A Study of Indonesian State-Owned Enterprises’ Boards of Commissioners and their Governance: An Introduction
Chapter One

A Study of Indonesian State-Owned Enterprises’ Boards of Commissioners and their Governance: An Introduction

The practice of corporate governance in private firms can only be applied to GOCs [SOEs] with care.¹

1.1 INTRODUCING THE CENTRAL RESEARCH QUESTION

This thesis examines the legal role of the Board of Commissioners in the governance of Indonesia’s state-owned enterprises (SOEs). More specifically, it considers the extent to which the relevant laws, regulations and modes of self-regulation relating to SOE governance (including the board of commissioners) influence the effectiveness of SOE governance in Indonesia.

The concept of effective corporate governance was first introduced to Indonesia in 1999, and it was formalised in the historic Law No. 40 of 2007 on Limited Liability Companies. The elucidation of the law expressly stated that the enactment of Law No. 40 of 2007 was intended to promote good corporate governance:

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Demand for the development of the business world in accordance with the principles of good corporate governance requires revision of Law No. 1 of 1995 Concerning Limited Liability Companies [the previous law].

Subsequently, in 2007, the Indonesian Minister for Law and Human Rights emphasised the importance of corporate governance when he introduced Law No. 40 of 2007 to the Indonesian Parliament. Prior to the law’s enactment, the minister addressed the Parliament, explaining the compelling need for the new law and for the implementation of corporate governance in Indonesia.

With this law, Indonesia adopted the Anglo-American model of corporate governance in which ownership and control of a company are separate. Talbot points out that this characteristic of Anglo-American corporate governance is attributable to widely dispersed corporation ownership. This separation of owners and controllers of a company also exists in Indonesian state owned enterprises. Since the SOEs’ ultimate owners cannot control the action of the SOEs’ agents, the notion of corporate governance is central to evaluating the governance of SOEs.

It is widely accepted that the establishment of a board of commissioners is critical to the application of the principle corporate governance. As Becht et al. note, the regulation of the company board is a central issue in the debate over corporate governance.

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3 The General Elucidation of Law No. 40 of 2007 Concerning Limited Liability Companies.
governance. Jensen states that ‘... in recent years, the debate [over corporate
governance] has focused on the activity of the board of directors, the most
outstanding governance mechanism of the internal control system’. For some
scholars, the two concepts—board and corporate governance—are more or less
identical.

The thesis examines the legal role of boards of commissioners in the governance of
Indonesia’s SOEs and, more specifically, determines whether a board of
commissioners can be a company’s principal actor in creating good governance of
Indonesian SOEs. SOEs are enterprises whose capital is owned (mostly or in its
entirety) by the state, as given in Law No. 19 of 2003 regarding State-Owned
Enterprises.

The term ‘legal role’ is used to clarify that the thesis analyses the role of the
Indonesian SOEs’ board of commissioners from a legal standpoint, not from a
business or economic standpoint; this thesis does not look at actual SOE board
practices and management. Rather, this thesis examines the governance of SOEs on a
strategic, regulatory level. The thesis culminates in a set of policy recommendations,
to be politically enforced by Indonesian state bodies and the Indonesian parliament.
As the study emphasises a legal point of view, analysis will focus on existing laws,
regulations and codes of self-regulations related to SOEs.

7 Ibid.
8 Michael C. Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control
Governance 73.
10 Article 1, Paragraph 1 of Law No. 19 of 2003.
1.2 SPECIFIC ISSUES TO BE ADDRESSED

As mentioned, the central issue to be analysed is the role of board of commissioners in the governance of Indonesia’s state-owned enterprises. In order to address this central issue, it is necessary to consider the following more specific research issues:

- What is the existing system of Indonesia corporate governance?
- What are the legal roles of SOEs’ board of commissioners?
- What factors contribute to the establishment of an SOE’s board of commissioners?
- How do relevant laws, regulations and self-regulation of SOEs affect SOE governance and board practice?

The objective of the thesis is to address the central research question through a series of four interrelated articles. At the time of writing all four articles have been either published or accepted for publication. The four articles are supported by a review of literature in the field.

