

Review of Corporate Governance in Asia

Corporate Governance in Indonesia

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Corporate Governance in Indonesia

1. Introduction

A. *The Financial Crisis and Major Corporate Governance Problems*

In the report on “Corporate Governance and Finance in East Asia, A Study of Indonesia, Republic Korea, Malaysia Philippines, and Thailand: Volume One (A Consolidated Report)” published in 1999, the Asian Development Bank (‘ADB’) reported that the economic crisis in Indonesia, Malaysia, Philippines, Thailand and Republic of Korea were caused by the failure in implementing prudent Corporate Governance. The factors emphasized by the ADB are:

- a. a high concentration of company ownership (57% to 65%);
- b. ineffective supervision by the board of directors (in Indonesia’s case, it is the Board of Commissioners since Indonesian Company Law applies *two tiers system*);
- c. inefficiency and lack of transparency on the procedures to acquire a company’s control;
- d. over reliance on external funding, i.e.: bank loans; and
- e. inadequate supervision by creditors.¹

In fact, during Soeharto era political support from Soeharto family was given to its crony. This had caused lack of financial responsibility. For example, state-owned banks are forced to lend money to companies that linked to Soeharto family and they are forced to accept loss. Given the extensive links between government and business leaders, a lack of transparency and a politicized legal system, almost any member of Indonesia’s corporate elite could be considered crony. Almost all of the wealthiest ethnic-Chinese businessmen owe their start in business to special favours handed out by friends in the government. The entrance requirement for this group is a continuing close, personal relationship with Soeharto family.²

Such crony relationship with government and Soeharto family had created in-efficiency due to privilege given in licenses and projects. This had caused bad governance practices in respective companies. Since many respective companies had been listed in the stock exchanges, such bad governance practices had abused minority shareholders rights, ie.: public shareholders.

Evidence shows that weak Corporate Governance practices in most of Indonesian companies have led to many deficiencies in their decision makings and corporate actions: Inefficient investments, highly financial leverage, maturity mismatch of their borrowings, and un-hedged foreign exchange exposures. These have made the corporate sector in Indonesia vulnerable to the currency shock during the crisis, leading to negative equity standing and inability to pay off their borrowings to the lending banks. A spiral effect that ultimately cause banks collapse in Indonesia.

B. *Brief Review of Recent Regulatory Reform on Corporate Governance*

Pre-Crisis Regulatory Reforms

¹ Asian Development Bank (ADB), “*Corporate Governance and Finance in East Asia. A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand*” (Edited by: Ma Virginita Capulong, David Edwards, David Webb, and Juzhong Zhuang), Vol. 1 and Vol. 2., 1999.

² Adam Schwarz, “*A Nation in Waiting: Indonesia’s Search for Stability*”. 2nd Edition, 1999.

In 1995, the Indonesian Company Law (the 'Company Law') and the Indonesian Capital Market Law (the 'Capital Market Law') were enacted. Prior to the enactment of these laws, Indonesian limited liability company ('PT') was governed by Commercial Code of 1847 that had been enacted by the Dutch government in colonial era. The Company Law is accordingly the basis for Corporate Governance in Indonesia. Under this Law, a limited liability company ('PT') is a separate legal entity in which the Board of Directors ('Direksi') is fully responsible for the company's management and the Board of Commissioners ('Komisaris') is responsible to supervise and advise the Direksi in running the company. Both Direksi and Komisaris are responsible for the disclosure of its financial statements to its shareholders in the General Meeting of Shareholders ('GMS').

For publicly listed companies, the Indonesian Capital Market Law of 1995 (the 'Capital Market Law') and regulations issued by the Capital Market Supervisory Agency (BAPEPAM) and Securities Exchange are the essential guiding principles in Corporate Governance. The main elements consist of disclosure requirements imposed to the publicly listed companies. In addition to the disclosure requirements, in 1996 the BAPEPAM Chairman enacted Decree No. 63/PM/1996, requiring publicly listed companies create the position of a Corporate Secretary. The decree points out that the responsibilities of a Corporate Secretary are to keep informed with capital market regulations, to provide public information on company's condition, to give advice to the directors in complying with capital market regulations, and to liaise between the company and its stakeholders (investors as well as the public at large). In summary, a Corporate Secretary has to assure Corporate Governance procedures in company are carried out properly.

Post-Crisis Regulatory Reforms

The sudden capital flight and the run on banks that marked the economic and monetary crisis of 1997, made it clear that serious improvements were necessary to restore investors' confidence in companies. Two elements of Corporate Governance merged as particularly crucial: 1) proper reporting of companies' financial situation and 2) the introduction of risk management systems, to control risks related to large exchange rate exposures.

Since 2000, the BAPEPAM has issued numerous rules and regulations to strengthen Corporate Governance of publicly listed companies. BAPEPAM has issued the Circular Letter No. 03/2000 requiring publicly listed companies to set up Audit Committee. This circular letter was supported by the Jakarta Stock Exchange ('JSX') Decree No. 315/2000 as amended by JSX Decree No. 339/2001 concerning listing requirements, wherein it requires company that intending to list its shares in JSX must have Independent Commissioner, Audit Committee, and Corporate Secretary. In November 2002, the BAPEPAM issued BAPEPAM Decree No. 20/2002 concerning independence of accountant of publicly listed companies in carrying out auditing services. The decree limits audit services for maximum 5 years in a row (for Public Accounting Firm) and maximum 3 years in a row (for an accountant). In December 2003, the BAPEPAM has recently issued two BAPEPAM decrees No. 40 and 41. The decrees consecutively regulate the responsibility of Board of Directors on financial reporting and the establishment of Audit Committee and guidance of duties of Audit Committee.

In March 2001, the National Committee of Corporate Governance (the 'NCCG') issued the National Code for Good Corporate Governance (the 'Code'). The Code consists of 13 chapters, i. e.: Shareholders; the BoC (Dewan Komisaris); the BoD (Direksi); Audit System; Corporate Secretary; Stakeholders; Disclosure; Confidentiality; Insider Information; Business Ethics and Corruption; Donations; Compliance with Health, Safety and Environmental Protection Regulations having the Force of Law; and Equal Employment Opportunity. Recognizing that a company or a group of companies belonging to a specific industrial sector may share unique characteristics amongst themselves, the NCCG intends to eventually formulate sectoral codes containing more specific principles of good and prudent Corporate

Governance, for which the Code will serve as a model. At the moment, the NCCG is in the process of drafting a sectoral code for the oil and gas industry and a sectoral code for banking industry. The formulation of principles of good and prudent Corporate Governance contained in the Code is intended to allow for constructive and flexible methods of raising standards of Corporate Governance in Indonesian companies, as opposed to adopting the more prescriptive methodology of imposing mandatory regulations having the force of law. The principles contained in the Code are intended to be dynamic, which should evolve in conjunction with the dynamic markets and structures. Therefore, future revisions of the Code are possible.

In addition to those rules and directives for publicly listed companies, the Indonesian government through Minister of State-Owned Enterprises (MSOEs) has also issued numerous rules and regulations to strengthen Corporate Governance of state-owned enterprises (SOEs). The recent SOE Law No. 23/2003 adopted Corporate Governance principles and directives as set out in the Code.

C. General Observation/Assessment on the Reform Efforts and Their effects on Corporate Governance Practices at the Corporate Level

General Observation/Assessment

As with all reforms in Indonesia since the financial crisis of 1997, there is a general acknowledgement that reforms are necessary in the national interest, a relatively small group of people are genuine public advocates and strong movers on reform, but there is a broad passive resistance to change. Reforms have therefore mostly materialized on paper only, in the form of very detailed and strict laws and regulations.

The current power and wealth distribution have grown into the remuneration and organization structures of companies and government institutions over many years. Enforcement of the new laws and regulations would upset these structures, and would require considerable courage of the enforcing institutions and a stable top-level political backing. Both have been rare. Law enforcers have been reluctant to punish individuals for behavior that was a normal part of the old economic and political system. There are also still cultural barriers against holding high-placed individuals responsible for their actions.

External legal pressure on companies to implement Corporate Governance practices has therefore been weak, so far. Moreover, Indonesia has introduced many of its reforms as a condition for the financial assistance of the International Monetary Fund ('IMF'). As this assistance is coming to an end at the beginning of next year, the incentive for reforms will weaken. The sense of urgency of individuals willing to reform, will further diminish as money starts to flow back into the stock and bond markets again.

As should be clear from the preceding, the main progress is not to be made in the updating of laws, regulations and codes, but in their enforcement respectively company's willingness to fully implement them.

A small but increasing number of companies is showing this willingness genuinely. The companies are usually led by visionary leaders who have maintained a reputation for a relatively high level of integrity during both the pre-crisis and post crisis economic order. In an economy that is more open to business leaders who are not dependent on a strong political network, the number of such leaders is expected to grow.

In some cases, a foreign company buying a stake in the Indonesian company, has accelerated the implementation of Corporate Governance. The number of such cases is

expected to increase, with foreign investors' gradually returning interest in Indonesia. Altogether therefore, the drivers for Corporate Governance reform should be expected from within, not from outside, Indonesia's economy. It will take at least five to ten more years until the improvements are significant.

Corporate Governance 2002 Report on Institutional Investor Survey³

There have been numerous researches/surveys on Corporate Governance in Indonesia carried out by organizations, such as Indonesian Institute of Corporate Governance (IICG) and Indonesian Institute of Corporate Directorship (IICD). Generally, these surveys scored Corporate Governance practices of publicly listed companies. To illustrate the general observation on the reform efforts and their effects on Corporate Governance practices at the corporate level, the most relevant survey is recent Corporate Governance survey carried out by the Jakarta Stock Exchange (JSX). In 2002, the JSX carried out survey to senior management and senior investment managers of local entities involved in investment in Indonesian stock markets (collectively referred to as institutional investors), including insurance firms, pension funds, research analysts, and fund managers. The survey was designed to provide an understanding of how institutional investors view Corporate Governance practices and disclosures in Indonesia in the context of their investment decisions.

Three highlighted issues from the survey are:

1. Factors affecting investment decisions

Corporate Governance is important to investors. On average, respondents to the survey said that they would be prepared to pay a premium of 17 percent for a company that is perceived to have good governance. In addition, the respondents put in economic macro and structural issues (or "external factors") such as legal certainty, security concerns and currency risk are considered to have the biggest influence on investment decisions in Indonesia and have the effect of overshadowing recent improvements in Corporate Governance. It is therefore a combination of factors, which is responsible for the continued low level of liquidity in the equity market.

2. State of Corporate Governance in Indonesia

50 percent of the institutional investors felt that there have been improvements in standards of business ethics and Corporate Governance in Indonesia. 38 percent of respondents felt that they have improved a little and 12 percent felt they have improved considerably. According to the survey report, there is a low level of awareness about new initiatives in Indonesia to improve Corporate Governance, including the issuance of the National Code of Good Corporate Governance.

Although it is not directly revealed from the survey, there is an indication that the institutional investors believe weaker crony relationship will provides better environment for the improvement of Corporate Governance. According to the survey, institutional investors believe that a reduction in "KKN" (corruption, collusion and nepotism) is of great importance for improving the existing governance practices. Other areas considered to be of high importance are described in the table below.

3. Perceived governance standards compared to other countries in the region

³ The Jakarta Stock Exchange and PricewaterhouseCoopers, *Corporate Governance 2002 Report on Institutional Investor Survey*, Jakarta, September 2002.

Consistent with the view of overseas, Indonesian investors also believed that Corporate Governance practices in Indonesia rank alongside other emerging markets, such as People's of Republic of China (PRC), India, Thailand and still lag behind those adopted in developed countries. The leading countries are still Singapore, Australia, Japan, and Hong Kong, China.

In relation to auditing and compliance, disclosure and transparency, and board processes, Indonesia was perceived to be comparable and in some cases better than other emerging nations in the survey. However, there was concern about perceived standards of accountability to shareholders. This may reflect in part the wider macro conditions of a weak legal system, which are beyond the control of listed companies or their regulators.

