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Is Indonesia serious about corporate governance?

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Most corporate leaders in Indonesia see corporate governance as legal governmental regulation – or rather nuisance – with which to comply. Governance rules are therefore perceived as an expense, rather than a way to reduce risks and prevent reputational or other disasters. Based on three decades of experience in the field, and rooted in sound academic research, I believe that corporate governance practices should not be seen as a mere expensive compliance exercise, but as a useful way to assess the performance of the organization and to reduce a variety of potential risks, while admittedly also complying with minimal legal rules, be they regulations of the Financial Services Authority (OJK) for listed (financial) companies, corporate company law, other specific hard governance rules or "soft" regulations.

The reforms formulated in the Indonesian Corporate Governance Roadmap, launched in 2014 by the OJK with the support of the International Finance Corporation, seek to achieve a strengthened supervisory role over company boards, improved quality of disclosure by companies through increased company transparency, and greater protection for shareholders and stakeholders alike.

Every year, the Indonesian Institute for Corporate Governance and other reputable institutions in Indonesia grant corporate governance awards; we wonder whether all the data should be taken at face value. What does seem to be clear from these annual corporate governance awards, though, is that among the top 20 best-governed listed companies, about half are strictly regulated top banks in Indonesia (BCA, CIMB Niaga, Bank Mandiri, Bank Danamon, Maybank, BRI, BTN, OCBC NISP, BNI and BTPN), as well as a number of well-esteemed state-owned enterprises such as PT Telkom Tbk, PT Aneka Tambang Tbk and PT Jasa Marga Tbk. The top 20 list is rounded out by reputable names such as PT Hero Tbk, PT Matahari Tbk, PT XL Axiata Tbk, PT Saratoga Investama Tbk and, of course, PT Astra International Tbk, which has consistently been perceived as among the top corporate governance performers. Other top 30 contenders include PT Garuda Tbk, PT Indosat Tbk, PT Kalbe Farma Tbk, PT Salim Ivomas Tbk, PT Unilever Tbk, PT Indocement Tbk and PT Wijaya Karya Tbk, to name a few.

Should equity investors limit themselves to well-governed companies, or should they look for (potentially undervalued) companies with specific governance attributes? This essay will take an institutional-actor investment perspective to find out why and how good corporate governance at a firm makes a lot of sense for any investor, especially to protect them against inappropriate and illegal behavior by powerful actors at the company. In order to answer this question without getting bogged down in detailed legal requirements, we need to first understand the basics of good corporate governance practices, and how actors use their power and networks to influence decisions within a company. The board's task is to govern the organization, implying that board commissioners need to fulfill the fiduciary duties of care and loyalty to the organization by supervising or monitoring and advising, and coaching top management or the board of directors, and mediate with different stakeholders that can affect the organization.

Ultimately, both the supervisory board of commissioners (BoC) and executive board of directors (BoD) supposedly make informed and thus reasonable decisions that will benefit the organization. Second, we need to acknowledge why corporate governance has a different meaning in Indonesia compared to an Anglo-Saxon investment context, from which a lot of global investment funds hail, and indicate some firm-specific governance attributes that specifically neutralize the country-level overall weak governance.

Global competition, good corporate governance

The last decade has become fiercer in terms of global competition, while at the same time, we have seen a dramatic shift

eastward toward Asian growth markets. What should foreign investors and international corporations be aware of when doing business in Indonesia? What policies and practices will positively affect the competitive advantage of Indonesian firms within the Association of Southeast Asian Nations (Asean) and even in a more global economic context, and how to enhance their competitive legitimacy? What are the particular pitfalls and challenges international business leaders are facing in Indonesia and Asean countries? More particularly, how do executives (BoD) and supervisory boards (BoC) effectively deal with or even attempt to strategically take advantage of institutional weaknesses without jeopardizing their reputation? And how can good corporate governance help to instill organizational values and norms that positively affect performance and guide corporate leadership to avoid the usual institutional pitfalls, while at the same time strengthen their organizations?

