goods and services that are cheap. With so many interests that the SOEs have to serve and without clear objectives, the Board of Directors and the

management will find it difficult to run SOEs and it will result in poor performance and loss of accountability.

## **Chapter Five**

### **Research Methodology: Carrying Out the Research**

When your study is to find out what people believe or think, the easiest and most effective method is to ask questions directly of the person. The purpose of asking questions is to find out what is going on in the heads of the subjects: their perceptions, attitudes, beliefs, feelings, motivates, plans, past events, and recall

(Brink and Wood, 1988: 146)

#### **Introduction**

This study is about corporate governance in Indonesian State-owned Enterprises (ISOEs). The main objectives are to examine the current state of corporate governance practices in ISOEs and the roles of the Boards. The purpose of this Chapter is to describe the research methods employed in this study and how the methods were applied in the field. In doing so, I divide this Chapter into five sections. The first section commences with an explanation of the data collection methods, sampling techniques and the sample employed in this study. The second section continues with a discussion of the qualitative interview as the primary data collection technique used in this study. In addition, it includes a discussion about how the information gathered from the interview was analysed. The third section presents the ethical issue inherent in this study and how to deal with this issue. The fourth section presents my experience from the fieldwork. Last section provides a summary of this Chapter.

#### **Data Collection Methods**

As previously explained in Chapter One, corporate governance is a new phenomenon to Indonesia. Therefore, it appears that very little is known

about corporate governance and to my knowledge, there has been no academic study conducted on corporate governance in the ISOEs. Having said this, this study is exploratory in nature and aims to 'clarify and define the nature of a problem' (Zikmund, 1997: 102).

Most exploratory research is not quantitative research and much of this research provides qualitative data (Zikmund, 1997: 102; Creswell, 1994: 146). Considering the objectives and the research questions being asked in this study, a combination of qualitative and quantitative methods was used in collecting data in order to take advantage of the strengths of the two research methods. White (2002: 9) states different methods are required to tackle different problems, and a combination of techniques will frequently yield greater insight than either one used in isolation.

### ***Quantitative Research***

The important characteristic of quantitative research is that it can be verified and replicated by other researchers; therefore, this research method is considered objective, representative, and scientific (Overton and van Diermen, 2003: 38). In quantitative research, the data can be gathered through four primary techniques: observations, questionnaires, structured interviews and the use of secondary data (Ibid: 39).

In this study, the quantitative data were collected from various sources such as government reports and other official statistical data, legal documents, the ISOEs' annual reports, the performance and financial audit reports of the ISOEs, the ISOEs' Master Plans, and the corporate governance evaluation reports in several privatised and non-privatised ISOEs. The quantitative data were as important as the qualitative data in that they provided information relating to the development and performance of ISOEs over time. As Brockington and Sullivan (2003: 70) state, qualitative methods could embrace quantitative method and use them for different and more nuanced purposes.

### ***Qualitative Research***

Qualitative research is intended to capture reality of people's subjective experience by asking them about it and then listening carefully to what

they say (Auerbach and Silverstein, 2003: 23). This type of research is interested in meaning—how people make sense of their lives, experiences, and their structures of the world (Merriam, 1988 in Creswell, 1994: 145). Patton (1990: 22) defines qualitative data as 'detailed descriptions of situations, events, people, interaction, observed behaviours, direct quotations from people about their experiences, attitudes, beliefs, and thoughts and excerpts or entire passages from documents, correspondence, records, and case histories'.

There are seven data collection techniques that are commonly used in qualitative research: (1) interviewing, (2) focus groups, (3) conversation and discourse analysis, (4) fieldwork diaries, (5) life histories and oral histories, (6) photographs, film and video and documents, and (7) participant observation (Brockington and Sullivan, 2003: 58-59). In this study, I used in-depth interviews as the primary data collection technique for qualitative data. In the literature, interview is argued as the most common and powerful way in which we try to understand human beings (Fontana and Frey, 2003: 62). It is a complete data gathering tool for obtaining in-depth knowledge of the subject under study. In line with this, it has been said that we live in an 'interview society' (Atkinson and Silverman, 1997 in Fontana and Frey, 2003: 63).

The reliance of this study on the analysis of in-depth interviews with selected individuals was due to the general unfamiliarity of the corporate governance issue in Indonesia. As it mentioned earlier, the notion of corporate governance was a new phenomenon and not many people really understood the concept, therefore, the use of a survey or mail questionnaire would not effectively capture perspective on corporate governance particularly in the ISOEs. The choice of this method was also based on other factors such as the availability of time, funding and the participants relevant to this study.

In addition to the in-depth interviews, another source of data in this study came from various documents such as presidential and ministerial speeches, public opinions in the mass media (newspaper and magazines, television), and on the internet. The rationale for using the mass media is three-fold. Firstly, corporate governance was an issue that frequently



appeared in the mass media. The opinions on the issue mostly came from politicians and academics that, to a large extent, had a big influence in shaping public and government views. Secondly, in a society where the intelligentsia had produced relatively few scientific journals or books on the subjects, the bulk of information on corporate governance contained in Indonesia's leading daily newspapers, television, and the internet was too valuable to disregard. Thirdly, although one could not be certain of the quality of information from the mass media, much factual information could be compared against other data obtained, for example, from the in-depth interview process. Hence, the advantages of those sources of information outweighed their shortcomings. The information obtained from the mass media was in the form of discussion or an open debate on the topic.

### ***In-Depth Interviews with the Elite***

For the purpose of this study in-depth interview with the 'elite' was employed. As suggested by Heracleous (2001: 169), behavioural observations and in-depth interviews in corporate governance research are useful to identify behaviours that matters and that point to, for example, higher Board vigilance or other concepts being measured. By definition, the 'elite' represents individuals or groups who belong to the top echelons of society. They are integral part of every community, government, occupation, and religion, as well as of other institutional spheres (Mills 1956 and Pareto 1935 in Odendahl and Shaw, 2002: 299). In this study, the 'elite' was determined by whether or not they fit the sample characteristics established in this study that are: position, reputation, experience, knowledge, and influence.

The reason for using the 'elite' interview was because regardless of the frequent published information on corporate governance in the government reports or in the mass media, the vast majority of people had very little knowledge of the issue. Hence, only a small number of people, mainly those who were in power and in positions of authority, had the knowledge, understanding, and direct access to the topic under research. As noted by Odendahl and Shaw (2002: 299), elites generally have more

knowledge than others. In this study, the 'elite' was comprised of high-rank government officials, members of Boards of Directors and management in the ISOEs, prominent academics, professionals and financial agency staff who had, as noted by Gillham (2000: 81), 'a privileged position as far as *knowledge* is concerned'.

### ***The Interview Guide***

Better results on the multi-dimensional aspects under study were gained by providing the interviewees with the opportunity to approach the issues using their own perspectives. Therefore, a semi-structured interview questionnaire with open-ended questions was considered to be the most appropriate technique. Open-ended questions were used to ensure that adequate answers could be given and gave the participants the freedom to answer creatively and not be limited by the options available in the cases of closed questions (see Neuman, 1997).

I developed an interview guide that consisted of six major questions. These major questions were then broken down into sub questions for clarity, for probing or for transition to subsequent questions. The questions were developed as such so they were not too 'textbook' based. The reason was the newness and the limited source of academic references on the topic under study in Indonesia. Having said this, participants might have had difficulty in providing theoretically based answers. Hence, as my supervisor noted, any attempt to find academic answers from the participants with pragmatic thinking might be unrealistic. In addition, to fit the characteristics of the participants, I delivered the interviews with slightly different questions for each different group of participants. For example, to government officials, ISOE executives, and commissioners or supervisors I focused the questions on the government and the ISOEs' roles in corporate governance initiatives. In contrast, I asked the participants outside government offices on how effective government was in promoting corporate governance initiatives. The answers from both sides would provide balanced information on the topic under study.

All questions in the interview guide were specifically developed for this study because there was no available questionnaire that had been

developed to examine the issues under study in the Indonesian context. The interview guide is presented in Appendix A of this study.

## **The Sampling Techniques and the Sample**

### ***The Sampling Techniques***

This study did not use random sampling techniques because the elite for the purpose of the in-depth interview were 'too rare' (Neuman, 1997: 337). In contrast, I used a combination of purposive sampling and snowballing sampling in selecting the participants. Purposive sampling 'occurs when the researcher makes a judgment on whom to include in the sample' (Overton and van Diermen, 2003: 43). The advantage of purposive sampling is that, as noted by Maykut and Morehouse (1997: 45), it increases the likelihood that variability common in any social phenomenon will be represented in the data. In this study, the variability came from the various backgrounds of the research participants.

The purposive sampling method, in my judgement, was an appropriate method to select the initial sample. The reason was because the individuals whose background were known and who were directly involved in promoting, administering and monitoring the corporate governance of ISOEs would provide better knowledgeable answers to the research questions of this study than others who did not. Their perspectives on the issues under research would provide significant outcomes to the research results. In addition, this technique satisfactorily met the research objectives and went well with the cost and time constraints inherent in this research.. Here, the emphasis of this study was to obtain better understanding on the topic under study rather than generalizability of the research findings.

Snowball sampling occurs when the sample cannot be determined in advance because the researcher does not know how to locate the people or they are 'hard-to-reach'. This sampling technique was utilised in this study because I anticipated that there were certain individuals who had the authority in the area under study whom I was not aware of in advance or due to their high status or position in the community I could not contact

them directly. Odendahl and Shaw (2002: 307) state 'Candidacy for elite interview often cannot be planned for adequately in advance of the project; rather, it emerges as part of the fieldwork'. Another use of snowballing sampling techniques is, as Bouma (2000: 122) notes, to 'gain access to certain types of people or to a particular group'. One of the major issues confronting researchers in the area of corporate governance has been limited access to individual Boards of Directors (Pye and Camm, 2003: 57).

### ***Implementing the Snowball Sampling Technique***

In the field, an additional sample using snowball sampling technique was necessary. This was because there were key individuals important to this study whom I was not aware of before I did my fieldwork. Consequently, they were not included in the initial sample. This additional sample was built based on the information provided by participants in the initial sample about some people who potentially met the criteria for the inclusion into the sample. In addition, I also obtained the same type of information from other people who did not participate in this study but who have been very supportive in assisting me. As Scheyvens, Scheyvens, and Murray (2003: 185) stated, 'The use of network is an important way of achieving access and gaining the cooperation of interviewees.'

Based on this information, I reached those individuals in two ways: (1) I contacted them directly (by phone, fax, or an email) and I asked for their participation, or (2) I asked the individuals who provided me with the information to introduce me to the targeted participants. The latter was found to be particularly effective to reach certain people who had high status, for example, high rank government officials and prominent business executives. This is to say that a simple phone call to the 'hard to reach' people from their acquaintances describing me and my research purpose was sufficient to encourage their willingness to participate. As stated by Neuman (1997: 338) 'Elites will use who you know, who talked to you, and who introduced whom as signs of approval or endorsement.'

In all cases the criteria for selecting the participants in this study were applied. This is to say that I did not conduct interviews with individuals who did not fit with the criteria and the objectives of this study.

The reason I mention this is because there were some instances when individuals in the government office asked me, directly or implied, to interview them.

### ***The Sample***

To be included in the sample the participants had to meet criteria established for this study that were: position, experience, knowledge, participation, influence and reputation. As stated by Odendahl and Shaw (2002: 302) 'The establishment of criteria for elite standing is central to any research undertaking concerning elites. Deciding on the evidence of elite status will direct the researcher to the relevant sources for identification'. The criteria were used in all types of sampling techniques. That is to say, the sample criteria for additional or replacement individuals obtained through snowball sampling were the same as those employed for the initial sample using purposive sampling technique.

The initial sample comprising of government officials and Board of Commissioners or Supervisors of the ISOEs was selected based on their current position and experience in the development and implementation of corporate governance in ISOEs. The rank of government officials included in this study was echelon III and higher. The professionals, financial agency staff and academics in the initial sample were selected on the degree and the nature of their knowledge, experience and participation in the promotion of corporate governance issues in public or academics forums (for example, their participation in seminars, conferences, and workshops), and on publishing articles in newspapers, magazines or academics journals.

Other participants, who worked as activists in non governmental organisation (NGOs), were selected based on their reputations and influence. The reason was they might have valuable knowledge on current development on the issue although they were not directly involved in corporate governance initiatives and reforms. Hence, their perspectives were still of value. They enhanced research results by providing a broader perspective; significant insights and data that were too valuable to be neglected. Kendall and Kendall (1998: xvi) argue that in dealing with

corporate governance issues, a practical approach that brings us closer to all interested parties is necessary.

To ensure adequate representation of participants and its relevance to the study, the participants for the in-depth interviews were selected from various backgrounds and organisations as follows:

- The Boards and Management of ISOEs;
- Government officials;
- Professionals and academics from leading organisations or universities such as the Indonesian Accounting Association,
- The Forum on Corporate Governance in Indonesia and NGOs,
- Academia;
- Staff in the Financial Aid Agencies such as the ADB and the AusAID.

Unlike quantitative research, the exact number of participants for this study was not known in advance. However, I planned that the sample size for the in-depth interviews would not be more than 40 participants. This number was refined continuously until it reached the saturation point; a situation when no new ideas are emerging (Oppenheim, 1992: 68) or when newly collected data is redundant with previously collected data (Maykut and Morehouse, 1997: 62). Douglas (1985) estimated that in-depth interviews with 25 people were necessary before reaching the 'saturation point' (cited in Maykut and Morehouse, 1997: 63). Lincoln and Guba (1985) state that interview research can reach saturation point with as few as 12 and probably no more than 20 participants if it is carefully carried out (in Maykut and Morehouse, 1997: 63).

In total, I interviewed 37 key individuals who met the criteria established for the research purpose listed above. I stopped the number of individuals interviewed at 37 because there was no new information uncovered or it had reached the 'saturation point'. Out of 37 individuals interviewed, five were women. The age of the participants ranged from 30 to 60 years old. The list of participants in this study is presented in Appendix B.

## **Data Analysis and Interpretation**

Data analysis and interpretation processes in this study were conducted in two phases, during the fieldwork and after the fieldwork. The data I gathered from quantitative and qualitative research methods were classified into two categories: *numerical* (quantitative statistical data) and *narrative* (qualitative words from interviewing).

### **Analysis of Interview Results**

The qualitative data, gathered from in-depth interviews and public opinions presented in the mass media and electronic sources were first transcribed in their original language, *Bahasa Indonesia*, and then they were classified into several categories based on the individual backgrounds of the participants: government officials, professionals, academics, NGOs, and financial aid agency staff. The next step was to identify the units of meaning in the data, a process referred to by Lincoln and Guba (1985, cited in Maykut and Morehouse, 1997) as *unitising* the data. Units of meaning were identified by carefully reading through transcripts and documents (see Maykut and Morehouse, 1997 for detail discussions). Adopting the constant comparative method suggested by Maykut and Morehouse (1997: 134), I compared a unit of meaning selected for analysis from one transcript to those contained in all of the other transcripts and subsequently grouped (categorised and coded) the units of meaning that had similarity into one category.

The purpose of categorising and coding the units of meaning is to develop a set of categories that provide a 'reasonable' reconstruction of the data a researcher has collected (Lincoln and Guba, 1985: 347 in Maykut and Morehouse, 1997: 134). In this study, I developed provisional categories of units of meaning guided by the objectives of this study and the research questions. If there were no similar units of meaning that could be grouped in the predetermined category, a new category was formed. Different from what is suggested by Maykut and Morehouse (1997: 135) that is to use index cards, large sheets of paper, and a paper cutter in the process of identifying the units of meaning in the data, I used a

computer word program which enabled me to cut and paste the units of meaning which had a similarity into one group.

In the process of unitising the data, I also came across units of meaning which fit into more than one category. In deciding what category that fit with the units of meaning, I used the 'look/feel-alike' criteria that were described by Lincoln and Guba (1985) as a way of describing the emergent process of categorising qualitative data (cited in Maykut and Morehouse, 1997: 136). In this process, the researcher asks himself or herself whether the unit of meaning in one transcript is very similar to the unit of meaning on another transcript. Through this systematic process, I discovered the themes for this study.

The quantitative data were tabulated and analysed using descriptive method to find trends and development. The data were presented in Tables and Figures. The qualitative data, on the other hand, were presented in descriptive, narrative forms after they were translated into English.

### **Ethical issues**

Since the subject of my study involved human participants, before I went for fieldwork I applied for and obtained ethical clearance from the Massey University Human Ethics Committee. This practice was in accordance with the Code of Ethical Conduct for research of Massey University, Section 4 article 24. Ethical issue involved confidentiality and anonymity of the participants. They were protected by ensuring that the data collected did not identify people and organisations by name. In doing so, data analysis and research results were reported in such a way that the information they contain could not be directly linked to anyone. Pseudonyms were used for people and places. In addition, to secure the confidentiality of the participants, no detailed information of each individual and organisation participating in the study will be given to anyone. All data gathered in this study are kept in a secure place at all times and will be destroyed when they are no longer needed.



## **Fieldwork Experience**

This research was divided into three stages. The first stage was from April 2002 to August 2003. The time was allocated to carry out literature review and to collect preliminary data, which served as sources of information to develop the interview guides. The second stage was from September 2003 to November 2003 to carry out my fieldwork in Indonesia. The major portion of my fieldwork was conducting a series of in-depth interviews with key individuals from various backgrounds such as government officials, the Board and management of both the ISOEs, privatised and non-privatised and the private enterprises, professionals, academics, NGOs and financial donor staff from the Asian Development Bank and the AusAID. The third stage was allocated to analyse the data and write the results.

## ***Contacting the Participants***

The participants selected for the in-depth interviews were first contacted either by phone, in person, or by e-mails. For the individuals who were willing to participate, I sent three Letters of Introduction: the first was from myself as the one who would conduct the interview, the second was from my supervisor explaining my status as a research student at Massey University, and the third was from the Director at *Badan Pengawasan Keuangan dan Pembangunan* (BPKP)<sup>52</sup> who was in charge of the evaluation of corporate governance practices in several ISOEs. I found the combination of Introduction Letters from Massey University and BPKP (the office where I work) were essential in gaining participants' trust and preventing me from their doubt about who I was and what the research was about.

Accompanying those Letters, I also sent the participants the Interview Guide and the Information Sheet which described what participants in the study were required to do, their rights to refuse to answer questions and to withdraw from the study at any time, and their freedom to ask questions when they needed clarification. They were also given assurance of confidentiality. The information given would be used only for academic

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<sup>52</sup> BPKP is a non-departmental government agency whose tasks are to conduct financial and performance audits in other government agencies.

purposes and was confined to the researcher. In addition, they would have an opportunity to look at the summary of the findings when the study was completed. The interview list is presented in Appendix B of this study.

Interviews were conducted continuously from September 2003 to October 2003. Beforehand, I planned to conduct the interviews in three months from September 2003 to November 2003. This was because I anticipated I would have to wait for a while before I received responses from the individuals whom I contacted. Fortunately, I obtained their responses sooner than expected and in many instances managed to conduct two interviews a day. As a result, I could shorten the duration of the fieldwork from three months to two months.

### ***Delivering the Interview***

The interviews were mainly held in Jakarta because all of the participants selected in this study lived in Jakarta. The interviews were conducted in various places such as formal offices, residences, and coffee shops. The time for interviewing was during and after working hours. The interviews were conducted in Bahasa Indonesia except for three participants who answered the questions in English: two of them were foreign consultants working in financial agencies and one was a government official who was fluent in speaking English.

Odendahl and Shaw (2002: 308) say that 'Scheduling interviews with the elite individuals is labour intensive, typically requiring several telephone calls with personal assistants or other gatekeepers'. Consequently, in their case, they had to substitute the face-to-face interview with telephone interviews. I experienced a similar situation where I needed to reschedule the interviews. The reasons were varied. In one instance, the interview was postponed because the individual whom I was supposed to interview had to represent their superior at a meeting. Another participant asked me to reschedule the interview because his office was surrounded by demonstrators and he was concerned with my safety. Nevertheless, I was fortunate because I did not have to change the interview approach from face-to-face to telephone interview.

'With elite individuals it is important that researcher make the most of the time allotted' (Odendahl and Shaw, 2002: 309). Given the time constraint within which elites operate, I decided to set the duration of interviews from 30 to 45 minutes. In my judgement, and as suggested by my supervisor, this time range was realistic and sufficient to deliver the main questions and to elaborate the answers. In the field, the least amount of time for the interviewing was 30 minutes and the maximum was two hours. On average all participants spent one hour for the interview.

With respect to ethical concern, I managed to consistently explain to the participants their rights to answer or to refuse the interview and also a guarantee of anonymity and confidentiality. The explanation was given before the interviews were carried out. In my observation, no participant seemed to be really concerned about their confidentiality and anonymity and in fact, some of them were willing to be photographed.

When I delivered the interviews, I did not translate the questions from English to *Bahasa Indonesia* because all of individuals participated in this study could read and understand English. However, I had to refine or paraphrase some questions in the interview guide from time to time. The reason for this was because to particular participants the questions were not specific enough to enable them answer the questions or they were uncertain about the questions. This situation is not uncommon. Individuals often have different vocabularies and, thus the questions need reinterpretation to make sense to each individual (Rice and Ezzy, 1999: 58). Hence, interviewers must be aware of interviewee differences and must be able to make the proper adjustments called for by unanticipated developments (Fontana and Frey, 2003: 70).

As the number of participants interviewed increased, I was more familiar with the questions and able to deliver the questions without having to consult the interview guide all the time such as I did in the early interviews. The benefit was that I was able to rearrange and deliver the questions according to the responses and interviewing atmosphere. As stated by Oppenheim (1992: 72), there will be a situation where participant's answers touch on more than one idea. Or, participants after they answered one question, they began to answer another question which

was further down in the interview guide (Rice and Ezzy, 1999: 60). Here, I needed to be flexible in deciding which ideas should be explored further without losing the focus. In addition, I used the 'probes' technique described by Gillham (2000) as a means for clarification, showing appreciation and understanding, justification, relevant, giving example, extending the narrative, and accuracy; to fill in the blanks in a participant's first response to a question (Rice and Ezzy, 1999: 61).

Another important matter was to carry out the interviews in a casual and friendly manner on the one hand, but directive and impersonal on the other (Fontana and Frey, 2003: 69). Hence, I tended to established informal conversations before and after the interviews to 'breaking the ice' and to help the participants get used to my voice and manner (Oppenheim, 1992: 71).

When I delivered the questions I was aware of participants' reactions to certain sensitive questions. For example, government officials were irritated when I questioned the capability of the government in motivating good governance practice or eradicating wrongdoing in ISOEs. Likewise, members of the Boards of Directors would be annoyed if I questioned them on the capability of the Board of Directors, in general or in the ISOEs, to promote good corporate governance practice. To avoid an uncomfortable situation, I asked sensitive questions in indirect and subtle ways. In some instances, some participants who did not expect to be asked certain questions asked me to stop the tape-recording for a moment to let them figure out the answers.

Providing the interview guide to the participants before the interview took place I found was useful in making the interview more efficient and effective. In some cases, the interviewees, having understood the scope of the research and being familiar with the topic, provided some relevant and important materials in addition to the interviews. However, handing over the interview guide in advance might also reduce their genuine answers because they had prepared themselves to answer the questions and they might ask other persons to assist them in answering the questions. In another case, I also found that having the interview guide provided in advance was not so important to certain individuals, commonly top

officials who were busy with their activities. Instead, they preferred to have me explained the content of interview guide before I conducted the interview.

A tape-recorder was used to record the interviews most of the time. As stated by Oppenheim (1992: 67), 'It is essential for the exploratory interviews to be recorded on tape' because it has some advantages. Firstly, the results from the interview can be analysed in detail afterwards and can be examined by more than one person. Secondly, the interview tapes will produce a rich store of attitudinal and perceptual expressions, in which questions and attitude items can be based. They provide a level of detail and accuracy not obtainable from memory or by taking notes (Rice and Ezzy, 1999: 63). In this study, all of participants interviewed except one agreed to be tape-recorded. For the one who did not want to be tape-recorded was willing to be photographed, I documented the interviews by writing down the answers. Shortly after the interview ended I reviewed those notes in order to reconstruct the interview as accurately as possible.

There were some interesting events with regard to the participants that I encountered during the interview process. One participant who already spent two hours in the interview requested another interview because he was not satisfied with his answers. The additional interview did not take place because I did not believe it would provide new insights to the answers he had previously given. As noted by Oppenheim (1992: 67), the primary objective of in-depth interview is to maintain spontaneity. By carrying out a similar interview, the individual might have rehearsed the answers. In addition, I was faced with time constraints.

In another case, one participant asked me for more questions when I said I have finished with the interview. The reason was because he did not want me to overlook any important questions that he might have known the answers. One interview took longer time because the interviewee was interrupted by phone calls, giving orders to and receiving reports from his secretary. When I interviewed the very top official in my office, his secretary served me with a drink which was very uncommon. Likewise, this situation would not ever happen if I met him as his staff instead of an interviewer.

In summary, my fieldwork experience in conducting interviews was best described, to a degree, by Odendahl and Shaw (2002: 309) when they said:

Some had smiles on their faces and a sparkle in their eyes; others appeared affectless, with deadpan demeanours. A few were obsessed with every possible boring detail. Several were incredibly shy and halting in their manner of speech. Yet all displayed impeccable manners.

### ***Why Good Responses?***

There were some factors which I thought contributed to the prompt responses from the individuals. Firstly, before I conducted this research I was a member of a team established by my office with the specific task to develop, assess, and assist several ISOEs in the area of corporate governance. In doing so, together with the team, I was assigned to provide seminars and workshops in the area of corporate governance. The assignments opened the opportunity for me to meet and make contacts with various people in the ISOEs and with those who were involved in the area of corporate governance. Some of those contact people were chosen and included in this study using purposive sampling techniques and constituted the initial sample. The initial sample was established before I did my fieldwork.

Secondly, another factor that I noticed contributed to good responses to this study was the newness of the subject. Since it was new, individuals both in public and private sector were enthusiastic in discussing and providing their opinions and ideas. Thirdly, I did not have race and cultural differences with the participants especially with those who were government officials because I shared the same type of environment and the same language as theirs. This situation would have been different if the research was carried out by a foreigner (see Storey, 1997). Fourthly, to some of the participants, to be interviewed was a sign of appreciation that I acknowledged their comprehension on the subject was higher than others. Finally, I must admit that there was also luck in obtaining good responses. Storey (1997: 19) on his reflection of fieldwork in a Third World country

states 'At times luck played a role as great as skill'. In a similar nuance, McDowell (1998: 2135 quoted in Odendahl and Shaw (2002: 307) states,

Somehow you have to get in there, and although we often, in writing up our results, talk blandly of our samples or our case studies, letting the reader assume that the particular industry, location, site, and respondents were the optimal or ideal for investigating the particular issue in which we were interested, we all know that the 'reality'...is a lot messier. A great deal depends on luck and chance, connections and networks, and the particular circumstances at the time. (emphasis in original)

Having mentioned the above, it was necessary to mention that there were three persons who first were willing to be interviewed but later canceled their interviews. Two were government officials who went overseas for job purposes and one was an academic who did not respond when I contacted him by an email to set a date for the interview.

### ***Who are the Elite in this Study?***

In the fieldwork the distinction among the elites, in terms of characteristics established in this study, was not as apparent as it was theoretically defined. The reason was that some of the 'elite' whom I interviewed could have different roles which fit into different characteristics. For example, one participant sat as a member of the Board of an ISOE while at the same time he was also a high rank government official. Another participant was a high rank government official who was also an academic in a leading university. In another case, the key participant was a member of the Board, a former CEO at a leading ISOE, an active executive director in an NGO, and at the same time served as a founder and a member of a committee for corporate governance reform. This situation to a large extent provided some advantages as well as disadvantages to this study. The advantages resulted from their extensive experiences which enabled them to provide meaningful answers. The disadvantages stemmed from their contrasting answers on similar issues being asked. The answers could be different contingent on how they positioned themselves when they responded to the questions. Hence, I asked them to decide which role suited best.

## **The Limitations of Research Method**

In utilising interview as a data collection method, one has to be aware of the limitation inherent in the method that is 'interviewer bias' influenced by the interviewer's own expectation or opinion. Interviewer expectation bias exists when the interviewers only record respondents' answers that are in conformity with the interviewers' expectations. Interviewers often record the answers they expect to hear rather than the answers meant by the respondent. In other words, they hear what they expect to hear. Interviewer opinion bias is resulted from a situation where the interviewers provide their own opinions and interpretations caused by the respondents providing vague statements. Another source of bias comes from the utilisation of open-ended questions requiring free answers and precise recording. The main source of bias comes from the paraphrasing process that requires the interviewer's personal selectivity.

To reduce any bias as low as possible, during interviews I attempted to create an atmosphere which was sufficiently uncritical for the participants to come out with any ideas or opinions whatever they might have, including some misconceptions. In addition, I reduced my role to an absolute minimum to avoid leading the interviewees (Oppenheim, 1992: 67). As such, I positioned myself as a listener and avoided providing my own opinions on the questions being asked. If something was not clear, I used a 'non-directive' prompt technique such as summarising what the individuals had just said (Oppenheim, 1992: 67). Occasionally, I provided examples or comparisons to elaborate the participants' views on some issues.

Having mentioned the above, I did not perceive bias from the interview process to be a major concern for this study. The reason was that the topic under study, although strategic, was not thought to be so highly sensitive that would put the participants in a difficult situation. In addition, much of the information was not deemed highly confidential. However, the occurrence of such bias cannot be totally ruled out.

With respect to the research results, limitations and bias inherent to the research method used in this study should be acknowledged. The non random sample for the purpose of semi-structured interviews prevents the



random sample for the purpose of semi-structured interviews prevents the results of this study being generalised in a statistical sense. Nonetheless, as mentioned by Merriam (1998, cited in Creswell, 1994: 158), the intent of qualitative research is not to generalise findings, but to form a unique interpretation of events. Having said that, the research method employed was considered satisfactory since the participants were individuals with specialised knowledge on the topic under study. I believed that less knowledgeable individuals would result in less useful information. Secondly, the uniqueness of this study—specific issues of corporate governance in the ISOEs—decreases the possibility of replicating this study exactly in another context. Thirdly, although every effort was made to ensure objectivity, my previous experience working closely with teams that carried out evaluation on corporate governance practices in the ISOEs might bring certain biases to this study. These biases might shape the way I viewed and understood the data I collected and the way I interpreted my experience.

## **Summary**

There are various approaches and research methods that can offer answers to such research questions. Indeed, the choice of particular research techniques, or combination of them, is central in determining the dimension for research questions. The nature and the research objectives of this study were best suited by using a combination of qualitative and quantitative methods. Each of these methods had its strengths and advantages which were useful for this study. Quantitative data came from several sources such as government reports, annual reports of the ISOEs, and other statistical data from different sources. The data were tabulated and analysed using descriptive method.

Qualitative data were mainly collected by using in-depth interview technique. The type of in-depth interview used in this study was the 'elite' interview. The sample for the interview was chosen using purposive and snowball sampling techniques. To ensure the representation and its relevant with the objectives of this study, the inclusion of participants in

the sample was based on certain criteria established for this study. The criteria were position, status, experience, knowledge, and influence.

The interview guide consisted of six major questions which were broken down into several other sub-questions. The actual participants for the in-depth interviews were 37 individuals representing different backgrounds and institutions.

The fieldwork was accomplished according to the research plan and it provided data and information which were important to obtaining meaningful results on the issue under study. Overall, my fieldwork in Indonesia contributed significantly towards my overall study. Discussions with key individuals helped me to explore many issues surrounding corporate governance that I previously had little knowledge about. All participants were very helpful in giving me data and detailed information that I could not possibly gain access to without their assistance. Another valuable aspect of my fieldwork was the opportunity to meet with key individuals and develop relationships with them. During the finishing of this study, I am maintaining contact with some of key individuals in order to further consult them along the research process. The next chapters are discussions of the empirical portion of this study.

## **Chapter Six**

### **Indonesian State-Owned Enterprises**

As a disgruntled 'owner' of a state enterprise I cannot even withdraw my patronage from most state enterprises, no matter how poor or expensive the service, since government has precluded any competition. All I can do is cast a ballot to determine the ultimate political masters of state enterprises. But elections rarely can deliver on accountability on individual issues, and even if state enterprise is a critical issue... there is no direct accountability through the political process (Porter, 1986 in NZ Business Roundtable, 1988: 32)

#### **Introduction**

This chapter is the empirical part of this study. It attempts to answer the question of 'What are the current practices of ISOEs?' This chapter is organised into seven main sections. The first section commences with a discussion about the origins of the ISOEs, which developed during the Dutch occupation of Indonesia. This occupation lasted for about three centuries. The second section reviews the evolution of ISOEs from the time Indonesia gained its independence to the present time. This section is divided into three subsections which follow changes in the government. The third section discusses the roles of ISOEs in the Indonesian economy. The fourth section shows the current financial performance of the ISOEs. The fifth section provides a review of privatisation and the state of the debate on this subject within Indonesian society. The sixth section discusses some issues concerning ISOEs, which have some impact on the ISOEs' performance. The final section provides a summary of this chapter.

#### **The Origin of ISOEs**

The origin of ISOEs can be traced back to the colonial era, when the Dutch government occupied Indonesia for nearly 350 years. At that time, the

Dutch government considered the development of infrastructure to be very important and therefore it should be run by the government (Booth, 1997: 149). This policy resulted in the establishment of many SOEs which operated in a variety of key areas including railways, roads, irrigation and seaports. In addition, Dutch governance also established other types of SOEs which operated in areas such as the post and telegraph systems, salt mines, coal mines, tin mines, printing offices, pawnshops, electric power generation, soda production, publishing, vaccines and drinking water and an opium factory (Pangestu and Habir, 1989 in Djamhari, 1996; Houben 1994: 192-4 in Booth 1997: 150). Those enterprises were managed by different government departments and were funded from different sources. The importance of SOEs to the Dutch government was demonstrated by the establishment of the Department of State Enterprises in 1908, which had the responsibility to manage the railways, the post and telegraph systems, salt mines, coal mines, tin mines and an opium factory (Houben 1994: 192-4 in Booth 1997: 150).

Although those enterprises produced public goods, they were expected to generate income through user charges. Between 1908 and 1921, the railways were able to gain larger profits than any other SOEs. The Post and Telegraph Enterprise, on the other hand, consistently made a loss (Houben, 1994: 196 in Booth, 1997: 150).

## **The Evolution of ISOEs**

After Indonesia gained its independence in 1945, the number of ISOEs increased and they became one of the key players in the Indonesian economy. The development of ISOEs can be divided into three different phases: (1) Old Order Regime, (2) New Order Regime, and (3) Reformation Order Regime.

### ***Old Order Regime – The Sukarno Era***

Indonesia proclaimed its independence from the Dutch on 17 August 1945, after years of war against the Dutch. Soon after that, Sukarno was elected as the first President of the Republic of Indonesia. During his

presidency, Sukarno and other political leaders, who had experienced the fight for independence, had a deep suspicion towards concepts such as market forces and private capital accumulation. Hence, capitalism was equated with colonialism and exploitation. As a consequence, a strong government was needed to protect the nation's hard-won independence and guard against foreign economic domination (Syahrir and Brown, 1995: 140). At that time, economic policy was directed under Sukarno's Democracy Guidelines known as *Demokrasi Terpimpin*.

Influenced by his orientation to socialism<sup>53</sup> and the fact that there were no Indonesian entrepreneurs, who could act as the economic players, his government began to participate actively in business by setting up its own enterprises, among which were banks, trading companies, airlines and manufacturing industries (Budiman, 1988: 115). During the Sukarno era, the government took over almost all the SOEs previously owned by the Dutch government and private enterprises.

The nationalisation of the Dutch SOEs was based on *Undang-Undang* (Law) No. 86/1958 and *Peraturan Pemerintah* (Government Regulation) No. 23/1958. The Dutch government was provided with compensation through an amount determined by a Committee, which had been appointed and based on government regulation No. 9/1959 (cited in the Ministry of ISOEs, 2003). To some extent, the strong involvement and intervention of the Dutch government in the economy, through SOEs, was seen as one phase in the continuing cycle of deregulation and intervention, *dirigisme* and *laissez faire*, which has characterised Indonesia over the last two centuries (Booth, 1997: 157).

Ideologically and legally, the government's involvement in business activities was justified by *Undang-Undang Dasar* 1945 (the Indonesian Constitution of 1945) article 33, which states:

- 1) The economy shall be organized as a collective endeavour, founded upon the basis of family spirit (*'Perekonomian disusun sebagai usaha berdasar atas azas kekeluargaan'*)
- 2) Branches of production essential to the state and which affect the welfare of most Indonesian people shall be controlled by the state

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<sup>53</sup> The type of socialism, shared by Sukarno and his followers, was a kind of synthesis of two contrasting philosophies, liberal humanism and Marxism (Chairul Saleh cited in Prawiro 1998: 15).

(*'Cabang-cabang produksi yang penting bagi negara dan yang menguasai hajat hidup orang banyak dikuasai oleh negara'*)

- 3) Land and water and natural riches contained therein shall be run by the state and to be used for the greatest prosperity of the people (*'Bumi dan air dan kekayaan alam yang terkandung di dalamnya dikuasai oleh negara dan dipergunakan untuk sebesar-besar kemakmuran rakyat'*).

Article 33 of the Indonesian Constitution grants the government exclusive rights to intervene and play a role in economic sectors which are considered strategic or areas which the government considers important in order to maintain the country's sovereignty and economic independence.<sup>54</sup>

Following the nationalisation of the Dutch SOEs, hundreds of private Dutch companies were further nationalised by the government. One of the reasons for this happening was because the Dutch declined to release their sovereignty over West Irian. In 1959, six of the former Dutch 'Big Ten' trading companies were converted into wholly state-owned companies (Booth, 1997: 316).