Table 1. Factors Influencing Investment Decisions

Top 10 factors affecting investment decisions		Score (1 = lowest, 5 = highest)
1.	Legal uncertainty	4.38
2.	Security Concern	4.38
3.	Quality of disclosure (particularly related party transactions)	4.38
4.	Reliability of financial statements	4.38
5.	Country risk	4.35
6.	Trend in profits	4.32
7.	Quality/experience of directors	4.29
8.	Corruption, collusion, and nepotism	4.29
9.	Political climate	4.29
10.	Volatility of the rupiah	4.26

Table 2. Business Ethics and Corporate Governance Standards in Indonesia

		Institutional Investors (%)
a.	Improved considerably	11.76
b.	Improved a little	38.24
c.	Remains largely	35.29
d.	Deteriorating slightly	2.94
e.	Deteriorating a lot	5.88
f.	Unsure	5.88

Table 3. Other Areas Where Improvements Could be Made to Existing Governance Practices

Top 10 Areas Where Improvements Could be Made to Existing Governance Practices:		Score (1 = lowest, 5 = highest)
1.	Reduction in KKN	4.77
2.	More reliable financial statements	4.59
3.	Greater disclosure and transparency in annual reports and financial statements	4.56
4.	Improve enforcement of existing rules	4.31
5.	More effective external audit	4.28
6.	Improvements in risk management and compliance processes	4.26
7.	Improved role of Audit Committees	4.25
8.	Clearer separation of company ownership and management	4.23
9.	Greater disclosure of director dealings with related parties	4.16
10.	Clearer definition of director's responsibility	4.10

D. Regulations and Practices on Corporate Governance

Survey on Corporate Governance in Indonesia in 2003

The Asian Development Bank Institute (ADBI) and the Forum for Corporate Governance in Indonesia (FCGI) have conducted a survey on Corporate Governance practices in Indonesia. The objectives of the survey are:

1. to get update of state of affairs in Corporate Governance, both in legislations/regulations and practices;
2. to identify remaining bottlenecks;
3. to make a comparison with other countries, i.a.: Republic of Korea, Thailand, and Malaysia; and
4. to make policy recommendations.

An overview of the regulations on Corporate Governance in Indonesia as well as results of the survey is incorporated in the country paper by the FCGI. The country paper consists of 5 (five) chapters wherein the contents are categorized by issue as set out by the ADBI. Following is summary of each chapter:

1. Chapter 1 figures out the financial crisis and major Corporate Governance Problems. This is followed by the brief overview of recent regulatory reforms in Indonesia, which divided in two sections: pre crisis and post crisis. Furthermore, general observation on the reform efforts and their effects on Corporate Governance practices is described by portraying recent Corporate Governance survey to institutional investors in 2002. The last sub-chapter overviews the ADBI-FCGI survey on Corporate Governance in Indonesia in 2003: its objectives, methodology, and survey result.
2. Chapter 2 describes the different aspects of shareholders rights. It starts with the description of the regulatory reform on shareholders rights in Indonesia and it is followed by the description of survey results. This chapter completes the description

of survey results with the assessment of shareholders' role and major constraints in Indonesia.

3. Chapter 3 describes the effectiveness of the Board of Directors and Board of Commissioners. As same as Chapter 2, this chapter starts with the description of regulatory reform and related developments geared to enhancing the effectiveness of the boards. The description of survey results includes an evaluation of the gap between regulation and practices and, finally, it provides assessment of the effectiveness of the boards and future tasks.
4. Chapter 4 figures out the role of other stakeholders in Corporate Governance by emphasizing the role of banks as well as labour unions and employees. The description of survey results on the role of banks as well as labour unions and employees is also undertaken. The last sub-chapter gives overview on prospects for the role of banks and employees and alternative Corporate Governance model.
5. Chapter 5 attempts to relate the overall Corporate Governance score of companies to their performance. This provides measures of the quality of Corporate Governance and firm performance and analysis on the association between Corporate Governance and performance.
6. Eventually, Chapter 6 concludes with policy implications for the future direction of Corporate Governance and other complementary reforms in Indonesia.

Methodology

To obtain information on Corporate Governance in Indonesian companies, three sets of questionnaires were developed by the ADBI. One set was directed at the Corporate Secretary, one on one of the Directors not being the president-director, and one on one of the Independent Commissioners.

Each of the questionnaires consistent of a combination of closed, multiple-choice questions into verifiable facts on a company's Corporate Governance-arrangements, and a set of judgmental questions for which respondents were asked to indicate their agreements with a statement on a Likert scale.

Questionnaires were sent to a total of 112 listed companies, mirroring Indonesia's industrial structure of listed companies. In each company, the Corporate Secretary, one of the Directors not being the president-director and one of the Independent Commissioners were sent a questionnaire. The questionnaires for the Directors and Independent Commissioners were slightly different from the questionnaires for Corporate Secretary whereby the first type of questionnaires contains judgmental questions and another type of questionnaires contains questions on factual information.

Survey Results

Replies were received from 66 companies. A reply was considered complete if at least two out of three of the representatives of one company responded. The companies that completed their reply are an equitable representation of the group that was surveyed. Followings are table of number of sample companies by industry, which their reply was considered complete, and table explaining number of complete reply.

Table 4. Number of Sample Companies by Industry

Industry		Number
1.	Textiles and clothes	15
2.	Chemicals	6
3.	Iron and metal products	5
4.	Electrical/electronics products	6
5.	Transport equipments	10
6.	Distribution and trade	14
7.	Food and beverages	10
Total		66

Table 5. Number of Complete Reply

		Number of Reply
a.	Complete sets of information and independent commissioners and directors opinion	16
b.	Factual information and independent commissioners opinion	16
c.	Factual information and directors opinion	34
d.	Factual information only	0
Total:		66

One possible bias of concern is that companies that have completed the survey can be expected to be the ones that are more advanced in their Corporate Governance systems. Some of the questions asked are directly related to legal regulations. Companies which have made little or no progress in Corporate Governance are less likely to respond. Caution is therefore necessary to imply that the results of the survey are a good reflection of the situation in all listed companies in Indonesia.

Also, a number of questions have been formulated in a judgmental way, asking the respondent's opinion on his/her own companies. A certain bias in the answers can be expected here too.

Thirdly, the respondents are all from the companies involved, which implies a kind of self-assessment. Were external stakeholders, such as shareholders and regulatory authorities involved in the survey, the results might have been quite different.

General Characteristics of the Respondent Group

The responding companies had a very high concentration of ownership, with 60% of the responding companies having one shareholder with a substantial voting right and effectively controlling the firm, and another 22% having two or more large shareholders effectively controlling the firm.

Table 6. Ownership and Control Structure

Ownership and control structure		Number of companies
1.	Concentrated ownership/control	42
2.	Concentrated control	4
3.	Collective control	13
4.	Diffused ownership	4
5.	Ownership	3
Total		66

The government played no role as a shareholder in the respondent companies, with only two companies indicating that government partly own the company but exercises little control. None of the other companies has any ownership in the researched companies.

Foreign ownership is more important in the respondent companies, with 22% of the companies having substantial ownership and control by a foreign company. As can be expected from the high ownership control, most (61%) of the president-directors of the respondent companies are either the founder of the company or belong to the founder's family. With regard to the ownership and control structure of the biggest creditor bank, the survey shows only 5% of the banks belong to the same group as the debtor company.

Table 7. Ownership and Control by Foreign Company

Ownership and control by foreign company		Number of companies
1.	Little owned	39
2.	Substantially owned/controlled	17
3.	Substantially owned with little control	3
4.	Others	7
Total		66

Table 8. Relation of CEO with the Largest Shareholders

Relation of CEO with the Largest Shareholders		Number of companies
1.	Founder	17
2.	Founder's family	22
3.	Professional manager	26
4.	Others	1
Total		66

Table 9. Ownership and Control Structure of the Biggest Creditor Bank

Ownership and control structure of the biggest creditor bank		Number of companies
1.	Mainly government-owned	12
2.	Belong to the same business group	3
3.	Belong to a different business group	22
4.	Owned/controlled by foreign banks	22
5.	Owned by small shareholders	0
6.	Others	2
Total		66

2. Shareholder's Role in Corporate Governance

A. Regulatory reform on Shareholder Rights

The regulatory reform on shareholder rights in Indonesia was started in simultaneously with corporate laws and regulations reform in 1995 wherein that year, Indonesia enacted two very important laws in corporate sector namely Company Law (for all limited liability companies) and Capital Market Law (for publicly listed companies and public companies). These are the main regulations of shareholder rights in Indonesia. In addition to these Laws, the National Code for Good Corporate Governance ('the Code') gives additional recommendations to the Company on protecting shareholders' rights in general and on minority shareholders' rights in particular.

As the "holy book" of corporate laws and regulations in Indonesia, the Company Law has stipulated numerous provisions related to shareholder rights and participation including provisions concerning protection of minority shareholders. The rights of shareholders as set out in the Company Law include the right to vote in the GmoS, to obtain a part of the profit of the company, the right to call for GMoS, the right to file a lawsuit in the court against directors and commissioners, the right to apply to the court for an investigation of the company, and the right to claim dissolution of the company.⁴

In addition, Company Law also provides minority shareholders with other rights to prevent a number of important corporate actions, such as changes of Articles of Association (AoA) of the company require a minimum of 2/3 (two-third) of the entire number of shares with valid votes and the decision is approved by a minimum of 2/3 (two-third) of the number of the shares. For merger, transfer of assets, bankruptcy, and dissolution, the decision will be considered valid if GMoS is attended by shareholders representing at least 3/4 (three-fourth) of the entire number of shares with valid votes and the decision is approved by at least 3/4 (three-fourth) of the number of votes. Most companies have incorporated these regulations in their AoA. Some have even introduced stricter protection of minority shareholders, by requiring of higher majority on voting in AoA changes as well as merger, transfer of assets, bankruptcy and dissolution.

Specifically for publicly listed companies, there are more regulations to comply with in contrast to non-publicly listed companies. Beside Company Law, other provisions concerning

⁴ See also shareholder actions against directors for breaches of fiduciary duty section

shareholder rights also stipulated in the Capital Market Law and BAPEPAM rules including the method for participation and voting in GMoS, election of directors and independent commissioners, shareholder actions against directors for breaches of fiduciary duty and the aspects of disclosure and transparency.

Shareholder participation in decision making

An annual GMoS has to be held within 6 (six) months of the end of the financial year. In case of bad financial status of company, an extraordinary GMoS may be held at any time required, but it is not compulsory. According to Company Law, the invitation to GMoS has to be made no later than 14 (fourteen) days prior to GMoS and it has to be made by using registered letter. For publicly listed companies, there is an additional requirement to make an initial announcement of invitation to GMoS 14 (fourteen) days before the invitation to GMoS, which is published in 2 (two) daily newspapers. With such announcement it is expected that the information of GMoS can be widely spread throughout regions in Indonesia and will provide adequate time for shareholder(s) to prepare proposals for the meeting agenda of GMoS.

The GMoS may be held by the request of shareholder(s) representing 1/10 (one-tenth) or a lower minimum number as may be stipulated in the articles of association, of the total shares issued by the company. The same threshold requirements also apply for Shareholder(s) to propose items for GMoS meeting agenda. In accordance with the Company Law, the GMoS will be held if it is attended by shareholders representing more than 1/2 (half) of the number of shares with valid votes, unless AoA stipulates a higher quorum than 1/2 (a half) of the shares. If the quorum is not reached, a second invitation to GMoS has to be made not later than 7 days ahead of the second GMoS and the second GMoS will be considered valid and therefore can make decisions if it is attended by shareholders representing at least 1/3 (one-third) of the total number of shares with valid votes. If quorum of the second GMoS is not reached, the head of the district court will determine the quorum upon the request of the company.

Even though the Company law has sufficiently regulated the procedure to hold an effective GMoS, there are some obstacles to hold an effective GMoS for shareholders participation. The major impediments often found in practice mostly related with asymmetrical information on the company and shareholder's rights as well as the domicile of shareholders who are spread throughout wide regions in Indonesia.

The asymmetrical information often occurs since most Indonesian shareholders, particularly minority shareholders, are not completely aware that they have certain rights that can be exercised in order to protect their interest in the respective company. However, efforts to educate these shareholders are growing, and a number of organizations which are concerned with the protection of the minority shareholders have been established. These organizations along with institutional investors such as pension fund are now frequently involved in several Company's GMoS to represent the minority shareholders.

The wide range of shareholders domiciled throughout regions also becomes another barrier for an effective participation of shareholders. Shareholders are often reluctant to participate in GMoS considering the distance and cost that they have to undertake for travel.⁵

In addition, the Company law does not recognize a shareholder voting by mail system. The shareholder or its representation has to attend the GMoS in order to be able to have voting rights.