Implementing "best" corporate governance practices may be a necessary first important buffer to safeguard shareholder and stakeholder rights and reduce potential threatening risks. But such implementation should go beyond mere tick-the-box compliance.

Because of the ongoing globalization of financial investments and international trade, corporate governance has become a mainstream concern when making investment or trade decisions in boardrooms and policy circles around the globe. Recent corporate debacles and fraud, economic and financial crises, and the growing global interdependency of financial markets have caused a heightened interest in corporate governance. Indeed, the 1997 Asian financial crisis and 2008 global financial crisis have reinforced how failures in corporate governance (and public governance) can harm shareholders and even ruin firms, and adversely affect whole economies, both in developed and emerging markets.

Corporate governance challenges in Indonesia are of a different nature because of a completely different sociopolitical business context and well-publicized legal institutional voids.

The mainstream corporate governance theory claims that top executives need to be closely supervised and monitored to prevent particular agency costs as a result of possible opposing objectives between executives and managers who likely will attempt to maximize their remuneration package during their increasingly shortened tenure in power, on the one hand, and shareholders whose aim is to optimize or maximize stock value and dividend payouts, on the other. The reason that there are potential opposing objectives between hired professionals and owner-stockholders is rooted in the fact that access to information is quite asymmetric, in a sense that shareholders have less detailed information on their company

than those who are running it on their behalf. This discrepancy allows top executives to take decisions that benefit short-term results, allowing them to optimize their own packages, often to the detriment of long-value creation. Hence, good corporate governance practices have been perceived by investors as reducing these information asymmetries, thus limiting risk and improving performance by well-governing boards who steer top executives to enhance business opportunities on the upside and reduce potential threatening pitfalls on the downside. However, corporate governance challenges in Indonesia are of a different nature because of a completely different sociopolitical business context and well-publicized legal institutional voids.

Under a narrow definition of corporate governance (in Western countries), the focus is on the rules in capital markets governing equity investments, which includes listing

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requirements, insider dealing arrangements, disclosure and accounting rules, fair remuneration and protections of minority shareholder rights. This “agency theory” or “shareholder model” sees the firm as a nexus of contracts between principals, or owners, and agents, each pursuing their own interests, which often conflict. The agency theory assumes isolated bilateral contracts between principals and agents, focusing on contractual efficiency, whereby corporate governance mechanisms aim at reducing this agency cost by aligning management to shareholders’ interests, providing legal provisions such as information disclosure and accounting requirements to provide control and efficient markets for corporate control. In addition, in Western countries, stock options were granted to those hired professional executives to allegedly make them think like owners. Not with overall success, though, as numerous failures and crises in the West testify. However, we could easily ask what kind of shareholders the board is representing? Does the board need to jump to the fancies of short-term investors (ie, hedge funds) or does it represent the interests of long-term investors? In an Indonesian context, this may not be a big issue since boards of listed Indonesian companies usually represent the power structures of the founding family, big institutional investors, sovereign wealth funds or the state, who usually have a longer-term strategic interest.

A broader definition of corporate governance, as expressed by the OECD principles of corporate governance (2004), stipulates that all shareholders should be treated equally and that board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company. Broadening the stakes beyond shares allows the stakeholder theory to recognize that the effectiveness of

corporate governance practices also depends on the influence stakeholders may have on the firm. Corporate governance then becomes the range of institutions, policies and power conceptualized as the relationships among stakeholders and shareholders – or crucial powerful actors – in the process of decision-making and control over the firm's resources.