In 1964, as a result of conflict between Indonesia and Malaysia, the government also nationalised all Malaysian, Singaporean, British and American companies (Djamhari, 1996). At the same time, the government established a policy known as the *Benteng* (fortress) policy. The objective was to create strong indigenous entrepreneurs who could compete with foreign and Chinese entrepreneurs. As argued by Ramanadham (1991), the state's objective of nationalisation is the 'indigenisation of economic activity'<sup>55</sup>. Table 6.1 shows the number of the Dutch companies taken over by the Indonesian government in the years 1958-1960.

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<sup>54</sup> According to a UNIDO and ICPE (International Centre for Public Enterprises in Developing Countries) survey published in 1983, there were 18 countries which shared a similar view to the Indonesian constitution. They were Botswana, Brazil, China, India, Malaysia, Mexico, Mongolia, Mozambique, Nigeria, Pakistan, Senegal, Sri Lanka, Thailand, Somalia, Vietnam, South- and North-Yemen, and Zambia (Wibosono, 1998)

<sup>55</sup> The popular term in Indonesia for 'indigenisation of economic activity' is *Indonesianisasi*

**Table 6.1 Nationalised Companies 1958-1960**

No	Company Type	Total
1	Pharmaceutical	17
2	Construction	10
3	Insurance	20
4	Bank	3
5	Farming and Plantation	236
6	Trade	58
7	Transportation	12
8	Livestock	11
9	Electricity	9
10	Railways	12
11	Industry/Mining	161
12	Publishing	2
13	Others	3
	Total	557

Source: Lubis, Hukum dan Ekonomi, 1992 in Ibrahim 1997.

John Sutter (1959: 2) documented nine types of institutional change that took place in the process of nationalisation. They were:

- Transfer of former colonial public enterprises to the Indonesian government
- Establishment of new State enterprises
- Transfer of private alien enterprises to the Indonesian government
- Increased government control over alien businesses
- Transfer of private alien enterprises to Indonesian organizations
- Establishment of new enterprises in sectors virtually closed to Indonesians
- Increased Indonesian equity ownership in corporations established by aliens,
- Increased participation in the management of alien companies
- Return of landholdings to the Indonesian community by alien enterprises (cited in Lindblad, 2002: 3)

The establishment of new ISOEs, operating in strategic businesses such as banking (Bank Negara in 1946), trading (Pantja Niaga<sup>56</sup>, in 1947), industry (Semen Gresik, in 1953), oil (Pertamina, in 1957) and tourism (Natour, in 1952), increased the number of the already nationalised ISOEs. As a result, in the early 1960s, the Indonesian government was estimated to own 822 companies in varying business activities (Kementrian BUMN, 2003: 2). The various forms of ISOEs at the time were:

- ISOEs based on the Dutch Laws; Indische Comptabiliteitswet (ICW) and Indische Bedrijvenwet (IBW)
- ISOEs based on a specialised Act
- Nationalised ISOEs
- ISOEs based on business law
- Government foundation (Mardjana, 1993: 170)

This nationalisation policy resulted in the replacement of foreign managers and workers with Indonesians within ISOEs. They were military officers, civil servants, political leaders or former Indonesian lower-level employees, who had little or no management or entrepreneurial backgrounds (Mackie 1967: 59 cited in Mardjana 1993: 169). As a consequence, a large number of ISOEs in the late 1950s and early 1960s were run by people labelled as 'bureaucratic capitalists' (Castles 1965 in Booth, 1997: 316-317) who obviously lacked technical competence and were mainly interested in using the enterprises as a means of self-enrichment. The involvement of bureaucrats and military officers in ISOEs' business has had a big impact on how the ISOEs have been managed up to the present time. One government official, interviewed in this study, explained how the number of the ISOEs was increased at that time. He states:

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<sup>56</sup> Panca Niaga, known as CTC, was previously a smuggling activity carried out by the Indonesian National Army in the Sumatra Island region. It was established to make money to fund the independence fight against the Dutch military (Daud, 1999). As suggested by the Vice President at the time, Mochamad Hatta, this smuggling activity was then legalised as an ISOE in 1947. Later, it was assigned to challenge the monopoly of the 'Big Five', the five large Dutch trading companies, which still enjoyed full rights to continue their operations in Indonesia.



In the beginning, the government did not have any intention to gain any profits from the ISOEs. The role of ISOEs was just to assist the government in delivering public services to the public. For example, when the government found difficulties in distributing fertiliser to the farmers, it established Pupuk Sriwajaya in Palembang to manufacture and distribute fertiliser around Sumatra and Java. This was then followed by the establishment of other similar agencies in other regions, such as Kalimantan with the objective of serving farmers across Indonesia. Later, they became ISOEs and had a status such as a Persero. In another area, the government created an agency called Tabungan Pensiun (Taspen) whose task was to manage the pension funds of government employees. The employees for this agency were recruited from the Budget Division of the Ministry of Finance. Later, this agency became Persero.

As the economy developed, the government established several banks, in addition to the two private banks which already existed (JAVASE Bank and BNI 46 Bank). The objective was to serve the various needs of Indonesian society. For example, to facilitate the export-import of ISOEs products to and from overseas, the government established the Bank Eksport dan Impor and Bank Bumi Daya. To support investment programmes, the government created Bank Pembangunan Indonesia.

Later, to enhance the government's capacity to develop infrastructure, such as roads and bridges, it established Hutama Karya. In order to be able to build high-rises, the government created PP, Waskita Karya, and Wijaya Karya. For low income groups, the government created Perumahan Nasional (Perum nas) whose task was to build inexpensive houses.

The establishment of ISOEs was done in stages, depending on need. To manage trading, the government established Panca Niaga and Dharma Niaga. The status of these companies was simply that they were government companies which were not intended to seek a profit. These companies grew into much larger companies.

Finally, the government considered that these companies should be classified based on their objectives. Some could make profits, some were for public services and some were still part of a government agency. This consideration resulted in the issuance of a government regulation which divided the government companies into three types:

- (1) Perjan, an agency which is part of the government institution, for example, the railways and pawn shops
- (2) Perum, a government company whose emphasis is more on providing public services rather than making profits
- (3) Persero, an agency specifically established to make profits. At this time, there was no discussion regarding corporate governance (B04, October 2003).

The nationalisation process, which created a huge number of ISOEs, had been used by the government to support *Kebijakan Ekonomi Terpimpin* (the Guided Economy Policy) established by President Sukarno. This policy dealt with the 'Indonesianisation' of the economy. The ISOEs were the best devices to implement the policy. As Robinson (1986: 80 cited in Mardjana, 1993: 171) notes,

The intention of Guided Economy was to construct a national industrial economy around state-owned capital. The seizure of the Dutch-owned trading houses and the establishment of State monopoly on the import of essential commodities was a clear indication that the private sector, indigenous or Chinese, was to be excluded from the most lucrative of trading monopoly.

The complexity of supervision and monitoring processes relating to the various kinds of ISOEs led the government to issue Act No. 19/1960 which standardised all ISOEs into one type of business form called *Perusahaan Negara/PN* (State Company)<sup>57</sup>. The capital of PNs could not be divided into shares. These PNs were then supervised by related Ministers and controlled by the Main Minister (Kementrian BUMN, 2003). With standardisation, the number of public enterprises was reduced to 223 by 1965 (Wirjasuputra and Rieffel 1972 cited in Mardjana, 1993).

Sukarno's political association with communist countries, such as the Soviet Union and China, and his decision to withdraw from the United Nations in January 1965 resulted in Indonesia being isolated from the

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<sup>57</sup> There were other enterprises that were not included as state companies, including PT Hotel Indonesia International and PT Sarinah, which were limited liability enterprises. Government Banks and PERTAMINA (a state oil company) were also excluded from the Act 19/1960 because they were regulated under specific laws.

world's capitalist system. Poor relations with Western countries, combined with political instability inside the country, reached its peak when the military, under the leadership of General Suharto seized government power in 1967. At that time, Indonesia suffered a severe economic crisis with huge debts and hyper inflation.

### ***New Order Regime – The Suharto Era***

In contrast to *Orde Lama* (the Old Order) regime, *Orde Baru* (the New Order) government implemented more liberal economic policies and changed the orientation of the economy, from a high level of direct government intervention and an 'inward-lookingness', to having more reliance on the market. Hence, the New Order was regarded as a 'developmental' regime, since it placed a high priority on achieving rapid economic development and in improving the level of national prosperity and welfare (Surbakti, 1999, p. 61). Starting in 1969, the New Order government implemented *Rencana Pembangunan Lima Tahun/Repelita* (the Five-year Development Plans) in order to achieve sustainable development growth. For this reason, Suharto, as the President at that time, was renowned as *Bapak Pembangunan Indonesia* (the Father of Indonesian Development).

The New Order government carried out several initiatives in order to recover from the economic crisis (Setiawan, 2002). Firstly, it sought out financial assistance from a number of Western countries, which then formed a consortium known as IGGI (Inter-Governmental Groups on Indonesia) and which is now called CGI (the Consultative Groups on Indonesia). Secondly, it opened new relationships with financial agencies, such as the World Bank and the IMF. Thirdly, it established more sympathetic policies towards private investment in general and foreign investment in particular. These sympathetic policies towards foreign investment were firstly shown by the stipulation of Law No. 1/1967 on Foreign Investment. Secondly, the government returned some nationalised enterprises to their previous owners. Together with these actions, the government provided assurances that there would be no more nationalisation of foreign enterprises. Thirdly, the government established

*Badan Pertimbangan Penanaman Modal Asing/BPPMA* (the Foreign Capital Investment Advisory Board). Fourthly, the government allowed 100 percent foreign ownership and there were no restrictions anymore on foreign equity and employment of expatriates.

Although the New Order government applied more liberal economic policies, the ISOEs were still part of the government economic policy to control the economy. However, the government tended to position itself as the 'regulator' rather than the 'leader' of the economy. To promote greater independence of the ISOEs, the government issued *Instruksi Presiden* (Presidential Instruction) No. 17/1967 and Law No. 9/1969, which changed the single legal status of ISOEs, from PN previously regulated under Act No. 19/1960 into three categories:

- (1) Perjan (Perusahaan Jawatan)
- (2) Perum (Perusahaan Umum)
- (3) Persero (Perusahaan Persero)

A Perjan is a governmental agency defined as a social service agency attached to a ministerial department whose objective is to deliver public services to society without seeking profit. A Perjan is regulated under IBW (Indonesische Bedrijvenwet, Stbl, 1927: 419). Its operation is managed, supervised and monitored by a relevant technical department. The management and staff are civil servants. Its source of funds comes from the government budget and its capital is not divided into shares. Its costs of operation and its annual profits or losses are part of the national budget. At present, the legal status of Perjan has been changed to other legal forms such as Perum or department agencies.

A Perum is defined as a public company. It is expected to generate revenue (to be as profitable as a comparable private company) by producing high quality goods and services in a competitive manner but at the same time it has a social responsibility to provide public goods and services to the public at low prices. Its source of funds comes from a separate government budget.

A Persero is defined as a limited liability company whose shares are wholly or partly (51 percent and over) owned by the government, on behalf

of the public. The main objective of a Persero is to earn profits. A Persero is managed by *Dewan Direksi* (the Management Board) that is autonomous from the government agency. In day-to-day operations, the Management Board is responsible to *Dewan Komisaris* (the Board of Commissioners). Table 6.2 shows the legal status and characteristics of ISOEs.

<b>Table 6.2. Legal Status and Characteristics of ISOEs</b>			
<b>Characteristics</b>	<b>Types</b>		
	<b>PERJAN (Government Agency)</b>	<b>PERUM (Public Company)</b>	<b>PERSERO (Limited Liability SOEs)</b>
Purpose of activities	Public Services	Mixed public services and profit making	Profit making
Relevant Law	IBW	Act 19/1960	Commercial Law
Relationship of the company to the government	Part of government agency	Autonomous organisation	Autonomous organisation
The Board of Directors appointed	By the president	By the president	By the shareholders general meeting
Capital status	Part of annual budget	Government participation	Capital share
Employment status	Public servant	Based on special regulation	Similar to private employees
Scope of business	Public utility (vital and strategic)	Public utility	Similar to private enterprises

Source: Djamhari (1996: 177)

Besides these three legal types of ISOEs there are other government agencies which operate like an enterprise because they have to produce financial statements but they are regulated under a different law. Examples are *Badan Urusan Logistik*/BULOG (The National Logistics Agency) and Pertamina. BULOG was established under *Keputusan*

*Presiden* (Presidential Decree) No. 39/1978 while Pertamina was regulated under Act No. 8/1971.

### **The Expansion of ISOEs**

During 1973-1983, Indonesia gained benefits from the significant increase of oil prices which dramatically augmented the government's revenues. As a result, the government was involved in a large number of development projects. It began investing widely in ISOEs and became the leader in developing basic infrastructure. The ISOEs' activities were expanded into many business sectors. At this time, leaders in various government institutions, such as *Departmen Industri* (the Ministry of Industry) and *Badan Investasi Negara/BIN* (the State Investment Board) developed strong political interests in the advancement of an interventionist and nationalist policy approach (Syahrir and Brown, 1995: 143). These leaders, according to Syahrir and Brown (1995: 143), were the principal opponents of the liberal economists based within institutions, such as *Departemen Keuangan* (the Ministry of Finance) and *Badan Perencana Pembangunan Nasional/ Bappenas* (the National Development Planning Agency), who had initiated the earlier reforms. Within the nationalist policy, it was a programme to raise a sense of national pride in Indonesian products. Hence, the government popularised the slogan '*Aku Cinta Produksi Indonesia*' (I love Indonesian products).

During the interventionist and nationalist era in the 60s and 70s the government issued Presidential Instruction No. 11/1973 to modify Act No. 9/1969. This regulation allowed the technical ministries to control ISOEs under their jurisdiction that were previously under the supervision of the Finance Minister. Following the issuance of the above regulations, the government issued Government Regulation No. 3/1983 concerning methods of supervision and control in each of those ISOEs. The main content of this regulation is as follows:

- 1) Supervision is jointly carried out by the Minister of Finance as the shareholder and technical ministers

- 2) The assets of Perjan are still part of the government assets, whereas the assets of Perum and Persero are separated from government assets.
- 3) Management of the ISOEs is lead by *Dewan Direksi* (the Board of Management,) whereas supervision is carried out by the *Dewan Pengawas* (the Board of Supervisors) in Perum and Perjan and *Dewan Komisaris* (the Board of Commissioners)<sup>58</sup> in Persero. The government acts as the shareholder.
- 4) Members of *Dewan Pengwas* and *Dewan Komisaris* are representatives of the technical ministries.
- 5) Top management (the executives) and the Board of Commissioners of Persero are appointed by the Finance Minister, based on the technical ministers' recommendations.
- 6) *Dewan Direksi* and *Dewan Pengawas* in Perjan and Perum are appointed by the President<sup>59</sup>.

To improve ISOEs efficiency and productivity, the President issued Presidential Instruction No 5/1988, which was followed by the issuance of two *Keputusan Menteri* (Ministerial Decrees); firstly, No. 740/1989 on ISOE restructuring, merger, joint operations, IPO and strategic sales and secondly, No 741/1989 on the simplification of ISOEs' control and supervision. Hence, decision making power was removed from the Ministry of Finance to the shareholder general meetings (SGM) and the Board of Commissioners/Supervisors.

In particular, Ministerial Decree No. 740/1989 instructed that all ISOEs, except those operating in financial sectors, had to undergo financial performance evaluations, based on a combination of three major

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<sup>58</sup> The Board of Commissioners or the Board of Supervisors is similar to the Board of Directors in Western countries' corporate governance structures.

<sup>59</sup> An anecdote behind the issuance of Government Regulation No. 3/1983 states that when ISOEs were under the supervision of the Ministry of Finance, the Director General in the Ministry of Finance carried out his supervision in a way that resulted in the ISOEs management being very disconsolate. He was considered to be bossy and he showed no respect to the management of the ISOEs. For example, he put his feet on the table at a meeting with the ISOEs management. This behaviour was considered ill mannered and not acceptable in Indonesian culture. As a result, the management in the ISOEs put pressure to the government to replace this Director General (Bawasir, Business Week, nd).

criteria: liquidity (likuiditas), profitability (rentabilitas) and solvability (solvabilitas). Liquidity measures a company's ability to cover short term liability. Profitability measures a company's ability to earn profits. Solvability measures a company's ability to cover total liabilities. Based on these criteria, the ISOEs would be ranked in four categories, 'very healthy', 'healthy', 'less healthy' and 'unhealthy'<sup>60</sup>.

Based on this evaluation, those ISOEs that continued to perform unsatisfactorily would be subjected to the following correctional measures:

1. A change in their status to better ensure the achievement of their objectives.
2. Allowing operational co-operation and contracts with the private sector.
3. Allowing a merger with another ISOE.
4. Dividing the enterprise into more manageable components.
5. Selling ISOE's shares through the capital market or direct placement of shares to improve capital and maximise dividends.
6. Establishing joint ventures with the private sector in order to extend market share, operational capability and improve returns to capital.
7. Liquidating or selling - if the above is not possible then ISOE sale or liquidation would be recommended.

In 1990, the government introduced performance measurements in ISOEs (based on rates of return, competitiveness and efficiencies) that linked management and the Board of Directors' incentives with the company's performance. The Board of Commissioners/Supervisors received 100 percent of their salaries if the ISOE was categorised 'very healthy', 90 percent if it was categorised 'healthy', 75 percent if it was categorised 'less healthy', and 60 percent if it was categorised 'not healthy' (Mardjana 1992: 271 cited in Djamhari, 1996: 125)

In practice, joint supervision in the ISOEs by the technical ministers and the Finance Minister created confusion within the ISOEs management

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<sup>60</sup> This categorisation has been criticised because it does not take into account the nature of the market within which ISOEs operate (Syahrir and Brown, 1995: 130)



as to whom they must be responsible. On the one hand, the ISOEs had to be financially responsible to the Finance Minister as their shareholder and on the other hand, the ISOEs had to be operationally responsible to the technical ministers. Consequently, the managers were not free from constant 'bureaucratic interference' (Clarke, 2003: 5) and from pursuing multiple and conflicting objectives. In ISOEs, this became a major issue especially for those ISOEs that did not operate in financial sectors.

In addition, the dualism in supervision of ISOEs also created an unhealthy relationship between the technical ministers and the ISOEs. The supervision, to some extent, became a burden on the management of the ISOEs<sup>61</sup>. One reason for this was that the technical ministers treated ISOEs as an inseparable part of their offices, which meant that the ISOEs had to support their operations financially which included providing travel allowances for the officials. Hence, it was unavoidable for the ISOEs to become cash cows for the technical ministers. This practice distracted the effectiveness of management operations in the ISOEs since they were under the care of the technical ministry

Another reason was that at any time the heads of bureaus, employing the relevant technical ministers, could summon to their offices the top management of an ISOE. As a result, this distracted the operations of the ISOEs, since the top management were seldom present at their offices to provide directions. The management of ISOEs had no other choice but to maintain an extremely good relationship with their superior and at the

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<sup>61</sup> Malik, a member of the PRA in a public hearing with the Energy and Mineral Resources Minister, commented that an 'ISOE such as Pertamina can make people rich but never becomes rich for itself' (*Kompas Online*, December 4 2004). An example can be seen in PT PLN (electricity). In 2005, the top management approved the giving of bonuses to the Board members and directors to the amount of Rp4.3 billion, notwithstanding the fact that the enterprise had suffered financial losses of Rp3 trillion in 2002 and 2003. The reason for providing bonuses, as stated by one of its directors, was because the executives' salaries in this company were less than that of other ISOEs' executives. This decision breached article 62 of the Limited Liability Act No. 1/1995. PT KAI and ensured the early dismissal of the directors and Board members. Perum Perhutani increased the salaries of its directors and Board members regardless of the financial performance of the ISOE. This increase did not apply to the employees. A survey conducted by Business Intelligence Report (BIRO) in November 2001, on asset values owned by the ISOEs' management, concluded that ISOEs management were very successful in managing their own assets but failed in managing those of the ISOEs (*Kompas*, March 24, 2002). Aharoni (1986: 133) states that the management of an SOE may treat their company as their feudal property (Aharoni, 1986: 133).

same time neglected their customers (RBI, 2001: 3). As noted by Aharoni (1986: 132), 'Managers of SOEs seem to spend more time than their private sector counterparts in managing the environment, aiming at co-opting the controlling agencies or assuring their allegiance.' This happened partly because the appointment of ISOEs' top management was made by the respective Ministers, instead of appointments being based on business performance. This condition remained from 1983 to the 1990s.

### ***Reformation Regime - After the Economic Crisis***

The majority of ISOEs were still loss making operations because of inefficient operations and poor corporate governance practices demonstrated by non-transparent and unaccountable operations. In 1998, BPKP audit reports revealed that the ISOEs suffered operational losses of Rp60.7 trillion (Warta Pengawasan, 2000: 7)<sup>62</sup>.

When the economic crisis hit Indonesia in mid-1997, the ISOEs, particularly those in the banking industry, suffered huge financial losses because of mismanagement and negligence. In the banking industry, imprudent banking practices resulted in the state-owned banks having to carry enormous unperforming loans. These banks, through the interference of government officials, granted many credits to companies owned by families<sup>63</sup> or friends of President Suharto and also active or retired bureaucrats, without undertaking proper risk management. The total amount of money, spent by the government to rescue the state-owned banks out of the crisis, reached Rp650 trillion or US\$ 65 million (Baasir, 2004).

Government efforts to bail out these ISOEs from bankruptcy caused a financial burden on the government budget. Hence, the New Order government did not have any alternative except to carry out reforms, in terms of the supervision and monitoring of the ISOEs in order to improve

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<sup>62</sup> Due to the continued loss making operations of ISOEs, people created their own brand name for ISOEs. They called them *Badan Usaha Maling Negara* (business enterprises which steal from the country), or *Badan Usaha Miskinlah Negara* (business enterprises which make the country poor) or *Beban Usaha Melilit Negara* (the business burden encircles the country)

<sup>63</sup> They are known as *Keluarga Cendana* (Cendana Family).

their performance. These reforms can be divided into several stages which are discussed below<sup>64</sup>.

### ***The Establishment of the State Ministry of ISOEs***

Considering the important role of ISOEs and the problems they faced with the existence of dualism in the supervision of ISOEs, the government considered that a better way to improve the ISOEs' performance was to manage ISOEs under the supervision of one agency<sup>65</sup>. This was done through the establishment of *Kementrian Negara Bidang Pemberdayaan Badan Usaha Milik Negara/Meneg PBUMN* (the State Ministry for the Empowerment of ISOEs) by Presidential Decree No. 101/1998. This was then followed by Government Regulation No. 50/1998 concerning the appointment of the Minister for Meneg PBMUN as the shareholder or the shareholder general meeting in Persero (Meneg PBUMN, 2003). This appointment took over the role of the Finance Minister in Persero. The number of Persero transferred to the State Ministry of the Empowerment of ISOEs was 163 SOEs (Presidential Instruction No. 15/1998). A year later, the government issued another government regulation, No. 96/1999 which transferred all ISOEs, including those in the banking industry, from the Ministry of Finance to the State Ministry of the Empowerment of ISOEs. However, five days after the issuance of this regulation, the government issued another Government Regulation, No. 98/1998, which transferred all the ISOEs in the banking industry back to the Finance Minister.

At the same time, the government issued Government Regulation No. 12/1998 on Persero and Government Regulation No. 13/1998 on Perum. Later, in 2000, the government issued Government Regulation No. 6/2000 on Perjan, to further improve the efficiency and the performance of ISOEs. The main points of Government Regulation No 12/1998 and No. 13/1998 were:

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<sup>64</sup> The discussion presented is largely drawn from the Ministry of ISOEs' publications in 2003.

<sup>65</sup> Analysts say that this policy showed a significant paradigm shift in managing ISOEs.

- The supervision of Persero is carried out by the Finance Minister, acting as the shareholder, while the supervision of Perum is jointly carried out by the Ministry of Finance and the technical ministers.
- The main objective of Persero is to gain profit, while Perum is to provide public goods and services without an obligation to gain profit in return. If the government demands that Persero perform social tasks then these tasks should be in the context of gaining profits.
- The management of the ISOEs is lead by *Dewan Direksi*, control is carried out by *Dewan Pengawas* in Perum and *Dewan Komisaris* in Persero. The government provides direction.
- *Dewan Direksi* (the executives) and *Dewan Komisaris* in Persero are appointed by the Finance Minister, based on the technical ministers' recommendations.
- *Dewan Direksi* and *Dewan Pengawas* in Perum and Perjan are appointed by the President.

When Abdurahman Wahid took power as the fourth President of Indonesia, on 28 October 1999, he expanded the role of the State Minister for the Empowerment of SOEs to include managing foreign investments. This was done by the issuance of Presidential Decree No 134/1999, which merged the State Ministry for the Empowerment of ISOEs with the Co-ordinating Agency for Capital Investment. The nomenclature for this new agency was *Kementrian Negara Bidang Investasi dan Pemberdayaan BUMN* (the State Ministry of Capital Investment and Empowerment of ISOEs). The key points stated in the Regulations are:

- *Kementrian Negara Bidang Investasi dan Pemberdayaan BUMN*, acting as the shareholder, is responsible for the supervision of Persero
- Notwithstanding, the supervision of PT. Kereta Api (the Railways) is still performed jointly by the Ministry of Finance and Ministry of Transportation
- The supervision of Perum and Perjan is jointly performed by the Ministry of Finance and the technical ministers

- The management of government assets in the ISOEs is performed by the Ministry of Finance

Tanri Abeng, as the first State Minister of Capital Investment and Empowerment of SOEs, formulated the first Master Plans for the ISOEs and this became the foundation for following ministers to manage the ISOEs in a business like manner. Since then, this Masterplan has been revised several times. Under Rozi Munir's leadership, the second State Minister of ISOEs, the Masterplan was refined to include, among others, the implementation of good corporate governance practices, based on three principles: transparency, independence and accountability.

In 2000, Government Regulation No. 98/1999 was replaced by Government Regulation No. 1/2000, to include the authority of the State Ministry of Capital Investment and Empowerment of ISOEs regarding the appointment and dismissal of *Dewan Komisaris* and *Dewan Direksi*, profit sharing, mergers, splits and liquidations. At the time, Tanri Abeng was replaced by Laksamana Soekardi who held the position only for eight months and was then replaced by Rozy Munir.

### ***Back to the Ministry of Finance***

When Wahid reformed his cabinet, the State Ministry of Capital Investment and Empowerment of ISOEs was closed down and thus the supervision of ISOEs went back to the Ministry of Finance. This occurred through the stipulation of Government Regulation No. 89/2000, which reinstated the authority of the Finance Minister as the shareholder and government representative at ISOEs shareholders' general meetings but it did not include the railways, which were still under the supervision of the Ministry of Transportation.

### ***A New Role for the State Ministry of ISOEs***

Soon after Megawati Sukarnoputri replaced Abdurahman Wahid and became the fifth President of Republic of Indonesia on 23 July 2001, she dismissed the Cabinet Ministry, known as *Kabinet Persatuan Nasional* (the

National Unity Cabinet) under Wahid, through Presidential Decree No. 228/M/2001 and she established her own Cabinet Ministry known as the *Gotong Royong*<sup>66</sup> Cabinet. Simultaneously, she reinstated the State Ministry of ISOEs and transferred the supervision of ISOEs from the Ministry of Finance to the State Minister of ISOEs. She appointed Laksamana Sukardi as the ISOE minister, who also held the position of Treasurer in Megawati's political party—PDI-P. Following this, the government issued Government Regulation No. 64/2001 concerning the transfer of the Finance Minister's authority as the shareholder and government representative in the ISOEs to the State Minister of ISOEs. However, this excluded the issuing of loan letters and the signing of ISOEs' annual reports.

Under this new regulation, the State Ministry of ISOEs has three main duties:

- (1) Acting as the shareholder at the general meeting of shareholders in Persero as stipulated in Government Regulation No. 12/1998 and Company Act No.1/1995 on Limited Liability Company.
- (2) Acting as as the Government representative in Perum, as regulated in Government Regulation No. 13/1998.
- (3) Acting as the agent for the financial advisor in Perjan, as stated in Government Regulation No. 16/2000 (*Peraturan Pemerintah*, 2001).

In the light of this duty, the ministry's functions, as regulated in Presidential Decree 101/2001, are:

- to formulate government policy in managing ISOEs, including supervision, improving efficiency, restructuring and privatising ISOEs
- to coordinate and enhance synergy of plans and programs, monitoring, analysis and evaluation in managing state-owned enterprises
- to forward outcome reports, suggestions and ideas for consideration in relation to his/her duties and functions to the President.

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<sup>66</sup> *Gotong Royong* is a practice of mutual cooperation.

Currently the organisational structure of the State Ministry of ISOEs consists of the Minister, Secretary, five Deputies, 16 Assistant Deputies, and four advisors. Responsibility among the four Deputies is divided according to four industry sectors: (1) financial services, construction and other services, (2) logistics and tourism, (3) agro industry, forestry, paper, printing and publishing, and (4) mining, strategic industry, power and telecommunications. One Deputy is responsible for restructuring and privatisation.

### ***The Stipulation of Act No.19 Tahun 2003***

In 2003, the People's Representative Assembly (PRA) endorsed Act No.19/2003 on ISOEs<sup>67</sup>. This long-awaited bill relating to ISOEs deals with operational procedures, restructuring and privatization. Accordingly, some laws which regulate ISOEs, including the Indonesische Bedrijvenwet (IBW) 1927 promulgated during the Dutch colonial period, were annulled. This does not include Government Regulation No. 12/1998 on Persero and Government Regulation No. 13/1998 on Perum. Under the ISOE Act, there are only two types of ISOEs: Persero (a limited liability company) and Perum (semi profit oriented company).

The ISOE Act No. 19/2003 contains many new aspects of Indonesian corporate law principles that were never dealt with in the past, not even in Act No. 1/1995 on the Limited Liability Company. Some of the important aspects incorporated in the ISOE Act No 19/2003 are corporate governance issues. For example, Act No. 19/2003 article 3 requires that in executing their duties the Board of Management must abide by the articles of association of the ISOE and the provisions of the law and they must practice the corporate governance principles of transparency, independence, accountability, responsibility and fairness.

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<sup>67</sup> Before the stipulation of ISOE Act No. 19/2003, ISOEs were regulated under different types of laws which created problems with supervision.

## **The Roles and Objectives of ISOEs in the Indonesian Economy**

The purposes and objectives of the establishment of the ISOEs as stated in the ISOE Act No. 19/2003 article 2 are as follows:

- To contribute to national economic development in general and state revenues in particular
- To earn profits
- To manage public benefits, by way of procuring high quality goods and/or services, which are adequate to fulfill the needs of the public at large
- To be pioneers in business activities that are not, as yet, carried out by private enterprises and cooperatives
- To actively participate in the provision of guidance and assistance to small scale businesses, cooperatives and the general public

Based on those objectives, the roles of the ISOEs are always significant to the Indonesian economy and never lessen. The latest evidence was seen when the economic crisis hit Indonesia in 1997-1998. Hence, their roles in the Indonesian economy were very significant, particularly in the development of infrastructure such as roads, transportation, telecommunication, electricity and the development of backward regions.

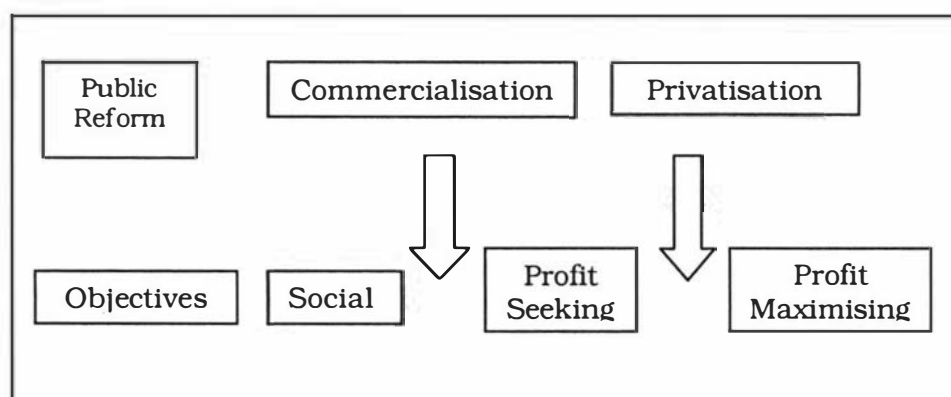
A common view, shared by the public, is that ISOEs should function as an agent of development and at the same time have a role as profit centres. Wibisono (1998) argues that, based on the interpretation of UUD 1945 article 33, the ISOEs mission is to provide 'welfare to the society' and therefore profits should not be the main focus. However, the annulment of *Perjan* and the transformation of the *Perum* legal form to *Persero* raise the question, 'Do ISOEs still bear a social mission in their activities?'

The change of *Perum*'s legal status to *Persero*, according to Ibrahim (1997: 113), creates theoretical confusion between social and economic functions. With *Perum*'s main function being to sell public goods and services to the majority of the public at low prices or even at loss, because it receives government subsidies the change of its legal form may indicate that the government now puts more emphasis on the 'enterprise' nature of



ISOEs rather than their 'publicness'. In the literature, it is known as commercialisation which is seen as a reorientation of the company's objectives away from social targets and more towards profitability targets (Bozec, Zeghal and Boujenoui, 2004: 79). Commercialised SOEs become profit seeking companies and later, when they are privatised, they become profit maximising companies (Bozec et al, 2004: 84). Figure 6.1 presents the impact of public reform on SOEs' objectives.

**Figure 6.1 The Impact of Public Reform on SOEs Objectives**



Source adapted from Bozec et al (2004: 85)

At issue here is a tendency among the management of Perjan and Perum to change their legal structure to Persero, regardless of ISOE's missions. One of the reasons, as conveyed by the interviewees, is for the ISOEs to become more independent and have less government intervention, particularly when the ISOE is subsequently privatised. This view is not new. Kay and Thompson (1986: 29) note that, in a UK case, senior management's interest in privatisation stems from a wish to be rid of Treasury control, without having to change the existing company structure or move to a more competitive environment. Another reason is there seems to be a common view, among the public and the management of the ISOEs, that Perjan, Perum and Persero are structured like a pyramid with Perjan at the bottom and Persero at the top. Here, there is a tacit perception among ISOE management that they would receive a higher

status by being managers of Persero rather than managers of Perjan or Perum.

Regrettably, the change of legal status has not shown any advantages for the ISOEs and public at large. Many Perums that have become Perseros still suffer from inefficient and unprofitable operations. For example, in 2003, PT Kereta Api Indonesia<sup>68</sup> (the railways) suffered an operating loss of Rp3 billion. Similarly, in 2003, PT Inhutani II (forestry industry) lost Rp58,6 billion. PT *Telkom* and PT *Perusahaan Listrik Negara* increased their tariff after their legal status became Persero. Also the quality of goods and services delivered to the public continues to be disappointing. In terms of services, railways users, particularly in economy class, still have to deal with dirty wagons and unfriendly staff. In addition, people still have to deal with dirty drinking water because the ISOEs fail in their responsibility to fulfil the public demand for clean water. In terms of business scale, the ISOEs are still unable to meet public demand. Faisal Basri, a lecturer at the University of Indonesia, states that PT Telkom Tbk. was not able to build more than 4 percent of the total telecommunication connections that people needed. In addition, PT PLN can only provide 60 percent of the total demand for electricity by households (*Tempo Interaktif*, March 23, 2005). This means there is a shortage in power supply which means that many people still live without electricity and have to endure power cuts and black outs time and time again.

### **The Performance of ISOEs**

To date, despite some of the better managed ISOEs successfully going public, the performance of the majority of ISOEs remains unsatisfactory. They are still struggling with poor performance characterised by low profitability, unfocused operations, red tape intricacies, low productivity, low asset utilisation and lack of customer and market orientation. One example is the financial performance of state-owned banks. Data in *Bank Indonesia* (the Indonesian Central Bank) showed that in the first semester

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<sup>68</sup> To date, the railways (PT *Kereta Api Indonesia*) still bear a social mission and therefore it should have been established as a Perum. It would be difficult for this company to gain profits if it could not charge the ticket price above the costs.

of 2005, while other banks increased their profits, the net profits of state-owned banks declined from Rp.7.45 to Rp.2.53 trillion, a decrease of 66 persen (*Kompas Online*, August 13, 2005).

Prior to the economic crisis, there were more than 160 ISOEs and these, together with their related entities, made up a total of approximately 630 operating units. To date, there are still approximately 160 ISOEs which are comprised of eight privatized SOEs, 131 Perseros, 12 Perums, and 15 Perjans (The State Ministry of ISOE website, 2005)<sup>69</sup>. The financial performance of those ISOEs, as of 2001, is presented in Table 6.3 below.

**Table 6.3 2001 ISOEs Financial Performance By Industry Group**

(In Billion Rp)

No.	Description	Number of ISOEs	Total Revenue	EBT	Total Asset	Equity	ROA (%)	ROE (%)
			1	2	3	4	2:3	2:4
1	Banking	5	64,169	6,752	475,361	30,020	1.42	22.49
2	Insurance	9	11,414	983	30,605	2,851	3.21	34.49
3	Financial Services	6	1,274	97	10,013	2,353	0.97	4.12
4	Construction Services	9	4,735	143	6,158	1,238	2.32	11.56
5	Construction Consultant	5	133	9	99	26	9.17	35.43
6	Construction Support	2	957	200	3,691	1,502	5.41	13.3
7	Valuation Services	4	662	-105.4	832	545	-12.67	-19.35
8	Other Services	2	145	28	245	231	11.36	12.03
9	Hospital	13	0	0	0	0	-	-
10	Ports	4	3,271	1,119	7,902	5,153	14.16	21.72
11	Shipping	4	2,070	113	6,416	5,136	1.76	2.2
12	Airports	2	2,288	850	6,078	4,449	13.98	19.1
13	Land Transport	3	1,997	40	3,204	2,429	1.23	1.63
14	Logistics	3	1,336	47	1,941	575	2.4	8.09
15	Trade	5	2,780	46	1,380	317	3.3	14.35
16	Dredging	1	175	-56	531	397	-10.55	-14.12
17	Pharmaceutical Industry	3	3,276	539	2,254	1,555	23.89	34.64
18	Tourism	3	328	62	471	294	13.11	21
19	Industrial Zone	7	334	140	802	607	17.51	23.14
20	Aviation	2	14,187	-11	10,215	957	-0.11	-1.17

<sup>69</sup> These numbers exclude the number of ISOEs that belong to local government.