⁵ Interview with Dandossi Matram, Capital Market Analyst/Board Member FCGI, 17 December 2003. He also added that most of Indonesian shareholders still could be considered as passive shareholders because of their lack of knowledge on the capital market and its market process.

Election of directors/commissioners and other Shareholder rights

Basically, the Company Law stipulates that one share one vote is applied unless stated in a different way by company's AoA. These provisions certainly give space to a company to introduce other voting right system particularly for election of directors and/or commissioners, such as cumulative voting rights.⁶ The Company Law allows company's AoA to determine 1 (one) classification of shares or more. Beside 1 (one) classification of common shares, other classification of shares are shares with a special vote, conditional or limited vote or without a vote; shares which after a certain period of time can be withdrawn or exchanged for another classified shares; shares which give its holder a right to cumulative or non cumulative dividends; and/or shares which give its holder a right to have priority over other holders of classified shares in the distribution of dividends and remaining property of the company in the event of liquidation. In Indonesian State-Owned Enterprises (SOEs), a special share owned by the government is called "*Dwiwarna Share*". It is a 'golden share' whereby gives the government special authority to replace the BoD and BoC of the company. Some SOEs that have been publicly listed have "*Dwiwarna Share*", such as: PT. Telkom Indonesia, Tbk. and PT. Antam, Tbk.

There are pro and cons of the cumulative voting rights system.⁷ It benefits for the minority shareholders since with this system, minority shareholders can elect their own representative in the board to represent their interest in the company. Basically, the Company law leaves this matter to the company AoA. However in practice most Indonesian companies, even publicly listed companies, have not introduced such voting system particularly in the election of directors/commissioners.

In order to protect shareholders from any corporate unlawful act that can cause losses, shareholders (with the minimum of 1/10 (one-tenth) of the total issued shares) have the rights to apply to the district court for an investigation of the books and records of the company. This mechanism allows shareholders to be able to inspect and have the copy of the register of shareholders, minutes of meetings, and the books and records of the company.

With regard to approval of major corporate transactions such as merger, and major acquisition of assets, Company Law has set a high standard of minimum voting rights where the decision of GMoS will be considered valid only if it is attended by shareholders representing at least $\frac{3}{4}$ (three-fourth) of the entire number of shares with valid votes and the decision is approved by at least $\frac{3}{4}$ (three-fourth) of the number of votes. Hence, 75% majority votes approval is needed for approval of such major corporate transactions.

Different approval is required for large related party transactions, which according to BAPEPAM rule, requires GMoS approval if the transaction amounts at least 10% of corporate revenue or 20% of equity. Beside being subject to approval from the GMoS, BAPEPAM rules also require such transactions, along with other transactions involving conflicts of interest for a director, commissioner or principal shareholders, to be disclosed to the public.

In the issuance of new shares, most Indonesian companies apply simple majority vote (50%+1) of shareholders in approving issuance of new shares. As it is stipulated in company's AoA, the Company Law leaves this matter to AoA. For publicly listed companies, BAPEPAM rules concerning pre-emptive right are also applied. Provision regarding pre-emptive right of shareholders provides the possibility to the existing shareholder to first

⁶ Cumulative voting: A system for electing corporate directors whereby a shareholder may multiply his or her number of shares by the number of open directorship and cast the total for a single candidate or a select few candidates (Black's law dictionary, West Publishing Co, 1996)

⁷ Robert C. Clark, *Corporate Law*, Little, Brown & Company Limited, Canada 1986 p. 363-364

subscribe or purchase any share issued by the company or to be sold by the other shareholder, proportionately with their shareholding composition. This right confers protection to the shareholders from unintended participation by other party that may, potentially harm the interest of the company or other shareholders.

With regard to the protection against hostile takeovers, currently Indonesia does not have specific law severely restricting hostile takeovers, such as Pennsylvania Senate Bill 1310, which was introduced on 20 October 1989. However, Indonesia has a number of regulations that indirectly provide defense mechanism from hostile takeovers in some cases. The Law banning Monopolistic Practices and Unfair Business Competition ('Competition Law') and BAPEPAM Rule on Tender Offer and Right Issue Process is indirect regulation providing defense mechanism from hostile takeovers. Based on Competition Law, companies are prohibited to have majority shares at several similar firms engaged in the same business sector and in the same relevant market if such ownership causes ones to control more than 75% of the market share of one type of certain goods or services. A bid in the form of a public invitation to shareholders to sell their stocks (Tender Offer) will be triggered following a bid by third party to take over a publicly listed company.⁸ The party that intends to make the Tender Offer must announce the plan of Tender Offer in at least two Indonesian daily newspapers, one of which must have national circulation.

The Company Law also provides assurance for shareholders in the event of disagreement with company action, the right to request for redemption of their shares (dissenter's rights) at a normal and reasonable price.⁹ If the shares that each shareholder asks the company to buy back exceeds the maximum amount¹⁰ as required by Company Law, the company has to make an effort to find other buyers for the shares. At this point, Company is expected to respect the decision of shareholder. Shareholders rarely use this right.

Shareholder action against directors for breaches of fiduciary duty

The Company Law stipulates that shareholders jointly owning at least 10% of shares have the right to file a lawsuit to the district court against members of Board of Directors and/or Board of Commissioners for their mistakes or negligence inflicting losses on the company.¹¹ With this provision, directors and/or commissioners that have been proven by court to have committed mistakes or negligence causing losses of the company are subject for civil sanction (to pay for damages) and/or criminal punishment. The rights to file a lawsuit to the district court can also be applied if shareholders jointly owning minimum 10% of shares propose to replace or to dismiss directors/commissioners that are believed to have violated law or articles of association, and the proposal is rejected by the GMoS.

With regard to sanction for directors and/or commissioners of public listed companies for the offence of insider trading practice, the Capital Market law gives maximum penalties up to 10 years imprisonment with administrative fine to reach Rp. 15,000,000,000 (fifteen billion

⁸ i.e. the acquiring of 25% or more of shares or equity securities of such company or the attainment of direct or indirect ability to control such company as demonstrated by an ability to determine the appointment or dismissal of directors or commissioners, or to amend such company's AoA, obliges the acquiring company to invite all shareholders to sell their shares for the take over price (Tender Offer).

⁹ The Company Law provides the possibility for a shareholder who could not agree with the company's action that may harm the interest of the relevant shareholder, to request the company to purchase their shares in a reasonable price. Under company law, this right can be exercised upon limited condition as follows: amendment of AoA, sale or guarantee or exchange of substantial property, and merger/acquisition/consolidation.

¹⁰ According to the Company Law, Article 30, Paragraph (1), the company can repurchase the shares that have been already issued with the provision that: (a) the repurchase is financed by net profit so long as this does not make the net property of the company smaller than the amount of issued capital plus compulsory reserves in accordance with this law; and (b) the nominal value of the entire shares owned by the company and its subsidiaries and pawned shares held by the company does not exceed 10% of the issued capital.

¹¹ Derivative suit

rupiahs). To date, a number of many insider-trading practices have been successfully solved by BAPEPAM, but in many cases the alleged practices could not be proven. A recent case related to insider trading practice in Indonesia involving PT. Indonesian Satellite Corporation (PT.INDOSAT, Tbk), a major satellite company in Indonesia was announced by BAPEPAM that there were not enough evidences supporting the indication.¹² This indicates that improvements on quality of investigation procedures are still needed.

Even though Corporate Law and Capital Market law have included minority shareholders protection principles, there are no specific provisions related to the rights to file a civil action suit for shareholders against directors/commissioners' breach of their fiduciary duties. However, a growing concern on the protection of shareholder rights have made such issue eminent in Indonesia, several NGOs and institutional investors have proposed the government to issue specific regulations regarding civil action suits in the area of capital market to protect public interest from losses or wrongdoing.

Additionally, Indonesia only has two laws that provide an opportunity for the public to file a civil action suit namely environmental law and consumer protection law. The civil action suit procedure is later regulated under Supreme Court decision No. 1/2002 concerning Civil Action Rights and Procedure

Disclosure and Transparency

These two principles are very important for public listed companies, BAPEPAM and JSX as the Capital Market authority are very strict in implementing disclosure and transparency regulations. To date, numerous regulations related with these principles have been issued by BAPEPAM and JSX such as the obligation to publish an audited annual report, the obligation to submit semi annual report, and the obligation to report changes of ownership. Nowadays, investors can easily obtain corporate information through the JSX and BAPEPAM websites or they could directly visit the Capital Market Information Center at JSX.

Disclosure and transparency are often linked with the finance and audit system of a company. As part of efforts to force listed companies to implement corporate governance, on 22 December 2003, BAPEPAM issued new regulation on the establishment and working guidelines of Audit Committee¹³. The regulation has obliged listed companies to establish an audit committee at the latest on 31 December 2004. Therefore starting that date, BAPEPAM has the authority to punish every listed company that is unable to comply with this regulation¹⁴.

According to the new regulation, the audit committee must consist of at least one independent commissioner and at least two other members who are not affiliated with respective company.

The Audit Committee also proposes to the GMoS the nomination of the external auditors, which later will be decided by Shareholders in the GMoS. However in companies that still do not have an audit committee, generally the GMoS authorizes to BoD to appoint external auditor.

The external auditor's opinion is very important not only for the audit committee but also for investors as it will determine whether the statements present fairly in all material respects, or show a true and fair view of the company's financial position, the result of operations, and cash flows and conform with all relevant national or international generally accepted

¹² BAPEPAM Annual Press release, 27 December 2002

¹³ Keputusan Ketua BAPEPAM Nomor: KEP-41/PM/2003

¹⁴ See also Table 10.

accounting principles. As per December 2003, of total 333 companies listed in JSX 300 companies (90%) has set up an audit committee.

Table 10. The presence of Audit Committees in Publicly Listed Companies since December 2001

	December 2001	November 2002	April 2003	December 2003
Total companies listed in the JSX	314	328	331	333
Total companies that have established an audit committee	46 (14%)	255 (78%)	277 (84%)	300 (90%)

Source: The Jakarta Stock Exchange

Recent corporate governance scandals in the world such as Enron, WorldCom, Xerox, Merck, etc, have indicated involvement of their external auditors in preparing false financial statements. To avoid such scandals occurring in Indonesia, the Ministry of Finance has issued regulation regarding limitation of audit period for public accountant and its firm. According to this regulation, the maximum period for external auditors to serve for a company is limited to 3 years for public accountants and 5 years for public accounting firms. BAPEPAM in coordination with JSX, The Indonesian Accountants Association (IAI), and The Association of Indonesian Public Listed Companies (AEI) has also issued Circular letter to support BAPEPAM rule on guidelines for the preparation of financial statement. With this Circular letter, public listed companies are expected to reveal all necessary information in their financial report not only limited to minimal requirements as stated in the BAPEPAM rule, but also other information.

For public listed companies, BAPEPAM also issued similar period limitation for public accountant and accounting firms in providing audit service for listed companies.¹⁵ As part of disclosure and transparency principle, BAPEPAM also requires every public listed company to publish their audited annual report within 3 months after the end of business year. Violation against disclosure and transparency principles as required by Capital Market law is subject for 3 years imprisonment and administrative fine up to Rp. 5,000,000,000 (five billion rupiahs).

¹⁵ Keputusan Ketua Bapepam/Kep-20/PM/2002 tentang Peraturan Nomor VIII.A.2

B. Description of Survey Results

Effective participation in decision-making

In line with the Company law, all companies apply the one-share-one-vote system that means 100% of the respondents state that there are no deviations on one-share-one-vote rule occurring in their company.

Most companies (61%) do not allow voting by mail. The survey has proof that even though company law does not regulate voting by mail system, some companies have introduced this system through their AoA. This is quite surprising since majority of Indonesian companies are considerably conservative in regard to the voting system. The implementation of a voting system through mail obviously will enable shareholders, which are widespread throughout Indonesia, to really participate in every company decisions. The Company Law also provides opportunity for proxy voting whereby virtually any individual can be proxy holder. However the law restricts employees, board of management as well as board of commissioners to act as a proxy holder. The survey indicates that minority of respondents (39%) state that anybody can serve as proxy. Hence, it should be noted that these respondents might have implied that directors, commissioners and employees are *also* not allowed to serve as proxy (as the law states). Recent developments have shown, a number of minority shareholders protection organizations have actively participated in several GMoS of publicly listed companies with the intention to protect minority shareholders rights during the GMoS.

