A CHALLENGE IN IMPLEMENTING GOOD CORPORATE GOVERNANCE IN FAMILY-CONTROLLED LISTED COMPANIES IN INDONESIA

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ABSTRACT

Good Corporate Governance (GCG) is one key element in improving economic efficiency and growth as well as enhancing investors' confidence. Corporate Governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. The development of GCG in Indonesia and in the Asian countries in general became increasingly important especially after the 1997 Asian Crisis. Countries with relatively poor corporate governance such as Indonesia, Thailand, Malaysia and South Korea, in fact experienced more severe impact compared with countries with a better corporate governance standard such as Singapore and Hong Kong.The experts believe, that those crisis has been amplified due to the unsatisfactory performance of the Board of Commissioners in controlling and stewarding the shareholders' interest, especially that of minority's. It is a given fact that majority of companies in Indonesia (listed or not) own concentrated ownership feature. Hence, in orther to implement of the GCG principales in Indonesian's companies, It is unrealistic to suggest that the companies must be transformed to become dispersed ownership enterprises.

Regarding to this facts, the purpose of this study is to investigate if concentrated ownership affects the implementation of corporate governance in listed companies in Indonesia. The data are gathered based on a variety of publicly available information, such as annual report, Indonesian Security Exchange Commission (BAPEPAM) filing and Indonesia Stock Exchange filing. The analytical instrument used to measure the good corporate governance practice is named Corporate Governance Scorecard, promulgated by OECD.

The final objective of this study is expexted to find out if the legislation and effective law enforcement can mitigate the negative effect of concentrated ownership on corporate governance practice.

***Keywords** : Good Corporate Governance, concentrated ownership, dispersed ownership, Corporate Governance Scorecard.*

1. INTRODUCTION

1.1 Background

This paper is part of research conducted by the author and his doctoral student, Johan Dharmawan. This paper will only describes a fraction of the research that is related to the results of score card measurement. The study itself was conducted to answer the question whether the practice of good corporate governance can only be done by a company whose shares are distributed. While we know that the majority of Indonesian company is a family company.

As we know that the development of good corporate governance in Indonesia and in the Asian countries in general became increasingly important especially after the 1997 Asian Crisis. In Indonesia, the free fall of Indonesian currency Rupiah (Rp) from Rp. 2.500,-/ USD to Rp. 9.300,-/ USD has trapped most of the big corporation into an insolvency condition. Many experts believes that the poor corporate governance practice in the region is the main culprit that caused the crisis (IICD, 2006; Nam & Nam, 2004; Tabalujan, 2002a; UN / ESCAP, 2001; ADB, 2000).

The crisis was further worsened by the fact that corporate governance is not well in placed in both the private and public corporations. The Vice Chairman of Indonesian Institute for Corporate Directorship IICD, Dr. Marcellino Pandin, highlighted that it had been a known fact for a long time that many Indonesian business leaders have seemingly put their own agenda, motives and profits above the professionalism and integrity (Pandin, 2002). They have undermined the trust given by the society and constituents and harmed the right of the society to have the benefit of a better quality of life. In some circumstances, former owners (entrepreneurs at times) continued to operate the company that has been floated as if it has not gone public. On occasion, owners undertook transactions that benefit themselves without the knowledge, let alone the consent of the investors (Wallace and Zinkin, 2005).

Countries with relatively poor corporate governance such as Indonesia, Thailand, Malaysia and South Korea, in fact experienced more severe impact compared with countries with a better corporate governance standard such as Singapore and Hong Kong (Tabalujan, 2002a).

The biggest challenge in implementing good corporate governance in Indonesia is the concentrated ownership characteristics, which is found in majority of Family Controlled Companies. Asian Development Bank (1999) revealed that the concentrated corporate ownership structure of Asian companies including Indonesia has given family based owners and their affiliated companies' excessive power to pursue their own interests to the detriment of minority shareholders, creditors and other stakeholders. It has also reduced the effectiveness of important mechanisms of shareholder protection such as the system of a Board of Directors, shareholder participation through voting and transparency and disclosure.

1.2 Problem Definition

Corporate governance is affected by the relationship among participants in the governance system. Controlling shareholders, which may be individuals, family holding or other corporation acting through a holding company or across shareholdings, can significantly influence corporate behavior.