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decision-making processes that are involved in making an organization function to create value. Institutions become the informal and formal rules of the game, which usually serve the interests and ideas of the most powerful groups. Institutions or powerful actors can become a self-sustaining system of shared beliefs about a salient way in which the game is repeatedly played for their own interests. Corporate governance can therefore be

International or local investors who focus on emerging markets have to deal with considerable information asymmetries in those less transparent emerging markets that could negatively affect the expected long-term income or return on the investment. But they are asymmetries of a different nature. Good corporate governance practices aiming to reduce those asymmetries assumedly have a positive impact on an enterprise's performance

both in the developed world and even more so in rather volatile emerging markets. Particularly in an emerging economy such as Indonesia, with rather weak legal institutions, the challenge for foreign investors does not lie in the traditional agency problem between ownership and powerful top executives, as in most Anglo-Saxon advanced countries, but rather in the tangible and intangible costs resulting from information asymmetry between local majority owners and foreign or local minority owners. The potential conflict may arise as a result of concentrated ownership, whereby the majority founding family or patriarch, institutional sovereign funds or state may not regard minority investors as equal partners. The latter has hardly any recourse within a context that is associated with underdeveloped or not-fully functioning legal institutions, carrying a significant cost when being operational in or investing in emerging markets. The entrenchment by controlling shareholders often results in conditions that are ideally suited for possible expropriation of disadvantaged stakeholders, often minority shareholders. Hence why the option of "voicing" concerns has hardly any effect in Indonesia, and "loyalty" may not be a real option for those minority nonequal partners, making "exit" the only other option for investors, adding to the already inherent volatile market swings. This inherent asymmetry is aggravated by the existence of particular governance structures and relationship-based governance or network culture perspectives in Indonesia that play into the hands of those actors – both BoD and BoC members – who can fall back on relationships with the powerful elite. Moreover, there seems to be a lack of legal culture, as my friend and Melbourne Business School colleague Benny Tabalujan convincingly argues, among the Indonesian business elite. Legal culture refers to "attitudes, values and opinions held in society, with regard to law, the legal system and its various parts," he said.

This absence of a genuine legal culture in Indonesia complicates any possible implementation of corporate governance programs. Any legal system is compromised of three sets of basic components: legal structure and legal institutions (or the legal hardware); substantive law (or the legal software); and a legal culture, which is the glue or "operating system." Indonesia has laws and legal institutions, but it needs a legal culture that puts these laws and institutions to work as they were designed to be used. The success of Indonesian law reform and implementation of corporate governance is dependent not only upon sound institutions, but also on the necessary mental attitudes and behavior of those actors managing and governing the organization. Indeed, hardware without a proper functioning operating system – the right attitude and mind-set to implement governance and organizational culture matters – will not work, and thus any reform or attempt to get corporate governance practices installed will ultimately be ineffective. In other words, proper and fair enforcement is needed.

The single focus of the shareholder model, however, seems to overlook the linkages or complementarities between culture and institutions in contexts that are fundamentally different from the mainstream Anglo-Saxon

context. Ideally, the board represents the organization and not just the shareholder who has put them in charge. Indonesian companies within a civic (continental) law context have adopted a hybrid firm-level formulation of a "bundle" of corporate governance practices that suit their interests, characterized by the institutional idiosyncrasies of Indonesia. Sometimes, a set of informal institutions or practices, such as pyramid investments, while keeping the holding company outside prying public eyes, may shape, constrain and interact with the boundaries of corporate law, and sometimes even substitute in filling certain "institutional voids." In the absence of specialist intermediaries, trustworthy regulatory systems or reliable contract-enforcing mechanisms or an independent court system, the traditional patronage mechanisms and patriarchal relationships prevailing in Asia will (continue to) kick in and help the firm to survive.

The corporate governance definition as applied in emerging markets emphasizes how to protect outside investors against potential expropriation of capital resources by insiders such as the founding patriarch or monopolistic power of the state, or how potential conflicts of interest between various corporate claimholders can be reduced. However, such a corporate governance approach does not say anything about the sociopolitical, coalition-formation among multiple actors and the institutional embeddedness of a firm in the broader Indonesian context. In other words, merely looking at the implementation of certain minimum legal corporate governance requirements – for instance, having one-third of members on a board of commissioners be independent commissioners, the existence of an audit subcommittee with an independent chair, the appointment of professional executives, gender diversity, explicit statements on quorum or having voting procedures explicitly defined in the bylaws – does not guarantee proper corporate governance standards. A company may comply with the letter of corporate law, but not necessarily with the spirit of corporate governance standards.