21	Docks and Shipping	4	1,560	134	4,270	801	3.14	16.73
22	Plantations	15	10,407	513	14,121	7,853	3.63	6.53
23	Agriculture	2	770	-5	312	92	-1.64	-5.55
24	Fisheries	4	121	-8	105	-12.2	-7.98	69.59
25	Fertilizers	2	9,637	1,200	13,815	6,863	8.69	17.49
26	Forestry	6	2,204	106	2,751	1,706	3.84	6.19
27	Pulp	2	768	-20	1,733	454	-1.14	-4.35
28	Printing and Publishing	4	659	69	876	524	7.86	13.13
29	Mining	3	2,475	547	4,818	3,385	11.34	16.15
30	Energy	4	33,491	4,737	83,823	25,459	5.65	18.61
31	Technology-based Industries	5	1,981	-43	4,558	2,990	-0.95	-1.45
32	Steel and Steel Construction	3	5,405	-241	7,270	4,882	-3.31	-4.94
33	Telecommunication	5	16,074	9,033	54,235	19,694	16.65	45.86
34	Defence	2	576	34	549	159	6.21	21.39
35	Cement	3	4,696	649	9,889	3,593	6.56	18.05
36	Textile Industry	2	644	25	533	276	4.66	9.01

EBT: Earning Before Taxes

ROA: Return on Assets

ROE: Return on Equity

Source: Kementrian BUMN, Master Plan (2002)

### Revenue

Data from Table 6.3 shows that 145 ISOEs (excluding Perjan) contributed revenue to the amount of Rp207,309 billion. Of these, 25 ISOEs provided total revenue of Rp166,485 (80 percent), 39 ISOEs contributed Rp31,147 billion (15 percent) and 39 ISOEs contributed revenue of Rp. 9,758 billion (5 percent). These numbers suggest that a large number of ISOEs performed poorly and contributed less to government revenues. In addition, out of 145 ISOEs, with total revenues of Rp207,390 billion, six ISOEs contributed revenue more than Rp10,000 billion (54 percent), three ISOEs contributed revenue between Rp5,000 to Rp10,000 billion (10 percent), 27 ISOEs contributed revenue between Rp1,000 billion to Rp5,000 billion, 25 ISOEs contributed revenue between Rp500 billion to Rp1,000 billion and 84 ISOEs contributed revenue less than Rp500 billion.

### *Profit and Loss*

Data from Table 6.3 reveals that out of 145 ISOEs, with a total profit of Rp28,793 billion, 11 ISOEs contributed a profit of Rp22,765 billion (79 percent), 24 ISOEs contributed a profit of Rp4,289 billion (15 percent) and 85 ISOEs contributed a profit of Rp1,686 billion (6 percent). Of the Rp28,793 billion profits of 145 ISOEs, 56 percent was contributed by 4 ISOEs with a total of Rp16,153 billion, in which each provided a profit of more than Rp2,000 billion, 3 ISOEs contributed Rp4,151 billion (14 percent) in total, in which each contributed a profit between Rp1,000 billion and Rp2,000 billion, 9 ISOEs contributed a total of Rp 2,180 billion (8 percent) in which each contributed a profit between Rp300 billion and Rp1,000 billion and the other 92 ISOEs contributed Rp2,304 billion profit in total (8 percent), in which each contributed a profit less than Rp100 billion. Of 145 ISOEs, 45 suffered losses in total of Rp1,010 billion, comprising 11 ISOEs that contributed losses of Rp. 846 billion (84 percent), 6 ISOEs that contributed losses of Rp136 billion (13 percent) and 8 ISOEs that contributed losses of Rp28 billion (3 percent).

### *Total Assets and Total Equity*

The total assets of 145 ISOEs were Rp772,501 billion. Of these 145, 4 ISOEs had total assets of Rp518,495 billion (68 percent), in which each had total assets of more than Rp50,000 billion. 6 ISOEs had total assets of Rp118,384 billion (15 percent) and each had total assets between Rp10,000 billion and 50,000 billion. 33 ISOEs had total assets of 71,736 billion (9 percent) in which each had total assets between Rp1,000 billion and Rp5,000 billion. 98 ISOEs had total assets of Rp30,879 billion (4 percent) and each had assets less than Rp1,000 billion.

The total equity of 145 ISOEs was Rp139,611 billion. Of this, Rp45,962 billion (33 percent) was from 3 ISOEs in which each had a total equity of more than Rp. 10,000 billion. Four ISOEs had equity in total of Rp29,222 billion (21 percent) with each of them having equity between Rp. 5,000 billion and Rp10,000 billion. 8 ISOEs had a total equity of Rp25,361 billion (18 percent) with each having equity between Rp. 2,000 and Rp. 5,000 billion. 28 ISOEs had a total equity of Rp26,425 billion (19 percent)

and each had equity between Rp. 500 billion and Rp2,000 billion. 102 ISOEs had a total equity of Rp12,641 billion (9 percent) and each had equity less than Rp500 billion.

*Return on Assets (ROA) and Return on Equity (ROE)*

Of 145 ISOEs, 12 had ROA (Return on Assets) above 20 percent, 25 had ROA between 10 percent and 20 percent, 27 ISOEs had ROA between 5 percent and 10 percent, 25 ISOEs had ROA between 2 percent and 5 percent and 25 ISOEs had ROA less than 2 percent. Of 145 ISOEs, 1 ISOE had ROE above 100 percent, 17 ISOEs had ROE between 30 percent and 100 percent, 38 ISOEs had ROE between 15 percent and 30 percent and 41 ISOEs had ROE less than 10 percent. Table 6.4 presents the targeted financial performance of ISOEs from 2002 to 2006.

**Tabel 6.4 Targeted Financial Performance of ISOEs 2002-2006 by Revenues**

in Billion Rupiah								
Year	Total Revenue	EBT	Total Asset	Equity	ROA (%)	ROE (%)	Description	
	1	2	3	4	1:3	1:4		
2001	207.39	27.783	772.501	139.611	3,60	19,90	Revenue	13 % /year
2002	237.567	30.573	831.162	157.189	3,68	19,45	EBT	12 % /year
2003	258.975	34.371	900.03	172.353	3,82	19,94	T. Asset	8 % /year
2004	284.116	37.537	963.346	182.572	3,90	20,56	Equity	8 % /year
2005	327.119	42.96	1.032.993	194.972	4,16	22,03	ROA	4 % /year
2006	378.668	49.734	1.113.067	209.562	4,47	23,73	ROE	4 % /year

Source: Kementrian BUMN, 'Master Plan' (2002)

In 2003, 47 of the SOEs had a total loss of Rp 6,08 billion, of which 84.4 percent (Rp5.13 billion) was contributed by 10 ISOEs: PT *Perusahaan Listrik Negara* (electricity), *Perusahaan Perdagangan Indonesia* (trading), PT *Pelayaran Nasional Indonesia/PELNI* (sea transportation), PANN *Multi Finance* (finance), *Indofarma* (pharmaceutical), *Industri Sandang*

Nusantara (garments), *Kertas Kraft Aceh* (paper), PT PN II (plantation), PT *Exploitasi dan Industri Hutan/INHUTANI* (forestry), dan RS <sup>70</sup> *Cipto Mangunkusumo* (hospitals) (Kompas Online, 4 December, 2004). Table 6.5 presents the financial performance of ISOEs from 2001 to 2004.

**Table 6.5 ISOEs Financial Performance 2001-2004 by Profits**

In Billion Rupiah

	2001	2002	2003	2004*
No of SOEs	150	158	157	158
No. unprofitable SOEs	48	58	54	31**
Total losses	2,222	9,589	6,081	4,492
No. profitable SOEs	102	100	103	127
Total profits	18.448	25.665	25.611	29.428
Total assets	810.419	935.587	1,163.644	1,177.755
Total debts	678.783	662.539	761,507	695.831

Source: *Jakarta Post* (2005)

\* unaudited

\*\* six companies had not reported and were assumed unprofitable

### **Privatisation of ISOEs**

Privatisation is an important factor in the improvement of corporate governance practice in ISOEs. Therefore, a review of the current conditions regarding Indonesia's privatisation programme is essential in order to assess whether this programme has improved corporate governance practices in ISOEs. Between 1973 and 1983, Indonesia gained benefits from the significant increase in oil prices which dramatically increased government revenues. As a result, the government, through ISOEs, became involved in a large number of development projects. The ISOEs began to take a dominant role in a number of sectors and public investments and were increasingly directed into heavy industries, petrochemicals and mining. During that time, the government issued

<sup>70</sup> RS is the abbreviation of *Rumah Sakit* (hospital)

Presidential Instruction No. 11/1973 to modify Act No. 9/1969. This regulation allowed the technical ministries to control ISOEs under their jurisdiction which had previously been under the Finance Ministry.

However, failing oil revenues, combined with the Pertamina crisis, created a budget deficit and therefore the government was no longer able to finance many development projects, including providing financial support to the ISOEs. As a result, the government began to implement a structural adjustment programme (Lomax, 1986)<sup>71</sup>. As practiced in other countries also suffering from the economic crisis in 1980s (e.g., New Zealand and Brazil), the government considered privatisation of ISOEs as one alternative source of government revenue. Indeed, privatisation, at that time, was considered as a pragmatic approach to overcoming financial crisis, especially with regard to reducing the government subsidy to ISOEs. More importantly, the privatisation programme became a precondition for receiving financial aid from international financial agencies, such as the IMF and the World Bank.

The sign of the government's attention to privatisation programmes was seen in a seminar on public finance at *Fakultas Hukum Universitas Indonesia*/FHUI (the University of Indonesia's Law Faculty) in January 1986. In that seminar, Ruchyat Kosasih, a representative of the Auditing Board of the Finance Ministry, suggested that those ISOEs that were in poor shape and were not of strategic importance to the country, such as trading companies, should be privatised (*Kompas*, 1986 cited in Djamhari 1996). He argued that privatisation would minimise financial risk for the government and at the same time alleviate the administrative burden of bureaucracy.

On 30 December 1986, President Suharto gave his first direction to Ministers to assess which ISOEs might possibly be privatised. The finance Minister at that time, Radius Prawiro recommended that only ISOEs under category Persero were considered suitable for sale. Other categories of ISOEs, Perum and Perjan, were to be excluded because 'they operated in branches of production essential to the state and governing the life and

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<sup>71</sup> At that time, the terms de-burecratisation and de-regulation became the new 'catch-word' for policymakers.



living of the public' (*Suara Karya* 19 January 1987 cited in Djamhari 1996).

On 4 February 1987 when the President chaired the EKUIN<sup>72</sup> cabinet meeting he instructed the EKUIN Coordinating Minister to assess which ISOEs showed losses from time to time and would thus be suitable for possible sale. Following this February meeting the President held another meeting on 4 March 1987 attended by the EKUIN Coordinating Minister, the State Secretary, the Chairman of BPKP and the Governor of *Bank Indonesia* (the Central Bank). The agenda was to discuss a privatisation programme from a wide range of perspectives. A committee, chaired by the EKUIN Coordinating Minister, was established. The purpose was to supervise a privatisation programme in a well-organized way in order to prevent conflicts of interests that might exist among the parties involved. On 25 October 1988, the committee presented its report to the President. The recommendation to the government was to carry out a privatisation programme carefully and flexibly and to consider possible corrective measures. The first ISOEs put on a privatisation programmes were PT Semen Gresik (cement industry), PT Indosat (telecommunication and satellite industry) and PT Telekom (international and domestic telecommunication industries), PT Timah (tin mining industry) and PT Bank Negara Indonesia (banking industry)<sup>73</sup>.

### ***Methods of Privatisation***

Methods used for the privatization process range from Initial Public Offering (IPO), to private placement by strategic investor or by financial institutions. Strategic investors are expected to provide fresh capital, mainly foreign exchange, which is badly needed by the government. This

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<sup>72</sup> EKUIN is the abbreviation for *Ekonomi, Keuangan dan Industri* (Economy, Finance, and Industry).

<sup>73</sup> In other countries, the privatisation programme commenced by selling smaller state-owned enterprises operating in a competitive industry, in order to develop a good record of accomplishment and credibility. Then the programme moved on to larger transactions. However, this approach could not be applied in Indonesia, due to pressure on the state budget which was suffering from a huge deficit. In this situation the government had to act quickly to privatise SOEs in order to secure the government budget.

capital is expected to help increase efficiency, transfer technology and enhance the competitive advantage of the companies in the global market (Abeng, 2000). Of these methods, the government considered partial privatization, through IPO in the stock exchange market, was the most appropriate option. The reasons were, at least, three-fold: Firstly, it created less political tension, especially from the political opposition because, by retaining the ISOEs shares of 51% or more, the government is still the majority shareholder. Political tension was also at eased because, through the IPO, the general public, as well as small and medium sized companies, had the opportunity to purchase the ISOEs shares. This means ISOE ownership was spread through to the public.

Secondly, by selling the ISOEs' shares through IPO, it established a market for corporate control, which was useful as an instrument in ensuring effective monitoring of company performance. If shares were not issued through capital markets, there would be less public scrutiny regarding the quality of management, resulting in less incentive for managers to be accountable and transparent. Thirdly, selling SOE shares through the stock exchange improved the activities of the capital market and accelerated the development of the Indonesian domestic capital market. The creation of a strong capital market facilitates substantial involvement by the private sector in investment and development.

The majority of the interviewees participating in this study agree with privatisation and they believe it does not have a detrimental impact on the national sovereignty of the country. As stated by one interviewee:

I do not believe that privatisation will put Indonesia under the domination of foreign companies. We have to acknowledge that foreign intervention is very strong. We learned that from the economic crisis. However, can we claim that the only way foreign companies dominate Indonesian economy is through their investment in ISOEs? The underlying philosophy of owning ISOEs is to improve societal wellbeing. But this is not the monopoly of the government because the private sector is, in fact, able to provide similar goods and services and often much better. For example, the ISOEs which have a social obligation to deliver clean drinking water fail to do so. To date, we still have dirty drinking water delivered to our houses. In contrast, a privately owned company [PT Aqua,] owned by the Tirta family is able to provide much better, clean

drinking water to the public. So, what is the importance of government ownership? (A03, September 2003).

To date, the privatisation programme<sup>74</sup>, albeit on and off, is still ongoing and gained momentum when the government formally included privatisation in the ISOE Act No. 19/2003<sup>75</sup>. In article 74 of this Act, the objectives of privatisation in Indonesia are stated as follows:

- To broaden public ownership in Persero
- To reduce government spending while at the same time increasing government revenues
- To increase companies' efficiency and productivity
- To create good/strong financial and management structure
- To create a healthy and competitive industrial structure
- To create a competitive advantage for Persero and to globalise its orientation
- To develop a business climate, macro economy and market capacity

Of the seven objectives stated above, only one objective has been pursued: that is the reduction of government spending and an increase in revenues. The realisation of other objectives is uncertain because, to date, there is no indication that privatisation is moving to achieve those objectives.

### ***Debates on Privatisation***

As in other countries, there are significant debates regarding privatisation. The proponents of privatisation argued that it is an effective means of reducing state controls; it encourages competition and enhances efficiency.

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<sup>74</sup> Besides gaining revenues from privatization, the government also has another source of revenues from selling the conglomerates' business assets that were bailed out by the government during the economic crisis. The agency assigned to managed and sell these assets is the State-owned Management Company supervised by the Finance Ministry.

<sup>75</sup> Prior to this Act, the privatisation programme had never been regulated under any laws and there was no formal plan or blueprint to guide the privatisation programme. Hence, it is not surprising that the objectives of the privatisation programme have never been transparent or consistent. Moreover, the government seemed to carry out the privatisation programme by trial and error.

They are dissatisfied with the ISOEs economic performances and believe that ISOEs have always been a 'money losing proposition'. In addition, it is deemed necessary to balance economic power in Indonesia, with ISOEs' assets sales directed to *Pengusaha Pribumi* (indigenous entrepreneurs). Privatisation is seen as necessary because, not only does it improves efficiency, that leads to an increase in profits, but it also enhances sound corporate governance practices through the independence, transparency and accountability of ISOEs. To effectively carry out the programme, the proponents of privatisation urge the government to be more aggressive in building privatisation campaigns and disseminating information on the benefits of the programmes to the public and local politicians, in order to win their support. In addition, they argue that the sale of ISOEs should be carried out through partial floatation of shares to the general public and co-operatives, combined with deregulation and adoption of private management practices (Mardjana, 1993). Similarly, privatised ISOEs should employ managers from the private sector. As argued by Cowan (1987), private entrepreneurs can manage industries more effectively and operate services more efficiently than can public entrepreneurs.

For the opponents, privatisation is an unconstitutional and risky process. It shifts the economy from a socialist to a capitalist system and therefore widens the economic and social gap between rich and poor and between pribumi and non-pribumi (commonly Chinese). Privatisation is seen as selling assets to foreign companies, which may result in foreign domination in strategic national assets. Hence, they argue that privatisation will not bring prosperity, equality or peace but only misery to the Indonesian economy. As Hatta, the founding father of the nation, once said, 'A political economy that is based on private initiative will only open the way for foreign capitalists to enter Indonesia. If this happens, the history of colonisation of the economy will be repeated.' (Lubis, 1997)

In his study, Djamhari (1996) noted that opposition to privatisation could come from those who:

- are ideologically predisposed against a competitive and market-oriented system

- view ISOEs as instruments for the state to achieve various objectives, such as stabilizing prices, providing employment, setting modernization examples, being an agent of development and being responsible for regional development
- view ISOEs as a necessary counterweight to a private sector dominated by ethnic Chinese Indonesians<sup>76</sup>.

Relating to the first point, this argument is based on the Indonesian Constitution of 1945, article 33 (2), mentioned in the previous section, which is interpreted by the opponents of privatisation as legitimacy for the government to establish, own and control ISOEs, particularly in strategic areas which the government considers important to maintain the country's sovereignty and economic independence. However, this argument is challenged by the proponents of privatisation, who say that the government does not have to own a company to control their activities. As noted by Aharoni (1986: 7), ownership does not always means control and control can be achieved without ownership. The government may control a firm through its dependence on the government. In the US, for example, most firms manufacturing weaponry are privately owned but the Pentagon's acquisition rules determine the firm's book keeping system and its way of calculating costs (Ibid: 9).

Djamhari (1996) also noted that those who did not find the benefits of privatisation in their interest were (but not limited to) bureaucrats in relevant technical ministries who benefited financially from the ISOEs they control and who received additional income by sitting on Boards of ISOEs, senior managers of ISOEs who feared their positions would be threatened and those private firms who might loose their favoured contractual status with ISOEs if they were privatised. In other words, as many analysts say, certain politicians or company management have their own personal agenda in rejecting the privatisation programmes, i.e., to retain their lucrative sources of income.

Another reason for opposing privatisation is related to the transparency of the privatisation process. A recent survey, conducted by

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<sup>76</sup> These political interests will even use racism to prevent ISOEs from being privatized to Chinese conglomerates or more open to public scrutiny.

the faculty of social and political sciences at the University of Indonesia, revealed that one of the main reasons 49 percent of respondents in Jakarta were opposed to privatisation was because of poor transparency in the sale process. The divestment of PT Indosat, for example, triggered public resentment because the process was not transparent and it was suspected that it benefited parties involved in the process. Hence, *Dewan Perwakilan Rakyat* (the People's Representative Assembly) requested that the State Ministry of ISOEs office postpone the entire privatisation programmes until the government and members of parliament had agreed on a concept for privatisation.

The opponents of privatisation often urge the government to postpone privatisation, especially during unfavourable market conditions, arguing that the asset price could rise later on. The unfavourable market conditions, as argued by the opponents, will put downward pressure on the price of the ISOEs' assets, which makes privatisation not a good idea. However, the counter argument is that there is no guarantee that the price will increase, particularly during legal uncertainty and in light of the government's poor record of accomplishment in implementing the asset sales programmes.

Some analysts argue that public opposition to privatisation is because the government fails to explain, in easily understandable terms, both the merits and demerits of privatisation, as well as the need for it in the country's current state. For example, the widespread protest against PT Semen Gresik's (cement company) privatisation programme was partly caused by the lack of information given to the employees, local government, the public and lawmakers about the importance of privatisation<sup>77</sup>. An economist, Didik J. Rachbini, states the necessity for more intensive dialogue between government and the stakeholders. He expects that the government (central and local), the politicians and the public's understanding about the privatisation programmes is a crucial

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<sup>77</sup> This is not confined to Indonesia. In New Zealand, for example, the NZ Business Roundtable (1988) suggested that there was a need for the government to clarify the objectives of privatisation, and establish a clear programme of privatisation. The purpose for this was to reduce uncertainty both about candidates for the privatisation process and about the ground rules for privatisation.

part of the country's economic reform, which aims to achieve sustainable economic recovery.

### ***Current Status***

Despite attention and efforts by the government to support the privatisation programme, progress is slow and opaque. Since 1998, the government has projected 12 ISOEs for divestment each year but has so far divested only some of them, because almost every deal was mixed up with political controversy and allegations of corruption. In 2000, not a single cent of the Rp6.5 trillion in revenues, expected from privatisation was collected. In 2001, only Rp3.5 trillion of the Rp6.5 trillion revenue targets were achieved (Kompas Online, December 10, 2001). Even these revenues were made available only through a further divestment in listed PT Telkom, which was privatised in 1995. In 2003, only Rp2.54 trillion of Rp6.2 trillion projected was realised from privatisation.

The slow process of the privatisation programme is due to the government's intention to keep the operation of ISOEs under its influence<sup>78</sup> (Djamhari, 1996). Similarly, government departments and other holders of political power have an interest to maintain the status quo (Syahrir and Brown, 1995: 136). In the literature, Haggard and Kauffman (1988: 25-6) assert that once an SOE is in government hands, there exists a tendency to keep it, regardless of ideology or performance. This results in the government seeming to be reluctant in pursuing a radical policy of transferring SOEs. Hence, some government officials perceive that the costs resulting from political and economic ownership transfer outweigh the benefits (cited in Djamhari, 1996). Table 6.6 shows the list of ISOEs subject to privatisation programme in 2001 and 2002.

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<sup>78</sup> This is not unique to Indonesia. In Russia, for example, the state retains a controlling stake of shares in 30% of all industrial firms, with a total output accounting for 20-25% of GDP. In addition, in large companies and companies in key industries, the state guaranteed itself the controlling power of majority shareholders through the so-called golden share (Kuznetsova and Kuznetsov, 1999: 437). A golden share gives the government the right to block any decisions taken in shareholders' meetings.

**Table 6.6 List of ISOEs Subject to Privatisation Programme**

No.	Name of ISOE	Business Types	Government Ownership (%)	Method of Privatisation
<b>A</b>	<b>Carry Over 2001</b>			
1	Indo Farma	Pharmaceutical	80.93	SS
2	Kimia Farma	Pharmaceutical	90.3	SS
3	Wisma Nusantara International	Hotel and Office Space	41.99	SS
4	Indosat	Telecommunication	65	SS/AGT*
5	Bank Mandiri	Banking	100	IPO
6	Indocement TP	Cement	16.87	Secondary
7	Tambang Bukit Asam	Coal	100	SS/IPO
8	Bandara Sukarno Hatta (PT AP II)	Airport Management	100	SS
9	Semen Gresik	Cement		SS
<b>B</b>	<b>2002</b>			
1	Angkasa Pura I	Airport Management	100	SS/IPO
2	Atmindo	Machinery	36.6	SS
3	Cambrics Primmisima	Textile	52.79	SS
4	Cipta Niaga	Trading	100	SS/IPO

Source: Kementrian BUMN, Master Plan (2002)

Another factor that has slowed the privatisation programme is that neither the government nor the ISOEs management have clear missions and objectives that are shared by society. This creates divergence of opinions between the government, the public and the PRA. Different views on the privatisation programme, between the PRA and the ISOE Ministry office still persist, not only on the definition but also on the scope of privatisation. The ISOE Minister stated that different perceptions on privatisation between government and the PRA become a burden to the government. Similarly, an Assistant Deputy of the ISOE Ministry expressed his concern 'How can we gain investors' trust if we are endlessly not in agreement'? (*Tempo Interaktif*, May 21, 2003). Similarly, Budiono, a former Finance Minister, admitted that the lack of political support has been the main obstacle to the country's privatisation programme (*Jakarta Post*, December 12, 2001). In this respect, one interviewee stated,



It is easy to understand privatisation if the government takes the initiative to make a campaign about privatisation vision and mission. Unfortunately, the government's privatisation programme is not equipped with a clear vision and mission. These factors are forgotten. The Master Plans of the State Ministry of ISOEs does not lay the philosophical foundation of privatisation but merely the action plans. In addition, ISOE Act No. 19/2003 does not solve basic problems existing in the ISOEs, including the audit issues (A03, September 2003)

In the ISOE context, one interviewee stated:

The objective of privatisation in PT PNM is unclear. It seems that it is merely to increase the company's image. A similar thing is happening in PT Jasa Marga. Its privatisation programme is not transparent and it is not for the consumption of the public. The reality is that I have never known the ISOEs to publish their prospectus when they plan to go public (P03, September 2003).

### **Some Issues in the ISOEs**

Over the years, there has been growing public concern about the performance of ISOEs relative to private enterprises. These concerns were instigated by the inefficiency, low productivity and money losing activities of ISOEs. Many ISOEs do not meet public expectations for product quality or quantity, due to their frequent inability to compete with already existing private companies and to adapt to technological advances. The products and services provided by the ISOEs are mostly poor and thus the public argues that the ISOEs are not operating in the best interest of the public at large. Many Perseros, whose mission is to seek profits, have been very unsuccessful in many areas and suffered unprofitable businesses.

There are some factors identified as the causes of inefficiency in the ISOEs. Firstly, ISOEs monopolising certain business sectors become the source of Korupsi, Kolusi, and Nepotisme/KKN (corruption, collusion and nepotism) rather than benefiting society. In many instances, they become a convenient source of cash for certain groups of people in the advancement of their own political interests. The latest incident was when Bulog (an SOE in charge of the availability of public basic needs, such as

rice and flour) was urged by a high ranking official, who was also a political party leader of GOLKAR<sup>79</sup>, to financially support his political party's activities to win public votes. This incident resulted in the establishment of a Buloggate Committee under the House of People's Representatives' supervision, whose task it was to conduct a thorough investigation of the matter. After a long process in court several people, including the political leader, were charged and found guilty of corruption.

Secondly, the ISOEs are managed and operated in similar way to charitable organisations, due to the fact that they have a tacit responsibility to accept anyone who wants to work in the enterprise. Although their contributions are unclear these people receive salaries and wages every month (*Kompas online*, December 4, 2004). In addition, the ISOEs still have a social obligation to provide employment. Hence, the State Minister of ISOEs, in a public hearing with the members of the PRA, admitted that, despite a decrease in the number of ISOEs employees from 742,025 in 2001 to 726,126 in 2003, the ISOEs are still overstaffed<sup>80</sup>.

On the privatisation issue, the government appears not to have a clear mission, which results in inconsistent and ever changing policies. The privatisation programme seems to be carried out based on who is in power and particularly who holds the position as the State Minister of ISOEs<sup>81</sup>. The current ISOE Minister, for example, focuses his programme towards improving ISOEs' performance and profits<sup>82</sup> rather than privatisation. As such, he does not have any plan to make a new privatisation list for. In addition, he does not support open privatisation, through public offering, because he considers it will lead foreign investors

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<sup>79</sup> GOLKAR (short for *Golongan Karya*) is a leading political party that supported the Suharto regime for almost 32 years.

<sup>80</sup> Excess employment in SOEs is not unique to Indonesia. In Italy, for instance, ILVA, an Italian state-owned enterprise, never produces any goods but puts people on the payroll (*The Economist*, January 22, 1994). Similarly, in the US, government agencies providing municipal services typically employ 20 to 30 percent more people for a given output level than do private contractors (Donahue, 1989 in Shleifer and Vishny, 1994).

<sup>81</sup> This is, indeed, not country specific. In New Zealand, for example, Brumby et al (1997) note that Shareholding Ministers and their SOE policies may change whenever the political party, or coalition, holding executive government power changes. In Greece all employees and top managers of SOEs are replaced when an opposition party wins an election (Shleifer and Vishny, 1994: 996).

<sup>82</sup> By enhancing profits, the government gains revenues from the ISOEs dividends.

to take control of ISOEs by becoming the majority shareholders. While the previous Minister was accused of selling ISOEs intensely and cheaply, the current Minister states that the government will not sell more than 51 percent of the ISOEs shares. The present privatisation policy of the State Ministry of ISOEs is to let the investors own between five and 10 percent of the ISOEs' shares. Relevant to this, it is worth quoting a statement from Stiglitz (1998):

These extensive powers [of the state] are matched by certain limitations.... The state can impose certain obligations on itself, .... but no government can impose obligations on its successors or even do much to stop itself from reneging on previous commitments [emphasis added].

## **Summary**

This chapter provided a review of the ISOEs from the era of colonisation to the present time. With a long history of existence, the ISOEs demonstrate their significant role in the country's economic development, especially in the era of economic crisis. Although the government tends to embrace market-oriented policies, it has never completely released its intervention in the Indonesian economy. In the 1970s and early 1980s, when the government experienced a huge flow in revenues affected by a sudden increase in oil price, it widened its role in the economy by establishing many new ISOEs, operating particularly in the infrastructure industry.

To date, the ISOEs have generated revenues of more than Rp490 trillion to the government budget and they provide employment. Therefore, their significance to national economic development cannot be ignored. Regardless, there are still a large number of ISOEs that are money losing enterprises and thus they have become a burden on the government budget.

To improve ISOEs' performance and reduce budget deficit, the government, under directions from the financial agencies, took some initiatives such as privatisation programmes and improving corporate governance practices in ISOEs.

Despite the revenues coming from privatisation, progress has been very slow and piecemeal and it seems to be an 'on and off' programme. There are many factors creating this condition, from public opposition and political intervention from the PRA to inconsistency in government policy. The next chapter will discuss corporate governance practices in the ISOEs in detail.

## **Chapter Seven**

### **Corporate Governance and the Boards in ISOEs**

Board membership is a serious matter. It is not about padding a resume or receiving high fees for little work because of one's reputation. It is not about filling the boardroom with people who will be pliable tools in the hands of executives. It is about courageous moral leadership that asks tough questions, insists on complete answers, and takes its role in the company and in society seriously (Gerald Zandstra, 2002: 19)

#### **Introduction**

As discussed in Chapter One, the severe economic crisis which hit Indonesia in 1997-1998 was the result of corporate governance failure, indicated by over-lending, over-investment and KKN, carried out by the conglomerates and ISOEs. The failure clearly demonstrated that corporate governance mechanisms were ineffective and the Boards, responsible to oversee the companies, had performed poorly. The importance of a Board arises from the separation of ownership and control. To ensure that management acts in the best interest of the company, the Board has the responsibility to monitor and closely evaluate the performance of the management. Hence, the Board function is that of an internal control mechanism, 'the first line of defence for shareholders against incompetent or lazy management' (Prowse, 1994: 13). In SOEs, the Board is more important because most operate in markets where competition for products and services is quite limited and thus they are not exposed to major external control mechanisms (Bozec et al., 2004: 8).

With this background, this chapter is organised around the three questions established for this study: (1) What are the corporate governance systems in the ISOEs? (2) What are the roles of the Boards in the ISOEs and (3) Are the Board roles effectively carried out in practice?

To systematically answer the above questions, this chapter is divided into five major sections. Section one begins with a review of corporate

governance in the ISOEs, which consists of three companies' governing bodies: the Shareholders General Meeting, the Board of Commissioners and/or the Board of Supervisors (the Boards) and the Board of Management. Section two discusses the corporate governance principles that relate to ISOEs: transparency, accountability and independence. Section three examines several aspects of a Board attributes including a Board's composition, structure, characteristics and processes. Section four discusses a Board's performance and effectiveness. Included in section one, two and three are the results of in-depth interviews and data from other sources, such as public opinions published in the mass media. The final section is a summary of this chapter.

### **Corporate Governance in the ISOEs**

The ISOEs are governed by ISOE Act No. 19/2003 and government regulations specific for Persero and Perum<sup>83</sup>. Based on ISOE Act No. 19/2003, ISOEs adopt a two-tier Board structure. The basic model of corporate governance structure under the ISOE Act 19/2003 for Persero and Perum is illustrated in figure 7.1.

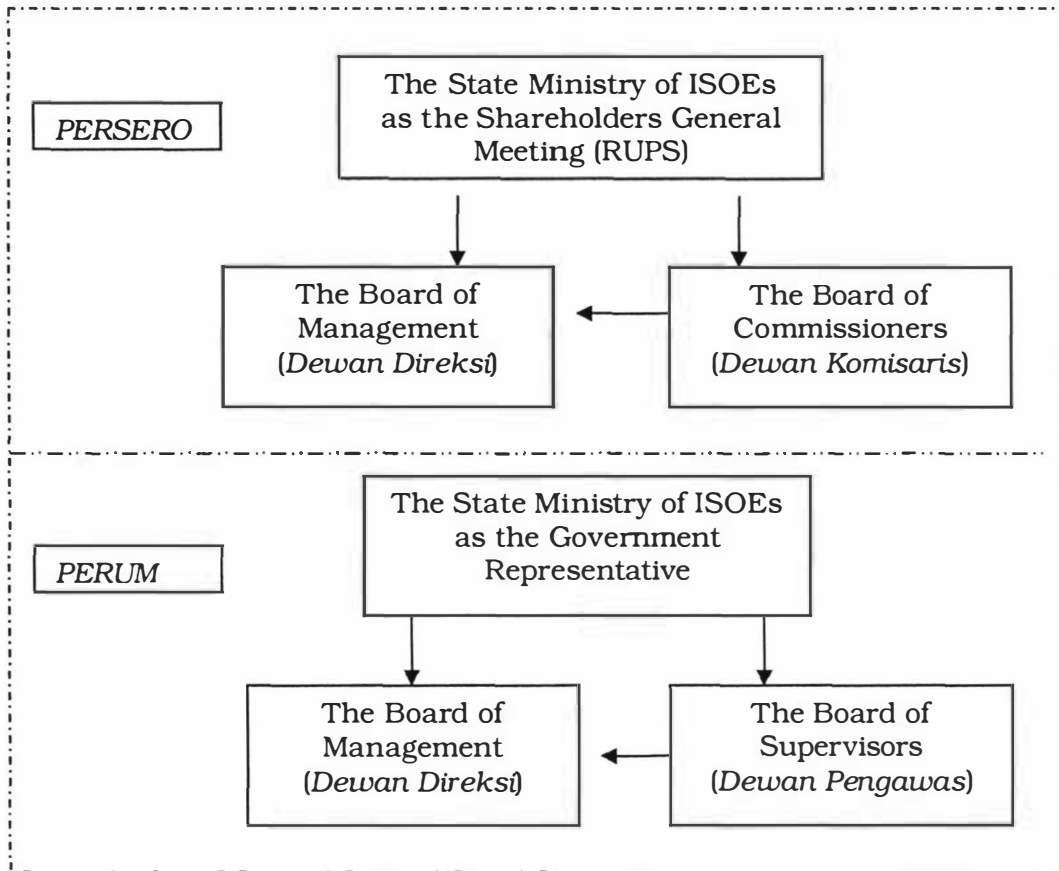
#### ***The Shareholders General Meeting<sup>84</sup> (Rapat Umum Pemegang Saham)***

The shareholders' general meeting (the SGM) is the highest decision making body of the Persero. It represents the power of the the company owners that are not delegated to the Board of Commissioners. The State Minister of ISOEs acts as the SGM if the government wholly owns the ISOE shares (100 percent). Hence, every written decision by the ISOE Minister which relates to the Persero, is the decision of the SGM, although it is not signed during the SGM. If the government partly owns the ISOEs' shares (less than 100 percent), for example, in the privatised Persero the State Minister of ISOEs acts as a shareholder and decisions are reached together with other shareholders at the SGM.

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<sup>83</sup> In addition, privatised ISOEs are regulated by the limited liability company Act No. 1/1995 in the same way as private enterprises.

<sup>84</sup> Another term is the Annual General Meeting (AGM).

**Figure 7.1 Basic Model of Corporate Governance Structure in the ISOEs**

There are two types of SGM: (1) the annual SGM and (2) the special SGM. The annual SGM of ISOEs is held once a year and the objectives are, among others, to review and approve the ISOE's budget and business plans, to determine the profit distributions, and to appoint and dismiss the members of the Board of Commissioners and the Board of Management. The special SGM is held whenever specific matters arise that need immediate actions and the decisions are reserved by the SGM. The specific matters can be, for example, a change in the Article of Association, an appointment or a dismissal of the members of the Board of Commissioners or the Board of

Management and if the Board of Commissioners or the Board of Management so require<sup>85</sup>.

In practice, the annual SGM in Persero is generally a formality to confirm what has been previously discussed and approved in the pre-SGM. The objective of the pre-SGM is to avoid unpredictable questions or potential disagreements in the formal SGM between the ISOE management, the Board of Commissioners and the State Minister of ISOEs. The pre-SGM is commonly attended by representatives of the State Ministry of ISOEs, who are the deputies or the assistant deputies of the State Ministry of ISOEs. Hence, the presence of a Minister in this pre-SGM is a rare occurrence.

In performing his role as the shareholder, the State Minister of ISOEs may have assistance from a team established by the President (e.g. PT PLN). This team consists of several Ministers whose task are to determine and re-evaluate strategic policies and decide action plans for solving enterprise problems on aspects such as legal matters, organisations and finance. These team decisions are then brought to the SGM.