As owners of equity, institutional investors are increasingly demanding a voice in corporate governance. In contrast to institutional investors, minority shareholders usually do not seek to exercise governance rights, but may be highly concerned about obtaining fair treatment from controlling shareholders and management (OECD, 1999)

It is a given fact that majority of listed companies in Indonesia own concentrated ownership feature. Asian Development Bank (1999) revealed that the concentrated corporate ownership structure of Asian companies including Indonesia has given family based owners and their affiliated companies' excessive power to pursue their own interests to the detriment of minority shareholders, creditors and other stakeholders. It has also reduced the effectiveness of important mechanisms of shareholder protection such as the system of a Board of Directors, shareholder participation through voting and transparency and disclosure.

The same findings are also voiced out by Morck, Shleifer and Vishny (1988); followed by Patrick (2001) and Nam and Nam (2004) that concentrated ownership has made the controlling shareholder powerful, which they no longer intend to maximize the profit of the company but rather pursuing their own objective.

The concentrated ownership has also been blamed creating adverse consequences in both microeconomics as well as macroeconomic level.

The research will try to map the effect of concentrated ownership on good corporate governance practices in Indonesia; particularly the effect on the right of minority shareholders and Responsibility of the Board.

The purpose of the study is to get a deeper understanding of how the concentrated ownership affects the practice and implementation of good corporate governance in Indonesian public-listed companies. Knowing of how to improve good corporate governance practice will hopefully helping the country to have economic recovery.

In detail, the objectives of the study will be as follows:

1. **To investigate if the concentrated ownership lead to inadequate protection for minority shareholders.** To get unbiased conclusion the study will select and segregate the concentrated ownership companies into 3 categories: Family controlled companies, Foreign owned companies and Banks. How the

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concentrated ownership affect the corporate governance behavior in each category will be examined.

2. **To investigate if the concentrated ownership will undermine the board performance in implementing the good corporate governance.** How the concentrated ownership affect the behavior of board will be examined in each category.
3. **To see if the adverse effect of concentrated ownership can be alleviated by the adequate regulations and their enforcement.** The methodology is to compare between the family controlled companies, which are proven to exhibit lower commitment on good corporate governance by previous studies, against the foreign owned companies, which are regulated and tightly controlled by parent company overseas and central bank, respectively.
4. **To find out if there are inherent company's characteristics in concentrated ownership firms, which can be exposed and promoted to foster the good corporate governance implementation.** It is a given fact that majority of the listed companies in Indonesia Stock Exchanges own concentrated ownership feature. Should the adverse consequence be proven by the research, it is still impossible or unrealistic to suggest the transformation of the listed companies from concentrated ownership company to become dispersed ownership company and hoping that later on the company will show a better good corporate governance practice. Therefore, a searching on positive characteristics or elements inside the concentrated ownership companies, which can foster the good corporate governance, is a better and sensible action.
5. **To find out if concentrated ownership companies can also enjoy the share premium.** Under what condition the share premium is given by the investors for the concentrated ownership companies.

This paper will describe only related to the first and second objective only.

2. THEORETICAL BACKGROUND

2.1 The Concept of Good Corporate Governance

The history of corporate governance in the Anglo-Saxon countries can be traced back to the 19th century, where the state corporation law in the US grants the rights for the corporate boards to govern a company without unanimous consent of the shareholders in exchange of statutory benefits. The role of corporate governance has become increasingly important over the time, especially with the recent events such as the collapse of Enron in the US, and HIH Insurance in Australia[1].

In response to the need of tougher corporate governance to mitigate further economic disasters, a number of regulations were introduced and revised, for example: the introduction of Sarbanes-Oxley in the US, the implementation of Basel II for the financial services / banking industry, and Solvency 2 that is applicable for companies operating in Europe.

Cadbury (2000) during the Global Corporate Governance Forum provided an overview of corporate governance concept that encompasses the economic stability and social equity as follow:

"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society" (Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000).

Furthermore, the OECD concept of corporate governance clearly states the functional roles of corporate governance in providing structure to the relationships of various stakeholders of a company.

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[1] The collapse of Enron and HIH Insurance are arguably caused by poor corporate governance practice (http://www.ccg.uts.edu.au/corporate_governance.htm)

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"Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring." (OECD, 1999).