As could be expected, the respondents generally answered that their companies provided their shareholders with adequate information on agenda items of the shareholders meetings, and that adequate time was given for questions and placing issues at the shareholders meeting. With only one exception, all respondents answered their companies to be adequate in these areas. Responses were more emphatic on the adequacy of the information provided on agenda items than on the available time for asking questions and placing issues.

Most of the shareholders' meetings (65%) lasted less than one hour, In 30% respondent companies the GMoS lasted between one or two hours and only 2% lasted over three hours. The survey also indicates that 56% of the meetings were attended by less than 25 people, 41% of the meetings were attended by 26-100 people and only 3% of the respondents claimed that their meetings were attended by more than 100 people. The researchers view both of these scores as much less than adequate to indicate a good corporate governance. The number of shareholders is low in comparison to the estimated number of shareholders in each company. It is also low compared to other countries, including the two other countries in the survey, Thailand and Republic of Korea.

Election of Directors, other rights of shareholder actions against directors for breaches of fiduciary duties

The Company law stipulates specific voting requirements for these aspects. For example, a 2/3 (two-third) majority votes of at least 2/3 (two-third) of shares that have to be approved at GMoS are needed to be able to make modification on the AoA. A minimum of 3/4 (two-third) majority of votes applies for mergers, consolidations and major sales and acquisitions. However, the survey indicates that to some extent some companies have set lower voting requirements for these aspects. The survey showed that most of the companies (around 80%) require at least a 2/3-majority for changes in the AoA of the companies. For the approval of mergers, consolidations, major sales as well as acquisitions for instance, some companies only required 2/3 majority voting rights to approve such decisions even though it is less than minimum voting requirements under the Company law. Just over half of the companies require a 2/3 approval of large related-party transactions. This is therefore not in competence with the law.

It is very striking that companies give their minority shareholders much less influence on the appointment and the removal of directors and auditors. Less than 10% of the companies require a 2/3-majority for any of these decisions. The rest require a simple majority. This is an indication that the dominant shareholders want to retain a strong grip on the management.

Equally, minority shareholders are also given little influence on the remuneration of the directors, with only 6% requiring a 2/3-majority on decisions regarding remuneration. In new share issuances, the minority shareholders are better protected, with 48% of the companies requiring a 2/3-majority decision. Not giving priority subscription in rights issues requires a 2/3-majority in only one third of the companies surveyed.

Respondents again stated that their companies gives adequate protection to shareholders in their priority subscription rights in the issuance of new shares or convertible bonds, with 94% of the respondents agreeing with this statement. This seems to be inconsistent with the outcome above where only one third of the companies requires a 2/3 majority on this issue. Respondents also overwhelmingly (96%) agreed that related party transactions are fully discussed and that it is not difficult to know how much equity ownership the major shareholders control.

Directors candidates are generally (74% of the respondents) disclosed before the shareholders' meeting, and minority shareholders can in most companies (86%) nominate candidates. Whether these possibilities are effective, given the dominant position of majority shareholders in voting on appointments of directors (113.4) is questionable. The unlikelihood (in 86% of the companies) of director candidates being rejected at the shareholders meeting further underlines this point. Cumulative voting has been introduced in 60% of the companies but tried at least once in only 20% of the respondents. In practice therefore, minority shareholders still have little influence on the composition of the Board of Directors.

Disclosure and Transparency

The use of the website to disclose any of the company information mentioned in the survey, is negligible. Only in a few incidental cases were resumes of directors, auditors'/advisors' fees and a company's general compliance with corporate governance standards put on the web. Some companies did not disclose at all directors selling or buying shares in their companies (23% of the respondents), resume/background of directors (8%), remuneration of the directors (23%), fees paid to external advisors/auditors (64%), policies on risk management (9%), and general compliance with corporate governance. Other non-disclosures were only incidental. All other companies reported the information surveyed in their annual report and/or to the regulatory authorities.

A surprising large number of (listed!) companies (30%) do not have a website at all. Of the companies that do have a website, almost all of them think they are informative, which contrasts interestingly with that fact that virtually none of the researched information is available on the web. Just over half of the websites is bilingual.

Almost all companies disclose semi-annual reports (92%) and quarterly financial statements (97%). Most of them (83%) also disclose consolidated financial statements.

Almost all respondents assert that the companies accounting and audit standards comply with international regulations (such as IAS and ISA), with only 6% admitting some relaxation. When looking at industry patterns in the corporate governance scores, the iron and metal industry, and to a lesser degree the transportation equipment and electronics industries tend to score consistently better than average. The food and beverage industry, interestingly,

generally had a more positive perception about its own corporate governance than other companies.

C. Assessment of Shareholders' Role and Major Constraints

The Company Law and the Capital Market Law, both of 1995, provide the basic provisions for the shareholders rights in Indonesia. They regulate basic shareholders' rights, such as the right to take action against malfunctioning directors and commissioners. They also protect the interests of minority shareholders by requiring a quorum and a qualified majority for a number of important decisions. Although Indonesia applies the one-share-one-vote principle, the Company Law allows for the application for different classifications of shares. Special voting rights are often applied to give more influence to certain shareholders in the appointment and removal of members of the Board of Directors and Commissioners.

During the last years, BAPEPAM and the Jakarta Stock Exchange have put particular emphasis on disclosure and transparency, i.a. by requiring listed companies to establish an audit committee and by imposing restrictions on the use of the same public accountant for several years.

Based on the law, Indonesia's shareholders' rights are well-regulated. There are however a number of circumstances that limit the actual application of shareholders rights.

Firstly, as this survey has shown, most companies are still controlled by one or two dominant shareholders. These majority shareholders still have decisive influence over the composition and the remuneration of the Board of Directors and, to a somewhat lesser extent¹⁶ Board of Commissioners, for which no quorum and minimum majorities apply.

Secondly, the involvement of shareholders in GMoSs and the setting of the agenda seems to be small. The number of attendants is small and the meetings last very short. Most shareholders seem to hold shares as in investment only and do not want or expect to be able to exert any influence on the company policy. (Interestingly, a number of respondent companies appear to not comply with the law on the minimum voting requirements mergers, consolidations and major sales, acquisitions and large related-party transactions.) The extreme action that they might take is to sell their share back to the company after GMoS if they lose their confidence in the company's performance. In practice, this rarely happens. Minority shareholders also hardly use their right to pool their shares to up to 1/10 of the total shares in order to call up GMoS or making a move against the majority shareholders' decision in GMoS.

Other possible reasons are travel distances or the fact that many shareholders actually have their shares through mutual funds. Voting by mail is not allowed in any company. Appointing proxies is allowed by law.

Thirdly, the disclosure of company information does not go far beyond the legal limits and is still mostly limited to the annual reports and the reports to regulatory authorities. The company's website, if at all existing, is hardly used to disclose information on its corporate governance system.

The passive and weak minority shareholders are the major constraint to aim proper check-and-balance and balanced controlling on the companies. The Jakarta Stock Exchange regulation requiring at least 30% of their BoC members to be independent in public companies is an attempt to improve the impartial monitoring of the company's management but, as other parts

¹⁶ Based on the JSX-regulations, at least 30% of the commissioners in publicly listed companies have to be independent commissioners

of this survey shows, the influence of the Board of Commissioners in general is growing but still limited.

Policy implications of these findings of the limitation of the effectiveness of shareholders' rights could be to encourage more active dissemination of corporate governance information beyond the legal minimum. Whilst this may not always appear to be in the direct interest of the majority shareholder, it is expected to improve the monitoring of the firm's performance and therefore its value to all shareholders. Current regulations on shareholders' rights are adequate, but the attitude of companies towards their shareholders (and vice versa) as stakeholders, and not only as providers of capital, needs to be changed if corporate governance is to improve.

Major shareholders should be also encouraged to allow voting by mail system included in AoA and to implement the cumulative voting system. These two instruments are very significant as shareholders control mechanism. With voting by mail system, minority shareholders that are often wide spread throughout Indonesia can actively participate in company's decision-making process.

The presence of company's website is also very important since it could become the bridge connecting shareholders with the company and vice versa. The survey finding indicates that only few respondents have their own website. Company should also improve their website with the latest condition of their company including their corporate governance condition. A comprehensive content of a corporate website is very valuable for its shareholders in order to protect their investment.

3. Effectiveness of the Board of Directors and Board of Commissioners

A. *Regulatory Reform and Related Developments Geared to Enhancing the Effectiveness of the Boards*

a. Board Structure & Minimum Number of Directors and Commissioners

Indonesian companies must have two boards¹⁷, a board of directors (BoD), responsible for management of the company and represent the company inside and outside of court, and a board of commissioners (BoC) responsible for supervising and giving advice to the BoD. Directors and Commissioners must perform their duties in the best interests of the company and may be personally liable for negligence or wrongdoing. Directors are not entitled to represent a company where they have a conflict of interest. The BoD must prepare, and submit to shareholders for approval at a GMoS, an annual report, the content of which is prescribed.

Indonesian Company Law requires a minimum of 2 (two) members of the BoC and BoD for public companies and publicly listed companies. Companies engaging in the mobilization of private funds and companies issuing bonds are required to have minimum of 2 (two) members of the BoC and BoD as well.

b. Minimum Number of Independent Commissioners

¹⁷ The European Continental legal system has **Two Tiers System** for company board structure. The company will have two separated boards, a supervisory board (the board of commissioner or 'BoC') and a management board (the board of director or 'BoD'). Countries with **Two Tiers System** are among others: Denmark, Germany, and the Netherlands. Since the Indonesian legal system is based on the Netherlands legal system, the Indonesian Company Law has taken up **Two Tiers System** for its company board structure.

Both Company Law and Capital Market Law do not recognize “Independent Commissioner” and/or “Independent Directors”. The terminology of Independent Commissioners was introduced by the JSX regulation in year 2000 (and the later-revised regulation in year 2001). The JSX regulation requires publicly listed companies to appoint Independent Commissioner(s). It remarks that listed companies are obliged to have Independent Commissioners proportionally equal to the shares owned by the non-controlling shareholders. The number of Independent Commissioners should not be less than 30 % (thirty percent) of the total number of commissioners. There is no additional and particular role of Independent Commissioners in the JSX regulation other than the role as set out in Company Law, i.e.: to supervise and give advice to the BoD. However, the National Code for Good Corporate Governance (‘the Code’) emphasizes the role of all BoC members to ensure the company performs its social responsibilities and consider the interests of various stakeholders of the company as well as to monitor the effectiveness of the Good Corporate Governance practices.

In addition to the requirement to appoint Independent Commissioner(s), the Code recommends Indonesian companies to appoint Independent Directors as well. According to the Code, depending on the specific character of the company, at least 20 % of the member of BoC and of the member of BoD should be “outside commissioner/director”. This provision is adopted by the Decree of Minister of State-Owned Enterprises (SOEs) (‘the SK No. 117/2002’) wherein it stipulates the number of Commissioners and Directors from outside of SOEs should be no less than 20% of the total Commissioners and Directors. After the SK No. 117/2002, State-Owned Enterprise Law No. 19/2003 was enacted. This law is stipulating as the first law explicitly stipulating Good Corporate Governance.

c. Restriction on Appointing Non-residents or Foreigners to the BoC and BoD & Age Restriction for BoC and BoD

Both Company Law and Capital Market Law do not have restriction on appointing non-residents or foreigners to the BoC and BoD. However, based on policy made by the Ministry of Justice, foreigners cannot be a Director or Commissioner in a non-foreign direct investment company (‘non-PT. PMA’). Foreigners can be a Director or Commissioner in foreign direct investment company (‘PT. PMA’) with the condition that only for the position of director of human resources has to be filled out by Indonesian. This policy is stipulated by the Ministry of Manpower and the Investment Coordinating Board (‘BKPM’).