The ISOEs Minister can also appoint a person<sup>86</sup> or a legal institution to represent him/her in the SGM with a provision that for certain matters, i.e. strategic decisions, the person or the institution representing the Minister reserves the right to obtain Ministerial approval. In practice, most SGMs are led by the Minister's staff because technically the Minister is not able to attend hundreds of SGM meetings. This practice may raise problems in some cases. For example, the Minister sometimes delegates his/her rights to lead the SGM to a low ranking government official in his/her office (A03, September 2003). As a consequence, in these situations, strategic decisions have to be postponed waiting for the Minister's approval, which may not be given until long after the meeting is concluded.

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<sup>85</sup> The SGM has three principal functions (Strätling, 2003: 74-75). The first is to inform the shareholders about the financial performance of the company, together with important management decisions. The second is to gain the consent of the shareholders for decisions that do not lie within the managerial discretion of the Board of Directors. The third is to provide a forum for discussion between directors and shareholders concerning past performance and future business policies.

<sup>86</sup> By a person, it means someone who works under the Minister who technically assists the Minister to oversee the related *PERSERO* (explanation of article 14.2, the SOE Act. No. 19/2003).



In Perum, there is no SGM. The State Minister of ISOEs acts as the government representative and represents the highest power in the corporate governance structure. Therefore, the ISOE Minister has a responsibility to establish development policy for Perum, which determines direction in achieving Perum objectives. This includes investment, business and sources of funding, the use of company profits and other development policies. The Minister may discuss the company plans or budget with technical ministers before making any decisions.

In practice, the power of the SGM in Persero and the government representatives in Perum, who represent the highest body in the company corporate governance structure, may not be able to be fully exercised because of the hybrid nature of ISOEs. There are other parties who have political and social pressures exerted upon them and these can be used to influence final decisions at the SGMs. These parties include the Indonesian Government, the PRA, the Labour Representative Associations and public pressure. Recently, for example, the government cancelled the divestment of 30 percent of PT BNI Tbk. shares, which had been approved by the State Minister of ISOEs in the SGM. Many analysts assumed that the cancellation was due to political and public pressure.

***The Board of Commissioners (Dewan Komisaris) and the Board of Supervisors (Dewan Pengawas)***

Under the influence of the colonial Dutch company laws, Indonesian company laws have adopted a 'two-tier' Board structure characterised by two layers of Boards; the Board of Commissioners or the Board of Supervisors and the Board of Management. Based on Acts No 1/1995 and No 19/2003, the title for the Board of Commissioners is *Dewan Komisaris* and in Perum it is *Dewan Pengawas*. The top level management in both types of ISOEs is titled *Dewan Direksi*. According to ISOEs Act 19/2003, members of the Board of Commissioners are appointed by the Minister of ISOEs while the Board of Supervisors' appointment is the responsibility of the President. The nomination of members may come from the technical ministers and other related parties. If the Board has more than one member,

one of them is appointed as the Chairman of the Board. The term of office for Board members is five years. The members of the Board can then be reappointed for one more term.

The personal qualifications required of Board members are integrity, dedication, the understanding of corporate management, adequate knowledge about ISOE business, and the ability to spend sufficient time in the exercise of their duties. In executing their duties, the Board must abide by the articles of association of the ISOE and the provisions of law. They must also practice the principles of professionalism, efficiency, transparency, independence, accountability, responsibility and fairness. To avoid conflicts of interest, ISOE Act No. 19/2003 prohibits a member of a Board from holding a position as a company executive in another ISOE or holding any other positions stipulated by law.

### ***The Board of Management (Dewan Direksi)***

The Board of Management comprises the top management of ISOEs. The right to make appointments and to dismiss members of the Board of Management in the Persero is the responsibility of the State Minister of ISOEs, while in Perum this right is exercised by the President of the Republic of Indonesia. The personal criteria for nominating a member to the Board of Management are professionalism, integrity, honesty, leadership, experience, good conduct, high dedication and a vision of company growth.

The appointment of these nominees for the Board of Management is made after they pass the *fit and proper test*<sup>87</sup> performed by a team established by the State Minister of ISOEs, when acting as the SGM or as a shareholder. The members of the team have to meet criteria that include professionalism and knowledge of management and related ISOE business. They must have high integrity and dedication and not have any conflict of interests with the nominee. The test should be carried out in an accountable, transparent, independent, and professional manner. The State Minister of ISOEs can also appoint an independent agency to perform the test. The criteria for passing the test are a demonstration of competency,

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<sup>87</sup> This test started in 2000.

psychological fitness and a high moral attitude. If the nominees pass the test they have to sign a management contract before they are appointed as directors. The contract contains directors' promises and their agreement to reach all targets determined by the shareholders.

In practice, the implementation of the test still draws public criticism. The problem is that the process, as well as the final decision taken by the ISOE Minister, is not transparent<sup>88</sup>. The State Ministry of ISOEs office has never published the names of nominees. For example, when the State Ministry of ISOEs office nominated several individuals for the position of the CEO in Perum Perhutani (forestry), the top officials in the office were reluctant to disclose the nominees' identity to Labour Union members. This raised concern within the Union because the nominees could have included individuals who were currently charged with wrongdoings<sup>89</sup>. In respect to transparency, one interviewee commented:

I think it [fit and proper test] needs to be fixed. The nominees should be required to deliver public presentations that show their vision, mission, and business plans on how to boost ISOE performances and to bring the ISOE to the free market competition and globalisation (P03, September 2003).

Some analysts alleged this test was merely a cover-up because, regardless of the submissions of feasible business proposals by nominees, there was no assurance that the proposals were implemented because there were no sanctions imposed by the ISOE Minister if the targets in the proposal were not reached.

Members of the Board of Management have a five year term to serve the company and can be re-appointed for a second term. They can be dismissed before their term ends if they are unable to fulfil their duties, as agreed in the SCI. Dimissal can also occur if they breach the article of

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<sup>88</sup> Using a *systematic random sampling*, a public opinion survey, by the Laboratory of Political Science of University of Indonesia in 2002, found that 55 percent of the respondents believed the appointment of directors was not transparent. In addition, they were suspicious that money was involved in the process (*Kompas Online*, March 12, 2002).

<sup>89</sup> Here, it is evident that employees are not yet recognised as important stakeholders within the enterprises.

associations and/or the laws, they are convicted of a crime or in the event of death. They can also request to be dismissed. To prevent conflicts of interest, a member of the Board of Management is prohibited to hold any executive positions in other ISOEs or private companies, other government institutions/agencies, both local and central or in any other institutions stated in the article of associations and the provision of laws. The Board of Management may appoint a Corporate Secretary whose main task is to deliver information to the directors and commissioners as requested.

### **Corporate Governance Principles**

As previously discussed in Chapter Two, there are certain principles which are important, in order to achieve good corporate governance practices: accountability transparency and independence. Being publicly owned, ISOEs are expected to be operating in accordance with government policy and to be accountable to both the government acting as the shareholder and the public as the stakeholders. In addition, being publicly owned, ISOEs are also expected to publicly disclose the details of their operations and financial conditions. This section discusses the implementation of corporate governance principles in ISOEs.

#### ***Transparency***

As discussed in Chapter Two, good corporate governance requires transparency because the agents (the management and the Boards) have more knowledge and information about the enterprise than the owners. The asymmetric information between agents and owners can be used by the agents to pursue their own interests and can result in make the owners at risk of losing their wealth. The reality is in SOEs the government often chooses not to be transparent in their financial operations, notwithstanding the public interest. This is particularly true when the SOEs are closely linked with politicians. Unsatisfactory performance, in the achievement of either commercial or non-commercial objectives, may reflect unfavourably on the government in power. Hence, the government will have little incentive to gather and publicise information which may discredit it (NZ Business

Roundtable, 1988: 33). Box 7.1 and 7.2 provides an example of non transparent behaviour carried out by the State Minister of ISOEs in the privatisation process.

#### **Box 7.1 The Sale of PT. Krakatau Steel Shares**

The sale of PT Krakatau Steel (KS) shares has raised public questions and suspicions. The members of the PRA, for example, contended that the process was not transparent and as such was open to corruption, collusion, nepotism and intervention. At issue was the fact that the public wanted to know why Ispat International NV, a British mining company was given a special privilege as a strategic partner of the ISOE. In addition, members of the PRA questioned Tanri Abeng, the State Minister of ISOEs, as to why they were not informed about the signing of the MOU between the Minister and Ispat International.

Mangoensoewargo, a former CEO of the company who resigned after the signing of the MOU, also questioned the procedure of the sale because it was done without the involvement of the Board of Commissioners and the Board of Management. According to Mangoensoewargo, by signing the MOU, Ispat International had the right to buy 49 percent of KS shares and combined with the *put option* right, it became the majority shareholders because it controlled 51 percent of KS shares. He also questioned the share selling price that was set very low at US\$400 million for 49 percent of KS shares instead of US\$ 500 million for the 25 percent, as offered by an Australian company.

The Minister in power, Tanri Abeng, did not deny that there was intervention from a certain group of people to try and influence his decision. For example, a senior Minister had contacted and questioned him as to why one consultant was not included for consultative and advisory job.

In his defence of the transparency issue, Abeng argued that he had followed all basic procedures and he considered the processes were transparent. He stated that in the privatisation process there might be certain people who suffered a loss and would bring up the issue of transparency.

He acknowledged that the government had signed the MOU with Ispat International, but it had not been finalised. There were still 12 steps to be followed to reach a final decision.

Later the public discovered that Soeharto's son in-law of, Indra Rukmana, controlled 49 percent of PT Krakatau Steel Shares through Ispat International where he held the majority of shares.

Source: adapted from various media sources.

### **BOX 7.2 Strengthen the Replacement Process in the ISOEs**

The replacement of Board members or management is a normal and natural process in business operations notwithstanding that in the SOEs. Unfortunately, a recent replacement of members of the Board of Commissioners or Supervisors raised resistance from a number of ISOEs employees. The reason for this might be the lack of transparency in the process. There is a growing suspicion that political interference may play a part in the process.

An example is the replacement of the Board members in PT. Bio Farma (pharmaceutical). On the one hand, the State Minister of ISOEs stated that he did not know about the replacement. On the other hand, the Secretary to the Minister stated that the Minister had been informed. Here, there were a contradictory statements coming from government officials, who were accountable for transparency towards the public.

The case of PT Bio Farma was not the only example. Similar example also occurred in other ISOEs such as PT Perusahaan Gas Negara (gas), PT Bukit Asam (coal mining), PT Semen Baturaja (cement industry), *Perum Perumnas* (housing estate), and PT Danareksa (fund manager).

In this context, there is an urgent need to implement good corporate governance practice in the process of Board members replacement. The main objective is to enhance transparency

Source: Adapted and translated from *Republika Online* (December 12, 2001)

To avoid a situation such as the one above, there should be corporate governance mechanisms that ensure timely and accurate disclosure on all material matters regarding the company, including the financial situation, performance, ownership, and governance of the company. These mechanisms include the annual reports which contain the financial and non financial aspects of the company.

To improve transparency in the ISOEs, the State Minister of ISOEs issued Ministerial Decrees No. 489/2002 and No. 185/2004 and these were followed by another Ministerial Decree No. 3/2005. The latter was issued to impose the effectiveness of the previous Decrees because there were a large number of ISOEs that did not abide by the two previous Decrees. In addition, the implementation of the Decree is expected to assist the public

in accessing certain information without having to go directly to the ISOEs office (the State Ministry of ISOEs website, 2005).

Regardless of these Decreess, transparency is still a big problem in ISOEs. For example, ISOE data that can be accessed by the public on the State Ministry of ISOEs website has been very limited and most of the spaces are left blank or the data is out of date because it has not been updated. Best practice requires that enterprises maintain websites which have comprehensive up-to-date information on their operations and structures and an archive of corporate governance documents, shareholder reports and past announcements and performance data (NZ SEC, 2004). In addition, the best practice on corporate governance requires that the non-financial aspects include information about each director, that it identifies which directors are independent and includes information on the Board's appointment, training and evaluation processes (NZ SEC, 2004).

The reality was that I found information concerning the members of the Board was very inadequate. Only a few of the ISOEs published the information regarding Board members' qualifications, positions in the government or other agencies and experience. In addition, all ISOEs left the information on Board remunerations blank. To date, the requirement to report directors' and Board members' remuneration is not mandatory and if this data is published and available to the public it is usually represented by one line as a total sum of money. Therefore, the public does not know the individual earnings of each member of Boards.

I asked the interviewees whether or not it is necessary for ISOEs to publish, in their annual report, the remuneration of each Board member and director. The majority of the interviewees responded that, for the time being, it might not be appropriate because both public and ISOEs management are not ready for this to be published, when there are a majority of people in Indonesia who still live in poverty. In addition, their readiness to publish the figures is also affected by the norm shaped by culture. The norm has a bearing as people do not show off their wealth openly. However, using culture as a justification is criticised by Jin Wei and Siever (1999) who says that 'Asian culture' may be over-applied as an

explanatory factor in discussions of transparency in government and business.

The fact is that the lack of transparency has meant the ISOEs lag behind Chinese SOEs in practicing good corporate governance. As reported by Xinhua (2004), the Commission on Corporate Governance in China has demanded full transparency in income distribution inside SOEs, in an effort to intensify public supervision over SOE executives. The results showed that in 2003 executives in China's SOEs earned 13.5 times that of the workers' average for that year which was up from 12.7 times in the previous year. The annual income of workers in centrally-controlled SOEs averaged 24,000 yuan (US\$2,900) in 2003, while that of top executives stood at 325,000 yuan (US\$39,200). The workers earned 19,700 yuan in 2002, compared with their managers' 250,000 yuan for the same year.

The majority of the interviewees were of the opinion that transparency practice in ISOEs is unsatisfactory<sup>90</sup> and, therefore, the first thing to be improved in ISOEs is transparency. In addition, requiring ISOEs to conduct their business transparently may not be effective if no sanctions are applied for not disclosing information. Having said this, the interviewees stated that the openness of business activities in the ISOEs should be exercised with caution. For example, the requirement to provide detailed information to the public, relating to company strategy and business plans, could be used by competitive private enterprises for their own benefits. One interviewee stated that transparency should not mean making the ISOEs 'naked' in front of their competitors' (B01, October, 2003).

### ***Accountability***

Best practice of corporate governance requires that public sector entities should report annually to inform the public of their activities and performance. This should include how they have served the interests of their stakeholders (SEC New Zealand, 2004). The reason for this is because these

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<sup>90</sup> During the interviews, I asked the interviewees to select a number from a scale of 1 to 5, where 1 represented 'very poor practice' and 5 is 'highly satisfactory'. The majority of them chose number 2, which was 'unsatisfactory'.



entities operate with public funding and therefore they have to be accountable to their stakeholders, such as employees and customers.

The flow of accountability within ISOEs follows the general structure of government responsibility. Staff in an ISOE are accountable to management who are in turn accountable to Boards. The Boards are accountable to the State Minister of ISOEs who in turn is accountable to the PRA.

This accountability is delivered by producing and publishing financial and non-financial information for the owners and stakeholders in a responsible and timely manner. This also includes an obligation to explain to the owners and stakeholders why an alternative approach is adopted – the ‘if not, why not?’ obligation. This information is subject to a financial and performance audit by the *Badan Pemeriksa Keuangan/BPK* (the Supreme Audit), the BPKP, and external and internal auditors. The audit reports are then sent to the departments and agencies concerned with the oversight of the ISOEs in question and are ultimately submitted to Parliament. One issue raised is the timing, i.e. when the accountability requirements should apply (Bottomley, 2000). As practiced, accountability of SOEs to the public will be after the event, while accountability to the SOE Minister will be before the implementation of the company’s policies.

In practice, implementing accountability in ISOEs can be problematic. As experienced in other countries, the accountability of ISOEs is generally not effective. The main problem occurs because there are no ‘ultimate owners’ at the end of accountability chains, who have the incentive to verify any reports provided by the ISOEs. In addition, the public and the PRA members know very little about the ISOEs. Time and again, members of the PRA make regular enquiries into ISOEs’ performance or company plans but much emphasis is put on the financial performance and the profits. Rarely do the members of the PRA enquire about the effectiveness of ISOES in achieving social objectives. Last but not least, the Reports of the Supreme Audit are not published and, although they are available to Members of Parliament they are, as already noted, usually ignored.

To ensure accountability, the government on behalf of the public can appoint an agent, such as the State Ministry of ISOEs, to direct and monitor the ISOEs. However, another agent must also be appointed to monitor the

Ministry in order to ensure that the Ministry acts in accordance with government policy. Hence, no matter how far up the chain of monitors we go, we never find the ultimate owners. Consequently, there is no effective monitoring in ISOEs because there is nobody who holds the final accountability in the chain of monitors (Clarke, 2003: 8). As Perkins (1994) notes, 'ownership by all of the people really means a sense of ownership by none of the people' (quoted in Mar and Young, 2001)

Regardless of this, it is worth noting that the requirement to openly publish strategic and sensitive information to the public, or to the PRA, may create disadvantages to ISOEs' business operations. As one of the interviewees stated, 'It can become a boomerang to the company' (D06, 2003). The reason for this is that by providing confidential information to the public competitors may use the information for their own benefits. The problem becomes worse if a stronger view of accountability is taken and an ISOE is required to explain or justify its actions to the PRA.

### ***Independence***

There are many factors that may have an impact on the success of good corporate governance implementation in ISOEs. In respect to corporate governance in privatised ISOEs, Wong says,

[G]overnments are partially an obstacle to better corporate governance because they like to be in control. But their control may not be in the interests of other shareholders. Management is aware of that tension and would like to be more independent of government practices (quoted in Roche, 2005: 234).

The independence of ISOEs can be determined by the nature of government ownership in these ISOEs. If an ISOE is wholly-owned by the government, the ministers have the formal and informal control over policy making and the corporate governance of that ISOE. In privatised ISOEs, the Board of Commissioners and the Board of Management may enjoy some freedom from government control because the government is not the sole owner of the ISOEs. However, whatever autonomy is given to SOEs, by their very nature certain decisions, particularly of the strategic type, will be and

must be taken by government in its capacity as shareholder. Hence, the government always remains in a dominant position and its influence over operational decision making should not be underestimated (Fernandes, 1986: 5).

In practice, the intervention of the government in ISOEs is still evident and exists, not only at the level of the governing body, but also at the operational level. At the governing body level, the current President of Indonesia, Susilo Bambang Yudhoyono, has signed the Presidential Instruction No. 8 /2005 on the establishment of the *Tim Penilai Akhir* (the Final Assessment Team) whose task it is to appoint nominees who have passed the *fit and proper* test to sit as members of Boards. Formerly, the team consisted of the President, Vice President, the Minister for Empowering Government Apparatus, the SOE Minister, the Cabinet Secretary, the Government Intelligence Bureau and technical ministers who oversee the ISOEs industry. However, since the public questioned the relevancy of the Government Intelligence Bureau in the team, the President has revised the Instruction and now the team consists of the President, Vice President, the SOE Minister and technical ministers. The representation of other government agencies on the team was annulled. This team is an addition to another team in the State Ministry of ISOEs whose task it is to perform '*fit and proper tests*' to the nominees for directorships.

The issuance of the Presidential Instruction, as argued by those who supported it, showed the President's good intentions to prevent collusions and nepotism in the selection and appointment of members of Boards and directors. However, others who opposed to the establishment of such a team argued that the Presidential Instruction tended to position the ISOEs as bureaucratic organisations under government control. By their very nature, ISOEs are economic institutions while the government is a political institution and therefore the two of them cannot be mixed. In addition, the Instruction somewhat implied that the President did not completely trust his own staff or the State Ministry of ISOEs. The reality is that it is technically not possible for the President, who has a very busy schedule as the Head of the Nation, to select members for Boards and directors from thousands of

nominees. If he is to establish a team to assist him in the process, then there is no guarantee that this team will be free from vested interests.

At the operational level, intervention is typically in the procurement of input materials, equipment and the selection of subcontractors, who are subject to government influences. The government may be involved in decision making processes to select suppliers for ISOEs or contractors to run large projects. When Suharto was still in power, he used to instruct state-owned banks, albeit subtly through his ministers, to lend money to companies that were linked to the Suharto family and to accept a loss if necessary. In addition, Suharto himself decided who would win the ISOEs' projects. An example was when he decided to grant a power project in PT.PLN to a company owned by one of his sons. The project involved several controversies in the bidding process and the competition was among companies owned by Suharto's children. In another case the mass media reported that the CEO of an ISOE was summoned by the State Ministry of ISOEs to meet with a foreign advertising company representative, who urged him to put his company ads in their advertising company. The CEO was very disappointed because he had to leave his work for something so insignificant (*Business Indonesia*, September 11, 2003).

There was one instance when the wife of a previous ISOE Minister invited all CEOs of the ISOEs to fundraise for her charity project. This received much criticism from the public. Another example was when the government established a team, on behalf of Pertamina, to negotiate with ExxonMobil on their contract extension in Cepu Block. The establishment of the team and the negotiations were without the CEO's consent and consequently not in accordance with the law. At issue was the fact that it was not clear who the team was representing—the government or Pertamina. The team consisted of highly ranked bureaucrats including the Chairman of the Board as the team leader, the Advisor of the ISOE Minister as the secretary, a Board member, the Vice Director in Pertamina, the Director of Government Revenue from Oil and Gas, the Advisor of the Coordinating Minister of Economy, the Head of the Coordinating Intelligence Agency and the Spokesperson for the President. The members of the PRA questioned the roles of particular individuals in the team who were not

Pertamina employees and the absence of the Pertamina CEO to lead the negotiation process. The CEO of Pertamina refused to sign any deal that in his opinion did not benefit Pertamina. As such, he was well aware that his decision would put his position at risk (*Kompas Online*, June 9, 2005). Therefore, time and time again, ISOEs could not safeguard themselves from the vested interests of various government officials and those close to the centre of power. A former CEO of an ISOE, interviewed for this study indicated a reason why Boards are under-performing. He said:

When I was a CEO, the performance of the Board of Commissioners was not optimal. That was not their mistake or their lack of intelligence but because of government intervention in the management process. Members of the Board of Commissioners had done their best but at the end of the day the government had the final say. (BoD04, October 2003).

In summary, being controlled by the government as shareholders, the ISOEs are never free from government intervention. The intervention may take place in the process of policy making and/or at the operational level such as the appointment and dismissal of Board members.

### **The Board of Commissioners/Supervisors**

As outlined in Chapter Three, the corporate governance literature states four main sets of Board attributes; composition, characteristics, structure, and process (see Zahra and Pearce, 1989). Board composition refers to the size and demographics of a Board. It also includes the concept of board independence. Board characteristics encompass directors' backgrounds, skills, training and experience. Board structure covers Board organisation and Board committees. Board process refers to the arrangements for a Board's operations including, for example, the frequency and duration of meetings, succession planning and the evaluation of directors' performance. The following section will discuss several aspects of Board attributes within ISOEs.

### **Board Composition**

The composition of a Board, as stipulated in the ISOE Act No. 19/2003, must be determined in such a way so that decision making can be carried out effectively, accurately and in a timely manner. In addition, a member of a Board should be able to act independently. Since Indonesia's corporate governance model adopts a two-tier Board structure, Board composition and CEO duality are not an issue. Instead, the issue is centred in the roles of the independent commissioners or supervisors and the multiple occupations of Board members because they may affect Board independence and effectiveness. To date, there are no regulations that limit the number of Boards upon which an individual commissioner or supervisor can serve.

### **Board Size**

There is no minimum or maximum number of Board members on any Board. Data from RBI (2001) shows that the number of Board members in ISOEs could range from none in PT Pilot Project Berdikari to eight in PT Asean Aceh Fertilizer (RBI, 2001). The number has also no direct relationship to the size of the ISOE. For example, PT Asean Aceh Fertiliser, with eight commissioners, a total asset of Rp940,664 billions and 786 employees is smaller in size than PT BNI, which has total assets of 109,413,336 and 15,421 employees (data as of September 1999). BIRO, a survey agency, suggests that the number of Board members be limited to two; one representing the government as the shareholder and one who is a professional from an ISOE or the private sector. It says 'there is no need to have a big number of members of Board of Commissioners if their performance is not optimum' (*Kompas Online*, August 4, 2000). To date, the government has not yet established any criteria as to the appropriate number of commissioners or supervisors in an ISOE, which in turn will affect the effectiveness of the Board. Box 7.3 provides examples of Board size in several countries.

### **Box 7.3 Is there an Ideal Size for a Board?**

The size of Boards varies based on a company's requirements. In Singapore, Board sizes ranged from 4 to 14 directors, with an average of 6.8 (Singapore Institute of Directors). In Malaysia, the average is closer to 9 directors. (KLSE, Pricewaterhouse Coopers) In the United States, the average size Board for a manufacturing concern is 10, reflecting no change in size over the past decade (the Conference Board).

Japan represents the extreme in terms of Board size although the number of directors has sharply decreased as roles and responsibilities have been redefined. Major Japanese firms have trimmed the size of their Boards as in the case of the Sony Corporation (from 38 directors to 10); Toshiba (from 33 directors to 12); Nissan Diesel (from 38 directors to 10); Fujitsu (from 38 directors to 10); Nikko Securities (from 38 directors to 10); and Japan Airlines (from 38 directors to 10).

Worldwide there has been a decrease in the size of Boards. A 1998 survey of sixteen countries showed Boards with 14 or more directors represented 46% of companies surveyed (versus 57% five years earlier.) By contrast, Boards with 13 or less directors increased from 43% to 54% of all companies surveyed (the Conference Board).

Source: Corporate Governance in Asia (<http://asiancorp.gov.aim.edu.ph>)

In 2000, there were a total of 1,011 members of Boards in ISOEs. That consisted of 138 CEOs with 407 executives, 129 Board chairmen and 337 commissioners and supervisors (Investment and Banking Research Agency in *Kompas Online*, August 4, 2000).

### **Board Independence**

Under the direction of the financial aid agencies, ISOEs are required to establish independent commissioners as best practice. This was followed up by Ministerial Decree No. 117/2002, requiring that 20 percent of Board members in non privatised ISOEs are from outside the government. In privatised ISOEs, the requirements are also dictated by the Bapepam Circulation Letter No. 03/2000 and Jakarta Stock Exchange Regulation No. 315/2000. In addition, to enhance Board independence, the State Minister of ISOEs issued Ministerial Circulation Letter No. 1/2004 that prohibits any member of a political party sitting as a member of the Board in Persero if he/she also holds a position as a member of the PRA.

At the operational level, there is no clear definition of what constitutes an independent commissioner or supervisor. *De jure*, members of Boards in ISOEs are independent because they are entirely outsiders and not part of the management (non-executive)<sup>91</sup>. However, *de facto* they may not be independent from the government as shareholder because they are appointed by and represent the interests of the government. To increase independence, the government normally appoints academia or professionals to sit on Boards as the independent commissioners or supervisors. But the problem still exists — who do these independent commissioners or supervisors represent?' In this regard, one interviewee stated:

I am not sure what is meant by independent commissioners in ISOEs. The meaning of independent commissioners, in my opinion, is those who are not the owners and who are not part of the management. Since Board members of the ISOEs are already not the owners they do not represent the management, thus, what exactly is the status of an appointed independent commissioner on the Board? At issue here is, in fact, to find out who is really representing the owner? The owner can be defined as someone whose wealth will be affected if something happens to the company. This is called direct ownership. If the independent commissioner is defined as someone who is not an active or retired bureaucrat, there is still an issue about how they are appointed. Is he or she appointed by the government or an outside party? If there are no criteria for an independent commissioner then it will come back to the same situation (A03, 2003).

PT BNI defines an independent commissioner as a member of a Board who is independent from the other commissioners and shareholders (PT BNI Online, 2005). Within this definition, PT BNI has two types of independent commissioners: (1) commissioners who are independent from ISOE management (the bureaucrats) and (2) those who are independent from the

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<sup>91</sup> As discussed in Chapter Three, in the Anglo-American corporate governance systems which adopt unitary Board structure, independent commissioners (or independent directors) are the non-executive members of the Board, who are independent in character and judgment and they do not have any relationship or circumstances which could affect, or appear to affect, their judgement (the Higgs Report, 2003). Their independence is believed to play an important role in ensuring an effective and impartial governance system within the company for the benefit and interest of shareholders.



management, other independent commissioners and shareholders. Likewise, PT Antam, another privatised ISOE, defines an independent commissioner as an individual who is free from the influence of commissioners and directors as well as the controlling shareholders. Hence, the independent commissioners are assumed to be non-government officials. This definition seems to be shared among the ISOEs and the State Ministry of ISOEs.

Another interviewee who was once an independent commissioner provided his own definition of an independent commissioner as follows:

An independent commissioner is a commissioner who is really independent. It means he or she stands between the majority and minority shareholders. When the majority shareholders are in trouble, the independent commissioner should support them. Likewise, if the minority shareholders do not receive a dividend because the majority shareholders so decide, the independent commissioner should voice the minority shareholders concerns (BoD04, October 2003)

The non-existence of a 'robust definition' for an independent commissioner or supervisor, according to Allen (2004), is a source of weakness within corporate governance rules in Asian countries, including Indonesia.<sup>92</sup> He notes that if there are definitions, they contain loopholes that allow people quite closely connected with either management or the controlling shareholders to become so-called independent directors.

Currently, most independent commissioners or supervisors in the ISOEs are retired high profile bureaucrats or military generals. A number of ISOE Boards have academia or prominent figures, albeit a few, on their Boards. An anecdotal reason put forward for the selection of academia to the Boards is to make the Boards less critical or vocal towards the government. It can be observed that there is some truth in this because some academics, known for their critical comments on ISOEs mostly in the mass media, were unheard after they became Board members.<sup>93</sup>

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<sup>92</sup> See Calpers (2005b) for a detailed review on theme of independent directors in the USA.

<sup>93</sup> At issue here is the fact that the ruling party and its members have the expectations of being appointed to the Boards of ISOEs. Thus, winning power in the elections implies changes of composition within Boards.

Whether the independent commissioners/supervisors are indeed independent in their role is unknown because there is no performance measurement available to assess their independence. With respect to this, it is worth noting that Jane Diplock (2004), the Chairwoman of New Zealand Securities Commission, states:

We think that directors who are independent are needed to add value to Boards, but only if those directors also have the character, skills, and judgement needed to be an effective director. There is no place for 'gin and tonic' directors, who have little to offer but their supposed independence – and this equally the case in the Private and Public sectors. Board appointments in the latter often occur outside the public gaze, with a tendency to treat them as a reward for past service elsewhere in the Public Sector. The 'old boy' syndrome has largely disappeared in the higher profile arena of stock exchange listed-companies and it has no place either among State-owned Enterprises and Crown entities. Board appointments, or elections, are simply crucial for the standard of governance thereafter.

The key to choosing independent Board members, according to Cunningham (2001,) is their business knowledge, interest in the job and owner orientation. In addition, he urges a company to avoid appointing celebrity board members and others for non-fundamental reasons, such as adding diversity or prominence to a Board. The reason put forward is that, just because an independent Board member is famous for international diplomacy or a senatorial position, it may be far worse to have this person on the Board than a chief financial officer with extensive industry and managerial experience. In other words, hiring someone for the sake of their name is a big mistake. You need someone who is willing to 'roll up their sleeves' and truly get involved (Tompkins, 1997). At the end of the day, being independent means exactly that: never going along with anyone when it does not seem right, does not feel right, or is not right (Kerr, 2004).

## **Board Structure**

### **Board Committees**

Following better practice in other countries and to improve Board effectiveness, the government requires ISOEs, particularly those whose legal form is limited liability enterprise, have assets which are more than Rp1 trillion, or have business in the banking industry to establish Board committees whose tasks are to assist members of Boards in their duties.

Board committees are a new phenomenon in Indonesia. The familiarisation of the concept came at about the same time as the concept of independent members of Boards was introduced. The objective of Board committees in ISOEs is to assist Boards in performing their duties and particularly to ensure the effectiveness of internal control and auditors (internal and external).

The chairman of each of the committees is the independent commissioner or supervisor. With the committee reporting directly to the Board, commissioners can perform better tasks in overseeing how the company is managed. ISOE Ministerial Decree No. 117/2002 does not mandate the establishment of Board committees in ISOEs, except for ISOEs that operate in insurance and financial services.

The most common Board committee established by ISOEs was the audit committee that assists the fiduciary duty of the Board. For privatised ISOEs, the requirement of an audit committee is regulated by ISOE Ministerial Instruction No. 103/2002 which is a revision of ISOE Ministerial Instruction 133/1999. The duties of the audit committee are: (1) to evaluate the audit report of the internal and external auditors, (2) to provide recommendations on the improvement and implementation of management control systems, (3) to ensure that review procedures concerning published information are in place, (4) to identify matters that need Board members and directors' attention and (5) to carry out other duties specified by the Board of Commissioners/Supervisors and directors within its scope of duties and under the provision of laws.

Many ISOEs are at haste to establish an audit committee regardless of whether or not the Board and Committee members clearly understand their

responsibilities. Moreover, to some analysts, the establishment of audit committee occurred merely to abide by the regulations. One interviewee commented on this,

We follow rules and regulations just as a formality; it is a matter of compliance. The examples are the establishment of Audit Committees and independent board members. Every company wants to have one. If we create rules then we have to monitor the implementation. In addition, sanctions should be applied if they deviate. But, the reality shows there is no criteria and measurement to evaluate effectiveness (BoD04, October 2003).

However, there were many examples in which an Audit Committee did not function as it was intended. The selection practice of Audit Committee members has so far not been based on competency and capability but it has depended on their closeness to Board members, the top management or the State Ministry of ISOEs. One anecdote revealed that if ISOEs established an Audit Committee then it was seen that they have practiced good corporate governance<sup>94</sup>. To my knowledge only a few ISOEs, mostly privatised ones such as PT BNI<sup>95</sup>, have a clear, formal charter that sets out the roles and delegated responsibilities of an audit committee, as set out by best practices. This is not unique to Indonesia. In New Zealand, Jean Diplock (2004) provides a similar example. She states:

In the course of an inquiry into the then stock exchange-listed company, Max Resources Limited, in 1999, the Commission was told by the company's auditor that as far as he was aware, the audit committee of the company had no charter, and had never met, although it had been established for some years. No minutes of audit committee meetings could be produced for the Commission.

If needed, the ISOEs may establish other Board committees such as a Nomination Committee, Remuneration Committee, or Risk Management

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<sup>94</sup> I observed that in one ISOE the Board had to accept a retired high ranking government official to sit on the Audit Committee instead of a young professional it would have preferred.

<sup>95</sup> Despite its several company misdeeds, PT BNI was ranked high in corporate governance practice and it provided very good disclosure of corporate governance practices in its website.

Committee. The Nomination Committee has the task to establish selection criteria and nomination procedures for the appointment of Board and management members. In addition, it has to establish a system for evaluation and providing recommendations on the number of Board members. A Remuneration Committee has the task to arrange salary and allowances systems and make recommendations on remuneration systems, including a pension system and a compensation for employees who are made redundant. Insurance and Risk Management Committees have the task of providing recommendations concerning business risks, and types and value of the insurance.

### **Board Secretaries**

A Board Secretary is part of a Board structure and is a person who plays an important role in the effectiveness of the Board. In developed countries, the role of Board Secretary includes giving the Board such advice and information on the Board may request, keeping custody of company documents, duly recording the minutes of Board meetings and attesting to the resolutions adopted by the Board. In ISOEs, this role has so far been neglected and little attention is given to the quality of the work. One Board Secretary interviewed explained that his job as a Board Secretary was only a 'side job' because he already had a low level formal position in a ministerial office. In carrying out his duties as Board Secretary, he was not provided with any facilities, not even a desk and a filing cabinet in which to put all the important documents. He said he did not have much to do because most of the tasks were already undertaken by the ISOE Corporate Secretary and his staff. Likewise, he did not have to prepare any of the Board's minutes of meetings because the Board had never held meetings. Hence, his main duty was merely to inform the Board members of the incoming Directors' meetings and to arrange the time so that the majority of Board members could attend the meeting. He then communicated the agreed time to the ISOE Corporate Secretary. This, in fact, was not in accordance with Government Regulation No. 12/1998 on Persero, article 25 (1) that states the Board should hold a meeting once a month.

## **Board Characteristics**

### **Board Backgrounds**

Being controlled by the government, the appointment of Board members is extremely vulnerable to government interference. Hence, it is not uncommon in ISOEs to see ministers, high-ranking bureaucrats (echelon I or II), military generals, members of political parties—some retired, some still in the middle of their career—sitting as Board members<sup>96</sup>. In Perum particularly, the explanation of article 56 of the SOE Act 19/2003) specifies that the Board of Supervisors is comprised of high ranking government officials whose responsibilities have a direct connection with Perum. The rationale, as shared by almost the interviewees who are executives and/or the members of the Board, is because the government has missions and the Board members are seen as 'government apparatus' and they are there to ensure and guard the government's missions in ISOEs. Therefore, they are expected to serve the interests of the government by accommodating the wishes of their superiors. As such, they cannot afford to ignore the bureaucrats' directions, because their careers are in the hands of their superiors.

Data on the State Ministry of ISOEs website, as of 2005, shows that all Deputies and Assistant Deputies in the Ministry office are members of Boards in at least one ISOE<sup>97</sup>. In addition, there seems an arrangement whereby a Deputy, whose duties are to oversee ISOEs in the banking industry, is assigned as a commissioner or supervisor to an ISOE in a non-banking industry. The common position for Deputies in the State Ministry of ISOEs office is that of Chairman of the Board (the ISOE Ministry Website, 2005; RBI, 2001).

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<sup>96</sup> In Japan, there is a custom known as '*amakudari*', meaning descending from heaven in which retired bureaucrats often find employment with private companies or public corporations formerly under their jurisdiction ('the old boy network').

<sup>97</sup> There are some, particularly the highest level officials, who sit on more than one Board.

## **Board Training**

To date, most ISOEs Board members hold very high qualifications in terms of their education. As one interviewee from a financial agency stated:

At the level of intellectual rigor, the qualifications of directors and commissioners, I suspect, is a lot higher than in the private sector. We did a survey of the qualifications of the Boards in a sample of commissioners and directors and it was amazing the highly academic qualification of directors and commissioners. I suggest it is higher than in Australia (C01, October 2003).