An institutional actor perspective

Research demonstrates that stronger corporate governance practices lower the cost of capital, reduce risk and positively influence a firm's value. However, we need to slightly shade these findings because high-performing South Korean firms, for instance – as in some form of "reverse governance" – may adopt good governance practices to signal the intention of good behavior by their powerful insider families, or *chaebol*, toward outside minority (foreign) investors. Similarly, our findings in Indonesia seem to also indicate that some organizations applying minimum corporate governance standards want to make a good name for themselves and use this enhanced corporate reputation to attract additional (foreign) investment. Obviously, such a causal relationship is hard to "scientifically" prove.

We specifically focus on the attempt by majority local shareholders to signal the implementation of particular "best corporate governance" practices to lure foreign investors. Indofood, for instance, especially since its

restructuring following the 1998 Asian crisis, has been characterized by good corporate governance over the last decade and a half. There seems to be a willingness by the Salim family to endorse a legal culture to adhere to what has been legally agreed upon and embrace values that signal trustworthy behavior. Those familiar with Indonesian history know how the Salim family was able to gain competitive advantage in Indonesia, not the least through cleverly benefiting from a special relationship with those in power, in a context of rather weak institutions, prior to the start of Indonesia's democratization process two decades ago. Nonetheless, the perception of having implemented good corporate governance has helped them to gain a good reputation among foreign investors. The late patriarch's lofty objective to "feed the nation" obviously did not harm this perception, either.

The institutional context of weak legal enforcement and concentrated ownership in Indonesia often results in potential conflicts of interest between majority owners and minority shareholders on the one hand, and in unethical if not corrupt behavior and violations of individual property rights on the other. Talking with numerous owners of listed companies, entrepreneurs and foreign investors during the last three decades seems to reconfirm the gut feeling that all parties seek to protect themselves from weak legal institutions where potential conflicts of interest between majority and minority shareholders often occur, and where corruption and property rights violations at all levels of society are still rife. How to address those "voids" of illegitimate rent-seeking behavior?

Should one apply some universal "context-free" governance principles as recommended by international institutions or international law firms? Although legal interpretations may seek to implement some "universal" governance standards or generic road maps, it seems that no "one best corporate governance way" really exists, as in minimally complying with certain standards guarantees full transparency, disclosure, equal shareholders' rights or full accountability. Indeed, there is no single global governance standard or codex that could be literally applied to any situation.

The effectiveness of corporate governance practices varies due to the institutional and cultural idiosyncrasies of different nations. The legal environment, the ownership structures, systems of governance and the functioning of the board of directors are often intertwined in Indonesia. For instance, Indonesia presents a unique cultural setting in a dynamic economy with the potential to advance the well-being

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of approximately 260 million people. Yet, we do not have a theoretical framework that explicitly addresses why corporate governance practices differ across countries or over time, and we consequently lack in-depth knowledge concerning the transferability of (global) corporate governance practices assumed to add value.

When a country is characterized by low overall governance quality – as in high opacity or a lack of transparency, and high levels of perceived corruption – it deters some investors from entering, while high governance quality incentivizes foreign firms to operate or invest in the host country. Due to this potential deterrence, a specific company in Indonesia, with its relatively poor country-level governance (compared to its neighbors or international standards), may decide to enhance and adopt its firm-level corporate governance to strengthen its competitive attractiveness to lure foreign investors. The reasoning is that applying specific governance mechanisms may improve the firm's performance in the process. Specifically, minority investors could be convinced if conflicts of interest could be reduced or potential devastative corrupt behavior significantly diminished. We therefore try to understand which dimensions of comparative corporate governance are most critical to affect the operating performance, while taking sociocultural sensitivities and weak legal institutions into account, and therefore potentially attract investment.