There is no age restriction for BoC and BoD, however the Civil Code stipulated the minimum age of person who may be capable to hold BoC and/or BoD is 21 years.

d. Separation of Chairman and CEO

By the nature of the two tiers system, there is separation of President Commissioner (Chairman) and President Director (CEO).

e. Maximum Election Term of Directors and Commissioners

There is no maximum term of both BoC and BoD in a company. No detail requirements stipulated under Company Law, Capital Market Law as well as the Code. It is mentioned in the Company Law that both BoC and BoD are appointed by the GMoS. The election term of BoC and BoD is to be specified in the AoA of respective company. Company’s AoA regulates the procedure for nominating, appointing, and removing members of BoD and BoC irrespective of the rights of shareholders in the nomination.¹⁸

¹⁸ Indonesian Company Law, Article 80 paragraph 1 and 4; and Article 95 paragraph 1 and 4.

f. Number of Boards on Which Individual may Serve

There is no regulation stipulating number of boards on which individual may serve. However, in the banking sector, an individual may hold position as director or commissioner in only one bank. Additionally, the existing regulations for securities companies and the stock market stipulate detailed requirement for candidacy and appointment of the BoC and the BoD, which restrict members of the BoC and BoD to hold double position in another securities company. It also requires the BoC and the BoD to provide a statement letter to the Company or stock market (as the case may be) regarding the fulfilment of such provision.

g. Board Committees

Both Company Law and Capital Market Law do not stipulate committees, which may be established by the BoC. The BAPEPAM Chairman issued a circular letter in 2000 wherein it recommends publicly listed companies to establish the Audit Committee.¹⁹ This recommendation is attributed to the publicly listed companies and public companies in order to heighten accountability as carried out by the BoC.

A more detail requirements are set out by the JSX regulation. The JSX stipulates that the Audit Committee shall consist of at least 3 members, one of whom shall be an Independent Commissioners of the publicly listed company and, concurrently, shall be the chairman of the Audit Committee. The other members of Audit Committee as required by Jakarta Stock Exchange are from independent third parties.

In organizing their duties, the Audit Committee shall submit reports regarding their examinations, to all members of the Board of Commissioners, not later than 2 (two) working days after accomplishment of the report. In addition, the Audit Committee shall periodically submit report regarding their activities to the Board of Commissioners, at least once in every 3 months. JSX also requires that the Annual Financial Statements of publicly listed companies shall contain report regarding the activities of the Audit Committee. Thus, for listed companies, an audit committee is mandatory.

In addition to the JSX regulation, the Code stipulates the BoC to consider establishing from among their members certain committee to support the implementation of the tasks of the BoC. Such committees shall report their findings and make recommendations with respect to their relevant mandates to the BoC. The establishment of such committees has to be reported in the annual reports. The following are various committees that may be established by the BoC, i. a.: Nomination Committee, Remuneration Committee, Insurance Committee except for Audit Committee which is mandatory to be established by the BoC according to JSX regulation.

h. Minimum Number of Board Meetings

Both Company Law and Capital Market Law do not provide any clear requirement for the BoC and the BoD to hold a meeting. However, since the BoC has to sign the annual report of the company together with the BoD, it is intended that the BoC may also hold a meeting to discuss such matter. In addition, from the provisions regarding the requirement of the BoD to make and maintain the minutes of the BoD meeting and to prepare the business plan and annual report of the company, it is intended that the BoC may also hold a meeting to discuss such matter.

However, according to the Code there is stipulation that the meetings of BoC should be held regularly, i.e. at least once every month in principle, depending on the specific characteristics

¹⁹ BAPEPAM Circular Letter No. SE-03/PM/2000 dated 5 May 200.

of the company. The BoC should adopt procedures for meetings of BoC and should clearly set out such procedures in the minutes of meeting of the BoC and when such procedures were determined and decided. A member of BoC can only be represented by another member of BoC at a meeting of BoC. Minutes of meeting should be drawn up for each meeting. Any dissent from decisions taken in the meeting of BoC has to be noted in the minutes of meeting. Each BoC member is entitled to receive a copy of the minutes of meeting of BoC, irrespective whether such member has been present or not at a meeting of BoC. Within 14 (fourteen) days from the date of the delivery thereof, each member of BoC has to advise the Chairman of the meeting concerned of his/her objections and/or corrections to any matter referred to therein. The same stipulation imposed to the BoD.

i. *Continuing Training Required for Directors*

There is no continuing training required for BoC and BoD.

B. Survey Results: Evaluation of the Gap Between Regulations and Practices

One third of the respondent companies operate in an environment with many competitors. One third operate in an environment with a few competitors. Around one half of the companies has business in international markets. Most companies, around half, indicate that overall quality is the major basis for competition.

Half of the respondents assert that their quality of corporate governance is about the same as that of other listed companies, and most of the rest of the companies state that it is better. Most of the respondents (69%) indicate that their companies have made at least slight progress in their corporate governance compared to three years ago.

Board Composition and Independence

Most respondent companies (80%) have a size of the Board of Commissioners of five or less. This is smaller than the size found in the other surveyed countries, mainly because Indonesia has a two-tier Board system. 33% of the companies have foreigners on the Board.

The Independent Commissioners are said to meet sometimes (55%) to rarely (27%) without management to discuss corporate matters. They sometimes (59%) to rarely (24%) alter the agenda as set by the president-director. They sometimes (52%) to often (38%) participate actively in the Board discussions. It is not very common for agenda items to be disapproved by the independent commissioners rarely (49%) to sometimes (35%), but their opinions during meetings are often (74% of the companies) recorded in the minutes. Most companies (85%) had believed their Commissioners are independent. There is no information revealed from the survey result whether their independent commissioners have met criteria as set out by the JSX regulation. According to the JSX data, as per December 2003 of 333 publicly listed companies 329 companies (99%) have had Independent Commissioners. Only 4 companies (1%) have not had Independent Commissioners yet. Furthermore, of 329 companies thereof 308 companies (94%) have met requirements as set out by the JSX while 21 companies (6%) have not met the requirements yet. Below is the table showing the progress on the establishment of Independent Commissioners in publicly listed companies since December 2001.

There is no clear duration for the appointment of independent commissioners, with 59% serving less than 3 years and 41% longer.

The responding Executive Directors and Independent Commissioners generally state that the Independent Commissioners are truly independent from the management or the controlling

shareholders of the company, with 73% of the Executive Directors and more than 90% of the Independent Commissioners agreeing with this statement. Nevertheless,

Table 11. The presence of Independent Commissioners in Publicly Listed Companies since December 2001

	December 2001	November 2002	April 2003	December 2003
Total companies listed in the JSX	314	328	331	333
Total companies that have had Independent Commissioners	188 (60%)	312 (95%)	319 (96%)	329 (99%)
Total companies which their Independent Commissioners have met JSX requirements	149 (79% of 188 companies)	290 (93% of 312 companies)	310 (94% of 319 companies)	308 (94% of 329 companies)

Source: Jakarta Stock Exchange

respondents gave a number of reasons why independent commissioners are sometimes not fully independent. The most frequently mentioned reasons are that the president-director effectively selects the board members, commissioners are concerned over the personal relationship with other commissioners and because management is better informed and has better judgment than the commissioners.

The Board of Commissioners or its nomination committee have the strongest voice in the selection and dismissal of independent commissioners in 40% of the companies. Controlling shareholders are found to have the strongest voice in 56% of the respondent companies. The influence of the president-director is remarkably low, with around 4% of the directors and commissioners mentioning that the president-director has the strongest voice in selecting or dismissing independent commissioners.

The Independent Commissioners still have an opportunity to give their independent opinion but do not (yet) have much influence on the agenda and discussions of the BoC meetings.

Removing a poorly performing president-director is in 13% of the companies decided by the controlling shareholder with some influence of the other managers. In 19% of the companies, the Board of Commissioners decides effectively, and 55%, the controlling shareholder decides with some influence by the Board of Commissioners. The controlling shareholder therefore effectively decides on removing a president-director in the large majority (over 76%) of the companies. The BoC (still) has little influence on the composition of the BoD. The controlling shareholders retain the dominant power here.

Functions of the Board and the activities of Board Committees

84% of the Boards have an Audit Committee as is required by law. They are usually (in 76% of the cases) made up of only a minority of independent commissioners. Almost none of the companies have a compensation or a nomination committee, which is not required by law but recommended by the Code.

98% of the members of the Audit committees have accounting/financing expertise. In contrast to the composition of the audit committee, the audit committees are usually (in 100%

of the committees) chaired by one of the independent commissioners. Almost always (91%), minutes are written of the audit committee meetings. The members' remunerations are mostly (54%) separately approved at the shareholders meeting. In 68% of the audit committees, there are written rules governing the overall audit function. Most audit committees (89%) select or even recommend an external auditor autonomously or conduct a proper review of his work. The audit committee is somewhat more involved in the approval of the appointment of the internal auditor and its supervision, with 89% percent of the audit committees indicating that they are involved to at least some extent.

Slightly less than half of the Boards indicate that they routinely formally evaluate the president-director's performance and his/her remuneration. More than half therefore indicate that they do this only sometimes or even rarely or never. This is striking given the fact that these are considered key responsibilities of the Board of Commissioners.

Most of the Boards (83%) meet less than five times a year, and three quarters of the meetings last less than 2 hours. Both are considered less than adequate by the researchers. The average attendance rate was 84%, which the researchers consider to be adequate.

Most respondents (over 80%) believe that the Board of Commissioners is a forum for serious discussion of company problems. 11% do not think so (the rest are neutral). Most respondents (75%) believe that the Board of Commissioners are not a formality.

When asked about the Board of Commissioners contribution to a number of tasks, the respondents replied that they found this contribution to be large especially in ensuring the integrity of the company's financial reporting (91%), ensuring proper disclosure and active communication with the shareholders and stakeholders (86%), The long-term strategy making (86%), ensuring the effectiveness of various governance practices (81%) and overseeing potential conflicts of interest including related-party transactions (85%). Their role was seen to be much less important in seriously reviewing directors' and key executives' remuneration (65%) and selecting, monitoring and replacing president-directors (56%). This supports the previous notion that the Board of Commissioners do play an advisory role, but are given relatively less influence on the management of the company.

Access to information, general support and director compensation and liability.

Education and training for directors and commissioners, beyond what is mandatory, are still rather uncommon. 53% only occasionally give such trainings, and the remaining 47% never. None of the companies actively provides these trainings.

Also, a minority of the companies provide a contact person for the support of independent commissioners. Only 35% of the companies provide a contact person.

Stock options appear to be very uncommon in Indonesia, with only 14% of the companies replying that they are given to president-directors. For outside directors, stock options or company shares are only very rarely (in less than 2% of the respondent companies) given. Also very few companies (6% of the respondents) have effective formal mechanisms for the evaluation of the performance of directors. 77% of the companies even do not have any mechanism at all. 9% of the companies provide a partial personal liability insurance for their directors, and the remaining 5% even provide full liability insurance. Most companies (86%) do not provide a partial personal liability insurance.

The independent commissioners do not often meet with managers or employees of the companies in order to obtain direct information about the company's state of affairs. 65% of the respondents indicate that the independent commissioners meet 'sometimes' and 24% indicating that they meet 'rarely' with managers and employees. The majority of the

companies (73%) indicate that the independent commissioners have unrestricted access to the company's documents and accounting system. Many respondents (45%) acknowledge that the independent commissioners do not always receive adequate information in time to process before every meeting of the Commissioners. Only one third of the respondents indicate that their company allows them to seek outside legal, financial and other expertise at the company's expense. More than half of the companies allow it only in exceptional cases. There are therefore noticeable limitation on the freedom of additional support for commissioners to carry out their tasks.

Almost all directors and commissioners surveyed regard the payment for independent commissioners to be adequate or more. There is however also a general major concern over the liabilities of the commissioners.

There are no clear patterns of some industries scoring better than others. Only the Transportation Equipment industry shows a slight tendency to score better on a relatively large number of questions.

The overall corporate governance score of companies in Indonesia showed very little variation over the different forms of ownership and control. Diffusely-owned firms and firms with professional managers not related to the controlling shareholders showed only a marginally better corporate governance than other companies.

C. Assessment of the Effectiveness of the Boards and Future Tasks

In assessing the effectiveness of the Boards, the following conclusions can be drawn from the recent legal developments and the survey findings:

1. The appointment of the Independent Commissioners

There have been some improvements in the effectiveness of the Boards in recent years. Some listed SOEs for the first time in their long histories have decided to appoint independent commissioners through a relatively fair and transparent process. These independent commissioners (including that of non-SOEs listed companies) are expected to initiate and promulgate the implementation of Good Corporate Governance in their companies.

By having the independent commissioners in the BoC, it is hoped that the BoC will be able to have a more independent voice and position towards BoD.

The survey findings indicate that almost all listed companies have Independent Commissioners, which, according to JSX data, meet the criteria of independence.