Regardless of this, most Board members had qualifications which did not match the business operations of their ISOEs. A survey carried out by Business Intelligence Report (BIRO) in 2000 found that most ISOEs commissioners/supervisors did not have business backgrounds (Jakarta Post, August 4, 2000).

Best practice requires that the Board should allocate time and resources to encourage directors [commissioners or supervisors] to acquire and to retain a sound understanding of their responsibilities and this should include appropriate induction training for new appointees (NZ SEC, 2004). Witt (1993) found that 80 percent of Chairmen and CEOs in his study believed that Board training should be made mandatory. Board training is also one of the first focuses of the OECD Roundtable recommendations (Roche, 2005: 93). In China there is compulsory training for Board members of public listed companies. The objective of the training is to equip Board members with a broad knowledge and understanding of rules and regulations and to keep Board members informed on the latest changes in the capital market (Ibid).

During interviews with Directors and Board members, I asked whether or not Board members had attended a board orientation or training programme for new members. This question was necessary because business organisations, operations and processes have become increasingly complex and therefore Board members have to keep up and have knowledge of these changes. The responses to the question were almost all the same. It appeared they did not have any such orientation or training for Board

members. One interviewee, a Director in a leading bank (D05, October 2003), was even amazed when I asked the question. He considered that Board training was not necessary. I could understand his reaction because there was a tacit recognition that high ranking bureaucrats, military generals, or prominent academics who sit on Boards are very much regarded as highly competent people. Thus, attending Board orientation or training programme would be perceived as lowering their credibility. Interestingly, the National Committee on Corporate Governance (2000), in its Code for Good Corporate Governance, does not include Board training as one factor that needs to be considered in its Code for Good Corporate Governance. This is somewhat of an indication that members of the Committee do not consider Board training important.

One interviewee (BoD01, 2003), who sat as a member on an ISOE Board, explained that when he was appointed as a commissioner, he did not receive any advice or guidance from the ISOE Ministry office about what he had to do or what was expected from him. Thus, he had to work out for himself what he thought he supposed to do as a member of the Board. Relevant to this, Lev (1997), the president of the Institute for Research on Boards of Directors, states:

No one can be confident that directors are making good decisions for a particular corporation when its directors are confused about what contribution they are supposed to be making there, how they need to be organized (both formally and informally) in order to make that contribution and how to use their organization in order to achieve their intended goal. Nor can anyone be confident that good decisions are being made by Boards in general when uncertainty prevails about what contribution they are supposed to be making to corporations, how they need to be organized to make it and how to use that organization in order to make the desired contribution.

Board orientations or training programmes are useful for Board members so that they can recognise their duties and responsibilities, rights and obligations as well as corporate governance best practice. In addition, it is also very helpful to familiarise Board members with the company specification and its industry. As noted by Horton (1999), the potential value



of a Board is directly proportional to its knowledge. Horner (2002) in the context of Board training for independent Board members says,

Independent directors committed to defending shareholder interests must take seriously the common wisdom that education is a lifelong process. At the same time, companies truly committed to building a culture of board independence must provide opportunities for director education, particularly at the start of a directorship.

One government official, who had extensive experience in carrying out audits and supervisions in the ISOEs, expressed his view of the importance of business knowledge the Board should have. He said:

One thing that is required from a commissioner or a supervisor is his comprehensive knowledge about business. For example, as a commissioner in the airport industry he has to really know about the nature of the business, for example, the landing area cannot be widened. Therefore, he cannot make product diversification based on such strategy. PT Pelindo, which has business in the harbour industry, has a different nature. A commissioner has to understand this because he cannot use the same approach for all conditions. Even in the same industry, for example airports, a commissioner for Sukarno-Hatta Airport should make different decisions from those made at other airports, such as in Solo or Surabaya, because each airport has its own competitive advantages. However, the competence gap between executives and commissioners is very wide and the commissioners are employed more for their bureaucratic competence than their entrepreneurship. For example, the Head of the General Office Support Bureau in a ministry office can be appointed as a member of the Board of Commissioners in various ISOEs. So what can we expect from him? (B02, September 2003).

Ideally, the management of an ISOE and its Board is required to possess not only business good judgment but also political skills. It is also necessary that members of Boards are well acquainted with the general policy of the government that appointed them and that they should be able to reach their own decisions within the framework of such policy in every particular case. As noted by George (2001), 'Over time it is essential that board members get to know the company well and understand and care about its history and culture as well as its vision for the future.'

## **Board Process**

### **Board Power and Duties**

The duties and powers of the Board of Commissioners or Supervisors as stated by the ISOE Act No. 19/2003 article 31, are to monitor the Boards of Management in managing enterprises and to provide advice. Specifically, as described in the explanation of the ISOE Act No. 19/2003, the duties of the Board are:

- to provide opinions and recommendations to the SGM with respect to the company's plan and budget proposed by the Board of Management
- to monitor the development of the company's activities and to provides opinions and recommendations to the SGM on matters considered important to company management
- to report instantly to the SGM when there is any sign of a decline in the company's performance
- to provide advice to the Board of Management in the management of the company
- to execute other monitoring duties specified in the Articles of Association and/or in the SGM (in the explanation of article 31 in the ISOE Act No.19/2003).

In carrying out its duties, the Board has the power to:

- examine books, letters and other documents, and cash for the purpose of verification and examination ISOE assets
- enter the yard, buildings and offices used by the ISOE
- request explanations from the Board of Management and/or other officials concerning every aspects relating to the ISOE
- request the Board of Management and/or other officials, under the Board of Management consent, to attend the Board meetings
- attend the Board of Management meetings and provide advice on subjects under discussion
- dismiss temporarily directors and provide the reasons for this action

- use other powers that are essential, as stipulated in the Articles of Association

These duties and powers are not exclusive and there is provision for other duties and tasks to be added by the Articles of Association. For example, the Board can approve the Board of Management in conducting certain legal actions and if necessary, the Board can manage the enterprise for a period of time. Resolutions of the Board must be adopted by deliberation and consensus. If no agreement is reached by deliberation and consensus then resolutions must be passed by a simple majority.

Based on the explanation above, Boards do not have the power to appoint, dismiss, evaluate and decide compensation for members of Board of Management as happens in Western countries. Hence, it is fair to say that currently the role of the Boards in ISOEs is positioned more as 'watchdogs' for the government as they perform a passive-reactive type of role, rather than being strategic decision makers who take an active-preventive role.

In practice, however, the Boards exercise their roles between two extreme situations. On one side, the Board's role can be very strong so it reduces the role of the Board of Management and managers in the decision making process. For example, there were situations where decisions were taken by Boards without the top management involvement (see interviewee's comment on this issue in the next section). On the other side, the role of the Board can be very weak which brings them under the control of the top management. The latter, as the interviewees argue, is a result of appointing Boards members merely based on their titles and positions in the government offices and their affiliations to the ruling party and not because of their capability to manage business. Consequently, this might have an impact on their competency and integrity. Anecdotes shared by the interviewees showed their appointments were financial compensation for their low salaries as government officials.

## **Board Meetings**

The minutes of Board meetings are very important. Many assert that if it was not in the minutes, it didn't happen. Likewise, the Board's decisions in the meeting should be properly recorded. Recording minutes is essential because if this does not occur Boards may end up spending most of their time debating the content of past decisions instead of dedicating their time to more meaningful matters. The Board agenda and accompanying material should be analyzed in advance of meetings. Questions and suggestions should be formulated, based on additional research and conversations with other members of the Board. If the agenda of the meeting is not properly defined and circulated well ahead of time, questions and issues can be raised unexpectedly during the meeting and commissioners or supervisors will not have enough information or time to make optimal decisions. Even though there is no standardized level of content and format for the minutes of Board meetings, it is important that the minutes have sufficient information to describe how Board members came to reasonable decisions.

From my personal experience, the Board in one ISOE never held its own Board meetings. The only meeting was a joint meeting between the Board and the directors. In addition, those meetings were ineffective since one or more of the Board members was always absent. This may have occurred because they were occupied with their main jobs in the government offices.

Another issue that I observed was that when there was a meeting between the Board and the directors the minutes of the Board meeting<sup>98</sup> did not capture the Board dynamics in the meeting. The minutes only showed the decisions reached in the meeting but they did not show how these decisions were reached. Were there Board members who disagreed with the decisions and suggested different alternatives? As Babcock (2003) notes, the familiar phrases commonly appearing in such Board minutes is often 'After a full discussion and review of all the relevant material, the directors unanimously approved the transaction.'

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<sup>98</sup> Minutes are considered legal documents by the auditors, tax office and courts and they represent the actions of the Board.

There was an anecdote regarding Board meetings wherein a member of the Board who did not possess any information about the enterprises' operations that would enable him to provide any advices needed to ask a Board Secretary for questions that he could raise in the Board meeting. In another situation, audit reports of the internal audit became the significant source of information for the Board. Best practice requires that Board members should not show up at meetings unprepared (Edelson, 1998).

### **Multiple Roles of the Board**

It is not unusual for high ranking bureaucrats and military officers to sit on more than one Board and to also have other roles (even if it is prohibited in the ISOE Act) that have the potential to create conflicts of interest. The reason for this occurring is that there are no rules that specify the number of Boards upon which a commissioner or supervisor can serve. For example, the Minister of Communication and Information, in President Megawati era, was member of the Board of Commissioners in several ISOEs such as PT Kimia Farma (pharmaceutical). He was an independent commissioner with PT Perusahaan Listrik Negara (electricity) and PT Pelabuhan Indonesia III (port). Previously, he was Chairman of the Board in PT Pupuk Iskandar Muda (fertiliser). His position as a member of these Board seemed to have commenced not long after he was appointed as an advisor for the State Minister of ISOEs in 1998.

While serving as a member of the Board of Commissioners, he also acted (now and then) as a consultant for good corporate governance within several ISOEs such as PT Perusahaan Gas Negara Tbk (gas industry), PT Elnusa (drilling), PT Jamsostek (social insurance for labour), PT Waskita Karya (consultancy), PT Surveyor Indonesia (surveys), PT Pupuk Kujang (fertiliser), PT Wijaya Karya (building contractors), PT Pembangkitan Jawa Bali (electricity), PT Pelabuhan Indonesia III (port), Perum Pegadaian (pawnshop), PT Pupuk Sriwijaya (fertiliser) (from various sources).

His various positions as a Minister, a Board member and a consultant for ISOEs could certainly lead to a potential for conflicts of interest and a question mark over his independence. There was a time when he was a

member of the Board in PT *Pelabuhan Indonesia* III and at the same time acted as a consultant on corporate governance for the same company. This raises doubt regarding his integrity, ability and availability to perform his duties effectively, because his main position as a Government Minister is a full time job.

One interviewee expressed his concern regarding the multiple roles of a Minister. He said,

One cannot hold two conflicting roles, as a regulator and as the one who is affected by regulations. Thus, our tradition to appoint the Board members from the regulatory offices can be contra productive and a source of moral hazard because he/she can choose which side to support. If anyone wants to secure a structural job in a government office, he/she can issue regulations that may create a loss to the company or vice versa. There is an obvious example. When the Minister of Technology was a member of PT. IPTN (aerospace industry) Board of Commissioners, all regulations in technology accommodated the interests of PT IPTN. Likewise, imagine if the Finance Minister was a member of Board of Commissioners in one state-owned bank. All foreign loans could be placed in that bank. This is a moral hazard (A03, September 2003).

The results of the interviews revealed that bureaucrats in the State Ministry of ISOEs also sat as members of Boards and had multiple interpretations of their roles. On the one hand, they perceived their role as an operator or facilitator to the ISOEs, which means they are merely an agent who is accountable to the owner. On the other hand, they act as a shareholder in the SGM representing the Minister who would require accountability from the agents. This situation results in loss of accountability because as agents they are accountable to the owners who are themselves. Likewise, the multiple interpretations of roles are a potential hazard for the development of opportunistic and collusive behaviour between Board members and the ISOEs' top management because the bureaucrats, perceiving themselves as an operator or a facilitator, may be involved actively in the ISOEs' operations<sup>99</sup>. One interviewee noted that top officials in the State Ministry of ISOEs, who are also members of Boards

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<sup>99</sup> Albert Dunlap (1995) used the term 'corpocracy' to note bureaucrats who run companies for their own good.

often visited ISOEs' business sites without clearly defined roles—as Board members or as regulators.

The multiple roles of Board members create a situation where one or more responsibility has to be sacrificed in favour of other responsibilities. For example, if bureaucrats who hold positions both in the government office and in the ISOEs spend too much time in directing the ISOEs then their responsibilities as government officials will be sacrificed, or vice versa. To make matters worse, it may be a case where they do not function well in all their roles. For the bureaucrats, their minimum involvement in Board activities can always be justified by their 'busyness' as government officials. In the private sector, Daily and Dalton (2002) justify the multiple directorships of the Boards as a sign of competence. They state,

Those individuals holding multiple directorships do so largely because they have developed reputations as expert decision-makers. We suspect these directors would therefore be extraordinarily protective of these reputations and be unlikely to risk them through their absence at board meetings. Why, then, would we deny these directors the opportunity to serve on those boards for which they feel they can contribute? More importantly, why would we deny those companies interested in such directors the benefit of their expertise and access to critical resources?

Nevertheless, as theorized by Ferris, Jagannathan and Pritchard (2003) in their 'busyness hypothesis'<sup>100</sup>, serving on multiple jobs over-commit an individual. As such, overcommitted Board members may attend Board meetings less well prepared, due to the time needed to comprehensively review the meeting agenda. In this case, Cunningham (2001) comments, 'It would be a rare person whose prominence and trustworthiness, not to mention access to the corridors of power, could remain valuable to a company that shares his service with so many others.'

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<sup>100</sup> This hypothesis was originally used by Ferris et al. (2003) to examine the effect of multiple directorships on corporate performance.

## **Board Performance and Effectiveness**

As has been discussed in Chapter Four, Board performance and effectiveness are significant in ensuring that enterprises are able to maximise profits for the interest of shareholders and stakeholders. This is particularly true in ISOEs, where the market for corporate control that can discipline the managers is weak. However, in the current situation, the public is still concerned with the performance of Boards. There were various instances where Boards were involved in wrongdoings and members have been put in jail for criminal charges. There were certain factors that contributed to these situations. It started with the appointment of Board nominees. It is only recently (in 2005) that the State Ministry of ISOEs has applied a 'fit and proper' test to Board nominees similar to that of directors. Therefore, the appointment of individuals to the Board previous to this time might be the result of political affiliation or rewards for good performance in a government office by providing the individuals with additional income and other motives that were hidden from the public eyes.

Another issue was the relative absence of Board regulations that clearly specified the basic rules for the organisation and the operation of the Board, together with rules of behaviour to which Board members should adhere. The most common rules stated by ISOEs are those stipulated in the ISOE Act and the Articles of Association. As a consequence, there is no alternative for assessing the performance of the Board, individually or collectively. A retired CEO of an ISOE who held Board membership in several companies explains as follows:

There are no clear criteria used by the government as the shareholder to appoint and to dismiss a member of a Board and/or the Directors. The same matter occurs in evaluating and monitoring the Boards' performance. The means that the government uses to evaluate the performance is merely the annual financial reports presented at the Shareholders General Meeting. The reality is that the performance of the Boards and directors is not merely a matter of financial numbers. There are other factors such as how fast the enterprise grows. Does the enterprise have programmes in human resource development, work culture, and corporate governance? However, these matters have never been the focus of the government (BoD04, October 2003).



The level of involvement and effectiveness of the Board of Commissioners or Supervisors in ISOEs depends primarily on the distribution of power among three agents: the sponsoring minister, the Chairman of the Board and the CEO. A powerful CEO may well dominate the Board's activities. Boards often find they are helpless, sandwiched as they are between the political power of the government and the managerial power of the management (Fernandes, 1986: 121). At issue is the fact that active and powerful ministers may extend their ministerial responsibility over the companies. In another situation, a strong Chairman may have considerable power to perform most of the CEO's tasks beyond his/her power and duties. As one interviewee revealed:

When I conducted an evaluation of Board roles in the ISOEs I observed that in one ISOE, the Chairman of the Board, a retired military General who was a former Chief of Staff, had a great deal of power in day-to-day operation of the enterprise. The CEO and management did not dare to question his decisions. He set up his own office side by side with the CEO office and he had a full time secretary. He conducted his job as if he was the CEO himself. This chairman could cancel decisions taken by management whenever he thought it was wrong. For example, certain vendors who failed to pass the company's vendor qualification test could government to him directly and then he changed the decision taken by the management (P03, September 2003).

This retired General even by-passed the top management when he fired management staff. In this situation, the directors were comfortable because it took the responsibility off them and thus they did not have to deal with any problems later on (B07, September 2003).

In ISOEs the general view of Boards is their lack of independence, lack of technical expertise, perceived low status, information shortage, lack of legal power and lack of incentives. Lack of independence results from their status as government officials, who must act upon and cannot refuse government instructions if they want to keep their jobs secure as bureaucrats. Lack of technical expertise is the result of Board members who do not have business experience that matches with the ISOEs industry (P02,

September 2003). For example, in one ISOE that operated a plantation business, only one of four Board members had knowledge and experience in the related business. Of the other three, one was a professor with a medical background, one was a retired military general, and one was a representative from the State Ministry of ISOEs office. This Board composition might have had a substantial impact on the Board performance and effectiveness.

Perceived low status is caused by the view that Boards' roles are just complimentary to the management. This is somewhat validated by the fact that Board members' salaries are half that of CEO salaries. As such, Board' performance is attached to the top management' performance. One government official said:

I am of the opinion that Boards in ISOEs are underperforming and there is no measurement or criteria to measure Board performance. Hence, their performance is attached to the directors' performance. Therefore, if the directors are successful in managing the ISOE, i.e. in terms of gaining profits, the public will assume that the Board has done a good job. Likewise, if the enterprise gains no profits or the directors are underperforming the public assumes that the Board has failed. This does not mean that the Commissioners or the Supervisors do not do anything because they do. However, the final measure of their performance still depends on the performance of the directors. This means that if the directors are smart, diligent and able to do many things the performance of the Board will be highly regarded. Thus, if I were a member of a Board I would be happy if I worked with successful top management (directors) because I would be perceived as a successful commissioner or supervisor as well (A03, September 2003, emphasis added)

Another simple indication to the perceived low status can be seen from the arrangement of articles of the Boards in the ISOEs Act. The articles of the Boards came after those of the Board of Management. In addition, on the BUMN Website, the Boards were put under the heading of 'management'. Here, it is fair to say that the Board is merely an 'ornament' (Lorsch, 2002: 1) and 'rubberstamp' mechanism. The BPKP study in 2000 provided an analogy of a Board as a 'mirage' since it seemed to exist but it was in fact something illusory or insubstantial. Boards tend to stand under

the shadow of their Board of Management. Regardless of this, in terms of their status as bureaucrats, Boards are still treated and wanted to be treated as the 'boss' rather than as a 'partner' in the business.

Information shortage is caused by Boards not having full time involvement in the enterprise operations and thus they may find it hard to keep up with information. The logical reason is because they have a full time job as government officials and this has a higher priority than attending Board meetings. As a consequence, Board members meet only occasionally and may not know each other particularly well. This unfamiliarity can make it difficult for Board members to oversee management. In the private sector, Board members who do not attend a meeting might have their salaries not paid and if they miss more than 50 percent of an enterprise's Board meetings for two years in a row they should resign from the board (Vogelstein, 1998).

Lack of legal power is demonstrated by the fact that Boards do not have the authority to appoint and dismiss the directors or to make strategic decisions. Even if it is critical to the directors' performance, the final say is in the hands of the ISOE Minister not the Board. One interviewee provided an example. When he was the CEO of an ISOE and close to his retirement, he asked the Board to select nominees and appoint his successor. He provided all the resources necessary to assist in the process, including the provision of financial assistance to hire a human resource consultant to select the right nominees. After all this effort had been made by the Board of Commissioners, the State Minister of ISOEs appointed someone else who was not recommended by the Board (BoD04, October 2003).

Lack of incentives is the result of not having wealth invested in the company and of not having the right to profit sharing. Here, as one interviewee put it, 'If a worse situation happened to the ISOEs, the Board members still have their formal jobs in bureaucracy' (A03, September 2003)<sup>101</sup>. In addition, Board members are neither rewarded for good performance nor penalized for bad performance. The consequence of the

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<sup>101</sup> In developed countries, private enterprises require Board members to have a significant financial stake in the company, primarily in the form of stock and/or stock options so as to align their interests with the shareholders' interests.

above is that Boards do not function as significant corporate governing bodies. Many Board members are 'playing it safe' as opposed to demonstrating performance-driven behaviour. As a result, the only time the public was aware of a Board's existence is when the ISOEs are in trouble. For example, when PT PLN, PT BNI Tbk, PT Bank Mandiri and PT Pertamina were indicted of wrongdoings, only one or two of the Board members went to the public and explained the problems<sup>102</sup>. Usually, Board members would be reported in the mass media as saying that they did not have any idea on matters surrounding the case and they were not informed by the management about the problems. Therefore, they needed time to examine the case in depth. Rarely have Board members explained to the public what precautions they have taken to prevent wrongdoing. Best practice of the duty of care requires Boards to implement appropriate measures to detect and prevent fraud.

Even if a Board attempted to mend the damage it was often too late because the damage was mostly beyond recovery and the ISOE had suffered financial loss. In all circumstances, the government is the last resort to assume the financial losses and therefore it is actually society that finally bears the burden. Another issue is that Boards have rarely been charged or been held responsible for ISOE wrongdoings. If Boards had to attend Court then they were merely there as witnesses. However, one of the interviewees, a retired CEO of an ISOE, tried to justify the Board position. He stated:

The Board members do not have to be as responsible as the Board of Management because they have limited roles. They need to be responsible in the event the ISOE has to be liquidated, has huge debt, or keeps too much cash [so the government does not receive dividends]. So, they are only

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<sup>102</sup> This might also be an indication of the lack of knowledge or unfamiliarity of the public about Board roles in a company. Therefore, the public or the mass media tends to run after the directors and the Ministry office for explanations. The very simple indication, in my view, that shows how people and business players perceive the roles of Boards in Indonesian companies, is seen from the way business people and the government arranges the Board's function within the organisational structure. The Board structure is mostly placed after the management. A similar arrangement is also found in the SOE Act. Board practice in the private sector is even worse. There was a case where the Board members were comprised of a driver and a house maid working for the owners. The owner, Eddy Tanzil, was found guilty of corruption and he was sentenced to 20 years in jail. Unfortunately, he managed to escape from jail and he has never been heard or seen since.

responsible for any company decisions that need their approval (BoD04, October 2003, emphasis added).

The fact is that the government tends to see the Board of Management and managers as the sole parties who hold responsibility for any misdeeds in ISOEs. An example was when the government treated members of the Board of Commissioners differently from directors in the Pertamina case. Two Commissioners from the ISOE, together with a former State Minister of ISOE and the management, approved the sale of two tankers that created a potential financial loss of US\$20 million to the government. The only sanction the government put on Board members was preventing them from voicing their opinions at Board meetings. In contrast, the Finance Director of the ISOE was dismissed and he is now awaiting criminal charges.

If charges are laid upon Board members who have an association with or are nominated by a political party, the economic nature of the cases can be shifted to political issues. Indeed, it is fair to say that holding a position as a Board member in an ISOE is the safest job because he/she works in very safe environment and it involves no risks. Besides, who would dare to charge retired generals, Members of Parliament or active Ministers of wrongdoings?

To date, the public does not know whether Board members have effectively performed their duties or how they have carried out their duties. What happens in boardrooms is not public knowledge. In this respect, it can be argued that, indeed, it is not the members of a Board who protect government interests in ISOEs, but it is the other way around. It is public knowledge that government officials have large responsibilities but are underpaid and thus their membership on ISOE Boards may compensate for their low salaries as government officials. The amount of remuneration attached to their Board membership is not disclosed but, in the large ISOEs such as Pertamina, it is very substantial and constitutes a significant addition to their government salaries.

## Summary

This chapter has discussed the corporate governance system and Boards in ISOEs. The ISOEs adopt a two-tier Board structure, similar to that practiced in European countries such as the Netherlands. As such, the corporate governance structure in ISOEs consists of three groups; the SGM, the Board of Commissioners (Persero) or the Board of Supervisors (Perjan), and the Board of Management. The members of the Board of Commissioners, as well as of the Board of Supervisors, are mostly bureaucrats and military generals—active and retired. Some of the interviewees argued that this practice is necessary because those bureaucrats and military generals are on the Boards to represent the government as the shareholder of the enterprises and to safeguard government investments. This also reflects the politico-social role of ISOEs. The Board's main role, as stipulated in the SOE Act, is to monitor and advise.

To improve Board independence in Persero, the government appointed independent commissioners to sit on the Boards who were commonly selected from academia and outside professionals. In practice, however, there are some issues relating to the independence of these commissioners. Firstly, it is about its concept and definition. In Anglo-American countries, that adopt one-tier Board structure, such as the USA or the UK, where members consist of executive and non-executive directors, an independent commissioner is defined as a non-executive director. In ISOEs that adopt a two-tier Board structure, all members of the Board are non-executives and therefore, by definition, they are all independent commissioners. Appointing one or more people to a Board, for instance from academia, will not make any difference to the Board's independence. Secondly, the government has had problems with establishing its own definition of an independent commissioner. Therefore, in practice, it has created confusion and inconsistency. For example, if the government defines an independent commissioner or supervisor as someone who is not a bureaucrat or a military person, then it would be inconsistent if the government then appoints a minister or a general as an independent commissioner or supervisor.

In general, the effectiveness of ISOE Boards is difficult to assess. There are a number of factors which contribute to this situation. Firstly, the requirement for Board nominees to pass the *fit and proper* test was only recently issued and there is no information available as to whether it has been implemented. Previously, the appointment and dismissal of Board members could have been a result of 'like and dislike' or political party association.

Secondly, there are no written job descriptions for each Board member that would indicate an individual's responsibility to the Board. Therefore, there is no means for the government to really evaluate the performance of each Board member.

Best practice, as suggested by CalPERs (2005a), requires that each Board should establish *performance criteria*, not only for itself (acting as a collective body) but also *individual behavioural expectations* for its directors. Minimally, according to CalPERS (2005a), these criteria should address the level of the director's attendance, preparedness, participation and openness. Best practice in New Zealand states that the effectiveness of a Board can be enhanced if the Board and directors regularly assess their own performance and that of their individual members against pre-determined measures of efficiency. The effectiveness of a Board's processes and the contributions of individual directors should also be assessed (NZ SEC, 2004). The non-existence of performance criteria and evaluation for ISOEs' Boards may not be fair to individual commissioners or supervisors, who have fulfilled their tasks well in their position.

In practice, the public and the government tend to evaluate Board performance based on company success. Therefore, even though Boards under-perform or do not perform at all, as long as ISOEs gain profits this is good enough. According to a study by BPKP (2000), Board members tended to like working with successful directors. Similarly, directors and the government were not much concerned with Board performance, as long as the ISOEs gained profits.

Considering all the above, the effectiveness of Boards should certainly raise some concerns. The government, the ISOE Boards and Directors still

have a great deal of homework to do in order to improve Board performance in the ISOEs.

The next chapter will discuss the government's initiatives on corporate governance in ISOEs and how those initiatives are implemented in practice.



## **Chapter Eight**

### **Corporate Governance: Initiatives and Implementations**

It is inevitable that in the wake of corporate governance scandals, regulators and corporations will rush to institute visible changes in board and sub-committee composition and structure – encompassing requirements as to a minimum number of independent directors, the separate roles of chairman and CEO, the existence and composition of board audit, remuneration, and corporate governance committees, etc. These are all focusing on things visible from the outside but they lead to an obsession with the structure, a belief in the proposition that 'one size fits all', and an overwhelming faith in the effectiveness of dogmatic fixed rules. The drive to more tightly regulate the membership and functions of boards is encouraging companies to view governance as a legal challenge rather than a way to improve performance (Graeme Samuel quoted in McLeod, 2003)

#### **Introduction**

Corporate governance rules, norms and procedures evolve gradually over time as SOEs develop and grow (Patrick, 2001: 12). They evolve in response to changes in the domestic and international economy together with the political environment, for example, financial market development, liberalisation of the economy, privatisation, foreign financing, more democratic government and pressure from aid donor agencies. In Indonesia, before the crisis hit the Indonesian economy, corporate governance was an unfamiliar term among the public and had never been an issue. The business community and management of ISOEs were mostly concerned with issues, such as total quality management (TQM) and key

performance indicators (KPI) that were more on the management side than governance<sup>103</sup>.

The major break-through that raised the awareness of the business community in the private and public sector (the ISOEs) of the importance of corporate governance occurred when a sudden economic crisis hit the country in 1997/1998. Many analysts, local and overseas, believed that poor corporate governance practices in Indonesia played an important role in making the crisis even worse and therefore, the business community was required to establish better corporate governance practices. In this respect, the financial agencies such as the IMF, the World Bank, and the ADB play a key role in getting government initiatives started, by providing the funds required to execute these initiatives. Hence, the implementation of good corporate governance practices in ISOEs became a precondition for the provision of financial aid to the Indonesian government.

Bad corporate governance can be detrimental to all parties involved in the enterprise's operations. Mitchell (2003), the president of The Mitchell Organization, lists parties that would be affected by bad governance as being:

- Shareholders who through their elected directors chose the executives leading the companies whose shares they own and who stand to lose on their equity investments.
- Employees, whose jobs, work environment, and life security are entrusted to the executives and therefore they 'pay for' the executives' lack of good manners with their jobs, their pensions, or sometimes even their lives.
- Directors, who are financially and personally responsible for the business conduct of the executives, lose out when the bad judgments and the following consequences come to the surface.
- Suppliers' businesses and financial stability are damaged by the actions of the executives who rudely ignore the obligations imposed by the code of noblesse oblige.
- Retirees who depend on the good governance of corporation, may lose pension benefits, their personal retirement investments in their company's stock and retiree medical plans, when rudeness rules.
- Communities in which a corporation has offices, plants, or other facilities stand to lose a significant corporate citizen, employer, and

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<sup>103</sup> As a comparison, in New Zealand, corporate governance was a little used term until the 1980s. It gained business and academic attention following the share market crash of the late 1980s, the occurrence of the Enron scandals in the corporate sectors and the golden handshake scandals in the public sector (Collin, 2004).

taxpayer when the company's leaders fail to understand or choose to ignore 'noblesse oblige'.

- Banks and other financial institutions may sink under the weight of bad loans, bad accounting, corrupt business practices and fraud upon their institutions brought about by bad client governance.
- Management itself ultimately pays for its rude behaviour through stock options that can become worthless, lost employment for themselves, criminal prosecution or civil lawsuits and private civil actions for damages.
- Customers (including the government) depend on companies to provide uninterrupted services and serious consequences may result from bankruptcies caused by the arrogance of accounting fraud.
- Other investors, such as bondholders, partners in joint ventures, and franchise holders, all depend on good governance to protect and enhance their investments—and rudeness will negatively impact each of them.
- Consultants are subject to financial loss and professional destruction when their clients are governed without regard to good manners and when the resulting misinformation fraud and collapse are laid at their doors.

In response to the situation in Indonesia, the business community in association with the government, the Capital Market Supervisory Agency (*Badan Pengawas Pasar Modal* or Bapepam), the Jakarta Stock Exchange (*Bursa Efek Jakarta* or BEJ), foreign consultants and financial agencies launched several initiatives to improve corporate governance practices, including the establishment of various institutions such as the National Committee on Corporate Governance (NCCG), the Indonesian Institute for Corporate Governance (IICG), and the Forum for Corporate Governance in Indonesia (FCGI). The NCCG for example has published the Code of Corporate Governance Practices which includes issues as follows:

- Responsibility to shareholders and the General Meeting of Shareholders
- Function, structure, responsibility, activities, appointment and remuneration of commissioners and directors
- Internal and external audits, information access and confidentiality aspects
- Function, qualification, responsibility and role of compliance officers

- Stakeholders' rights and participation in monitoring corporate management
- Disclosure of information about corporate actions and on the implementation of good corporate governance
- Information confidentiality and prevention of improper use of information.

The main objective of these many initiatives is to restore investors' confidence, especially that of foreign investors who play an important role in advancing Indonesia's economic development. Other objectives are to establish rules and systems, and to raise awareness of and to disseminate corporate governance concepts to the public in general and the business community in particular. This latter objective is something that is important because so far there are only a few people who understand the concept of corporate governance and these people are considered to be the 'elite'.

The dissemination of the concepts and ideas was carried out in the forms of seminars, workshops, publications, conferences and surveys<sup>104</sup>. As a result, corporate governance became a mainstream discussion and an issue that must be dealt with in Indonesia. More people, mostly academics and analysts, became aware of corporate governance concepts, or at least the term. Those who were involved in the corporate governance institutions started discussing and disseminating the concepts of corporate governance and paid more attention to the roles and the effectiveness of the Boards in private companies and in ISOEs.

With this background, this chapter attempts to address the following research questions: Firstly, 'What are corporate governance initiatives in ISOEs and have the initiatives been effectively carried out in order to

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<sup>104</sup> To my knowledge, the many initiatives established post crisis by business communities seemed to fade away, especially after corporate governance programmes funded by the international financial agencies were completed. The only corporate governance institution that is still disseminating concepts and ideas on corporate governance, at least in the mass media, although there has been a reduction in the number of articles, is the FCGI. In addition, the number of public companies that were willing to participate in corporate governance index survey (CGIS) by IICG decreased over time. In 2004, it was only 22 of 330 companies that participated in the survey. In 2001, 2002, and 2003 respectively there were about 22, 33, and 34 companies that participated.

increase the performance of ISOEs?' Secondly, 'What factors (if any) could deter the implementation of good corporate governance in ISOEs? To answer these questions, the chapter begins with a review of the many initiatives carried out by the government in order to improve corporate governance practices in ISOEs. Section Two continues with a review of the effectiveness of those initiatives in practice. Data used for the purpose of a review were gathered primarily from a series of in-depth interviews with key participants and other sources such as public opinions published in the mass media. In assessing the interview results, a number of factors are considered in the light of the interviewees' backgrounds, interests and expertise. Section Three examines other external factors such culture, law enforcement and public governance that might have an impact on corporate governance reform in ISOEs. Section Four reviews the impact of privatisation on corporate governance practices in the ISOEs. Section Five briefly discusses the viability of adopting and adapting the Western corporate governance model in ISOEs. The last section provides a summary of this chapter.

### **Corporate Governance Initiatives in the ISOEs**

In parallel with corporate governance initiatives in the private sector, the government through the State Ministry of ISOEs has taken several initiatives to improve corporate governance practices in the ISOEs. These initiatives, to a large extent, were part of government commitments to the IMF. The corporate governance reform of Indonesian ISOEs includes the following:

1. Strengthening of the roles and responsibilities of Boards of Commissioners or Supervisors to be more active in supervising and advising Boards of Management of the ISOEs.
2. Redefining the roles and responsibilities of the board of directors to be clearer, particularly in relation to the primary objectives of each ISOE.
3. Establishing audit committees for the board of commissioners.
4. Establishing a transparent and well-defined criteria and selection process for the boards of commissioners and directors.

5. Introducing a statement of corporate intent for ISOEs which will remain in state ownership long term. This document is an agreement between the ISOEs and the government as shareholders and includes performance targets and other indicators to hold the ISOEs accountable (Tjager, *Jakarta Post*, May 15, 2000).

As in the private sector, the dissemination of the concepts and ideas of good corporate governance in ISOEs was carried out in the form of seminars, workshops, or surveys. To my knowledge, surveys on corporate governance in the ISOEs were mostly carried out by foreign agencies and consultants, independently or jointly with the government. At issue is the fact that the results of those surveys are confidential and not given out as public information. One of the interviewees, a foreign consultant who undertook the survey, confirmed this fact. As a result, the public is unable to assess whether or not the ISOEs have implemented sound corporate governance practices, let alone provide its views on the issues.

To carry out the initiatives the ADB provided a programme loan<sup>105</sup> to the amount of US\$400 million. The government provided US\$650,000 for the project (*Jakarta Post*, 12 December 2001). The programme objectives were to (i) introduce sound corporate governance practices within state-owned enterprises<sup>106</sup>; (ii) separate commercial activities from public service obligations of ISOEs; (iii) restructure the corporate and financial aspects of SOEs in preparation for eventual privatization; (iv) establish fair and transparent procedures for managing labour redundancies and (v) apply existing or develop new guidelines for the procurement of ISOEs and their effective enforcement mechanisms. The duration of the programme was three years, from 2002 to 2004. In this respect Calvin Wong, managing

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<sup>105</sup> The programme loan is subject to public suspicion. Some people argue that multinational corporations in developed countries use corporate governance initiatives as a strategy to penetrate markets in developing countries. In doing so, they join together with the financial agencies to lean on developing countries so they will apply corporate governance models similar to those of the agency's own countries, despite the striking differences in legal structure. In addition, the public asserts that corporate governance initiatives recommended by the financial agencies are used as a disguise to generate foreign loans in other projects.