A lot of today's efforts in socializing good corporate governance concept in Indonesia are centered in the form of education as they are deemed to be critical (Kurniawan & Indriantoro, 2000). Unfortunately, despite investments that have been made, the Indonesian corporate governance practice still arguably has a long way to be deemed as effective due to Indonesian systematic factors such as: Indonesian legal culture (Tabalujan, 2002a), the effect of family capitalism (Tabalujan, 2002b), the competition environment (Simanjuntak, 2001) and the legal framework (Simanjuntak, 2001; Husnan, 2001).

2.2 Corporate Governance and its Impact on Company's Market Values

In light of the importance of corporate governance, its concept and application have been discussed in a number of literatures. One of the notable ones includes a study by Shleifer and Vishny (1997) that discusses the role of corporate governance from the capital market point of view. They describe corporate governance as a system that deals with the ways in which supplier of finance to corporation assure themselves of getting a return on their investment (Shleifer & Vishny, 1997). Their concept demonstrates the significance of corporate governance in providing legal protection to ensure financiers getting the returns on their investment.

A number of studies have confirmed the importance of good corporate governance in relation to the company's performance. Good corporate governance should prevent the misappropriation of company's resources by the controlling shareholders and ensure better decision-making, which in turn will be reflected in higher stock price (Nam & Nam, 2004).

Coombes and Watson (2000) from McKinsey & Company show in their corporate governance survey that the institutional investors are willing to pay premium for companies with good corporate governance, especially in the Asian and Latin American countries. This happens because when the financial reporting standards are perceived to be poor in providing the necessary protection to the investors, good corporate governance becomes a crucial investment selection criterion. Two years later, another survey by McKinsey & Company (2002) re-affirms the above argument with the results that show 78% of investors in Asia are willing to pay 20% to 25% premium for companies with proven good corporate governance.

3. RESEARCH METHOD

3.1 Research Method

The objects of the study are listed companies in Indonesia Stock Exchange, which have the characteristics of concentrated ownership. A company has a concentrated ownership characteristic if its majority shares (over 51%) are held by controlling shareholder, who may be individual, family or other corporation acting through holding company or across shareholding. Presently, the population of listed companies are 329, of which the majority exhibit the characteristic of concentratedownership.

The study will use the corporate governance score card, developed by OECD, to measure the company's good corporate governance implementation. The instrument has a set of questions pertaining to each principle, which must be answered and scored.

The main hypothesis is : Does the concentrated ownership lead to inadequate protection for minority shareholders and undermine Responsibility of the Board?

The study is to find out whether the score of the right of the shareholder and Responsibility of the Board are not satisfactory.

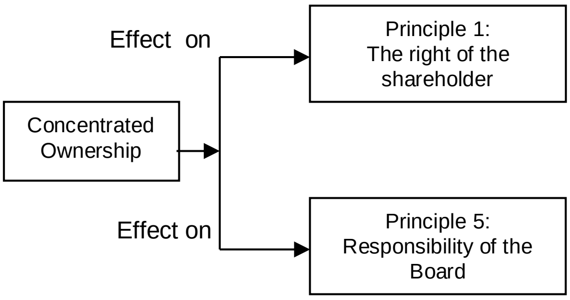

Figure 1: Effect of Concentrated Ownership on two OECD's Principles

3.2. Data Collection

The data collection was based on a wide variety of publicly available information, such as annual reports companies' website, Security Exchange Commission (BAPEPAM) fillings, Indonesia Stock Exchange fillings, meeting minutes and notes from corporate shareholder's meetings, company's press conference available sources

The total weighted score was used to evaluate the level of corporate governance of each individual company. To arrive at conclusion of how good a company implements the corporate governance, the research use a governance score card, developed by IOD Thailand, based on OECD 5 Principles of Good Corporate Governance. Each of the Corporate Governance Principle has its own set of questions. Thus, implementation of each principle can be scored quantitatively. Total questions involved are. Each question has scoring system as follows: Good = 3 points; Fair = 2 points; Poor = 1 point. For many cases, scoring system has only 2 types: good or poor.

The overall corporate governance score of each company is computed based upon the weighted average of the following:

- Principle 1: Right of the (minority) Shareholders = 20%
- Principle 2: Equitable Treatment of Shareholders = 15%
- Principle 3: Roles of Stakeholders = 15%
- Principle 4: Disclosure and Transparency = 25%
- Principle 5: Responsibility of the Board = 25%.