The corporate governance deviance in Indonesia and most other Asian countries with a civic law tradition, with the exception of the common law jurisdictions in Singapore and Hong Kong, and to a lesser extent Malaysia, is socioculturally rooted in a dominant national relationship-based governance instead of a rules-based governance system. Moreover, the

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motivation to potentially expropriate assets from a listed firm is lower in common law countries where there exists a higher investor protection.

Since no reliable universal rules can be taken at face value, foreign investors are advised to distill some generic basic "rules of thumb" when setting up operations in Indonesia. Here are some suggested heuristics, or rules of thumb: foreign investors who have decided to line up with local Indonesian partners need to clearly state all the responsibilities of the different (majority and minority) partners in the venture. In addition, they carefully need to choose a reputable and trustworthy partner with similar objectives and goals. Finally, the foreign entity needs to emphasize an effective pro rata financial investment in the firm's ownership structure in the case of a joint venture. Moreover, foreign investors may

need to adopt a beyond "comply and explain" heuristic to incite long-term effectiveness of board practices and adapt to the local sociocultural context without jeopardizing international standards. For instance, when applying the two main functions of the supervisory board – such as a monitoring or control function and an advisory role – its importance may be influenced by institutions, sociocultural characteristics and other elements of the corporate governance bundle, such as the reputation of family shareholders attempting to neutralize the weak legal institutional protections of all shareholders.

Furthermore, when foreign investors decide to buy stock on the Indonesia Stock Exchange, our research – by Peter Verhezen and Geoff Martin, 2018, Melbourne Business School, and initiated by discussions with the International Finance Corporation in Jakarta; and a recent book and subsequent *Strategic Review* essay by Verhezen, Williamson and Soebagjo – took into consideration the specific Indonesian institutional setting of concentrated ownership of family businesses or state-owned enterprises, on the one hand, and institutional voids on the other, when analyzing which governance variables were affecting financial performance. The main concern is that this combination of weak governance at the country level and conflictual owners at the firm level occasionally results in rent-seeking or corrupt behavior. However, our empirical research did not find the typical assumed agency problems, indicating that other linkages and interdependencies of corporate governance practices are playing a more crucial role in an emerging institutional Indonesian market context. The focus turns to the interactions between insider-outsider conflicts and accountability conflicts in an emerging market context. Obviously, foreign but also domestic (minority) institutional investors are willing to pay a premium for good governance, and they search for firms that have good governance practices and promote the adoption of voluntary codes of good governance, as in a self-regulatory "comply or explain approach." Just after the 1998 crisis, investors were willing to pay up to a 28 percent premium for firms that were perceived to be well governed. Indeed, quite a number of studies confirm investors will pay a premium for well-governed companies as they tend to perform better. Today, these premium rates are rather marginal since the perceived volatility or risk has been dramatically decreased in almost all companies since 2001.

The pressure for foreign capital and product markets may not necessarily lead to convergence to international governance standards. Board independence, for instance, is not systematically linked to outright positive performance, and concentrated ownership monitoring its top management functioned as a substitute for independent directors who arguably did not have any significant impact on performance. Complying to have a minimal number of "independent" members on the board seems more a tick the box exercise than actually impacting financial performance. With a controlling shareholder in most listed companies in Indonesia, the fundamental governance problem is not necessarily opportunistic rent-seeking behavior by executives and directors at the expense

of public shareholders at large, but rather potentially inappropriate or opportunistic behavior by the controlling family shareholders at the expense of minority shareholders, as indicated above.