<sup>106</sup> This project helped to train 120 government officials, SOE managers and staff in corporate governance mechanisms.

director for governance services in the Asia-Pacific says, '... government tend to lead the movement for better corporate governance.' (cited in Roche, 2005: 234). Another Chinese academic states,

Policy-makers around the world have another important reason to be concerned with corporate governance: low corporate governance standards also breed corruption.... Rules of corporate governance, such as accountability, transparency and fairness, have profound impacts on the motives and constraints for both the corrupted and the corruptors involved in corrupt practices (quoted in Roche, 2005: 17)

The initiatives of corporate governance reform in the ISOEs came with time. To enhance the ISOEs performance and to promote good corporate governance practices in the ISOEs, the government established the State Ministry of ISOEs, which separated the ownership function of the government from its other functions. The main task of the Ministry is to assist the President in formulating policies and coordinating supervision of ISOEs. To promote good corporate governance practice in ISOEs, the State Ministry of ISOEs carried out several initiatives. Firstly, the ISOE Minister issued Ministerial Decree No. 23/1998 that requires Boards and management to report transparently to the State Minister of ISOEs concerning any business transactions in which they or their family are involved that could have the potential to create conflict of interest between them and the ISOEs. This report is opened for public scrutiny and thus the the public is able to assess whether these activities would be open to corruption, collusion and nepotism. Secondly, the State Ministry of SOEs issued Ministerial Decree No. 117/2002 concerned with the Implementation of Good Corporate Governance Practice in ISOEs. It requests ISOEs to consistently implement good corporate governance practices and/or establish their operational foundation on good corporate governance<sup>107</sup>. In this Decree the State Ministry of ISOEs defines corporate governance as:

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<sup>107</sup> Some of the government officials interviewed in this study argued that the government is more prepared to impose good corporate governance practice in the ISOEs than in the business sector.

...the process and structure used by ISOE organs to enhance business success and accountability with the ultimate objective to achieve long-term shareholder value, whilst taking into account the interest of other stakeholders based on the provision of laws and ethical values.

The Decree also requires that all ISOEs be equipped with a number of supervisory organs, such as an internal audit division for assisting the top management and an Audit Committee for assisting the Board. If needed, the Board may establish other committees, such as a Remuneration Committee and a Nomination Committee. Thirdly, the State Ministry of ISOEs requires all ISOEs' management to produce and sign a Statement of Corporate Intent (SCI). SCI contains agreed targets and expected performance which need to be achieved by the ISOEs Board and management during their term in the office<sup>108</sup>. The objective is to improve transparency and disclosure. As a pilot project, the SOE Ministry office has requested 35 ISOEs to produce and sign the SCI<sup>109</sup> and it will be followed by another 50 ISOEs (*Kompas Online*, April 1, 2003). Fourthly, the SOE Ministry office developed a Performance Incentive System<sup>110</sup> and Appointment Agreement to improve Board performance and efficiency within the ISOEs (the Minister's speech, 2003). Fifthly, the ISOE Minister requested independent consultants and a non-departmental government office (Badan Pengawasan Keuangan dan Pembangunan/BPKP)<sup>111</sup>, to carry out corporate governance evaluation in ISOEs, in order to obtain an actual pictures of current corporate governance practice in ISOEs.

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<sup>108</sup> Christensen (1998: 284) notes that France was the first country to use this concept (known as performance contract system) in the 1960s and today many developing countries, especially in Africa and Asia, have introduced this concept in one form or another.

<sup>109</sup> A critique on this type of performance contract is that it commonly neglects non-financial performance indicators and means of measuring their achievement. The reason for this is either because it requires the government to put a commercial value on social services, or because of an assumption that SOEs are not actually providing those services (Good Governance Group, 2000).

<sup>110</sup> The introduction of a performance incentive was part of the ADB programme loans requirement.

<sup>111</sup> The English name for BPKP is The Supervisory Board of Finance and Development. The BPKP is a non-departmental government office whose main task is to carry out financial and performance audits on government offices.



## The Initiatives in Practice

The Indonesian government's initiatives to improve corporate governance practice in the ISOEs, to some extent, have produced some positive results. Through the issuance of regulations to guide and direct the ISOEs on the implementation of good corporate governance practices, the ISOEs do not have any options but to follow better practices, such as the establishment of an audit committee<sup>112</sup> the appointment of corporate secretary and independent commissioners, signed management contracts and published annual reports which contain information regarding ISOE corporate governance practices.

Nevertheless, the objective to have good corporate governance practiced in the ISOEs still seems far off. Day by day, the public see how ISOEs, including those that have been privatised, are involved in various corporate misdeeds and criminal allegations. PT BNI Tbk (banking), for example, despite its high score on corporate governance practices<sup>113</sup>, suffered a Rp1.7 billion loss in 2003 because of weaknesses in its internal control. The CEO and two directors of PT Bank Mandiri granted credit approval to certain companies, regardless of a recommendation from its own risk management unit not to endorse such credits. Instead, the director replaced the key person in that unit by another person who supported the directors' decisions. These wrongdoings created huge non-performing loans and had the potential for a financial loss of more than Rp1.3 trillion. Just recently, the CEO of PT Industri Sandang Nusantara (garment industry) was charged with embezzlement and put in jail because he was found selling government assets (asset stripping) to third party, which had the potential for causing loss to the government approximately of Rp70 billion (*Sinar Harapan*, August 25, 2005).

To make matters worse, the ISOE Minister, in a public hearing with Commission VI of the PRA, informed members that there were indications of corruption practices in a number of ISOEs, including PT Bank Rakyat

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<sup>112</sup> So far, 30 ISOEs have established Audit Committees. They are mostly in privatized ISOEs and those that will go public in the future.

<sup>113</sup> PT BNI was ranked 7 out of 36 companies participating in the *Corporate Governance Perception Index* (CGPI) survey, undertaken by the Indonesia Institute for Corporate Governance (IICG), and it was ranked first out of 16 ISOEs by BPKP.

Indonesia, PT Bank Negara Indonesia, PT Bank Mandiri, PT PLN, PT Jiwasraya, Perusahaan Gas Negara, Indofarma Tbk, RRI, Rajawali Nusantara I, PT Pupuk Kaltim, PT Angkasa Pura I, PT Pelabuhan Indonesia III, PT ASDP (Angkutan Sungai, Danau, dan Perairan), PT Djakarta Lloyd and PT Pelindo II (*Media Indonesia Online*, May 20, 2005). Hence, it is not unexpected that a Director in one privatized ISOE says 'It can be said that the existing business processes are just the same with those of before the commencement of good corporate governance programme' (cited in Poeradisastra, *Swa Online*, April 28, 2005).

Relevant to this, Jamie Allen (2003), the Secretary-General of the Asian Corporate Governance Association (ACGA), suggests that Asian corporate governance is a case of good in parts and rotten in others. On the positive side, he notes that 'awareness has risen, governance is firmly part of policy, reform is underway in all major economies; there are higher standards (on paper) and emerging shareholder activism'. On the negative side, he believes that the depth of change had been shallow with a lot of 'window dressing'; governance is seen as a compliance issue, not a competitive one; regulators will vacillate and that significant disincentives to shareholder activism continue to exist. The consequence, as argued by Roche (2005: 69), is that whatever improvements are happening in practice, Indonesia is still unable to persuade investors that it is serious about governance. One foreign consultant in corporate governance, interviewed for this study, shared a similar view. He said:

Indonesia has done good things in corporate governance but it is not good in explaining what it has been doing. And this is made more complicated because in the Asian region Indonesia has a unique legal system with the two board structure compared to countries like Singapore, Malaysia, and Hong Kong which have one board system. So it is more complex for outside people (outside Indonesia) to actually understand the corporate governance regime and improvement in Indonesia and I don't think it's well understood and it's not being well communicated by the Indonesian advocates of corporate governance change (C01, October, 2003).

As stated above, in 2003, three years after the commencement of corporate governance initiatives by the government and the business

community, the State Ministry of ISOEs requested the BPKP to perform an evaluation on corporate governance practice in 16 ISOEs. The results showed that none of the ISOEs attained a 'very good' score. The criteria used for assessing corporate governance practices in the 16 ISOEs included commitment, structure and process. Table 8.1 to Table 8.4 present some of the results of the BPKP corporate governance evaluation in 16 ISOEs in 2003.

**Table 8.1 Corporate Governance Score for the 16 SOEs by Classification**

CLASSIFICATION	SCORE	NAME of the SOE
Very Poor	SCORE < 50	
Poor	50 <SCORE< 60	
Satisfactory	60 <SCORE< 75	PT KAI, PT Peln, PT PLN, PT Jasa Marga, PT Sarinah, PT Kimia Farma Tbk, PT Danareksa, Timah Tbk, PT HI Natour
Good	75<SCORE <90	PT Bank BNI Tbk, PT Pelindo II, PT ASEI, PT Krakatau Steel, PTPN VIII, PT Surveyor Indonesia, PT Adhikarya
Very Good	90 <SCORE< 100	

Source: BPKP 'Evaluasi Corporate Governance di BUMN' (2003)

**Table 8.2 Corporate Governance Score for the 16 ISOEs by Business Ares**

NO	NAME OF ISOEs	BUSINESS AREA	SCORE
1.	PT Bank Negara Indonesia, Tbk.	Banking	86.18
2.	PT Kimia Farma Tbk.	Pharmaceutical Industry	69.78
3.	PT Timah Tbk.	Mining	67.76
4.	PT Adhi Karya	Contruction and Engineering	71.75
5.	PT Asuransi Ekspor Indonesia	Export and Credit Insurance	79.62
6.	PT Danareksa	Investment Management	69.52
7.	PT Hotel Indonesia	Hotel and Restaurant	64.67
8.	PT Jasa Marga	Road Toll	72.32

9.	PT Kereta Api Indonesia	Railway	74.47
10.	PT Krakatau Steel	Steel Industry	77.86
11.	PT Pelabuhan Indonesia II	Transportation	78.63
12.	PT Pelayaran Nasional Indonesia	Passenger and barge	73.27
13.	PT Perusahaan Listrik Negara	Electricity	73.67
14.	PT Perkebunan Nusantara VIII	Plantation	77.83
15.	PT Sarinah	Retail	68.03
16.	PT Surveyor Indonesia	Survey	76.54
		Average	73.89

Source: BPKP 'Evaluasi Corporate Governance di BUMN' (2003)

**Table 8.3 the Average Score for Privatised and Non-Privatised ISOEs**

CLASSIFICATION	NUMBER	AVERAGE SCORE	SOES
Privatised (Public Company)	3	74.57	PT. Bank Negara Indonesia, Tbk. PT. Kimia Farma Tbk. PT. Timah Tbk.
Non-privatised	13	73.71	PT. Adhi Karya (persero), PT. ASEI, PT. Danareksa, PT. HI, PT. Jasa Marga, PT. KAI, PT. KS, PT. Pelindo II, PT. Pelni, PT. PLN, PT. PN VIII PT. Sarinah, PT. SI

Source: BPKP 'Evaluasi Corporate Governance di BUMN' (2003)

**Table 8.4 The Instruments of Good Corporate Governance**

INSTRUMENT	ISOEs	
Code of Corporate Governance	4 of 16 SOEs	PT. Bank BNI Tbk., PTPN VIII, PT. Pelindo II, PT. Adhi Karya
Code of Conduct	7 of 16 SOEs	PT. Bank BNI Tbk., PT. Krakatau Steel, PT. Danareksa, PT. Sarinah, PT. Pelni, PT. Timah, PT Pelindo II
Statement of Corporate Intent	2 of 16 SOEs	PT. PN VIII, PT Sarinah

Source: BPKP 'Evaluasi Corporate Governance di BUMN' (2003)

Currently, the government's initiatives on corporate governance seem to be at a standstill. There are very few activities carried out in the State Ministry of ISOEs and the ISOEs on this subject. This is very different from previous years, when the crisis started, and the financial agencies were still providing financial and technical assistance to the government. Therefore, some people asserted that the initiatives were likely to be cosmetic.

The following section addresses factors which may impact on the successful implementation of good corporate governance in the ISOEs.

### **Factors That May Affect the Effectiveness of Corporate Governance Initiatives in ISOEs**

#### ***The Absence of Owners***

The first factor that may affect the effectiveness of good corporate governance initiatives in ISOEs relates to the issue of ownership. As discussed in Chapter Four, having the government as the single owner of ISOEs one could expect that there would be no agency problems because the government has the power to control and monitor the managers of the ISOEs. However, agency problems are much more complex in ISOEs because the contract between the agents and principals cannot be effectively imposed. On the one hand, the agents are represented by a loose coalition of various groups which is comprised of the managers, the Boards, government ministers and officials, labour unions and members of Parliament. On the other hand, there is no real owner whose interests and wealth are at risk if the company goes wrong. The government as the shareholder can be seen as just another agent in the corporate governance chain because it has to be responsible to the public. In this respect, one interviewee stated:

Corporate governance in ISOEs is much more relevant and important than that in private enterprises because, unlike corporate governance concepts in developed countries in which the agents of publicly owned enterprises have clear relationships with the owners and the majority and minority shareholders, the relationship between the agent

and the owners in ISOEs is so distant and unclear. Even if it is said that ISOEs belong to the public and they are the shareholders, I can say that it is only illusionary ownership wherein the public pretend to have shares in the ISOEs (A03, September, 2003).

Therefore, the agency problem may not only exist between the government and the ISOEs' management but it may also exist between the government and the public at large because within a contract setting the government may act as an agent to the public in a similar way as the ISOEs management. As such, the interests of the government may not align with those of the general public.

The absence of owners and an unclear definition of agents, according to one interviewee who carried out corporate governance evaluations in the 16 ISOEs, have created some perplexities in the implementation of corporate governance (P03, September 2003). For example, the Deputies in the SOE Ministry considered that the role of the ISOE Ministry is that of a representative of shareholders<sup>114</sup>. Another Deputy said that he considers he was an agent, an operator or a facilitator within the ISOEs. This situation was explained by an interviewee, who noted,

The Deputies in the State Ministry of ISOEs declined to consider themselves as a regulator or shareholders. They prefer to call themselves an operator whose task is to manage ISOE investments (B02, 2003).

In practice, there is no elaboration on the meaning of 'operator' or 'facilitator' or any detail regarding the job descriptions. The perceived role as an operator, according to one interviewee, might be simply a justification for their active involvement in ISOEs business operations (P08, October, 2003). The State Minister of ISOEs himself regards his office as the shareholders of ISOEs.

To some extent, the unclear relationship between the ISOE Ministry and the ISOEs can be understood because the ISOE Act No. 19/2003 states that it is only the ISOE Minister who is the representative of the government as the shareholder. Therefore, his staff may decide whatever

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<sup>114</sup> This somewhat justified why top officials in the Ministry office sat as members on various ISOE Boards.

roles suit them: a representative of the shareholders, a member of the Board, an operator or a facilitator.

To be effectively functioning as the representative of the shareholders, the Minister and his staff must think like owners. An academic who did not agree with the multiple roles of the Ministry of SOEs staff said,

The role of the State Ministry of SOEs in the corporate governance systems is not an agent or an operator. It is acting on behalf of the principal. I suspect the desire of the bureaucrats in the Ministry office to be involved in the ISOEs' operations is because they have vested interests. I do not understand, they set the rules and they are the ones who violate the rules (B02, 2003).

### ***Lack of Understanding of Corporate Governance Concept***

As discussed in Chapter Two, there are various aspects of corporate governance documented in the literature, from the agency theory to the stewardship theory of corporate governance; from a narrow concept of the shareholders' value to a much wider concept concerned with the stakeholders' value; from the roles of the governing bodies to the implementation of corporate governance principles. Good understanding of these various aspects of corporate governance would provide a real impact on the success of the initiatives.

However, this may not be the case in the ISOEs, at least at this time. A former Deputy of the State Ministry of ISOEs, Benny Pasaribu, expressed his personal view regarding the preparedness of the State Ministry of ISOEs in carrying out corporate governance programmes. He said,

In my opinion, the implementation of foreign concepts like corporate governance in the ISOEs will fail particularly if those concepts are 'top down'. This is because the low level staff [in the State Ministry of ISOEs office] is not well educated and their interest in reading is low. Besides, this office has not yet practiced good governance (Darma and Sadikin, *Warta Pengawasan*, 2000: 14, emphasis added).

This view, indeed, raises doubt on the success of corporate governance initiatives in the ISOEs. The reason for this is that the State

Ministry of ISOEs staff who are responsible to provide examples and guidance on how to practice good governance have not yet understood the concepts, let alone how to implement them. One interviewee, who had experiences in carrying out corporate governance assessments in a number of ISOEs, was of the opinion that the knowledge of corporate governance among the staff in the ISOE Ministry needs to be enhanced. She said,

In the State Ministry of ISOEs, a Deputy explained to us [team from BPKP] that corporate governance initiatives had been carried out by his office a long time ago. Thus, according to the Deputy, there is no need to be surprised if now the office requests ISOEs to implement good corporate governance. However, the example he referred to was the initiative to improve the Total Quality Management in the ISOEs. In addition, when I went with personnel of this office to one ISOE to carry out corporate governance assessment, they were not able to answer questions raised by the management on corporate governance matters. This is, I think, the reason why the State Ministry of ISOEs has not yet formulated measurements on Board performance (P03, September 2003)

Judging from my personal experience in disseminating corporate governance concepts in the ISOEs and the results of the interviews for this study, there seemed to be misconceptions about corporate governance and corporate management. Hence, it was not surprising to find the ISOEs' top management established teams that comprised middle level management in the name of corporate governance, whose tasks were to improve the quality of management or management processes instead of devising necessary means for sound corporate governance practices, such as formulating job descriptions for the Boards, designing Board business orientation and training programmes and establishing performance measurement for Board evaluation. These teams certainly did not have the power to impose corporate governance policies at Board level therefore, corporate governance initiatives in most ISOEs just ceased at the middle level management. With respect to this, a consultant from a foreign agency, interviewed for this study commented as follows:

Perhaps there is too much agonizing to simply talk about implementing corporate governance without sufficient



intellectual discussion about what it actually is. The problem is that no one in Indonesia has yet started an intellectual discussion about what corporate governance actually is. In addition, there is insufficient forum and institution to coordinate and prioritise what it is needed for substantive corporate governance reform. So there is a possibility and reality that there are some misguided attempts at improving corporate governance in Indonesia. In addition, how can you implement something you don't actually understand or agree to or at least agree to disagree? People would implement what they thought was corporate governance and then they complaining about the results. I don't think that this debate has started in Indonesia. It is important to have the debate however frustrating it is. Stop talking about corporate governance and let's start implementing it (C01, October 2003)

Dr. Apreda, based on his study on corporate governance in Latin America, stresses the importance of understanding of corporate governance in order to make it work. He states:

Academics may speculate on the scope and objective of corporate governance, politicians on its merits, and marketing experts twist it to serve as advertising copy, ... without an understanding of what it is for, widespread acceptance of the principles and practice, proper enforcement of whatever regulations are put in place, it makes little sense to discuss further. An ounce of enforcement is worth a pound of unenforced regulations (quoted in Roche, 2005: 20).

### ***Lack of Commitment and Consistency***

Good initiatives relating to corporate governance do not automatically result in good practices, because they need strong commitment and consistency from all players who are responsible for the success of those initiatives. The CEO of PT Astra International, a multinational automotive company, acknowledges that the biggest challenge in the implementation of good corporate governance is not in the establishment of structures but in the commitment to seriously implement good practice. In addition, he says that good corporate governance is a process that needs patience and continuous improvement (cited in Pambudi, April 28, 2005).

Regrettably, the public see that even the State Ministry of ISOEs which is supposed to be a good example of good corporate governance

practice breached its own regulations. For example, Laksamana Sukardi, the previous State Minister of ISOEs, was appointed as the Chairman of the Board of Pertamina (an oil company). This appointment breached Article 33 of SOE Act 19/2003 that prohibits such a practice in order to ensure members of the Board fully focus their energy, minds and attention to their duties. In addition, the prohibition on holding multiple positions is to protect enterprises from conflicts of interest. Being appointed as the Chairman of the Board, while at the same time holding a position as the State Minister of ISOEs and also being an executive in a political party<sup>115</sup> was breaching the Law and had the potential for a conflict of interest. On the one hand, Sukardi as the ISOE Minister acted as the SGM, whose power and duties were to oversee and give direction to Pertamina. On the other hand, he was also the Chairman of the Board, who should abide by and implement every direction from the State Minister of ISOEs, who was himself. This meant accountability was lost because his dual roles put him into a position as the 'advisor' as well as the 'executor'. Consequently, he had to be accountable only to himself. Some analysts asserted that his position on the Board was a means to gain access to Pertamina funds that could be used to finance his political party's campaigns. Indeed, his appointment was made very near to the presidential election<sup>116</sup>.

Another problem related to his appointment was his effectiveness as the Chairman of the Board due to the fact he already had a full time job as a Minister. As a result, an overcommitted Minister might serve less frequently on important Board meetings and, consequently, diminish his effectiveness as a Board member<sup>117</sup>. Best practice states that Board members should be selected and appointed only when the Board is

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<sup>115</sup> The political party was Partai Demokrasi Indonesia Perjuangan/PDIP (the Indonesia Democratic Party in Struggle).

<sup>116</sup> To his supporters, his appointment was justified. Firstly, Pertamina belonged to the government and therefore, the President could elect whoever she preferred to be the Chairman of the Board, in order to secure government assets. Secondly, his position would enhance and secure the Board decision making processes because he was directly involved in the ISOE operation.

<sup>117</sup> Having said this, there is no information about how often he attended as a Board member. Unlike in other countries, which have a developed corporate governance system, the information regarding Board meetings in ISOEs is not available to the public.

satisfied that they will commit the time needed to be fully effective in their role (NZ SEC, 2004).

The public, politicians, and economic analysts continued criticizing his dual roles and insisted that the Minister resign from his position as the Chairman of the Board in Pertamina. One member of the PRA questioned Sukardi's decision and cynically asked why Sukardi did not just sit on all the Boards of ISOEs, rather than just a selected one or two ISOEs. Sukardi's decision to sit as Chairman of the Pertamina Board somewhat damaged his image as someone who had full commitment in promoting good corporate governance in the ISOEs. Eventually, he had to resign from the position because his political party lost the presidential election and he was no longer a Minister.

Another issue that shows the inconsistency of the government in practicing good corporate governance is the appointment and dismissal of Board members. As discussed previously, in ISOEs the appointment of Board members rests in the hands of the State Minister of ISOEs for Persero and the President for Perum. In practice the appointment and dismissal of the Board members is not transparent. For example, the State Minister of ISOE dismissed Luluk Sumiarso, the Chairman of the Board in PT. PLN (an electricity company) without his knowledge. From what was reported in the mass media, he was not informed about his dismissal and knew nothing about it until he attended a ceremony held by the State Ministry of ISOEs to appoint his replacement.

The reason for his dismissal, as stated in a press release from the State Ministry of ISOEs, was to maintain the Board's independence. At the time Sumiarso sat on the Board he was also the Director General at the Ministry of Energy and Mineral Resources, whose duty it was to oversee and regulate the energy and mineral resources policy. His position, as a regulator on the one hand and as a member of the Board on the other hand, was perceived as an impediment to his independence that may affect his policy making. As stated by Aharoni (1986: 309) in different roles an individual may perceive a situation differently. This situation was acknowledged by Sumiarso when he said:

Conflict of interest took place when I as the Director General did not want to raise the electricity tariff for the interest of public at large but as the chairman of the board of commissioners in PLN, I would like an increase in the tariff (*Kompas Online*, October 18, 2003).

Anecdotely it was said that he opposed the increase of electricity tariffs, even though it had been decided by the Board of Management under the government's direction.

Another example was when the State Ministry of ISOEs replaced the CEO of PT Bank Mandiri with a CEO from a public bank. The Ministry did not carry out the '*fit and proper*' test specified in the ISOEs Act No. 19/2003. It was not until a member of PRA questioned the appointment that the ISOEs Ministry provided justification for its action. It stated that the reason why the test was carried out after the appointment was because the Ministry had knowledge concerning the capabilities of the new CEO.

Not all Commissioners accept the ISOE Ministry's decision to remove them from their position. One member of the Board of Commissioners in PT Telkom (telecommunication), Rahardjo Tjakraningrat, challenged the Minister's decision in court and he won. The reason given was that the Minister's decision breached company law which states that members of Board of Commissioners and Board of Management should be informed before they are dismissed from their positions. Nevertheless, Tjakraningrat was not reinstated to his former position as a member of the Board of Commissioners.

Despite its public statement that regulators should not sit on Boards in order to maintain Board independence, the State Ministry of ISOEs continues to appoint top government officials (usually the Secretary and Director Generals of the technical ministries) as members of various Boards. As such, it is fair to argue that the government and the ISOEs' governing bodies are paying no more than lip service to improving corporate governance practices in ISOEs. One interviewee, who carried out a corporate governance evaluation in several ISOEs, noted:

In my observation, the State Ministry of SOEs just wanted to know whether or not the ISOEs had implemented Ministerial Decree No. 117/2002. In practice the commitment was not so strong even in the Ministry office.

When we did corporate governance assessment in the Ministry office, the Deputies who were supposed to fill in the questionnaires by themselves delegated the tasks to their staff. Thus, I observed that commitment was weak (P03, September 2003)

In addition, she said,

In our presentation of the results of corporate governance practice in one SOE, the Boards did not ask any questions. They did not show or have any interest in the results. Their intention was to finish the report quickly and submit it to the State Ministry of ISOEs. This would mean that their job of following the Ministry instruction was done. Hence, I think we are still far-off from the ideal situation (P03, September 2003)

Relevant to this, the CLSA in its Annual Asian Corporate Governance Report comments:

Much of the improvement is in form: making publicly stated commitments to good corporate governance setting up of board committees, appointing nominally independent directors, etc. ... The commitment to corporate governance is not yet clear. In all the markets, cases abound of egregious transgressions (quoted in Roche, 2005: 59)

One interviewee argued that corporate governance reform was more superficial than substantive (C01, October 2003).

Most of the interviewees urged the government, the State Ministry of ISOEs, the Boards and the Directors of ISOEs to seriously commit themselves and be consistent in their attitudes to good corporate governance practices because these are essential to gain and maintain investors' trust. If this is not case, the objectives to attain business prosperity through good corporate governance practices may not be achieved.

Factors used as the criteria to evaluate commitment of corporate governance in ISOEs included the following:

- The establishment of rules and regulations on corporate governance such as the Code of Corporate Governance, Code of Conduct, and Statement of Corporate Intent;

- The dissemination of corporate governance concepts across company;
- The implementation of good corporate governance; and
- The availability of information to stakeholders through for example the annual reports.

Table 8.5 shows the results of a BPKP evaluation on corporate governance in 16 ISOEs where commitment had a very low score of 48.66.

**Table 8.5 Score Based On Corporate Governance Aspects**

Aspects	Ideal Condition	Average Score Based Actual Evaluation	Classification
Commitment	100	48.66	Less sufficient
Shareholders roles	100	87.84	Good
Boards	100	71.00	Sufficient
Directors	100	77.03	Good
Supporting roles	100	82.36	Good
Stakeholders awareness	100	82.16	Good

Source: BPKP ‘*Evaluasi Corporate Governance di BUMN*’ (2003)

Regardless of the lack of commitment described above, it is worth noting one ISOE whose top management was really committed to implementing good corporate governance even though it was not an easy process. Box 8.2 describes my personal experience observing corporate governance reform in one ISOE.

**Box 8.2 Corporate Governance Reform in one ISOE**

In one ISOE that operates in venture capital, the CEO and the top management had a strong commitment to carrying out corporate governance reform in their company and thus were eager to have their corporate governance practice assessed by our office, the BPKP. A good assessment of its corporate governance practice would enhance the company’s image before the government and the public, which would be good for its business.

However, after several meetings and discussions we (the team from BPKP) found that there was a misconception on what they meant by corporate

governance. In the top management's view, improving corporate governance meant that they had to focus on strengthening the internal control which was part of corporate management. As a result, the top management did not show any interest when we stated that corporate governance reform had to be started from the 'top', i.e. from the Board. When the top management finally agreed to include the Board members in the process we found that the Board appeared to not share a similar enthusiasm with the top management.

The relationship between the management and the Board members tended to be bureaucratic in a similar way to the government offices. Members of the Board were the superiors and the management were the subordinates. Not once did Board members attend any of our discussions. When the top management carried out a seminar on corporate governance no members of the Board attended, except one who came late and had to leave early.

We were finally able to interview the Board members. The interviews were conducted in a very formal way because the persons who we interviewed were high ranking government officials and the Corporate Secretary reminded us to deliver the questions politely so it would not make the Board members upset. Later, when we distributed self-assessment questionnaires to gauge Board members' opinions and understanding of corporate governance and company operations, the responses were very disappointing. Of the five members, only one returned the questionnaire shortly after the due date. The rest were obtained only after several approaches by the Corporate Secretary and after we stated that the results of the assessment would be submitted to the State Ministry of ISOEs. This indicated that members of the Board did not take any interest or had little understanding of the importance of corporate governance and their roles in promoting good corporate governance practices.

Regardless of the difficulty at the beginning, the corporate governance reform in this ISOE is still going on to this date. It has been able to develop Code of Better Practices and Job Descriptions for the Board members. In addition, the Board members have established their own Board meetings separate from Directors' meetings, which are carried out after office hours.

One of the interviewees, A02 (October, 2003), stated that corporate governance reform in this ISOE was the best example of how corporate governance reform in ISOEs should be established. It was not 'top down' based on government instruction, but 'bottom up' and 'voluntary' based on the awareness of the importance of corporate governance to the company success.

Source: Personal experience 2001

### ***Unclear Programmes***

In examining the effectiveness of corporate governance initiatives in the public sector, the questions which came into my mind were firstly 'Did the government have clear programmes?' and secondly 'Did the initiatives come from a genuine intention of the government or were they simply aimed at abiding by the rules set by the financial aid agencies? When I put these questions to the interviewees, the majority of them were of the opinion that the government did not have clear programmes in carrying out corporate governance in the ISOEs. As one prominent academic, who led the corporate governance programme in his university, stated:

The government does not have any clear programmes particularly in the dissemination of the substance. If we talk about corporate governance we talk about institutions. Yet, what are the objectives of the ISOEs? They do not have clear missions. The thing that the State Ministry of SOEs does is change the Boards and the directors. At the moment we are just in the introduction or discussion stage (A01, October 2003).

In terms of the continuation of the programme, another interviewee stated:

As usual, in the beginning we like to create initiatives but later we forget to continue to the next stages. We are always trapped in a process. The ISOE Act is good; it specifies an obligation to produce a Statement of Corporate Intent that contains promises to achieve certain goals. However, how willing are the government and the ISOEs quantify those promises. We have '*ewuh pakewuh*'<sup>118</sup> culture that may reflect in behaviours such as 'we understand that you know, so the important thing is that you make the ISOE grow.' It is not supposed to be like this. If the company has to grow, what percentage of it should grow? Let's put it in the details. In addition, it is not only the directors and commissioners who have to keep their promises, but the government too. The government should not get in the way; do not ask SOEs to run but then hold their tails (BoD04, October, 2003).

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<sup>118</sup> These are a Javanese words that describe an uncomfortable feeling when disturbing a person, particularly someone who has a high status (e.g., in the office) or who is old.



With regards to the ISOE Master Plans, one interviewee said, 'The Plans are unclear and are not applicable because the government facilitates too many interests (P04, September 2003). In addition, it is common to discontinue one Master Plan and replace it with a new one if the ISOE Minister is changed. For example, the ISOE Master Plans formulated under the previous minister, Tanri Abeng, were discontinued even though they could be developed (P03, September 2003). In this respect, RBI (2001: 9) provides this assumption for the reason leading to this discontinuation.

... Sukardi also saw positive aspects of the Master Plan created by the previous Minister, particularly in terms of its concept. However, Sukardi faced a dilemma. If he continued with the previous Master Plan then he could be construed as being 'part of the past'. On the other hand, if he decided not to continue with the previous plan, he also had no better options (emphasis is in original).

Stiglitz's (1998) has a comment on such a practice:

These extensive powers [of the state] are matched by certain limitations.... The state can impose certain obligations on itself, ..., but no government can impose obligations on its successors or even do much to stop itself from reneging on previous commitments [emphasis added].

The fact is that there is no specific unit or division in the State Ministry of ISOEs that is responsible for overseeing and ensuring that initiatives will achieve the objective of having sound corporate governance practiced in ISOEs. My observation is that if the ISOEs had established independent directors and an audit committee, with or without the assistance of foreign consultants, then they thought they had carried out the programme and implemented good corporate governance.

### ***Multiple and Conflicting Objectives***

Before good corporate governance practice can be really implemented, the government needs to first establish clear missions and objectives for each of ISOEs, particularly in relation to trade-off between their socio-political

and commercial missions and objectives. As discussed in Chapter Four, unclear missions and multiple objectives distract the ISOEs from their main goal, which is to increase the wealth of the nation<sup>119</sup>. Hence, providing greater clarity on the missions and objectives of the ISOEs should improve the effectiveness of their governance arrangements. It is expected to facilitate the Boards and management of ISOEs to act within clear parameters, which are aligned with the preferences of the shareholders. To illustrate the unclear mission and objectives of ISOEs, within the context of decentralisation and regional autonomy, one of the interviewees in the government office stated:

The roles of ISOEs as an agent of development and profit seekers have to be clear and right. As an illustration, PT PELNI's ferries have to go to all provinces even though these ferries only carry five people. Can we imagine how much money this company has to spend in order for its ferries to reach those regions? The local governments in the regions where PT PELNI's ferries go ashore ideally should have accepted certain costs as a kind of subsidy to their people. However, these costs are borne by PT PELNI. This situation has to be solved with public management mechanisms. If the cost should be borne by the central government without any participation from the local government, then PT PELNI should be ready to experience losses all the time (B02, September 2003).

Without having clear missions and objectives, the problems existing in the ISOEs will never disappear. As one of the interviewees said,

I am of the opinion that the prospects of ISOEs are not promising if we do not know which ISOEs should be kept by the government for social and political reasons and which ones are kept for commercial purposes. The SOE Act No. 19/2003 states that both the Persero and Perum are for profit purposes. However, when TVRI [a government owned TV station] changed its status from Perum to Persero

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<sup>119</sup> To date, the ISOEs still have the obligation to supervise and to provide credit finance and technical assistance to small enterprises and co-operative (*Kredit Usaha Kecil dan Koperasi/KUKK*). At issue here are the small enterprises and/or co-operative has businesses which are outside the core competence of the ISOEs. Their industries can range from textile, handicraft and car repairs to trading. This means the ISOEs management needs to have a deep knowledge of all types of industries.

and proposed to the government that it close its unprofitable broadcasting stations in several regions, the government was terrified. If those TV stations were closed, the public would be outraged. They would say 'What is wrong with the government? We have had independence for a long time and now we suddenly lose our connection to information' Here, we do not see that the government has a clear mission. It reflects in the way the government decides on what should be retained and what should be released to the private sector. What should be a Persero and what should be a Perum (A03, 2003, emphasis added)

### **External Factors That May Affect Corporate Governance in ISOEs**

Corporate governance in ISOEs does not exist in isolation. There are other external factors that may affect the effectiveness of corporate governance practices. The first factor is the corporate and social culture. In terms of social culture, one interviewee, an NGO activist, provided a long explanation on this subject. He stated,

To me governance is about culture; it is not merely regulations. Here, culture is affected by environment. Corporate governance is poor because the environment is not conducive to practicing good corporate governance. This has been proven. When the managers in ISOEs wanted to implement good practices, they failed because the environment was not accommodative. Let's take PT Timah as an example. The management had proven that it could practice good corporate governance evidenced by the evaluation of an independent consulting firm. But when the government gave more autonomy to the local government through decentralisation, the problem started. The local leaders freely interfered with PT Timah business operations. Another example from the private sector showed how PT Astra and IBM had to establish Public Relation to specifically deal with government institutions. It could have been in relation to bribery activity.

What makes matter worse is we do not have any commitment to deal with the problem. We do not face a bad environment, such as corruption as a challenge but we accept it as it is. There is a saying that 'we can eat together'. To find individuals who have a strong commitment to change bad environment to good is very difficult. We do not have any problems with regulations because we have most of them from Capital Market rules

and regulations to the ISOE Act. But, a strong willingness to change and practicing good culture that we do not have.

Culture is the umbrella over other factors. Under it, there is bad politics and low law enforcement. People tend to think that if they breach the laws, there are always ways to get away with it. They can bribe anyone within the system. Another thing that is worth mentioning is how people perceive materiality. If we work for years and we still take the busses to go back and forwards to our office, people will think we are stupid. However, if someone is able to buy a new car, even though he works for only a couple of years, people will praise him. This happened to me and the comments came from my relatives who had joined a religious group.

We have a great culture, for example, the culture of tolerance. Sadly, this culture is used to justify wrongdoings. Tolerance is perceived as allowing mistakes without sanctions. Another example is the culture of helping each other (*tolong menolong*). This is perceived as helping each other in committing frauds. So, by definition our culture is good but it is used for bad reasons. When the Enron scandal occurred, instead of establishing preventive action, so that a similar situation could not happen in Indonesia, people took the case to justify the company's wrongdoings. They said that if corporate scandals could happen in the USA, that had better systems, what could they do in an environment where corporate governance was not sophisticated as in the USA? (N01, October 2003).

In terms of corporate culture, bureaucratic mentality is still prevalent in the ISOEs, one interviewee commented:

The main cause of corporate governance failure in the ISOEs is culture. The ISOEs have been run by government employees for years. Therefore, their business culture is bureaucratic rather than entrepreneurship. Consequently, the Supreme Audit still thinks it is necessary to perform financial audits on privatised ISOEs, even though they do not belong to the government anymore. They are public companies. This bureaucratic culture has to end or else the government will always treat ISOEs as its own property and no different from other government institutions. (B04, September 2003).

Roderick Deane, who holds chairmanships in several New Zealand companies, says 'At the end of the day, you can't legislate for honesty.

Integrity is something which derives from people's value sets and that's not found in a legislative framework.' (quoted in Kerr, 2005).

The second external factor that may impact on corporate governance practices in the ISOEs is law enforcement. As one interviewee commented,

On the issuance of regulations, we have an outstanding achievement, 'jumping over the world'. However, in implementation we are weak because there are no sanctions imposed. What we commonly do is 'urge' people (BoD04, October, 2003).

Relevant to this, one foreign consultant said that corporate governance can only be built on a sound legal structure and framework. However, the Company Act in Indonesia is deficient in providing a sound base for corporate governance (C01, October 2003).