4. RESEARCH FINDINGS

The study applied the Corporate Governance score cards, developed by IDEA nets, based on OECD concept on 5 Principles of Corporate Governance. The result of applying this analytical tool was the portrait of corporate governance implementation in public listed companies in Indonesia.

The total score of Indonesian listed company is 64; which is below the good criteria of 70 points. It is expected to know that 2 lowest score are happened on Right of the Shareholders (Protection on minority shareholder) and Responsibility of the Boards. The Protection on minority shareholders received the lowest average score of 50.37%; while by the Responsibility of the Boards gets 59.02%.

Table 1. Score of 5 OECD Principles of Good Corporate Governance

Category	Score		
	Min	Max	Avg_
Overall	48.65%	88.85%	64.96%
Right of Shareholders	40.58%	76.81%	50.37%
Equitable Treatment of Shareholders	61.11%	94.44%	86.35%
Role of Stakeholders	33.33%	100.00%	63.64%
Disclosure and Transparency	48.96%	97.92%	70.81%
Responsibility of the Board	39.68%	94.44%	59.02%

Indicated by the poor score of The Right of the Shareholder, the study supports the argument that concentrated ownership indeed adversely affects the protection of the minority shareholder.

The lowest score of Protection on minority shareholders are caused by the ability of controlling shareholders to build up a strong fortress to protect their own interest often as the expense of minority shareholders. The study discovered that the concentrated ownership lead to inadequate protection for minority shareholders, based on the following findings:

- **Electing Board members and external auditor**

  The controlling shareholders failed to involve the minority shareholders in selecting and nominating the Board member, as well as external auditor.

- **Deciding Board's Remuneration**
  The Controlling Shareholders failed to involve the minority shareholders in deciding the Board's remuneration.
- **Justifying the Dividend**
  The study also revealed that the poor practice was also found in explaining the rationale of paying dividend.
- **Disclosure**
  It was also evidenced that there was no public record regarding the resolution of the issues and their voting results.
  Anti take over Mechanism
  Unlike in 'dispersed ownership structure', the concentrated ownership phenomena in Indonesia provide the management of the company some kind of protection against the market control mechanism. The management is protected behind the controlling shareholder, who has the absolute voting power.
- **Board's share-ownership**
  As Board members tend to be loyal to controlling shareholders, the Board' share-ownership is also considered as the device to increase controlling shareholders' control power, the higher the Board's share-ownership, the poorer the situation for minority's protection.

About the Responsibility of the Board, Its score ranked the second worst among five OECD's principle of good corporate governance. It was also far below the satisfactory level of 70%.

Table 2. The score of Board Responsibility

Measures	Score
Mean	59.0%
Minimum	39.7%
Maximum	94.4%

- **Conflict of Interest**
  The Board under review was considered failed in establishing the framework of good corporate governance in the companies due to their conflict of interest. OECD suggested that the chairman must be an independent commissioner in order to produce an objective independent judgment for the best interest of the firm. Majority of companies under surveyed; i.e.: 81% failed to meet this criterion.
- **Role of Board of Commissioner**
  The research found out that Board of Commissioners from 91% of the companies under review did not carry out their duty to make BOD performance assessment. Moreover, none of the company.
- **Board's competencies**
  Only 28% of the companies had clear written corporate governance policy and articulate it to the company's employers.

5. CONCLUSIONS AND FINAL REMARKS

5.1 Conclusions

The study has shown that concentrated ownership adversely affected the Good Corporate Governance practice in Family Controlled Companies in Indonesia Stock Exchange. Concentrated Ownership not only eroded the protection of minority shareholders, but also hindered the Board exercising their independent decision for the benefit of all shareholders, especially the minority's.

The score card analysis pointed out that the total score of applying 5 principles of OECD's Good Corporate Governance was 64%, which was lower than the minimum acceptable level of 70%. The lowest scores happened on 2 principles; namely: The Right of Minority Shareholders and the Responsibility of the Board, with the score of 50.37% and 59.02%, respectively.