Where shareholder rights are not well protected, investors will compensate for this deficiency by taking controlling positions in the firm, or expect clear idiosyncratic governance practices to be put in place to guarantee some minimum level of proper oversight of top management, but especially over majority shareholders to neutralize for potential expropriation of company property – or tunneling, be it cash flow, assets or even equity as in insider trading practices – away from the listed company. We found some form of hybridization in a sense that "best governance practices" are adopted and customized according to their particular circumstances and institutions.

The use of reputable auditors and inclusion of related party transactions in the shareholder agreement indicate such signaling effects. Indeed, our research indicates that the presence of reputable auditors ("Big Four" auditors) has a positive effect on financial performance, which is likely due to the perceived improved transparency and disclosure. Considering the weak legal enforcement and less than stellar protection of individual shareholder rights under Indonesian law, these listed firms on the Indonesia Stock Exchange signal their willingness to be more transparent, and thus reliable or trustworthy, by engaging a reputable third-party intermediary. Similarly, our findings reveal a positive effect on the return of assets with the implementation of strict rules to constrain or forbid related party transactions that could be interpreted as a proxy for potential expropriation, collusion or outright corrupt behavior. In other words, by having proper mechanisms and procedures in place that will limit the potential of corruption or expropriation or tunneling of cash flow or assets, the Indonesian firm indicates its willingness to limit unfair practices or curb possible corruption.

In addition, a block-holding family or state-owned ownership was predicted to negatively affect the net income of the Indonesian listed firms, unless the company explicitly disclosed the beneficial ownership (or block-holding owners). Furthermore, we found a positive relationship between foreign institutional ownership and the firm's return on assets. This is likely due to the perception that these institutional owners would bring into or require some sound minimal governance practice from the firm.

Responsible leadership beyond compliance

We argue that understanding and addressing the specific corporate governance attributes may allow equity and debt investors to focus on the most impactful governance mechanisms, while enabling them to take "advantage" of the usual institutional voids and information asymmetries in Indonesia and other Asian emerging markets, through networks and sometimes collusion with the powerful elite. Similarly, corporate governance provides valuable guidance for boards and corporate regulators in terms of where to focus when instigating corporate

governance reform. Enforcement is key to making good corporate governance work. However, merely complying with some "universal" set of corporate governance variables may not be sufficient to convince or secure sustainable investments.

Our research strongly indicates the importance of institutional gatekeepers like external auditors and the strict implementation of measurements that reduce the chance of rent-seeking behavior such as minimizing related party transactions. Nonetheless, the level of compliance with codes entails significant implementation costs and remains relatively low in most emerging markets. The powerful actors in family and state-owned enterprises need to adhere to a mind-set that is congruent with a legal culture that accepts accountability and responsibility for one's actions, and does not rely solely on a form of patrimonialism – a patriarchic system of relationships where a father-like patriarch exerts real authority in social, business or political contexts.

From the perspective of the company's management, corporate governance can be interpreted as reducing threatening risks, rather than a mere legal obligation or a pure cost factor. From a corporate governance and international business perspective, we did not find clear evidence that the presence of explicitly disclosed block-holding family or state ownership is undermining financial performance, which provides some comfort to existing and potential investors in Indonesia. Our data offers empirical proof that international trust can be provided by clearly limiting or completely forbidding related party transactions, or by emphasizing the presence of foreign investors and reputable foreign third-party intermediaries such as trustworthy auditors that positively affect the financial performance of the Indonesian firm.

Foundational corporate governance standards need to be contextualized, while individual leadership at (both supervisory and executive) boards should be continually tested over time. We believe that those boards with impeccable legitimacy – worth the investors' trust – and integrity will prevail in an ambiguous, uncertain and often volatile situation. Such responsible leadership that is grounded in specific firm-level corporate governance practices will continue to attract investments when business opportunities are created. Applying effective and appropriate corporate governance practices that could guide and steer an organization will need to be sensitive to the institutional and organizational characteristics in Indonesia. And equal respect for all capital providers and human talent through proper contractual and informal relationship building are the first necessary steps to create and sustain a competitive advantage in an increasingly fierce global economy.