The third factor is public governance. It is worth noting that merely focusing on good corporate governance is not sufficient for the development of the Indonesian economy. This also requires sound public governance. Public governance is generally understood as a new cooperative relationship between and among government, the private sector and civil society. Hence, as noted by Allen (2000: 27), an improvement in public governance is the counterpart to better 'corporate governance'. The latter is unlikely to work effectively without the former and vice versa.

The majority of interviewees were very sceptical of the potential success for the corporate governance initiatives if sound public governance does not exist. The reason given was that the ISOEs would have to compromise their good corporate governance practices if they were forced to bribe or give kick-backs to government officials in order to obtain business licences and projects from government offices or in determining the amount of taxes they had to pay (M07, September 2003). Although it is not something to be proud off, the fact is that the practice of corruption, collusion, and nepotism still persists in the public sector sphere. Here, it is important to simultaneously carry out reform of corporate and public governance because they affect each other. As one interviewee stated, 'We cannot clean the floor with a dirty broom' (BoD05, October 2003).

## **Privatisation and Corporate Governance**

In the literature, many scholars argue that commercialisation and further, privatisation will have a positive impact on corporate governance practices. Nestor and Thompson (2001: 18) in their research article titled 'Corporate Governance Patterns in OECD Economies: Is Convergence Under Way' state:

Evidence on privatization experience to date has consistently shown that the change in ownership improved performance considerably at the firm level, in terms of both productive efficiency and profitability. This is largely the result of vast improvements in corporate governance.... Hence, privatisation has created the conditions for a profound change in the corporate governance context.

Privatisation will expose the ISOEs to the external control mechanisms where other parties (stakeholders) besides the government will be able to assess the Directors and Board members' performance. The corporate governance arrangement is clearer and the objectives can be measured because the ISOEs are able make a separation between their socio-political and commercial objectives. They are expected to be more accountable because they have to report to the public from time and to time. The financial statements have to be audited by a recognized public accounting office. Based on the audit reports, the public will judge their performance. If they are not following the regulations, they will be penalised. For example, the U.S. Securities and Exchange Commission (SEC) rejected PT *Telekom* 2002 financial accounts because the Indonesian accounting firm that carried out the financial audit was not known by the SEC. After more than seven months of uncertainty, Telkom managed to avoid delisting by finally resubmitting its audited financial statements. Another example was PT Antam (mining industry) that had to report within minutes to the Australian SEC when an incident occurred in an area of its operations. Here, the shareholders were given information to make their decisions in order to protect their interests. As such, the government and the ISOEs management will no longer be able to conceal under-performing managers and Board members because the public is now well informed.

Hence, the potential for interference from the bureaucracy and politicians will be reduced and the ISOEs will become more independent.

The majority of the interviewees agreed that privatisation has had a positive impact on corporate governance practices in the ISOEs. As one interviewee stated:

I support privatisation because it does not move the assets and employment. It is also the way to introduce good corporate governance in ISOEs. In addition, if all ISOEs are privatised, we will not need the State Ministry of ISOEs. A Bureau in the Ministry of Finance will be able to carry out the job, as an institutional investor (BoD04, October 2003).

Another interviewee stated:

On average, the corporate governance score in privatised ISOEs is higher than non-privatised ISOEs because they have to consider more than one owner. For example, when this office [BPKP] carried out corporate governance evaluations in three privatised ISOEs, it had to do it properly so that it would not be perceived differently by external parties particularly the minority shareholders. (B02, September 2003, emphasis added).

In practice, however, privatisation itself is not a guarantee of good corporate governance practices in the ISOEs. Data, shown in Table 7.1, shows that the score of corporate governance practices in two privatised ISOEs, PT Kimia Farma Tbk. and PT Timah Tbk., were ranked lower than those of non-privatised ISOEs. These two ISOEs were both ranked 'satisfactory'. In addition, a comparison of corporate governance scores between privatised and non-privatised ISOEs, presented in Table 7.2, showed a small difference on their scores of 74.57 and 73.71 respectively. Hence, it can be argued, non-statistically, that a positive relationship between privatisation and corporate governance has not yet been presented. Besides, even if privatised ISOEs gained a higher score (e.g., PT BNI that was ranked first among the 16 ISOEs), it was not a guarantee that in reality this ISOE practiced good practices. As discussed in the previous section, PT BNI recently lost trillion of Rupiahs because of

weaknesses in its internal control and the role of its Board. In relation to this, one interviewee stated his view as follows:

Privatised ISOEs are no different from non-privatised ISOEs. For example, their annual reports are not published publicly. They just put the reports in the JSE library and that is all. This means they are not serious in implementing transparency. If they were, they are supposed to distribute the annual reports to other libraries such as the university libraries (A01, 2003).

Corporate governance scoring is useful to provide a picture of the current state of practices. However, it has inherent weaknesses because it can only measure the 'tangible' aspects of corporate governance such as the structure and processes. The 'intangibles' aspects of corporate governance, the links between one's talents, experience, integrity, character and store of knowledge, is so far unmeasurable.

In terms of independence, the influence of the government in the privatised ISOEs may be lessened but it may not be completely removed. Even though the ISOEs are privatised, they are still ultimately under government control, since the government appoints the majority of the directors. In addition, if the government still holds the 'Golden' shares, the government has the right to veto the appointment and the dismissal of Board members as well as Directors. One interviewee commented on this issue as follows.

The government still wants to have the right to veto in the appointment and dismissal of the Board members and the top management. This is not right because the government still wants to dominate the ISOEs. If the government has 75 percent shares and still asks for Golden shares that too much because being the majority shareholder, the government can still enforce its aspirations on strategic issues. But if it only owns 10 percent, i.e. it is the minority shareholder,] golden shares are required as a safeguard, for clear purposes. However, the fact of the matter is golden shares are just to gain a power of veto and particularly to dismiss the Board and the top management or to change the company business. This is in fact not necessary because we already have rules on how to appoint and dismiss the members of the board of Commissioners or Supervisors and the Board of Management (BoD04, 2003).



Similarly, another interviewee said:

Even if the government only owns one percent, it still has the right to veto. The question is 'Does the government really have the real intention to release its control over ISOEs when they are privatised?' (P04, September, 2003)

Nevertheless, as many scholars argue, the government will never relinquish its power to influence SOEs, no matter who is the majority owner in an SOE. The only difference is in the manner of exerting such influence.

### **Prescribed Corporate Governance Model: One Size Fits All?**

The current development of corporate governance in Indonesia, particularly in ISOEs is largely affected by Anglo-American concepts prescribed by the financial agencies such as the IMF, the World Bank, USAID and the ADB. The question is, 'Can the concepts be directly adopted and implemented in the ISOEs corporate governance systems, considering the fact that there are differences in company legal systems, business culture, and socio-politics?' Relevant to this question is Doornbos' (2001) view on the implementation of good governance in the public sector. He states that standards and principles, which are applied by financial agencies through 'intervention-oriented good governance', are likely to be derived from the way these agencies perceive and handle the world around them. That is, from their own particular—and cultural—perspective, even though they may be presented as having 'universal' value. Moreover, he argues that if certain standards or practices are now advocated globally, this cannot be because they are intrinsically universal but because the financial agencies would like to see them being taken up for universal adoption—presumably because this might make life easier for aid agencies. If the Western-derived standards and principles were insisted upon, it would mean that the non-Western countries have to adjust their politico-cultural setting to that of Western countries. A consequence is that, in reality these standards and principles do not seem to go very deep. Doornbos (2001) suggests letting academia develop the concepts as they

presumably would take cultural variations as the point of departure and would try to better understand the merits and demerits of different configurations of governance in different contexts.

Patrick (2001) in his study on corporate governance and the Indonesian financial system states that there are significant differences between the East Asian and the Anglo-American model of corporate governance. The East Asian model is export oriented, relationship oriented and bank oriented, and emphasizes a substantially greater degree of active state intervention, involving cooperation among government and business policymakers to overcome perceived market failures and implement 'industrial policy'. The Anglo-American model is free trade oriented, market oriented, capital market oriented and emphasizes much less state intervention and is limited to the provision of necessary economic infrastructure, physical infrastructure (such as roads) and public goods (such as education and defence). Penga et al (2003: 357), based on their study in Russia, are not optimistic that a straightforward application of agency theory in a transition economy, characterized by a great deal of institutional differences compared with the West, would be fruitful.

In relation to this, one interviewee from a financial agency suggested that in order to effectively implement good corporate governance practices it is better for Indonesia to change the two-tier board to a one-tier board structure because the one-tier has more advantages than the two-tier Board structure (C02, September 2003). On the other hand, one interviewee who held several Board memberships was ascertained that the two-tier Board structure was suitable with the Indonesian business environment (BoD04, October 2003). The important thing is, as another interviewee stated, before government puts corporate governance concept and principles into effect in the ISOEs, it must first consider which type of corporate governance model it wants to implement. Should it be the American, Japanese, German or European corporate governance model or should it build its own model (P04, September 2003). Once the model is established, the government can establish regulations concerning structure and processes. In doing so, it is necessary to take into account factors such as cultural, legal and political systems in building a model. As

such, extensive intellectual discussions among the stakeholders of ISOEs are needed.

## **Summary**

This chapter examines the government initiatives on corporate governance in the ISOEs. The initiatives were started in 2000 at the same time the financial agencies came to assist the government in dealing with the economic crisis. Since then, there have been several programmes carried out by the government from establishing a separate agency (the State Ministry of ISOEs) whose task is to represent government as the shareholder of ISOEs, to overseeing the ISOEs through regulations. The initiatives have provided some good results in that there has been increased awareness among the people sitting on the governing bodies in the ISOEs of the concepts and the importance of corporate governance. In addition, regulations and guidelines issued by the State Ministry of ISOEs have made the ISOEs more transparent than they were previously and this had made it difficult for Board members and the management to conceal the ISOEs operation from the public. An example is the requirement to publish the enterprises' operation online so that public can access it without difficulty. This increases the ISOEs accountability to the public.

However, the initiatives seemed to be moving very slowly, almost standing still. The implementation of corporate governance principles has also not been very effective. The information from the State Ministry of ISOEs' public statement showed that some ISOEs were late in releasing their annual reports to the office and to the public. In addition, the information offered for public consumption was very limited. The ISOEs are still not free from government and political intervention. From time to time the ISOEs had to carry out operations that were not part of their missions, and this affected their performance. Hence, clear missions, objectives and an understanding of the ISOEs' roles in relation to the country's economic development will enhance the ISOEs' performance in the future.

Several factors that might have an impact of slowing the initiatives were identified. They were: (1) the absence of effective ultimate owners, (2) lack of understanding of corporate governance concepts, (3) lack of commitment and consistency, (4) unclear programmes, and (5) multiple and conflicting objectives

Besides internal factors, there were external factors identified that might have affected the effectiveness of promoting sound corporate governance practice in ISOEs. These factors were culture, law enforcement and public governance.

Privatisation has so far not shown its effectiveness in enhancing good corporate governance practices in privatised ISOEs. There were some examples to support this claim such as the incidents of wrongdoing in PT BNI, PT Kimia Farma, and PT Bio Farma. Hence, the government, as the majority shareholder in these privatised ISOEs, should put more effort to avoiding the recurrence of such wrongdoings by, for example, paying more attention to the intangible aspects of corporate governance such as integrity, leadership and honesty in addition to structure and process.

The adoption and adaptation of the Western corporate governance system in ISOEs such as independent Board members and Board Committees needs to take into account the differences in culture, political setting, laws, public governance and readiness of the market. Therefore there needs to be more intensive intellectual discussions, among parties involved in the Indonesian business community to establish a model that is suitable for the business and public environment and to avoid a focus on form over substance. The next chapter will discuss a summary of some key findings in this study.

## **Chapter Nine**

### **Discussions of Key Findings**

In the 21st century, stability and prosperity will depend on the strengthening of capital markets and the creation of strong corporate governance systems. While it is encouraging to see emerging economies rebound from the traumatic financial crises of the last several years, it is important that the momentum for reform of corporate governance regimes be maintained. (Witherell, 2000)

#### **Introduction**

The overall aim of this research was to examine corporate governance practices in ISOEs, with particular emphasis on the roles of the Boards and related government initiatives to improve corporate governance practices. In doing so, a literature review of corporate governance and SOEs' concepts relevant to this study, as well as the results of the empirical research, have been presented in the previous chapters. The objective of this chapter is to provide a summary of the key findings discussed in previous chapters and to raise important issues that are worth consideration by policymakers, ISOEs and academic elite.

This chapter consists of five sections. The first section highlights some of the key findings discussed in Chapter Six with background theory covered in Chapter Four. The second section discusses key findings in Chapter Seven on corporate governance practices in ISOEs and the role of Boards, taking into account the literature review presented in Chapter Two and Chapter Three, the literature review of this study. The third section discusses some key findings discussed in Chapter Eight, government initiatives and factors that affected their effectiveness. The fourth section discusses briefly other factors that have not been discussed in the previous chapters but which may have significant effect on the success of corporate governance practices in ISOEs. These factors involve culture, public governance, the legal system, the relationship of ISOEs with the

PRA and the audit function. Finally, the fifth section provides the summary of this chapter.

### **Key Findings on ISOEs**

This section highlights some of the key findings discussed in Chapter Six, the empirical part of this study that attempted to answer the research question stated in Chapter One, 'What are the current practices of ISOEs?'

### ***The Objectives***

As has been discussed in Chapter Four, the objectives of SOEs are particularly economic. They are engaged in the production and marketing of goods and services and they are designed to add wealth to society. In addition, SOEs can be used as a vehicle to achieve both the social and political objectives of the government.

To some extent, some ISOEs, despite being very few in number, have attained some of those stated objectives. For example, on the economic side, some ISOEs have been able to produce profits and consequently pay taxes and dividends to the government. On the socio-political side, ISOEs have also carried out pioneering business activities in undeveloped regions for a long period of time and have actively participated in providing financial and consultative assistance to small and medium enterprises, cooperatives and the public. ISOEs have opened up job opportunities to hundreds of thousands of people and functioned as a government instrument to prevent social unrest.

However, in practice, half numbers of ISOEs are still running at a loss and thus they have become a burden on the government budget. The problems that the ISOEs face are similar to those documented in the literature: the ever changing objective, unclear objectives and political interference, which are inescapable and play a significant role in the process of determining and achieving the objectives. This interference can come from various parties, such as bureaucrats, political parties and other pressure groups such as NGOs. It is public knowledge that ISOEs are time

and time again used to serve the various interests of political parties and the government elite, at the expense of benefiting society.

### ***The Rationales and Motives of SOEs***

An SOE is one of the many tools used by governments to fulfil their expanded roles of controlling certain key sectors (Mazzolini, 1979), to cure market failures [Atkinson and Stiglitz 1980], to maximize social welfare and to charge prices that more accurately reflect social marginal costs (Shleifer and Vishny, 1994). Fernandes (1986: 220-221) identifies five motives for the establishment of SOEs: (1) the national strategy of a country, (2) the 'natural' monopolies concept, (3) the 'commanding heights' perspectives, (4) the 'unattractive' investments approach and (5) the absence of an organised domestic private sector.

In the Indonesian context, the rationales and motives stated above apply to a certain degree. The expanded roles can be seen by the existence of a great number of ISOEs that are involved in various industries from salt to airplanes. The role of solving market failures was particularly evident when the Indonesian economy was hit by crisis. In 1997/1998, for example, the ISOEs in the banking sector played an important role in stabilising exchange rates and inflation. As such, ISOEs became the only players driving the Indonesian economy.

The national strategy concept was applied at the beginning of Indonesia's independence. The government and other political leaders at the time had a deep suspicion towards concepts such as market forces and private capital accumulation. Hence, capitalism was equated with colonialism and exploitation. As a consequence, a strong government was needed to protect the nation's hard-won independence and guard against foreign economic domination (Syahrir and Brown, 1995: 140). At that time almost all SOEs owned by the Dutch government and private Dutch enterprises were taken over by the Indonesian government.

The absence of an organised domestic private sector was also a motive for the government to establish ISOEs. After independence, Indonesia did not have strong pengusaha pribumi (indigenous entrepreneurs) to drive the development of the Indonesian economy. As

such, ISOEs were used as a means of extending pribumi (indigenous) ownership. Herein, the government established various ISOEs, which were run by bureaucrats, political leaders and military officers, to create strong indigenous entrepreneurs who could compete with foreign and Chinese entrepreneurs. As a result, a large number of SOEs, in the late 1950s and early 1960s, were run by people, labelled as 'bureaucratic capitalists' (Castles 1965 in Booth, 1997: 316-317).

The 'natural' monopolies and maximising social welfare concept was applied by the Indonesian government, based on the Indonesian Constitution of 1945 article 33, which states:

- 1) The economy shall be organized as a collective endeavour, founded upon the basis of family spirit (*'Perekonomian disusun sebagai usaha berdasar atas azas kekeluargaan'*);
- 2) Branches of production essential to the state and affect the welfare of most Indonesian people shall be controlled by the state (*'Cabang-cabang produksi yang penting bagi negara dan yang menguasai hajat hidup orang banyak dikuasai oleh negara'*);
- 3) Land and water and natural riches contained therein shall be run by the state and to be used for the greatest prosperity of the people (*'Bumi dan air dan kekayaan alam yang terkandung di dalamnya dikuasai oleh negara dan dipergunakan untuk sebesar-besar kemakmuran rakyat'*).

In practice, the interpretation of the word '*dikuasai*' in article 33 (2) creates continuing ideological arguments, particularly in debates over privatisation. To the opponents of privatisation, the word '*dikuasai*' can be interpreted as 'shall be owned' by the state and therefore privatisation of the ISOEs, particularly those that affect the welfare of society at large such as telecommunication, water and electricity, is an infringement of the Indonesian Constitution of 1945. In contrast, the proponents of privatisation argue that the word '*dikuasai*' means 'control'. In this regard, the government, even though it does not own the companies, can still have power over the businesses through regulations such as pricing, anti-trust and social policies.

The concept of 'commanding heights' held true, particularly at the beginning of the independence era. This was when the country was lacking private entrepreneurs with capital who could lead the Indonesian economy. As the country's economy developed, numerous private



enterprises with strong entrepreneurship and capital investments were established. They are now involved in infrastructure and basic economic industries, although they are mostly operating in already developed regions. Notwithstanding, the 'unattractive' investments motive still holds true to date. The ISOEs still have an obligation to produce products and provide services that are unattractive to the private sector because providing those services requires huge capital investment but the profits are small. Some examples of this are the production of low price vaccines and the provision of transportation (land, sea and air) to numerous remote areas across the country. In addition, for the undeveloped regions the ISOEs still play an important role in driving their economic development.

Regardless of this, there is one motive that applies to all of the ISOEs but to this date it has not been attained; that is to maximise social welfare. As discussed in Chapter Six, a large numbers of ISOEs are incapable of creating profits, let alone maximising the wealth of the nation. They are, indeed, not effective as an agent of development as it is claimed by the proponents of ISOE establishment. The fact is, even though the government keeps saying that it will close the loss-making ISOEs, those ISOEs maintain their businesses and continue as an administrative and financial burden to the country.

### ***The Performance of SOEs***

In Indonesia, the performance of the majority of ISOEs remains unsatisfactory. Their problems are similar to those documented in the literature and they are characterised by low profitability, unfocused operations, red tape intricacies, low productivity, low asset utilisation and lack of customer and market orientation. Management and the Boards lack the incentive to perform better because their wealth is not determined by their ISOEs' performance. In addition, there are no sanctions enforced by the government if they perform poorly. The ISOEs' managers face soft budget constraints, wherein bankruptcy is not a credible threat to their positions. It is in the government's interest to bail them out in cases of financial distress.

Last but not least, the practice of KKN (corruption, collusion and nepotism) by people who have gained access to the ISOEs has had a significant effect in damaging ISOEs performance. Therefore, ISOEs need to be controlled and managed by groups of people who not only have business knowledge, (a situation which already exists), but also who have integrity, leadership and ethical values. As such, they will not be easily tempted to be involved in any wrongdoing, caused by greed in the pursuit of financial gain, known as 'short-termism'—the state of sacrificing the long-term health of the enterprises in order to maintain short-term profitability. One interviewee explained that there were instances where ISOE managers who ran a business in the forestry industry decided to cut and sell most of the trees in order to gain high profits that would increase their performance and, consequently, their remunerations (B07, September 2003). They did not consider the sustainability of the business. To ensure high standards of ethical behaviour the government, through the State Ministry of ISOEs, needs to establish Codes of Conduct and Ethics, accompanied by continuous awareness and compliance programmes.

To improve the ISOEs' performance, the State Ministry of ISOEs has established Masters Plans that outlines three main strategies to develop ISOEs. The strategies were accomplished in three stages: (1) Consolidation (2002), (2) Revitalisation (2003-2004) and (3) Development (2005-2006). These strategies include a programme to review the non-profit operations of ISOEs with a view to transferring them from the ISOEs to private sector companies (*Jakarta Post*, December 12, 2001). Specifically, this programme is to:

- identify public service obligations (PSOs) and assess their impact on the financial performance of ISOEs
- separate PSOs from the commercially viable activities of ISOEs
- define the rules for tendering PSOs to private companies

Regardless of this, to date the number of ISOEs that suffer from financial losses is still half the total numbers of ISOEs. Data in Table 6.4 shows that the number of ISOEs that suffered from unprofitable operations in 2001, 2002 and 2003 were half of the total ISOEs; 48 of 102,

58 of 100 and 54 of 103 respectively (Kementrian BUMN, 2003). In addition, time and time again the government, through the State Ministry of ISOEs, seems lacking the incentive to commit, carry out and deliver any programme in ISOEs. For example, the progress of the 2001 programme stated above appears to be very slow, if not standing still. Now in 2005, there is no public statement explaining the progress of the programme and what has been done by the government to attain the programme objectives.

Good planning through the establishment of the Master Plans, obtaining funding from financial aid agencies and hiring expertise from overseas, are not automatic guarantees for a successful programme. In any programme, no matter how good the planning, it is individuals who play a significant role in ensuring the programme is delivered effectively. As such, there is a need for consistency and commitment from those individuals in order to execute, monitor and evaluate the programme continuously. It is worth noting that this situation has arisen not because the government does not have a clear vision to direct the ISOEs but because it does not have enough commitment, good will and consistency to attain this vision. In addition, there is seldom continuous monitoring and evaluation in place to ensure the attainment of programme objectives. In many instances, good programmes were discontinued and replaced by new programmes because there was a change of government. Relevant to this, Healy (2003: 42) states that 'organisations don't succeed or fail, the individuals who lead and manage them do.' Unless the government has a strong-willed commitment to improving ISOEs' performance ('walk the talk' is not only a matter of rhetoric), there is not much that the public can expect from the ISOEs, albeit expecting them to achieve their foremost objective, to maximise public welfare as commanded by the 1945 Constitution.

### **Privatisation**

As discussed in Chapter Four, privatisation has various objectives, from increased government revenues to enhanced individual freedom. In the Indonesian context, privatisation has become the means to generate

revenues for the government budget. Despite incoming revenues from privatisation, progress has been slow, due to various factors including the following:

- The government, as well as the ISOEs management, lack clear a privatisation mission, overall strategy and objectives that are shared by society and this results in lack of political support. This also results in the absence of systematic efforts to restructure and prepare ISOEs for privatisation.
- The government and other vested interest groups tend to keep the operation of privatised ISOEs under their influence and to maintain the status quo. In doing so, there is a high degree of secrecy in the process and as a result, almost every deal is mixed up with political controversy and allegations of corruption.
- There is a lack of incentives for ISOEs to participate enthusiastically in the programme, because the management and the Board are not involved in the selection of ISOEs for privatisation and there is no provision for ISOEs to retain a percentage of the privatisation proceeds
- The absence of institutional arrangements to oversee the privatisation process

Regardless of rhetoric from the government that privatisation is part of the structural adjustment program which will open up the economy to global market competition, it is clear that the main objective of privatisation is short-term that is to raise funds in order to reduce budget deficits. In doing so, the government does not put much emphasis on strengthening the market for competition and improving the overall performance of ISOEs. Thus, the privatisation programme does not have a great impact on the national economy. The government tends to improve the performance of ISOEs whenever it has an intention to privatise those ISOEs.

## **Key Findings on Corporate Governance**

The objective of corporate governance is to search for ways to alleviate the agency problem caused by the separation of ownership and control. This is achieved through the establishment of a corporate governance structure and processes that align the interests of the self-interested managers with those of the owners. As such, the managers are held responsible and accountable for their acts which then minimises self-interested managerial behaviour.

In ISOEs, corporate governance systems are there to ensure the alignment of the government's interests and the ISOEs' management interests with those of the public as the stakeholders. This section highlights some key findings discussed in Chapter Seven, which is the empirical portion of this study that attempts to answer the research question, 'What are the corporate governance systems the ISOEs?' stated in Chapter One.

### ***The Concept***

As discussed in Chapter Two, there is no universally accepted definition of corporate governance. It can mean different things to different people. In ISOEs, corporate governance is defined as:

The process and structure used by ISOE organs to enhance business success and accountability with the ultimate goal to achieve long-term shareholder value, whilst taking into account the interest of other stakeholders based on the provision of laws and ethical values (the Ministerial Decree of ISOEs, 117/2003).

In practice the operationalisation of the above definition may be problematic because it offers no further explanation of who are the shareholders and stakeholders. As discussed in Chapter Four and Eight, there is no real owner in an ISOE who has the incentive to ensure that management and Board will act in his/her best interests and who can claim all the benefits created by that ISOE. In addition, shareholders and stakeholders have no clear boundary in an ISOE because the public, including the government, is both stakeholder and shareholder. At issue

is the fact that if the shareholders' and stakeholders' identity is unclear then the ultimate objective of corporate governance, i.e. to create shareholder value while considering the interest of stakeholders, is blurred and hence not attainable. In my view, the ultimate goal of good corporate governance practice in ISOEs is, indeed, to achieve sustainable development for the benefit of society, through the right balance between economic, social, individual and society goals. As such, the ISOEs should not carry out business operations that harm the environment (e.g., polluting the air and rivers).

With regard to the above, the government, through the State Ministry of ISOEs, needs to re-evaluate the definition and develop a broader definition that suits the characteristics of ISOEs, which have both social and commercial objectives. For example, the World Bank (1999) defined corporate governance from two different perspectives—company and public policy:

From the standpoint of a corporation, the emphasis is put on the relations between the owners, management board and other stakeholders (the employees, customers, suppliers, investors and communities). Major significance in corporate governance is given to the Board of Directors and its ability to attain long-term sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company and at the same time its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and, at the same time, to stimulate them to minimize differences between private and social interests.

Therefore, it would be insufficient for the government to merely adopt the private sector definition of corporate governance, of which the main focus is merely to maximise the shareholder value. Comprehensibility and clarity of a corporate governance definition is critical because it will minimise the room for interpretation among all parties and it will help in the development of objectives, the means of attaining those objectives and the monitoring process. Notwithstanding, in the development of such a definition it is essential to give the public a chance to make a contribution to the discussion. This can be done through open public discussions.

There is an obvious disadvantage if the government or the ISOEs managers are left free to make their own judgement of whose benefit they have to serve: the disadvantage may be the loss of accountability.

### ***The Objective of Corporate Governance***

As has been discussed in previous chapters, the objective of corporate governance is to establish processes and structure that can protect the interests of the shareholders and the stakeholders. To attain this objective, the government undertook various initiatives including the stipulation of regulations, the dissemination of the concept through seminars and workshops and the evaluation of corporate governance practices in selected ISOEs.

Regardless of this, there are still issues that have to be dealt with by the government, Boards and ISOE management. Many ISOEs are still loss making companies and having suffered financial losses. They are not able to generate revenue and contribute income to the government budget. Despite such a condition, public still witnesses self-interested managers and members of Boards use their discretion to reward themselves with high bonuses (e.g., PT PLN). This shows that corporate governance and corporate management are not effective in ISOEs. As discussed in Chapter Two, corporate management is the managers' responsibility; it is task-oriented. Corporate governance is strategy oriented and is the responsibility of the Board (Tricker, 1994: 10).

The ineffectiveness of corporate management today may be the result of the fact that management, from the top to the bottom level, are unable to establish and carry out sound organizational functions such as planning, staffing, administration and direction, measurement, internal control systems, innovation, representation, decision making and operations. The ineffectiveness of corporate management results in bad practices such as 'mark up', asset stripping, and KKN.

The ineffectiveness of corporate governance has been the result of Boards' inability in '... correctly motivating managerial behaviour towards improving the business and directly controlling the behaviour of managers' (Keasey and Wright, 1997: 2) and incapability in providing strategic

directions. A concern raised by Standard & Poor over corporate governance practices in PT Antam Tbk, one of Indonesia's largest mining and mineral-processing company, is their lack of independence. Only two of the five commissioners meet local or global standards for independence (PT Antam Website). At issue here is the fact that if an ISOE such as PT Antam, which has issued its shares in overseas capital markets, could only attain 6+ on a 10 scale of corporate governance rating, then one can predict the corporate governance score of the majority of ISOEs that have not gone public. Discussions of Board ineffectiveness will be presented later in this chapter.

### ***Basic Principles of Corporate Governance***

There are some basic principles which good corporate governance must follow: transparency, accountability and independence. The main benefit of practicing the good basic principles of corporate governance is that it maintains and increases public trust.

### **Transparency**

The objective of practicing transparency in the ISOEs is to assist the public, as the stakeholders, in making decisions and judging the performance of the ISOEs. However, the results of this study show that transparency in ISOEs, regardless of the issuance of several Ministerial Decrees, is still a long way from best practice. The information that should be provided by ISOEs online should include corporate and business profiles, organisational structure and a description of the top management and the Board, affiliations, products and services, financial and operating performance, company working plans and contributions (BUMN Website, 2005). Most of the ISOEs have provided such information to the BUMN Website but the quality of this information is very poor. The information relating to the Board, for example, is either incomplete (some of it is left blank) or out of date. This simply reflects poor practice of corporate governance.



Using the internet as a means of disseminating information is a sign of openness. However, the people who manage the information need to really understand what type of information is needed by the public. Moreover, in order to be effective, the information needs to be accessible, reliable, relevant, comprehensive and up to date. This can be achieved only if the government and the ISOEs' management have a strong commitment to transparency. Otherwise, the practice of transparency is just a matter of lip service.

There are several factors that may contribute to this situation. Firstly, the Decrees stop at the normative level. As such, there is no further guidance provided to assist ISOEs management in the implementation and evaluation process. Therefore, there may be a case where the ISOEs' management has different views as to what constitutes transparency. Secondly, the ISOEs are still run by bureaucrats or people who maintain a feudalistic culture of secrecy. Those people tend to hold onto information and knowledge rather than share it with the public. The rationale is that the more they share information with the public, the more the public will know about their mistakes and consequently, they will receive a great deal of public criticism. As such, they are generally very sensitive to public criticism because it is seen as negative opinions or personal attacks intending to bring down their reputation and careers. Thirdly, records and data are often seen as personal property or the enterprise's possessions. In spite of legal requirements and government policy, there is often resistance to releasing information that may result in negative political, personal, organizational or other consequences. Fourthly, public management is not in the habit of providing good documentation and consequently, they find it difficult to provide reliable, accurate, continuous and timely information. Finally, both government and the ISOEs' management have not yet recognised that being informed and observing ISOEs' activities are public rights and therefore it is the obligation of both parties to provide the required information actively or passively. The fact is transparency is an obligation and therefore it cannot just be dependent on the good-will of the government or the ISOEs. At the

end of the day, it is the public who owns the information; the ISOEs' management only manages that information.

### **Accountability**

Accountability is a system that mandates full reporting of the results of responsibilities (Bavly, 1999: 15). A mandate is the result of an institution (this can be in the form of political or government institutions, private or public companies, non-government organisations or social and business communities) using others' resources. The objective of accountability is to enable external parties to measure performance. Pitkin and Farrelly (1999: 253) argue that without accountability corruption and fraud can flourish. Box 9.1 below indicates factors that show when accountability fails.

#### **Box 9.1 Accountability Fails to Do Its Job**

- When 'accountability' is no more than reference-sized books of information
- When people consider accountability is 'administrative work'
- When more time is spent debating how performance will be measured and rewarded than how performance can be improved
- When nobody can remember all the priority goals
- When policymakers do not sustain financial support for improvement plans
- When it feels like coercion or bribery

Source adapted from National Commission on Accountability in Higher Education (2005)

Best practice of corporate governance requires that ISOEs produce an annual report to inform the public of their activities and performance. The basic ingredients of a good annual report are that it is reliable, accurate, relevant and timely. In practice, accountability in ISOEs is still low. There were instances where ISOEs were so late in providing this information that

any decisions relating to the company had to be postponed. A recent example was PT Pertamina, which could not publish its financial report for 2004 until late 2005. Hence, the State Ministry of ISOEs had to wait before making any decisions. In addition, the accountability of ISOEs to the government does not mean that they meet public needs because the type of information needed by the government may be different to that required by the public.

The following are some factors which contribute to poor accountability. Firstly, there are no 'ultimate owners' who have the incentive to demand and enforce the ISOEs be accountable. Secondly, there is no clear guidance from the State Minister of ISOEs as to what the criteria are for accountability. Thirdly, as in transparency, there are no sanctions for not providing information (e.g. the annual report) on time. The likelihood is that if Board members are also officials in the State Ministry of ISOEs then their colleagues, who oversee the ISOEs and who will receive the report on behalf of the 'owner', would be hesitant to sanction them. Fourthly, the public and the PRA members know very little about ISOEs. In terms of outside parties, members of the PRA regularly enquire and discuss ISOEs' performance and working plans with the ISOEs management; however, their concern is only for profits. Rarely do members of the PRA enquire about the effectiveness of ISOEs in achieving social objectives or implementing sound corporate governance.

## **Independence**

Government intervention, albeit diminished, persists in ISOEs and is unavoidable so long as the government has control over ISOEs through the ownership of shares, whether it is wholly or partly owned. The intervention may take place in the process of policy making or in the appointment or dismissal of Board members. As a result, ISOEs tend to operate as appendages of government rather than as largely independent institutions charged with commercial functions of public interest. In this kind of environment, Board members tend to be passive in their roles and act only as the 'rubber stamp', 'watchdog', or 'fire-fighter'.

Many people argue that the only way to avoid government intervention is through privatisation. This may be true to some extent. However, the government can still retain its control through 'golden shares'. Having said this, it is worth noting that government intervention is not totally bad because in some cases intervention is required, for example, in privatised ISOEs which operate in monopoly businesses, such as PT Indosat (a telecommunication company). Intervention ensures that the enterprise does not make any policies or decisions which could be harmful to national security or the public. In doing so, it is important that government intervention on public policy, political or national interests would not conflict with commercial interests and consequently be detrimental to minority shareholders

### **Key Findings on the Boards**

The absence of a market for corporate control of ISOEs makes the corporate governance control mechanism heavily reliant on Boards. The results of this study reveal that the performance of Boards in ISOEs was poor and their roles were ineffective. Several factors for this have been identified in this study.

### ***Lack of Legal Power and Responsibilities***

In Chapter Seven, the power and duties of Boards, based on the ISOE Act 19/2003, have been discussed. The main duties of Boards are to provide advice and carry out monitoring. What is lacking in the Act is that it does not give power to Boards to appoint and dismiss Directors. This makes Boards appear not to have the power to discipline the directors, whenever they take wrong decisions. Similarly, the advice given by Boards can be ignored by Directors because Boards do not have the power to impose sanctions if the directors choose to disregard their advice. In addition, the duty of Boards to provide advice is not accompanied by the responsibility to join together with the directors to establish strategic planning or make decisions. In practice, Boards would find it problematic to provide advice and monitor situations in which they have no involvement or knowledge.

Currently, in non-privatised ISOEs there is no obligation to provide the Board report separately from the management report in the annual report. Thus, Boards are under no pressure to be accountable to external parties. Powel (1987: 167) properly describes this situation when he says:

...in many countries, the status and authority of corporation supervisory boards do not adequately reflect the importance of the role that they should be performing in monitoring and controlling enterprises under their control and linking the higher components in the accountability supervisory system.

As a consequence, Boards only function as a supplement within the corporate governance mechanism.

### ***Lack of Incentives***

The absence of a market for corporate control creates a situation where there is no threat of hostile take-over and the poor performance of Boards will not affect their market value. In addition, if something unfortunate occurs to an ISOE, for example if it goes bankrupt, the Boards are not at risk because they do not have a personal stake in the income or losses generated by the ISOEs. Besides this, whenever an ISOE faces financial problems, the government tends to bail it out from bankruptcy<sup>120</sup>. When an ISOE goes bankrupt, it is a common practice of the government to reassign the members of the Board to another ISOE Board.

These conditions make Boards very passive and it lessens their sense of responsibility to exercise their oversight duties<sup>121</sup>. One reason for this situation, as noted by some of the interviewees, might have been because if a worse situation occurs within an ISOE, Board members still have their formal jobs in the government bureaucracy. Furthermore, if Board members are involved in wrongdoing the government seems reluctant to

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<sup>120</sup> An example of this situation occurred when the government bailed out PT IPTN from its financial problems by providing fresh capital to the total of more than Rp1 trillion through the 'debt to equity' swap method. In addition, the government gave financial assistance to pay an employees' settlement.

<sup>121</sup> A far worse case is told anecdotely, in a year 2000 BPKP study, which revealed that a member of the Board in one ISOE did not even know that he was a Board member.

extend charges against Board members<sup>122</sup>. It is fair to say that it is not Boards that protect the government interests but the other way around. Having said this, it is argued that the agency problem in ISOEs is not among the three company organisations in ISOEs (the State Ministry of ISOEs, the Boards, and directors) but between these three and the public at large, including the employees.