2. The establishment of Audit Committees

In accordance with the regulations, 84% of the listed companies now have an audit committee. This committee of the BoC should be led by an Independent Commissioner, which is the case in the 100% of audit committees in the companies surveyed. The committee's main function and role in Indonesia's listed companies (regulated by JSX circulars and BAPEPAM, or SOE Ministerial Decrees for SOEs) are focus in three following aspects:

1. Improving company's financial reporting
2. Overseeing the implementation of Good Corporate Governance (GCG)
3. Corporate control

Though it is too early to say that the Audit Committee has been effective in carrying out their duties and because of that has improved the effectiveness of the Boards, the establishment of the Audit Committee is a very important milestone to that improvement. The survey findings indicate that good progress has been made in establishing audit committees in a relatively short time. Their focus so far appears to be on the internal auditing, more than on the external auditing.

3. The BoC meetings performance

Besides the appointment of Independent Commissioners and the establishment of the Audit Committee, the improvement of effectiveness of the Boards can also be seen through their presence in the Commissioners meetings. Because these meetings should be reported in the Annual Report as well as their performance in attending the meetings, the presence of the members of BoC in Commissioners meetings have improved.

The survey findings indicate that almost all listed companies have Independent Commissioners that do actively participate in the BoCs' meetings and that their opinions are recorded. However, the Independent Commissioners do not often alter the agenda as set by the president-director or disapprove agenda items.

The Boards of Commissioners still play a limited role in the selection and dismissal of independent directors and the president-director and evaluating the president-director's performance and his/her remuneration. All these cases are still predominantly decided by the controlling shareholder.

Overall, the survey findings indicate that the meetings of the Board of Commissioners are generally a forum for serious discussion but that the BoC does not really have much influence on the company's management and policy. Companies have not yet provided a lot of supporting facilities, such as education and training, to enable to Commissioners to carry out their duties.

Future Tasks

The role of the BoC needs to be strengthened and its effective influence on the management and policy of the company needs to be brought in line with the responsibilities of the BoC.

One of the future tasks of the BoC is to implement a fair and transparent performance measurement and remuneration systems for the BoD which has mostly not yet been carried out.

Other most important task is to clearly define the meaning of the independency of the Independent Commissioner and its legal status, because the JSX regulation does not give any indication for the placement of Independent Commissioners in the BoC. The Company Law stipulates that BoC is by nature an independent body, and thus the so-called independent commissioner would seem to be unnecessary. But in practice, the independency of the BoC is hardly achieved, and thus it needs the implanting of an outside/independent commissioner(s) to by forcibly improve its independency.

Companies should also consider bringing their BoC in line with ideal size of BoC composition. ADBI suggested that the ideal size of BoC consist of 10 commissioners. Education or training for commissioners to improve their capabilities and knowledge especially on their responsibilities and liabilities under the law should be also encouraged.

As part of efforts to force companies to implement Corporate Governance, it should be taken also into consideration to making mandatory all non-mandatory committees, under BoC beside Audit Committee, most notably the Nomination Committee, Remuneration Committee and Insurance Committee.

4. The Role of Other Stakeholders in Corporate Governance

A. Regulatory and Other Environment for Banks

Pre- Crisis

The Asian financial crisis in 1997 has highlighted the weaknesses of the domestic banking system and hence underlying corporate governance. In Indonesia, a weak supervision from Central Bank and violations on banking regulation has become major corporate governance problems in banking sector.

A number of aspects have contributed to the vulnerability of Indonesian banking sector such as ownership concentration of banks on several business groups²⁰, political intervention to state banks (national private banks as well in some cases) in directing loan to certain business groups without proper assessment, and special facility provided by the government for a number of business groups in supporting their business activities.²¹

At that time many business groups were able to take up huge loans from state banks and private banks as well as offshore loans, apparently without limit and proper evaluation. Regrettably, these activities were not well monitored by Central Bank even though the amounts had already breached legal lending limit requirements. As a result, huge amounts of bad loans occurred within internal group companies.

During the crisis

In 1997 even though banking crisis in Indonesia did not directly caused by the exchange rate turmoil, however the depreciation of the IDR certainly creates less confident from the public to the banks, which made them rush to draw money to be placed in foreign currencies in overseas banks.²² For major banks, their aggressive expansion and imprudent lending policy has led to illiquidity and insolvency due to credit defaults.

This condition has forced the government to protect Indonesian banking sector through depositors protection program and the injection of Central Bank liquidity loans to banking sector. The depositors protection program and injection of emergency loan from Central Bank were intended to restore public confidence on Indonesian banks. However, weak supervision from Central Bank on the utilization of injected loans has invited many critics due to the possibility that these loans can be used by banks owner to finance their affiliated companies.²³

²⁰ See Table 12.

²¹ Soebowo Musa and I Putu Ary Suta, *Membedah Krisis Perbankan: Anatomi Krisis dan Penyehatan Perbankan*, Yayasan Sad Satria Bakti, Jakarta, Indonesia, p.205-208

²² Dr. Wimboh Santoso, *Indonesia's Financial and Corporate Sector Reform*, Banking Research and Regulation Directorate, Bank Indonesia, Jakarta, p.26-27

²³ Although the injection of Central Bank liquidity loans was extended to many Indonesian banks, however most of these loans were concentrated on a number of major banks such as BCA, Bank Danamon, Bank Exim, BUN, and BDNI

**Table 12. Ten Major National Private Banks per 31 December 1996
(Assets in trillion rupiahs)**

Banks	Total Asset	Owner	Core Business
BCA	35,3	Salim Family (Salim Group)	Cement, Automotive, Food
Bank Danamon	21,9	Usman Admadjaja Family (Danamon Group)	Property, Bank
BII	16,7	Eka Tjipta Widjaja Family (Sinar Mas Group)	Paper, Food
BDNI	16,5	Sjamsul Nursalim Family (Gajah Tunggal Group)	Property, Finance, and Tire
Lippobank	10,2	Mochtar Riyadi Family (Lippo Group)	Finance, Property
Bank Bali	7,6	Bali Financial Business Group	Finance
Bank Niaga	7,3	Tirtamas Group	Cement, Finance
BUN	7,1	Bob Hasan/Ongko Group	Agrobusiness and property
Panin Bank	5,4	Mu'min Ali Gunawan	Property and Finance
Bank Duta	5,2	Bob Hasan/Sigit H Soeharto (Berdikari Group)	Agrobusiness and Plywood

Source: Lehman Brothers, Castle Group and Bank Indonesia
Note: 1 US\$ = Rp. 2,400

The closure of sixteen banks in November 1997 dramatically accelerated the unfolding economic and political crisis. The efforts of the Indonesian government to restructure the banking sector that had grown out of control in terms of lending policy and capital adequacy have been a key element in its reform policy. Banks were re-capitalized, at a huge cost to the government, merged or closed.

Post-Crisis

In an effort to address the country's financial crisis, the Government of Indonesia has created two institutions to help restructure the banking sector as well as individual companies to restructure their corporate debt. The Indonesian Bank Restructuring Agency (IBRA) was established by the government to oversee the bank restructuring process, while the Jakarta Initiative Task Force (JITF) was formed to mediate between corporate debtors and their creditors particularly those involving foreign lenders.

In January 1998, the Indonesian government established a special agency to assist the banking restructuring program. This agency was formed under Presidential decree No. 27 year 1998 on the Establishment of Indonesian Bank Restructuring Agency (IBRA). The main role of IBRA is focusing on restoring national banking sector and assuring the return of state fund that was previously extended to the banking sector through the injection of Central Bank liquidity loan program.

In April 1998, there were 54 banks under the control of IBRA, which comprised of four state banks, 11 regional development banks and 39 national private banks, with criterion either their emergency fund received from Central Bank amount to more than 200% of the capital

base or the risk based capital adequacy ratio (CAR) is less than 5%.²⁴ Under this scheme, IBRA is replacing Central Bank position as the creditor of these banks. In some cases, IBRA also converting these debts into ownership shares (Bank Take Over).

At the end of re-capitalization program, it is expected that the government shares in those banks will be divested to interested parties. To date, IBRA has sold government shares in a number of re-capitalization banks such as BCA, Bank Bukopin, Bank Danamon and Bank Niaga as an effort to return state funds.²⁵ Beside re-capitalization program, the government has decided to consolidate and merge a number of state banks as well as private banks. Four state banks were consolidated into a new bank with the name Bank Mandiri²⁶ whilst nine private banks were also consolidated into one with Bank Danamon as the surviving bank.²⁷ Additionally, the merger waves were concluded with the merger of five private banks to form a new bank with the name Bank Permata.²⁸

Recently, the Indonesian government has decided to terminate IBRA operation in 27 February 2004. The government will then establish Deposit Guarantor Agency, a new institution that will handle only small remaining assets left from IBRA. The closing down of IBRA can be considered as a conclusion of series of Indonesian hard effort programs to overcome the financial crisis that was hit Indonesia in 1997. Previously, in 2003 settlement of corporate debt restructuring through JITF mechanism has been also completed.

Since 1998 to date, there are a number of regulations related to banking sector reform policy have been enacted by the Indonesian government. These laws included a new Banking Law (Law No. 10 year 1998) as the amendment of Banking Law No. 7 year 1992 and a new Central Bank Law (Law No. 23 year 1999) as the amendment of the previous Law on Central Bank (Law No. 13 year 1968), the Law on Foreign Exchange Traffic and Exchange Rate System (Law No. 24 year 1999).

In promoting Good Corporate Governance practices, Bank Indonesia has introduced a number of rules, among others pertaining to the following attempts:²⁹

1. To enhance the competence and integrity of the bankers through the implementation of fit and proper test upon the bank's shareholders and management
2. To hold up the consistency of law enforcement through the institution of Banking Investigation Special Unit, which is proposed to evidently discover the violations against banking rules in order to identify the root of the problem and coerce prompt repressive actions.
3. To require the bank to appoint a Compliance Director, holding the responsibility to ensure the bank's compliance with the existing regulations.

With regard to improve the performance of banking supervision, Bank Indonesia has also focusing its exertion toward these following aspects:

1. Harmonization of bank supervision organization, particularly the structure and responsibility.
2. Improvement on the management of bank supervision, including but not limited to the rise of supervision efficiency and transparency, enhancement of supervisor competence, accountability and recognition, as well as reward and enforcement.

²⁴ Op.cit. p.26

²⁵ See Table 14.

²⁶ The consolidated banks consist of Bank Bumi Daya, Bank Exim, Bank Bapindo, and Bank Dagang Negara

²⁷ The consolidated banks consist of Bank Danamon, Bank PDFCI, Bank Tiara, Bank Tamara, Bank Duta, Bank Nusa Nasional, Bank Pos, and Bank RSI

²⁸ The consolidated banks consist of Bank Bali, Bank Prima Express, Bank Universal, Bank Artha Media and Bank Patriot

²⁹ Santoso., Op.,cit. page 41

3. Employment of risk based supervision
4. Rectification of prudential regulations with emphasis on risk control.

Table 13. Ownership Structure of Indonesian Major Banks per 31 December 2003

Banks	Ownership (%)
PT. Bank Mandiri, Tbk	Indonesian Government (80.00)
PT, BNI, Tbk	Indonesian Government (99.11)
PT. Bank Danamon, Tbk	Asia Financial (Indonesia) Pte (61.88), Indonesian Government (24.46).
PT. Bank Niaga, Tbk	Commerce Asset Holding Berhad (51), Indonesian Government (45,1).
PT. Bank Panin, Tbk	Panin Life Tbk (41.98), Voltrain PTY LTD (11.16), Crystal Chain Holding (8.99), Omnicourt group (8.85)
PT. Bank Central Asia, Tbk	UOB Bank Singapore (19.17), Farindo Consortium (17.96), CSFB Singapore (11.53), Indonesian Government (6.55)
PT. Bank Lippo, Tbk	Indonesian Government (54,75), PT. Lippo E-Net (8.57)
PT. Bank Permata, Tbk	Indonesian Government (97.17)

Source: Jakarta Stock Exchange

In addition to banking supervision, at the moment the House of Representative is currently drafting the new law on Financial Services Authority (FSA Law). The FSA is expected to substitute the role of Central Bank with regard to banking supervision. According to current draft of this law, the banking supervision department, which currently under Central Bank, will be removed to FSA, Central Bank will only focus on monetary issues. In spite of handling the supervision issues, FSA will also replace BAPEPAM and Financial Services traffic Department under Minister of Finance. This will make all financial services related functions to be consolidated into a single roof body. However, the draft of this law still receives many challenges including from the Central Bank.