Concentrated Ownership led to inadequate protection for minority shareholders. The weak protection of minority shareholders was derived from the fact that the controlling shareholders fail to give a fair chance to the minority to involve in electing the Board members, determining the individual Board's Remuneration, appointing and deciding the fees for external auditors, and justify the rationale and the amount of dividend payout. On top of that, the controlling shareholders exhibited the practice of pyramidal holding and crossholding to increase their voting power in controlling the company. In deciding any strategic decision, the controlling shareholder could everytime achieve their intention by exercising their

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voting right. On top of that, Equity ownership owned by Board member was also used to safeguard the power of the controlling shareholder. The thin market, which caused the absence of the market control mechanism (such as take over) has also shielded the controlling shareholders in exercising their will.
Concentrated Ownership undermines the Responsibility of the Board. The poor performance of the Board in exercising their fiduciary duty, especially in protecting the Right of Minority shareholders was due simply to their lack of independence in making decision and judgment. The controlling shareholder influenced the Board by ways of the following:

1. The controlling shareholder normally held the position of chairman of the Board of Commissioner. The other family member may also sat at the President Director position. The study revealed that the FCC, whose chairman was not the member of the family, could attain a better corporate governance scores. It also unveiled that fact that FCC, whose independent commissioners were more than 25% of the total Board of Commissioners, could also obtained a higher score.
2. Deciding individual Board member compensation was still done by the Controlling Shareholder. Annual General Shareholder Meeting decided the total amount of compensation. Even the total amount of compensation was actually planned and decided by Controlling Shareholder. It was natural that Controlling Shareholders could influence the other Board members through this privilege. Promoting or even requiring the listed company to have independent remuneration committee would bring the Board be more impartial in protecting the minority shareholder.
3. Board member appointment was still the privilege of the Controlling Shareholder. The Controlling Shareholder chose the board based on their comfort feeling on the candidates rather than the professionalism of the candidates. Again, whoever candidate chosen by Controlling Shareholder would materialize in Annual Shareholder Meeting through voting.

5.2 Final Remarks

It is indeed a given fact, that most of the family controlled companies are having concentrated ownership characteristic. Despite the result of the studies, mentioned earlier, that concentrated ownership has created adversed effects on minority shareholders and performance of the Board; it is irrational to expect that the listed companies in Indonesia are transforming themselves to become dispersed ownership entities. Therefore it is necessary to conduct further research on dig deeply if there are several inherent characteristics attached to the family controlled, which can distinguish the good companies from the bad companies in implementing Good Corporate Governance.
To overcome the dominance of control for minorities, there should be a variety of measures such as:

1. The independent nomination committee, which is now on volunteer basis, must be changed to be mandatory. Thus, the decision of appointing the Board member will be shifted to the committee. The committee in this case must establish a clear standard operating procedure of how to do fit and proper test. To ensure the candidate meeting the minimum requirement to be eligible sitting in the Board of public company, he or she must also pass competency-test that is conducted by the independent body (such IOD-UK, AMA-USA).
2. The independent remuneration company is now also still on volunteer basis. Bapepam must make it to be mandatory in order to reduce the strong influence of the controlling shareholders. It is true that it is not common that a listed company announces the compensation of individual Board member to the public; hence, the decision of the committee can be reported to Bapepam in the confidential report, not being published to the public.
   Hence, the control lies on Bapepam to ensure that the remuneration is decided fairly and objectively based on the Board member's responsibility and competencies.
3. It is also recommended to set a minimum percentage of share ownership

floated to the public to build up a more liquid market, so that market control mechanism will be in effect.

Higher percentage of share ownership will also create more confidence on investors to put their money. The study revealed that companies, which floated 40% or more their shares, obtained a higher score. The Board of this group must work properly to satisfy the larger base of investors. They can also work in a more independent fashion along with less power of the controlling shareholders.

4. It is strongly recommended that the controlling shareholder and Board attend the comprehensive training on good corporate governance. Such kind of training is made compulsory for the candidates, who apply for Board's position.

   To institutionalize the concept of good corporate governance, it may also be a good idea to introduce the good corporate governance at the formal education. This subject must be compulsory for the university students who are in business major.
5. It is recommended that the regulatory body set up a rating agency, which scores the implementation of good corporate governance in each of the listed company at Indonesia Stock Exchange. This practice will speed up the awareness and then the company's will to implement better good corporate governance. The availability of rating will also increase the investors' confidence in investing in Indonesia's stock as they have more indicators to market good decision.

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