Board passiveness has created a situation where the Board can be easily misled by management. For example, PT Kimia Farma (pharmaceutical) without the full knowledge of its top management marked up the sales numbers in its annual report which then showed a considerable increase in profits. In the following year, the sales numbers were adjusted and reduced significantly. Hence, profits in the previous year became losses the following year. The reason for the losses, as explained by the management, was due to substantial sales returns. When the deception was finally discovered, one member of the Board commented 'In the beginning I thought they made a mistake in calculating the costs, but I found out later that they were being fraudulent' (*Tempo Interaktif*, November 11, 2004). As such, it is fair to say that independent Board members do not do enough homework to understand in depth the business of the companies on whose Boards they sit. Therefore, they have trouble judging whether their management is doing well or poorly. It could be said that Boards in ISOEs carried out 'pantheonic' roles more than performance or conformance roles (see Chapter Three). As Mitnick (1986: 49) argues 'Many such boards [pantheonic board] appear to do little or nothing of substance (cited in Cochran and Wartick, 1997: 18, emphasized added).

It is worth mentioning that certainly there are Board members who carry out their duties responsibly. However, they are few in number and may not be strong enough to improve overall corporate governance systems and practices in the ISOEs. One member of a Board interviewed in this study described his initiatives to effectively carry out his duty as follows:

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<sup>122</sup> This is not unique to Indonesia. In China a similar situation occurred. Dahya, Karbhari, and Xiao (2003) found that in two corporate scandals, the supervisors went free while the directors were charged with fraud and deception.

Being a Board member, I try my best to do what I am supposed to do. Without having detailed guidance of what I have to do, I carry out my duties using various approaches. For example I make questionnaires, arrange Board meetings or site visits (BoD04, October 2003).

### ***The Wrong Man in the Right Place***

The government, through the State Ministry of ISOEs, appoints highly qualified individuals to sit on Boards. However, in many cases their qualifications do not correspond with the ISOE's business. For example, the government appointed a Director General of Energy and Mineral Resources to sit on the Board of an ISOE whose business was fertilisers. Another example was the appointment of a professor in medical science as a Board member in an ISOE whose business was agriculture. This certainly affected their effectiveness in providing advice and exercising monitoring roles. Here, it is worth noting a statement by the Acton Society Trust::

Even to the most casual observer it is obvious that the selection of members of the Boards of nationalised industries is a matter of great importance. Unless Board members are skilful, enterprising and able to cooperate harmoniously, the nationalised industries will not be run as efficiently as they should (quoted in Aharoni, 1986: 308).

In exercising their fiduciary duty, Boards may use assistance from internal and external parties such as internal auditors and consultants. However, at the end of the day they are the ones who have to make the decisions. Thus, the composition of Boards should represent a broad range of qualifications, experience and expertise in accounting, finance, law and other related disciplines. The danger of not having the required expertise is that Boards can be misled by the management. There is an alternative to aligning the knowledge of Board members to the ISOEs business environment, especially for a new member. This can be achieved through Board training programmes. However, these have also not been put into practice.

In terms of selecting the right individuals, it was only recently that the government required nominees of Board membership to take and pass the 'fit and proper' test which had already been applied to nominees for directors. Whether this test had been applied to Board nominees was unknown, because the criteria and the results of the test were kept from the public. Therefore, there was no way the public could have knowledge about it. In order for such a test be imposed fairly and consistently, it needs to be performed by a single independent institution, using criteria that is transparent to the public and applied consistently. The test should aim to prevent individuals with disreputable pasts, who could bring potential harm to the ISOEs, becoming Board members. The test should also ensure that nominees are motivated individuals who will act in the long-term interests of the ISOEs. If the test is carried out responsibly it can act as a means to prevent the government from appointing incompetent Board members.

### ***Lack of Independence***

As discussed in previous chapters, the majority of Board members were high rank government officials or representative of the ruling party. As a consequence, their motivation in representing the public interests was affected by their dependence on the government and the ruling party. In his study of Thai SOEs in 1984, Garner (1984: 24) found that Boards tended to give more weight to government interests rather than their enterprises' interests and to administrative rather than commercial considerations. The enterprises thus tended to operate as appendages of government rather than as largely independent institutions charged with commercial functions of public interest. Although this study was more than two decades ago, it is still relevant to the present day because practice has not changed much, particularly in ISOEs.

If the alternative to increased Board independence is to hire the so-called 'independent commissioners' or 'supervisors' from outside the bureaucracy (e.g., from academia to prominent well known public figures) the question remains, 'Who do they represent?' It can be observed that in the boardroom the independent board members have been ignoring public



interests. For example, when there was a dispute between the employees of PT Dirgantara Indonesia (aerospace industry) and the top management over the laying off of a thousand workers, the independent board members were silent. There was no single public statement from Board members to reveal their views on the matter. They stood behind the back of management and the government and allowed them to deal with the problems. Thus, they were safe and untouchable by the public and the employees. This was in contrast to the position taken by three directors who resigned from their positions in order to show their sympathy with the employees and to express their disagreement with the CEO's decision to dismiss a thousand employees.

In my view, it is essential to appoint independent Board members who really know whom they represent and who can then really act independently from Board members who represent the government and political groups. As such, it may be worth adapting the Board structure to that such as in Germanic Boards, where the employees have a representative on each Board.

### ***The Absence of Board Assessments***

According to Lorsch (1997: 2), Board assessments are critical to improve Board effectiveness. An assessment of a Board's functioning permits its members to share observations and concerns which they have never discussed before. Currently there is no Board assessment, individually or collectively, to objectively evaluate the performance of ISOE Boards. Therefore, Board members' appointments and dismissals are often followed by public suspicion and speculation. Performing an assessment of a Board's performance is essential to assess whether a Board has exercised its duties according to its mandate and a set of rules. Likewise a Board assessment demonstrates 'good practice' to shareholders and stakeholders. The Canadian Joint Committee on Corporate Governance (2001) states that:

Regular assessment of the board's effectiveness, and the contribution of individual directors, is essential to improve governance practices. The governance system should

include a process for the evaluation of the work of the board, its committees, and individual directors.

Good Board assessment may, and even should, uncover areas for improvement and gaps in performance. In addition, the results of the evaluation serve as a warning system that enables the government to perform corrective action before Board's low achievements or misconduct causes harm to the ISOE. However, failure to do so will allow Boards to operate at a less than optimal level of effectiveness.

Best practice, as suggested by CalPERS (2005b), requires that each Board should establish *performance criteria*, not only for itself (acting as a collective body) but also *individual behavioural expectations* for its directors. Minimally, according to CalPERS (2005), these criteria should address the level of director attendance, preparedness, participation and openness. Best practice in New Zealand states that effectiveness of the Board can be enhanced if the Board and directors regularly assess their own performance and that of their individual members against pre-determined measures of the efficiency and effectiveness of board processes, and on the contributions of individual directors (NZ SEC, 2004). The nonexistence of performance criteria and assessment may not be fair to individual commissioners or supervisors who have done a really good job in their position.

### ***Ineffectiveness of Audit Committees***

As discussed in Chapter Seven, the establishment of an Audit Committee is a trend in ISOEs. There is a tacit assumption that by establishing an Audit Committee the ISOEs have practiced good corporate governance. At issue here is the fact that the Audit Committee is filled with individuals who cannot keep up with the ever changing ISOE business environments. As one interviewee commented, 'The Audit Committee members tended to use their out dated knowledge or experience to deal with current ISOEs problems.' (P09, October 2003). This occurred because the members of the Audit Committee were mostly retired high-ranking government officials, who did not have any motivation to improve their knowledge. There was no

set of criteria to be a member of the Audit Committee. The appointment was solely at the government's discretion.

The best practice of an Audit Committee, as recommended by the Canadian Joint Committee, requires that Audit Committees should adopt a formal written mandate that is approved by the Board and that sets out the scope of the committee's responsibilities. This mandate should be disclosed to key stakeholders and a regular assessment of the effectiveness of the committee against the mandate should be conducted and reported to the Board. The mandate should set out explicitly the role and responsibility of the Audit Committee with respect to:

- its relationship with and expectation of the external auditors
- its relationship with and expectation of the internal auditor's function
- its oversight of internal control
- disclosure of financial and related information
- any other matters that the Audit Committee feels are important to its mandate or that the Board chooses to delegate to it.

### **Key Findings of Factors That May Affect Corporate Governance Initiatives**

In any initiative, there are factors that may affect its effectiveness and they would cover many dimensions. The results of this study focussed on the internal factors that had some impact on the effectiveness of the corporate governance initiatives. External factors such as culture, public governance and law enforcement are beyond the discussion of this study.

#### ***Commitment and Consistency***

The results of this study showed the government and Boards lacked commitment and consistency in implementing good corporate governance in ISOEs. On the government side, it was observed that in various cases the government breached its own set of rules and regulations. For example, in the appointment and dismissal of Board members and

Directors the government did not always follow the rules and mixed the process with conflicts of interest. Many times the government by-passed the Boards to directly deal with the management. This created ineffective Boards that functioned merely as 'rubber stamps' and 'watch-dogs'. Regarding the other initiatives, it was observed that the government did not establish a Plan or Plans that systematically outlined the stages of how to improve corporate governance practices in ISOEs. The fact is that the initiatives seem at a standstill, or have even disappeared. This is certainly unfavourable for the long term objective to achieve sustainable development.

On the Boards' side, they tend to apply a 'wait and see' and 'wait for directions' (*menunggu petunjuk*) approach. This is not unexpected in a paternalistic culture such as that found in Indonesia. The rationale might be 'Why do we have to be bothered changing something that we are not instructed to do so and it does not affect to our position and welfare.' Therefore the attitude has become 'leave it to later'.

### ***Lack of Understanding***

From my personal experience disseminating corporate governance concepts to ISOEs, I found that there were still misconceptions about the nature of corporate governance. The majority of the ISOEs management and Boards viewed corporate governance as the responsibility of management. This was because they confused 'governance' with 'management'. Consequently, the motivators and executors of corporate governance programmes in ISOEs were usually top and middle management. Rarely were Boards present at the event, let alone contributing to the process.

### ***Unclear Programme***

To date, there is no a detailed Plan or Plans of corporate governance established or published by the State Ministry of ISOEs. Unfortunately, several activities under previous programmes, such as the evaluation of corporate governance in ISOEs, seem to have died down along with the

discontinuation of financial assistance from the financial agencies. This somewhat supports the contention that the government does not have a strong-willed commitment and consistency towards corporate governance. Similarly, there seem to be no initiatives coming from the ISOEs management or Boards. As mentioned before, in a paternalistic-bureaucratic culture, where '*menunggu petunjuk*' (waiting for instruction) is customary, such behaviour is not unexpected.

### **Summary**

The government has started initiatives to improve corporate governance practices in ISOEs by issuing regulations and policies on corporate governance, as well as carrying out evaluations on some ISOEs. However, in the early stages of these initiatives the results of this study show that there are still some issues that have to be dealt with by the government and ISOEs. The first issue is the concept of corporate governance. In my view, the definition of 'corporate governance' provided by the government is unclear and does not reflect the real characteristics of the ISOEs, which have many stakeholders. As a result, the bureaucrats and ISOE management have mixed views regarding their roles and whose objectives they have to serve. Hence, the government needs to refine the definition so that it corresponds with the characteristics and purpose of the ISOEs.

The second issue relates to the practice of good corporate governance principles. The results of this study show that transparency, accountability and independence are weak in ISOEs. There were many instances where important information relating to the public interest was kept hidden from the public (e.g., the criteria used in the appointment and dismissal of Board members), the ISOEs' management were late and unreliable in providing public information (e.g., in the submission of annual reports), or decisions were not based on well-thought out considerations but made because of political intervention (e.g., in the case of privatisation and tariff decisions). Better accountability requires substantial improvements in the quality, cost-effectiveness and utilisation of data (NCAHE, 2005: 15). A better implementation of corporate

governance principles will provide the stakeholders with the answers to reasonable questions regarding the performance and activities of ISOEs. The fact is that real improvement in practicing corporate governance principles will come through a sustained effort, including reform of institutional information practices.

The government and ISOEs need to be more consistent and committed to the implementation of good corporate governance principles. The government, ISOEs' management, the Boards and the public (represented by the PRA or other institutions such as NGO) need ongoing and vigorous dialogue. The PRA in particular must play a key role in communicating public expectations to the government and the ISOEs management in terms of transparency and accountability. In addition, it can challenge the ISOEs to do what is required and build public support for them to succeed. The final result of this effort would be the alignment of ISOEs' interests with those of the public.

In terms of Board effectiveness, there are a few suggestions that can be given. Firstly, many observers suggest that in Asian culture stakeholders other than shareholders, especially employees and creditor banks can also play a useful role in corporate governance (Nam and Nam 2004). Hence, it may be beneficial for ISOEs to have employees represented on Boards, such as in Germany. Secondly, there is an urgent need to establish Board evaluations to improve Board performance. To avoid conflict of interest, the process should be performed by an independent institution that applies the criteria consistently. Thirdly, the Board and its committees should be empowered by giving them more autonomy and power to make decisions and implement strategies. This will enhance their responsibility and accountability towards their ISOE.

While some regulations have already been put in place, the challenge is to ensure they are effectively implemented. Efforts should be directed not only to developing rules and regulations supporting corporate governance, but also to ensuring that good corporate governance practices are embedded in the culture and norms of the individuals charged with responsibility.

## **Chapter Ten**

### **Conclusion**

#### **Introduction**

This chapter serves as the conclusion to this study. In this chapter, a summary of each chapter is presented. In addition, this chapter outlines several important issues gained from the results of this study, which including summary of key findings and some policy implications of the results. Suggestions for further research are presented in the final section of this chapter.

#### **Summary of Chapters**

In Chapter One, I presented the background of and the arguments for carrying out this study. The motivation of this study stemmed from the fact that (1) poor corporate governance was claimed to be one of the causes that intensified the economic crisis Indonesia experienced in 1997/1998, (2) there was no research that had been done on corporate governance in the ISOEs despite the fact that the ISOEs play a significant role in the Indonesian economy, and (3) there was a need to provide some evidence through empirical research that can be used by policymakers and other parties to contemplate some issues and to make some improvement accordingly. In addition, this chapter discussed some issues of corporate governance across countries, the research questions, and the importance of the study.

Chapter Two discussed the theoretical background of corporate governance documented in the literature. The purpose of this Chapter was to provide a basis for the analysis and discussions in the empirical portions of this study. Using agency theory approach, several subjects of corporate governance were discussed. They covered the concept, objectives, systems, and basic principles of corporate governance. The

discussion of corporate governance concepts revealed that there is no universally accepted definition of corporate governance. This chapter also discussed two main corporate governance systems adopted by countries around the world: market- and group-based systems. In market-based systems, the objective of corporate governance is to maximise shareholder value. Thus, the managers should act in the interests of the owners. Control emanates from the Board of Directors (internal mechanism) and the market for corporate control (external mechanism). In group-based systems, the objective of corporate governance is to maximise stakeholder value. Control is mainly derived from the Board of Directors which comprises various representatives. In theory, there is a heated debate between opponents shareholder and stakeholder value. Each argument has its advantages and weaknesses.

Chapter Three served as theoretical background on the Board of Directors, a governing body that is claimed to be the most significant corporate governance mechanism in a company. The discussion in this Chapter was important to provide basis for discussions in the empirical portions of this study. This chapter reviews two main models of board structure adopted around the world: one-tier and two-tier board structure. In one-tier board structure, board composition and board leadership are the most debated issues. Both of the issues address the significant role of non-executive board members and the separation of chairman of the Board and CEO to increase the independence of the Board. In addition, this chapter reviews the roles of the Board and Board Committees in corporate governance systems.

Chapter Four was a review of the theoretical background and practice of SOEs documented in the literature. The review revealed that state-owned enterprises' performance was mostly poor. The causes of such poor performance were varied, ranging from having multiple and conflicting objectives to lack of authority and accountability. To improve SOE performance, many governments undertook several reforms including corporatisation and privatisation. These were seen as an effective means to



increase SOEs performance. However, the results of such reforms were mixed.

In terms of corporate governance, the systems are much more complex than those of in the private sector because SOEs are run by various agents with undefined shareholders. In SOEs where a market for corporate control is non existent, the roles of the Board of Directors are significant as an internal control mechanism. However, reality shows that their role is generally ineffective. Some of the reasons are because Board wealth is not at risk if the company goes wrong, Board members are self-interested individuals who seek to fulfill their own interests, and there are no ultimate owners who have the incentive to control Board performance.

Chapter Five was a discussion of the research methodology employed in this study. This study employed qualitative and quantitative research methodologies to capture different data. The sample was non-randomly selected using the purposive and snowball sampling technique. The primary data were collected through in-depth interviews with key individuals. In addition, data were collected from other sources such as public opinions published in the mass media. A total of 37 individuals were interviewed. They came from various backgrounds including government officials, practitioners, academics, NGO activists, Board members and Directors. The fieldwork was carried out in 2003 from September to October in Jakarta, Indonesia.

Chapter Six reviewed the current practices of ISOEs, and aimed to answer the first research question developed in this study. The ISOEs were originally Dutch companies that were left by their owners when colonialism ended. Since then, the government established more ISOEs to enhance the economic development of the country. The review of the ISOEs showed that despite several government reforms carried out to improve their performance, the majority of the ISOEs were still money-losing enterprises. In addition, the privatisation programme considered as the one alternative to enhancing the ISOEs performance was not very successful because of the unclear policies and controversies involved in the process. The main objective of privatisation, as observed currentlt, is

only to raise government revenue. To date ISOE reforms are still ongoing, albeit moving very slowly. The policy taken of the government is to reduce the number of ISOEs. Hence, those that are unprofitable and continuously under-perform will be closed or merged with other ISOEs.

Chapter Seven discussed corporate governance systems and the Boards in the ISOEs. The results of the study revealed that the government has carried out several initiatives to improve corporate governance systems and practices in ISOEs. However, the initiatives were not very effective in changing practices. Several reasons were identified. Firstly, the government seemed to borrow a concept or definition from the private sector that is not compatible with and does not reflect the nature of ISOEs. Secondly, the initiatives, as argued by interviewees, tended to focus on form over substance. To date, there are no Board regulations established to guide Board processes, despite the fact that the Board's performance is unsatisfactory. Therefore, there are no criteria that can be used to assess the Board performance. Thirdly, there was no commitment of the part of the Boards to consistently apply sound corporate governance practices. The indications were that Boards did not establish their own separate Board meetings and, if there were such meetings the attendance rate of members was low. This might be the results of ignorance or low understanding of Board responsibilities. Board members tended to think corporate governance is the responsibility of the management and not theirs. One way to improve Board understanding is to establish Board training where Board members are introduced to corporate governance concepts, Board roles within the concepts and the business operations of the enterprise.

Chapter Eight examined government initiatives and practice of corporate governance in the ISOEs. The initiatives were started in 2000 at the same time the financial agencies came to assist the government in dealing with the economic crisis. Since then, there have been several programmes carried out by the government including establishing a separate agency, the State Ministry of ISOEs with the tasks are of representing government as the shareholders of ISOEs and to oversee ISOEs through regulations.

The initiatives have provided some good results wherein they increase Board members' awareness of corporate governance and Board roles within the context. However, since the establishment of a new government, the initiatives seem to moving very slowly, if not standing still. This was indicated by fewer discussions, less activities in disseminating corporate governance concepts in ISOEs and the discontinuation of the evaluation process of corporate governance practices in ISOEs.

Several internal factors that might have impacted to the slowness of the initiatives were identified; they were: (1) the absence of effective ultimate owners, (2) lack of understanding on corporate governance concepts, (3) lack of commitment and consistency, (4) unclear programmes, and (5) multiple and conflicting objectives.

In the implementation of corporate governance principles (transparency, accountability and independent) the practices in ISOEs were still far from satisfactory. Some were still late in releasing their annual reports to the State Ministry of ISOEs and to the public<sup>123</sup>. If the annual reports were published on time, the information published for public consumption was very limited specifically on the corporate governance matter. As inherent in their nature, the ISOEs were never free from government and political intervention. Time and again, the ISOEs had to carry out operations that were not their mission. This affected their performance. Hence, clear missions, objectives and understanding of the ISOEs' roles in the country's economic development will enhance the ISOEs performance.

With regard to the implementation of corporate governance principles, the public information relating to the ISOEs as difficult to assess as it was incomplete, and much of it was unreliable because it was out of date.

Privatisation has so far not shown effectiveness in enhancing good corporate governance practices in privatised ISOEs. There were some examples to support this claim such as the incidents of wrongdoing in PT BNI, PT Kimia Farma, and PT Bio Farma. Hence, the government as the majority shareholder of these privatised ISOEs should make more effort to

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<sup>123</sup> This can be seen from the State Ministry of ISOEs website [www.bumn-ri.com](http://www.bumn-ri.com).

avoid the recurrence of such wrongdoings, by for example putting more attention on the intangible aspects of corporate governance such as integrity, leadership and honesty than just structures and processes.

Chapter Nine presented some key findings from the results of this study. It was revealed in this study that for the majority of ISOEs performance was unsatisfactory. The cause of the unsatisfactory performance was the multiple and conflicting objectives. The results of this study also show that the government and the ISOEs still need to establish a concept and framework of corporate governance that is compatible with the ISOEs social obligations. Therefore, the objective should be focus to stakeholder rather than shareholder value.

Another area that needs attention is the ineffectiveness of the Boards. The results of this study identified several factors that contributed to this ineffectiveness. Firstly, the Boards being appointed by the government functioned as the representative of the government; thus, they did not represent public interests. Consequently, they were usually silent on situations that related to public interests. This is undesirable because the ultimate owners of the ISOEs are the public, including the employees of the ISOEs. Therefore, it may be beneficial for the Boards to include representatives of the employees. Secondly, the nonexistence of Board assessments resulted in the absence of a reward and punishment system. This might affect board motivation to do better because the over and under-achievers would gain the same reward. Thirdly, Board members held multiple jobs that prevented them from functioning effectively as members of a Board. These multiple jobs also opened up the potential for conflicts of interest.

All the above were to a large extent caused by the lack of understanding, commitment, and unclear programmes of practicing sound corporate governance. In addition, factors such as culture, weak law enforcement, political interference and poor public governance had a negative effect. There has to be improvement in these factors in order to effectively implement sound corporate governance in the ISOEs.

### **Key Findings and Some Policy Implications**

Using the agency theory approach, this study examined corporate governance practice and the roles of the Boards in ISOEs. As discussed in Chapter Two, agency theory is based on the assumption that the managers (the agents) are not trustworthy people; they consist of rational, self-interested people with opportunistic behaviours. Therefore, their interests may conflict with those of the owners (the principals). These conflicts of interest between the managers and the owners create agency costs. To reduce these costs, the owners, having very little control over the company, need to assign another agent, the Board whose task is to align the managers' interests with those of the owners and to ensure the company performance enhances the wealth of the owners. These three parties construct what is called the 'corporate governance tripod'.

In ISOEs, resolving the agent-principal problem is more problematic than in the private sector, because in ISOEs ownership is blurred. The government, represented by the ministers and bureaucrats, is not the real owner of ISOEs; it is another agent in the agent-principal relationship which may have interests that conflict with the ISOEs objectives and public interests. For example, the results of this study showed that at the macro level, the interests of the government on the issue of privatisation and the appointment of the Board members did not correspond with those of the public.

In practice the government, represented by the State Ministry of ISOEs, acts more like an agent than the owner of the ISOEs. From the results of this study it is found that the bureaucrats in the State Ministry of ISOEs preferred to regard themselves as an operator or a fund manager for the ISOEs than as an owner. As a result, they involved themselves in the operational operation of the ISOEs and since their personal interests were not tied up with the economic performance of the ISOEs lacked incentive to act as an owner on behalf of the public.

Considering the above discussion on agency theory, if it is used as a basis to explain and solve corporate governance issues in ISOEs, the issues should be approached from a broader context to include all stakeholders including society as the ultimate owner of the ISOEs. In this

respect, the agent-principal relationship in ISOEs needs to be examined within two levels. The first level is the agent-principal relationship between managers of ISOEs as the agent and government as the quasi owner. Here, corporate governance mechanisms are established to reduce the agency costs arising from the conflicts of interest between the managers and the government. The second level is the agent-principal relationship between the government as an agent and the public as the owner. Likewise, the corporate governance mechanisms established at this level should be able to reduce the agency costs arise from conflicts of interest between the government and the public.

Having said the above, the government, having the mandate to run and control the ISOEs, needs to establish corporate governance systems that can align the interests of all parties benefiting from ISOE operations. At micro level, for example, the representation of employees on the Board is important to increase Board independence. As argued by Rosser (2004: 124), employees have not been a key actor in corporate governance policy making in Indonesia. At macro level, the government, acting as an agent, needs to joined work with the politicians in PRA (can be regarded as the Board in a company) to establish corporate governance systems that can align the government interests with those of the public as the ultimate owners. As such, corporate governance mechanisms in ISOEs are a synergic effort of all the constituents of society, which is the stakeholder, including government, politicians and general public.

One of the alternatives to reduce the agency problems is to establish a performance contract that specifies the mutual obligations and responsibilities of the principal and the agent. In the micro level, the performance contract is established between the government and the ISOEs management. In the macro level, the performance contract is between the government, representing by the State Ministry of ISOEs, and the PRA as the representative of the public.

Likewise, the results of this study suggest that there is an urgent need for reconceptualisation/redefinition of corporate governance concepts. In doing so, the government cannot simply borrow the concepts of corporate governance from the private sector because the nature of

ISOEs is not the same as of private companies. In addition, it is worth noting that copying other countries' corporate governance concepts or asking foreign experts to establish corporate governance models for ISOEs may not be well-suited to the Indonesian context. As such, more efforts are needed in the area of development of total concepts through intellectual discussions with all relevant parties such as members of the PRA, academia, ISOE employees and NGOs. This is especially important in Indonesia because at the moment only a few people, the 'elite', have a clear understanding about the concepts. The more people that understand the concepts the more people can provide their inputs and the more acceptable and applicable the concepts are. Lastly, policymakers and other parties responsible for carrying out and implementing corporate governance in ISOEs need to understand that systemic reform is hard work, therefore strong-willed commitment from all parties involved is needed. In the absence of such commitment, the objectives of long-term stakeholder value, ISOE accountability and transparency in operations and reporting, and internationally acceptable corporate governance practices will remain illusory.

As discussed in Chapters Two and Three, corporate governance issues in the private sector are centred on three parties: the executives, the Board and the owners. Here, the Board functions as a protector of the owner's interests. In ISOEs, where the ultimate owner is the public at large, the performance of the Board should not be measured simply by their ability to protect the interests of the government, i.e., contributing profits and dividends to government budget (the economic factor of corporate governance); instead, it should be measured against the socio-political contributions of the ISOEs to the public at large. As such, the measurement of Board performance should encompass the ISOEs ability to provide high quality goods and services and job opportunities. In achieving high performance, the Boards should be able to control the ISOEs to operate in a responsible manner that is not to create 'externality costs' such as pollutions. Corporate governance in ISOEs will not be good if it fails to recognise and accommodate public interests.

The literature shows that corporate governance reform includes shareholders/investors activism aim to closely monitor the activity of governing bodies in a company where they invest their capital (e.g., CalPERS in the USA). In ISOEs, corporate governance reform should include the empowerment of the stakeholders as the ultimate owner of the ISOEs. One alternative is to appoint independent Board members who represent employees such as in the Germanic Board structure. The representation of employees on the Board would have more benefits than costs. For example, it will reduce the friction between employees and management such as happened in PT Semen Gresik and PT Dirgantara Indonesia. By having representation on the Boards, the employees are better informed about business decisions are taken by the ISOEs. William W. George (2001) chairman and CEO of Medtronic Inc. argues that Board members should be selected more for the contribution they can make, not the position [as bureaucrats] they hold (emphasis added). He says 'Being a great member takes more than ability, prestige and title; it takes time, dedication and commitment.' Here, the representation of employees on the Board can help to clearly define the accountability of Board members as a group of individuals who are independent from the influence of government and management. It is argued that good corporate governance in ISOEs will not be achieved if it obstructs the participation of employees as one of the main stakeholders.

The results of the study also show that Boards need to be given more responsibilities to involve actively in the appointment and dismissal of the directors and in the formulation of strategic planning. As in the Germanic corporate governance model, the Supervisory Board elects the members of the Board of Management as well as making business decisions. Currently, the role of Boards of Commissioners or Supervisors in ISOEs is similar to that of in Chinese companies where the Board of Supervisors is merely an organ responsible for supervising the Board of Management and corporate operations rather than a decision making organ.

Being involved in the process the Board would have the commitment to oversee the managers' performance and to ensure that the objectives are achieved. The responsibilities will balance the power between the Board



and the management and enhance the role of the Board to not just being a 'rubber stamp' mechanism. These given responsibilities, however, may only be effective if the Board selection process is carried out responsibly using a set of reliable criteria to appoint the right persons to the job. As such, this study concurs with the idea of Timmins (2002) who says that in the public sector Boards should be depoliticised to the extent that ministers would appoint the Chairman, but each board would appoint its other members.

The results of this study suggest that the development of corporate governance concepts in ISOEs needs to take into account external factors such as culture<sup>124</sup>, politics, law enforcement and public governance that impact on the success of corporate governance. Therefore, it is important to the promoters of corporate governance in ISOEs to work hand in hand with the policymakers to establish a conducive environment by promoting the right culture, strengthening law enforcement and establishing good public governance. Having said this, the involvement of experts from various disciplines in development of the concept is central. At issue here is how to establish good governance in totality, that is both good corporate governance and public governance under the principles of transparency, accountability and independent. Likewise, this study questions the applicability of corporate governance prescribed by the financial agencies if this is merely on form over substance. The OECD (1999: 23) sees that there is a need for the 'observance of environmental and social standards' in corporate governance reform. Hence, the government and the ISOEs' management need to develop and establish corporate governance mechanisms which go well with the nature and the environment of ISOEs and these mechanisms should be clearly understood by all relevant parties. If this is not the case, corporate governance reform in ISOEs may only a matter of rethoric or lip service.

Finally, based on the results of this study, there are some issues that need further attention from policymakers.

- 1) The results of this study revealed that currently only a few of Board members who have adequate understanding of the difference

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<sup>124</sup> Lu and Batten (2001: 5) argue that the main challenge in the implementation of corporate governance principles is culture.

between corporate governance and corporate management. As discussed in Chapter Two, corporate governance is the Board's responsibility not management's; therefore, there has to be Board skill improvement through workshops and training programs. Simultaneously, the corporate governance reform needs to establish a set of Board regulations (or Board Charter) that clearly guide (1) Board member selection, (2) Board functions (3) Board incentives, (4) Board performance and assessment and (5) Board reward and punishment.

- 2) It is suggested that the State Ministry of ISOEs establish a specific unit or division whose task it is to develop a reform agenda and to oversee the programme. As such, this specific unit may work with other local agencies that have the expertise in the field.
- 3) At the early stage of corporate governance reform in ISOEs, it is necessary to apply mandatory rules of corporate governance in ISOEs specifically in the implementation of the principles by which they operate and are evaluated. Gradually, after the entire ISOEs are able to fulfil the mandatory rules, they can self-regulate on matters that are specific to each company.

### **Limitations of the Study**

This study includes some important limitations which should be acknowledged. Firstly, the use of non random sampling as the basis for selecting interviewees may limit the generalisation of the results of this study. Secondly the use of interviews in collecting the primary data had an inherent limitation in that they were influenced by the 'interviewer bias' which might affect the research results. Here, the interviewers might record respondents' answers based on their own opinions and interpretations. Thirdly, this study is exploratory in nature and the limited quantity of questions included in the interview may be lower than required to provide a clear understanding of the topic under study. Fourthly, the use of agency theory as the means to explain the complex relationships among governing bodies in ISOEs may not have captured the full nature of corporate governance systems in ISOEs characterised by blurred

ownership. Lastly, the context of this study is ISOEs; therefore, generalising to another setting is potentially problematic and should be taken into account.

### **Suggestions for Future Research**

This study has addressed several issues relating corporate governance practices in the ISOEs. However, it still leaves other important issues that need to be explored. In this section I highlight a range of possible future research themes and research needs on corporate governance in ISOEs.

Research and intellectual discussions have a powerful impact on policy in Indonesia; they affect the climate of opinion, improve the quality of the policy debates, and helps focus and improvement on policies. However, as evidence in the literature review on corporate governance, it is clear that Indonesia, particularly the ISOEs, is under-researched. This study is exploratory in nature. Considering the fact that the establishment of governing bodies in the ISOEs aims to provide strategic directions to improve ISOEs' financial performance, more research using a case study approach examining the relationship between ISOEs performance and the effectiveness of the Boards is need to provide empirical evidence on the matter. This type of case study has been carried out in many developed countries but none has been undertaken in the ISOEs. Another issue suggested to be studied is the role of independent board members and Audit Committees in Board effectiveness. Case studies comparing the performance of ISOEs that have and do not have independent board members and an Audit Committee will be useful to provide evidence on the effectiveness of the Western model in the ISOEs. Finally, the implementation of good corporate governance principles is a significant factor on gaining trust from stakeholders. Hence, there is a need to examine the perception of stakeholders such as the employees and the customers on the implementation of corporate governance principles in the ISOEs.

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### The Interview Guide

#### Corporate Governance in Indonesian State-owned Enterprises

**Please note that the information obtained from this interview will be used only for academic purposes. No part of the information will be used for any purposes other than academic study. It will not be passed on to any government or other agency. The report will not identify any person by name. The analysis of data will be undertaken and reported in such a way that information cannot be linked directly to any person.**

#### Part I: State-owned Enterprises

1. What is your opinion of state-owned enterprises performance in general?
2. Should Indonesian economy depend on state-owned enterprises? If yes, why? If no, why not?
3. In your opinion, do the state and its apparatus have the capability in managing state-owned enterprises?
4. What is your opinion of government control in state-owned enterprises?

#### Part II: Privatisation

1. What is your opinion of privatisation programme in Indonesia?
2. What specific issues of privatisation concern you the most? Do you think these issues should be given greater attention in the formulation and implementation of privatisation policy? If so, why? If not, why not and what issues should be emphasised
3. In your opinion, does privatisation effective in reducing government control i.e., prompting good corporate governance practices in state-owned enterprises? If yes, in what way? If not, why not?

#### Part III: Corporate Governance in General

Poor corporate governance practices have been repeatedly been mentioned as one of the causes of Indonesia financial crisis and might have intensified the crisis once it began. McKinsey & Co.'s Investor Opinion Survey in Asia in 2000, for example, ranked Indonesia as the worst in corporate governance practices.

1. In your opinion, what are the causes of such poor practices in Indonesia?
2. Do you think privatisation is effective in promoting good corporate governance practices ISOEs?
3. How would you compare corporate governance practices in ISOEs before and after privatisation
4. With regard to control and decision -making mechanisms, do you think privatised ISOEs are given more autonomy than you previously had before privatisation? If yes, in what way?
5. Can corporate governance model and practices in the Western countries be implemented in ISOEs?
6. What is the main rationale, motive or objective of the corporate governance

- programme currently being undertaken in ISOEs?
7. What are the reasons that make Indonesia was considered the worst country in the implementation of good corporate governance practices?
  8. How could corporate governance be implemented more effectively?
  9. Who are the main proponents of the corporate governance? Who are its main opponents?
  10. Academics and practitioner s argue that it is important for a company to implement good corporate governance principles such as: independence, accountability, transparency, and fairness. Do you think they have been implemented consistently and effectively in ISOEs?

#### **Part IV: Boards of Directors**

Boards of directors are a group of people in a company considered to be one of the key players in the implementation of good corporate governance practices.

1. What is your opinion on the effectiveness of Board in ISOEs i.e., in terms of providing direction and carrying out control?
2. What do you think of government appointing government officials as the members of Board of Directors?
3. What do you think about the importance of independent board and board committees in ISOEs?

#### **Part V: Government Roles**

1. Does government have clear programmes in terms of promoting good corporate governance practices in general and in state-owned enterprises?
2. What should be the roles of government in terms of promoting good corporate governance?

#### **Part VI: Factors Affecting Corporate Governance**

It is argued that corporate governance can be influenced by various factors such as legal, socio-economic, politic, law enforcement, regulations and cultural traditions that are unique to each country?

1. In your opinion, what factors may contribute most, least, or hinder the implementation of good corporate governance practices in general and ISOEs?
2. What are specific issues of corporate governance concerned you the most? Do you think these issues should be given greater attention in the formulation and implementation of corporate governance practices in ISOEs? If so, why? If not, why not and what issues should be emphasized?



## Appendix B

### Interviewee List

No.	CODE #	OCCUPATION
1	A01	A Program Director at a leading university
2	A02	A Lecturer and a member of Indonesian Accountant Association
3	A03	A Lecturer and a Director in government office

No.	CODE #	OCCUPATION
1	BoD01	A member of the Board and a Director in Government Office
2	BoD02	A member of the Board and Ex-CEO of a Bank
3	BoD03	A member of the Board and a Chairman of government agency
4	BoD04	A member of the Board, a member of NGO, a founder of corporate governance committee, ex-CEO of an ISOEs.
5	BoD05	A member of Audit Committee

No.	CODE #	OCCUPATION
1	B01	Ex-Deputy at government office ATj
2	B02	Deputy at government office
3	B03	Director at government office
4	B04	Deputy at government office
5	B05	Director at government office
6	B06	Director at government office
7	B07	Head of Division at government office
8	B08	Head of Division at government office

No.	CODE #	OCCUPATION
1	D01	Director and a member of the Board
2	D02	Corporate Secretary and a member of the Board
3	D03	Director at Panasonic Gobel and ex BEJ Chairman
4	D04	Director at a private company
5	D05	Director of a Bank
6	D06	Director of a private company
7	M07	Manager in a leading public company

No.	CODE #	OCCUPATION
1	C01	A foreign consultant in Corporate Governance
2	C02	A foreign consultant in Corporate Governance

No.	CODE #	OCCUPATION
1	P01	A Chairman of Public Accounting Office
2	P02	A shareholder of a private business
3	P03	A consultant of corporate governance
4	P04	A consultant of corporate governance
5	P05	A consultant of corporate governance
6	P06	A consultant of corporate governance
7	P07	A consultant of corporate governance
8	P08	A consultant of corporate governance
9	P09	A consultant of corporate governance
10	P010	A Member of corporate governance institution

No.	CODE #	OCCUPATION
1	N01	A member of a leading NGO
2	N02	A member of a leading NGO