In summary after the crisis, corporate governance in Indonesian banking sector is improving. Banks are now more carefully in screening loan applications and closely monitoring the performance of their debtors. The role of banks as stakeholders in ensuring proper corporate governance of their debts has strengthened because of:

- Tighter regulations from the government and Central Bank on banking supervision and corporate governance. Central Bank has also ordered banks to strictly implement risk assessment method in their credit selection process.
- The government policy to disintegrate banks out of their former owners (which previously belong to the conglomerates) and more arm's length relationship with clients. As part of debt restructuring program under IBRA facility, the ownership of banks are transferred to the government.
- The elimination of political pressure of banks to extend loans to certain companies. Such activities are no longer occurred due to the reform era. Additionally, the financial crisis in 1997 has become lesson to learn for Indonesian bank not to extend loans without proper assessment.

Along with the initiatives above, the national committee on corporate governance (NCCAG) has issued a specific code on Corporate Governance for Banking Sector. Such code is meant to be a complimentary to all existing initiatives toward better corporate governance practices in the banking sector. Such code provides a reference for banking sector that would like to apply corporate governance practices up to the international or better practices standard, not only compliance with the existing law and regulations

B. Status of Labor Unions and Employees

One area in which the political changes have had the most important impact, is the area of industrial relations. Indonesia had already ratified all eight ILO convention on workers’ rights.

The rapid development and growth of national federations of trade union began in 1998, the year of ratification of ILO Convention No. 87 of 1948. This illustrates that workers are able to fully utilize their right to organize. In 1998 there were only 11 federations, but their number has increased dramatically in each of the following year.

Table 14. Number of Trade Union in Indonesia

Year	Number of Trade Union Federation	Number of Trade Union at Plant Level
2000	36	11.464
2001	60	15.750
2002	66	15.750
2003*	74	16.347

* Period of January –October 2003
source: ILO

With the appointment of a former trade union leader as Minister of Labor, the Ministry has issued a number of regulations and implemented a policy that has very much strengthened the position of trade unions. This has resulted in a large proliferation of newly established trade unions.

Law No. 21 year 2000 concerning Worker Union/Labor Union has further facilitated the establishment of labor associations/unions.

After a period of many strikes, lock-outs and street violence in 2000 and 2001, the Minister of Labor has used his personal influence to reduce the labor unrest.

The number of strikes in workers involved has gone down in 2003 compare to the last three years.

Table 15. Number of Strikes in Workers Involved

Year	Number of Cases	Number of Workers
2000	273	126.045
2001	174	109.845
2002	220	97.325
2003*	134	56.464

* Period of January –October 2003
source: ILO

Nevertheless, the government's policy has much swung the balance of powers in industrial relations in favor of the employees and of trade unions. Companies have been forced to accept trade unions as equal negotiating parties.

A problem is the lack of expertise and experience of trade union leaders and other employee representatives, causing negotiation processes to be often erratic and unpredictable. Most Indonesian companies are still equally inexperienced in negotiating with employees' organizations on an equal basis.

The most recently issued labor legislation, *Law No. 13 year 2003 concerning Labor*, tends to be more balanced, and puts limits on the permitted actions by trade unions. The government has also limited the number of trade unions it recognizes, by imposing more requirements with regards to unions membership administrations.

The law obliges all companies employing 50 employees or more, to establish a 'bipartite co-operation institution', or workers' council. This Council, by law, shall function as communications and consultancy forum concerning manpower matters in the company. Further regulations on its establishment and composition still need to be formulated by the Minister of Labour at the time of writing of this paper.

The main challenge in labor relations will be for both employers and employees to reach a culture of consultations and trust, before resorting to legal or even disruptive actions. Employees and company trade unions have generally shown to be constructive in their approach. However, outside interference by political interest groups in the intra-company negotiation process has occasionally created disruptions.

As the effects of labor relations on a company are perceived to be much more direct than the effects of shareholders and banks, the prospects of reaching mutually satisfactory labor relations during the next five years are better than those for a significantly improved corporate governance.

C. Description of Survey Results

Banks as Stakeholders

According to the survey, most of respondents (44 respondents) state that the ownership & control structure of their biggest creditor bank either consist of foreign banks or banks which belong to a different business group. Only a few respondents (3 companies) stated that their biggest creditors bank belong to the same group. At this point, the researchers believe that the involvement of these banks should be able to create a significant impact toward good corporate governance practices.

Practically all respondents who consist of Independent Commissioners and Executive directors state that after the crisis many banks screen loan applications more carefully and monitor firms more closely since the Asian crisis. This can be understood since a weak monitoring and supervising system were among the main cause of Asia crisis especially in Indonesia. Almost all respondents also state that the banks now play a more active role in corporate restructuring and that their company is 'very much' interested in having a more stable long-term relationship with their creditor bank(s) for advice on business and financial strategies, better credit access and avoiding liquidity shortages and premature liquidation.

More than half of the respondents however also indicated that their company had reduced its dependence on bank loans. Inadequate expertise of bank officers to meet corporate demands for diverse financial services was another factor that made companies reluctant to develop more close relationships with their banks. Other factors that respondents indicate as hampering closer relationships with their banks are reluctance to reveal sensitive corporate information, the concern of being stuck to a bank and the possible negative impact of a bank's own distress. With regard to creditor banks that hold equity shares of the company surveyed, the respondents generally believed that the shareholding strengthens the bank's monitoring incentives and reduces the chances of premature liquidation. Respondents differ however on the question of whether such shareholdings by banks will reduce the conflict of interest with other shareholders, or whether the banks will exert a stronger influence on the investment decisions by the banks.

In companies where banks are represented on the BoC of the firm, the respondents believe that this will lead to better monitoring and more favourable terms of financing. A minority of the respondents, especially the independent commissioners, however also believe that the bank's influence over the firm will disadvantage other stakeholders.

In summary therefore, in the view of the respondents, banks have assumed a more professional relationship with their debtor firms and have intensified the monitoring of their loans and the firm's performance. At the same time though, there are signs that banks are re-developing a closer relationship with debtor firms through being represented at the firms' BoC. The survey results indicate some of the potential risks inherent in this development, such as more favourable access to financing and disadvantage to other stakeholders. International literature points at the risks of this representation of partial interests in the BoC. The most commonly accepted view is that it is the BoC's task to look after the interests of all stakeholders as a whole, and not to consist of representatives of partial interests. Moreover, if banks are represented on the BoC, there is a risk that the BoD will not reveal all necessary financial information to the BoC.³⁰

Employees as Stakeholders

The employee structure (total number of employees and the change therein during the past three years, the share of managerial/supervisory employees, the share of employees working for more than 10 years at the firm and share of employees with college or university education) is not very much different from that of the other surveyed countries. Also in the frequency of employment practices such as the use of self-directed teams and problem-solving groups or quality circles and job rotation) the Indonesian companies are comparable to their counterparts in Thailand and Republic of Korea. Most (on average more than 75%) of the companies surveyed apply these practices.

Like in the other countries surveyed, employee stock ownership plans and stock option plans, are much less common in Indonesia. Less than 20% of the Indonesian companies surveyed have such plans. Profit sharing or performance based incentives are however more

³⁰ Drs. S.C. Peijl, et., al. *Handboek Corporate Governance*, Kluwer bv, Deventer, The Netherlands, 2002. p. 71-75

common, with around two-thirds of the companies applying such incentives in their remuneration system.

Thus, most companies in Indonesia apply modern employment and human resource development techniques, but still few have schemes to encourage stock-ownership by their employees.

73% of the companies have a joint labour management committee (JLMC), most of them for already more than 10 years. Under the labour law introduced in 2003, and the implementing regulations, the remaining 27% (which have more than 50 employees) must also establish a JLMC. The issues discussed tend to relate only to direct employment matters, remuneration and working conditions. Business strategy, sales or production plans are much less discussed in the JLMC.

Labour unions are becoming increasingly common, with 80~~75~~75% of the respondent companies now having a labour union. The respondents also tend to agree that labour unions have become more powerful since the start of the crisis, with just over half of the respondents that have labour unions agreeing with this statement. 29~~27~~27% is neutral on this statement and 20~~24~~24% does not think that labour unions have become more powerful. When it comes to increased participation of employees in corporate decision making, this is generally less the case. Only 35~~34~~34% of the respondents state that employee participation in corporate decision-making has increased. 45% state that employee participation in corporate decision-making has not increased, the rest of the respondents being neutral on this question. Also on the expectations of increased employee participation, a slight majority tends to think that employee participation will not increase.

Most respondents expect only a limited influence of each of the various factors that could lead to increased employee participation, i.e. democratic reform in the country and the growth of an educated middle class, the weakening family control in the wake of the Asian crisis, the increased importance of human capital and empowerment of core employees, and the growing role of employees in shopfloor decision making or share-ownership. All this points to the fact that companies accept that labour is becoming more important and influential because of political and society developments. At the same time though, companies give still little indication that they regard labour as an increasingly important and strategic resource, let alone as a possible new partner in new forms of governance. Most companies (more than 70%) do however expect that the stronger labour voice will reduce abusive behaviour of the controlling owners of the companies and better observation of workplace related laws. Most surveyed directors and independent commissioners however regard independent commissioners and minority shareholders as a more important factor to control abuse by controlling owners, than labour. Expectations on the effects on company performance are ambiguous. Most respondent companies (around 70%) expect a higher productivity and better performance due to improved information flow, decisions and enforcement, but also expect that the interests of labour will be better serviced at the expense of shareholders. This result could be interpreted in that companies expect additional benefits from better company performance to fall mainly to employees. Opinions are divided over the question whether these activities will make labour too strong and lead to loss of experienced labour. The overall impression from the replies of the respondents is that companies are still unfamiliar and slightly uncomfortable in dealing with the increased power of labour.

D. Prospects for the Role of Banks and Employees and Alternative Corporate Governance Models

As a result of Indonesia's currently shifting balances between government, society, employers, employees, and national and regional governments, new forms of governance are emerging. Generally, employees, local communities and regional governments are winning more power. Companies and the national government are paying more and more attention to involving these groups in giving accountability. A very striking example is the long successful resistance of the provincial government of West-Sumatra, backed by employees and other community members, against the take-over of Semen Padang by Mexican cement producer CeMex. Semen Padang had agreed with the Indonesian government to ultimately buy a majority stake in Semen Padang, but the Indonesian government was unable to overcome the local resistance against the agreement.

The democratic election system and a general fear of mass demonstrations and violence, have made legislators and government officials pay much more heed to popular moods.

These developments have an impact on the functioning of banks and employees as actors in corporate governance. Employment, community services and local ownership have become more important assessment criteria, compared to financial performance and accountability. As international corporate and project financing in Indonesia are still at a low level, the relative importance of local development banks has grown. These banks often also apply local cultural and even religious standards in their financing policy. Local governments, communities and religious groups play an important role in the policy of these banks.

Private companies are still somewhat uncomfortable with the increased power that recent laws and regulations issued by the Ministry of Labour have given to employees and trade unions. Companies generally expect a better compliance with labour regulations, but also expect any increased firm performance as a result of improved international communication and broader involvement in the companies' decision making process not to benefit the shareholders. Companies do not yet regard labour as a strategic resource and even less as a new partner in new governance models. This not entirely surprising, given the often low level of education of the many unskilled workers in many companies. Large parts of the population in general, including employees, are still easily influenced by rather extreme political ideas. Indonesia, at the start of its democratization process, has a large number of political organizations and parties across a wide political spectrum ranging from communist to fundamentalist religious groups. Some of those groups have rather far-reaching views on the role of companies in an economy and a society. Companies are understandably reluctant to yield too much influence to these groups in the company's management. A number of companies is therefore providing trainings to the representatives of labour in the workers' councils.

After initial problems between 1999 and 2001, labour relations in Indonesia currently look more constructive. Most companies that observe the labour laws are finding workers' councils to be co-operative. Workers' councils and workers tend to understand the joint responsibility of labour and management in the continuity of the company and have so far not proven to be susceptible to the more extreme ideas of far-left or far-right political groups. Consultations, consensus and joint problem solving fit better into the Indonesian culture than polarized opinions and conflict. Prospects for a constructive dialogue between labour and management on labour-related issues in Indonesia are therefore good. A more far-reaching involvement of labour in strategic company issues is however unlikely, as entrepreneurs want to retain their entrepreneurial freedom and flexibility. The Indonesian, especially the very important Chinese-Indonesian business culture, is characterized by fast top-down decision-making and often short-term orientation in pursuing business opportunities. Commitment to

particular sectors and using human resources, knowledge and training as anything more than footloose means of production, generally does not fit well in this business culture.

On a local and regional level however, local governments and local community based organizations may be expected to experiment with new corporate models in order to stimulate business activities and employment as investment by private companies remains limited due to perceived political uncertainties or a poor investment climate. In these regions, co-operatives are expected to become more important. Also partnerships of local government institutions with community groups are expected to emerge. Examples are found in West-Sumatra and South Sulawesi. These corporate models have a very different balance between management, employees, capital and government. Joint ownership by government and employees, and local government financing becomes more important. Time will have to tell whether these alternative governance models turn out to be viable. Sound investment decisions, professional business management and a non-corrupt government will remain prerequisites for success.

5. Analysis of the Relationship between Corporate Governance Practices and Firm Performance

The researchers in Indonesia believe that more researches need to be done with extended and deeper variables. At this moment, it is very difficult to seek a clear link between a company's corporate governance practices and its efficiency and overall corporate performance. There are still many other interfering factors or variables especially political instability that influence Indonesia's financial and capital market hence the stock market value of companies might not be a reflection of company's performance. This opinion is supported by the findings that there is very little evidence of a relationship between corporate governance and companies' performance and long term survival, a fact that is opposed our expectation.

A. Measures of Firm Performance and the Quality of Corporate Governance

One overall measure for Firm Performance is Tobin's q. Tobin's q is the ratio between the book value of a company's net assets, and the total value of the company's stock as listed on the stock exchange. This indicates the expectations that investors have for the profitability of the company in relation to the value of its assets, which is widely used as a good proxy for a company's overall financial performance.

Another indicator that is used to measure a firm's overall performance, is its return on assets (ROA). This indicates the profit that a company is making relative to the value of its assets. It differs from Tobin's q in that it does not incorporate the expected future earnings, which are reflected in the company's stock price.

The measures of the quality of corporate governance in Indonesia consist of four elements:

- shareholders' rights;
- effectiveness of the Board of Commissioners;
- the opinion of executive directors;
- the opinion of one of the independent commissioners.

Taken altogether, the total corporate governance score of Indonesia compares not unfavourably with that of the other surveyed countries. The score is slightly lower than the score of Thailand, but much higher than that of Republic of Korea.

On shareholders rights, Indonesia had a score of 66.2, out of a total maximum score of 100. This score is relatively much better than its score for board effectiveness, which were 38.8

out of a maximum score of 100. This should not be surprising as the replies contain a large judgmental element whereby corporate secretaries are asked to comment on the rights of shareholders. Corporate secretaries may be inclined to state that shareholders have adequate rights, especially when looking at their rights on paper (in the Company and Capital Market Law). It would have been very enlightening to also have the views of the shareholders as to their perception of the influence they can practically exercise. The fact, for instance, that voting by mail is not allowed and that shareholders are often located in locations far from the location of the GMoS, probably leads them to not attending the shareholders' meetings. In most GMoS, less than 25 shareholders actually showed up.

B. Analysis: Association between Corporate Governance and Performance; determinants of Governance Quality

The correlation coefficients between firm performance variables (Tobin's q and ROA) and the corporate governance scores (overall corporate governance score, shareholders' rights, and board effectiveness) in Indonesia are all positive, which indicates a positive relationship between firm performance and corporate governance. This is also illustrated in the grouping of the firms by overall their corporate governance score, which shows a positive relationship with Tobin's q. In comparison to the other countries surveyed, the impact of the corporate governance score on Tobin's q is relatively large in Indonesia, and even significantly larger than in the other countries surveyed.

The relationship between board effectiveness and Tobin's q appears to be stronger than that between shareholders rights and Tobin's q. Indonesia's score on shareholder's rights is however better than on board effectiveness. This suggests that emphasis should be put on board effectiveness in further improving corporate performance.

Firms with diffuse ownership (without controlling owners) have a marginally better corporate governance than firms controlled by a single domestic owner or a limited number of controlling owners. There is hardly a difference in the corporate governance score between stand-alone companies and companies that are part of a larger group. Also, the difference in corporate governance score between firms substantially held by foreigners and those mainly held by Indonesians is marginal. The corporate governance score in companies with the president-director being a professional manager is somewhat higher than in companies where the president-director is a member of the controlling family.

By industry, the highest overall corporate governance scores on average are found in the transportation and the iron and metal industries. The lowest scoring industry was the chemical industry.

As for the contribution of employee (non-managerial and non-supervisory) participation practices (EPP): self-directed teams, program-solving groups or quality circles, job rotation or cross training, employee stock ownership plans, stock option plans, and profit sharing or performance-based group incentive pay, EPP in Indonesia turns out to have a statistically significant impact on Tobin's q. This indicates that either these participation practices lead to better operational performance or the market evaluates these practices favorably.

C. Discussion of the Results

The results of the analysis between corporate governance and company performance indicate a relatively strong relationship between corporate governance and company performance in Indonesia, as compared to the other countries surveyed. Indonesia's weak law enforcement system may be a factor in explaining the relatively high value that investors attach to good corporate governance in Indonesian companies.

Participation of employees is also valued highly, which may be due to the perceived potentially troublesome relationship between employees and employers in the newly democratic Indonesia. Such participation is still in its infancy in Indonesia, and the survey results indicate that companies should put much emphasis on improving the participation.

Shareholders' rights in Indonesia are better developed than effectiveness of the board of commissioners. There may be a methodological bias, but it also underlines the general experience that Indonesia is quick with 'paper' reforms but slow with actual change. The relationship between board effectiveness and Tobin's q appears to be stronger than that between shareholders rights and Tobin's q. This suggests that emphasis should be put on board effectiveness in further improving corporate performance.

The very small differences in corporate governance scores for various types of companies (firms with diffuse ownership versus firms controlled by a single domestic owner or a limited number of controlling owners, stand-alone companies versus companies that are part of a larger group and even firms substantially held by foreigners versus firms mainly held by Indonesians) is actually very surprising. The corporate governance score in companies with the president-director being a professional manager is somewhat higher than in companies where the president-director is a member of the controlling family, but even here the difference is not as big as theory would suggest. Companies controlled by one or a few shareholders, and/or managed by a relative of the shareholder(s) appear to be no less aware of the importance of corporate governance than diffusely owned companies.

The researchers in Indonesia believe that more research needs to be done to provide further evidence of the link between a company's corporate governance and its efficiency and overall corporate performance. At the moment, many other factors, such as the still relatively high volatility of Indonesia's financial markets caused by its still relatively high perceived political instability, seem to influence the stock market value of companies.

6. Conclusion: Policy Implication for the Future Direction of Corporate Governance and Other Complementary Reforms

Indonesia has elaborated laws and regulations to regulate the different aspects of Corporate Governance. The researchers have not come across major deficiencies in these laws and regulations. Company Law and Capital Market Law are the main legal references for Indonesian companies with respect to Corporate Governance aspects. For publicly listed companies in particular, BAPEPAM and JSX rules are also playing an important role in implementing prudent Corporate Governance. The Code, which was issued by the NCCG in 2001, has also become an important guideline for many Indonesian companies and can be considered as a major milestone in the development of Corporate Governance in Indonesia. In addition to those rules and directives for publicly listed companies, the Indonesian government through Minister of State-Owned Enterprises (MSOEs) has also issued numerous rules and regulations to strengthen Corporate Governance of state-owned enterprises (SOEs). The recent SOE Law No. 23/2003 adopted Corporate Governance principles and directives as set out in the Code. Hence, it should be noted that the improvements on the laws and regulations supporting Corporate Governance practices still necessary to be done due to the rapid development in the Corporate Governance area.

However, from the survey findings we point out our policy recommendations, which would focus on two areas consisting of:

Shareholders' role in Corporate Governance

Policy implications of these findings of the limitation of the effectiveness of shareholders' rights could be to encourage more active dissemination of corporate governance information

beyond the legal minimum. Whilst this may not always appear to be in the direct interest of the majority shareholder, it is expected to improve the monitoring of the firm's performance and therefore its value to all shareholders.

Current regulations on shareholders' rights are adequate, however some modifications on the GMoS provisions should be taken into consideration such as to make it compulsory for company to hold an extraordinary GmoS in case of a bad financial situation. Additionally, more could be done to inform shareholders about their rights. This could be a task for the JSX. If corporate governance is to improve, the attitude of companies towards their shareholders (and vice versa) needs to change to shareholders being stakeholders and not only providers of capital.

The survey findings also indicate that the majority of respondent companies do not include the voting by mail system as an instrument of shareholders participation. Only a small number of respondent companies have incorporated this system into their AoA. Voting by mail is an example of an alternative solution to encourage shareholders participation. This system is very relevant to a country like Indonesia where shareholders of a company are often geographically widely dispersed. Voting by mail is not regulated in the law, which implies it is allowed. Notaries should be informed about this, and major shareholders should be encouraged to specifically allow it in the articles of association.

It has been noted though, that shareholders, board members and even notaries are not fully informed about these laws and regulations. Notaries, for instance, often prefer to work with standard articles of association. Major shareholders are not always interested to actively disseminate all laws and regulations on shareholders rights and board effectiveness. Therefore, active dissemination on information on the laws and regulations to all relevant parties, remains an important issue.

Another important finding of this survey is regarding the implementation of the cumulative voting rights system. The survey indicates that although the majority of respondent companies have recognized a cumulative voting rights system, regrettably this system is rarely used in practice. Therefore, companies should be encouraged to use cumulative voting system in their decision making process as part of shareholders control mechanism.

The survey also shown that only a few respondent companies have their own website. The absence of a website has caused difficulties particularly for shareholders in an attempt to search for information related to the company. Companies should provide adequate information including their corporate governance condition. The website should become one of the important tools in disseminating corporate information to the shareholders.

Effectiveness of the Board of Directors and Commissioners

The survey findings indicate that good progress has been made in establishing audit committees and Independent Commissioners in a relatively short time. To date, almost all listed companies have Independent Commissioners and Audit Committees. Even though this progress is boosted by JSX rule on Independent Commissioners and Audit Committees, still it has shown little concern from Indonesian companies toward corporate governance practices. Sanctions and penalties for companies that violate the JSX rule on Independent Commissioners and Audit Committees should be also more specific since current regulation does not clearly state the sanction for violators. Hence, it should be taken also into consideration to making mandatory all non-mandatory committees, under BoC, most notably the Nomination Committee, Remuneration Committee and Insurance Committee.

The requirement to set up Independent Commissioner and Audit Committee is regulated in the JSX Rules. This means only companies that are listed in the JSX have to comply with such requirement. Companies that are listed in other stock exchange (Surabaya Stock

Exchanges) are not required to set up Independent Commissioner and Audit Committee. Additionally, BAPEPAM sets this requirement as recommendation since it is put in one of BAPEPAM's Circular Letters. To make this requirement nationally enacted for and adhered to by all publicly listed companies, it is suggested this requirement has to be set out in the law. The revision of Capital Market Law has to address this issue accordingly.

Overall, the survey findings indicate that Companies have not yet provided a lot of supporting facilities, such as education and training, to enable to Commissioners to carry out their duties. Therefore, companies should be encouraged to train their commissioners particularly on their responsibilities and liabilities under the law

One of the future tasks of the BoC is to implement a fair and transparent performance measurement and remuneration systems for the BoD which has not been carried out.

Another most important task is to more clearly define the meaning of the independency of the Independent Commissioner and its legal status, because the JSX rules do not give any indication for the placement of Independent Commissioners in the BoC. The Company Law stipulates that BoC is by nature an independent body, and thus the so-called independent commissioner would seem to be unnecessary. But in practice, the independency of the BoC is hardly achieved, and thus it needs the implanting of an outside/independent commissioner(s) to forcibly improve its independency.

A specific issue is the education of local and regional governments, who have received more powers in the wake of the regional autonomy. Their knowledge on the importance of corporate governance in a region's investment climate is often limited and their horizon for decision-making often politically determined. Local and regional governments are actively involved in the setting up of public-private-community-owned companies. Active dissemination on the importance of corporate governance principles in regional economies is therefore also very important. Local economic regulations must not be allowed to deviate from nationally implemented laws and regulations.

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