1.3 BACKGROUND AND CONTEXT OF THE RESEARCH

Prior to addressing the specific issues to be considered, this section will outline the background and context of the research.

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1.3.1 Corporate board structures

There are two fundamental types of corporate board structures, the unitary board model and the two-tier board. The unitary model is used by common law countries such as the United States, Australia and the United Kingdom. In comparison, the two-tier system is found in such civil law countries as Germany and the Netherlands. In the two-tier board, there is a distinction between the Board of Commissioners and the Board of Directors. While the Board of Directors constitutes the company’s management and is responsible for the daily activities of the company, the Board of Commissioners ensures that the company is headed in the right direction.\(^\text{12}\)

Under the two-tier board regime, the board of commissioners or supervisory board is a company’s central organ and has a legal responsibility to ensure that the company’s management is performing its duties well. In short, in the two-tier system the main function of Board of Commissioners is to direct, govern, monitor, oversee, and supervise a company’s managers.\(^\text{13}\)

Indonesia employs the two-tier board model by way of Law No. 40 of 2007 regarding Limited Liability Companies. Law 40 is the successor to Law No. 1 of 1995; prior to this law, Indonesia, as a colony of the Netherlands, employed the two-tier model under the Dutch Commercial Code of 1847.\(^\text{14}\) In the Netherlands and Germany, the strategic role of board of commissioners primarily includes appointing and

\(^{12}\)Synthia A. Sari, John Halligan and Wahyu Sutiyono, 'The Roles of Board of Commissioners Within the Corporate Governance of Indonesian State-Owned Enterprises' (Paper presented at the 14th IRSPM Conference Switzerland, 7–9 April 2010) 6.
\(^{13}\)Ibid.
discharging members of company management.\textsuperscript{15} In contrast, under Law No. 40 of 2007 the Indonesian board of commissioners does not have power to appoint and discharge members of the board of management; the law only authorises a board of commissioners to suspend members of the management board.\textsuperscript{16} This right of suspension refers to the authority to fire directors temporarily, as long as the board states the reason for the suspension and holds a general meeting of shareholders within 30 days of the suspension date.\textsuperscript{17} However, as an SOE’s board of commissioners does not have the right to elect and dismiss members of the board of directors, this power is placed in the hands of the shareholders or in the hands of the government.

1.3.2 State-owned enterprises

The Indonesian Constitution of 1945 emphasises the importance of the SOE’s role in the Indonesian economy and society. This emphasis underlines the need to ensure that SOEs are subject to effective governance. Article 33 of the Constitution provides: ‘(1) The economy shall be organised as a collective endeavour, founded upon the basis of family spirit; (2) Branches of production essential to the state and which affect the welfare of most Indonesian shall be controlled by the state; (3) Land and water and natural riches contain therein shall be run by the state and to be used for the greatest prosperity of the people’.\textsuperscript{18}

Article 33, particularly paragraphs 2 and 3, is the legal instrument by which the Indonesian government regulates SOEs in order to support the nation’s economy, to

\textsuperscript{16} Article 106 of Law No 40 of 2007.
\textsuperscript{17} Ibid.
\textsuperscript{18} Article 33 of The Indonesian Constitution of 1945.
uphold living standards and to maintain societal justice.\textsuperscript{19} The Constitution legally mandates the Indonesian government to operate the SOEs for the benefit of society. Scholars argue that the constitutional mandate requires the government not only to establish SOEs, but also to ensure that the SOEs operate properly.\textsuperscript{20}

In Indonesia, SOEs are commonly considered to be agents of development and progress for several reasons: Firstly, SOEs are granted the authority to control and manage vital objects pertaining to public utilities, such as water, electricity and telecommunications. Secondly, SOEs are required to generate profits from the resources they manage. Thirdly, SOEs play a role as a major economic power that can determine market prices at a national or international level. Fourthly, SOEs contribute to social responsibility and partnership programs for small businesses. Finally, SOEs are expected to manage national assets based on principles of professionalism and transparency.\textsuperscript{21}

Additionally, with total assets of Rp. 1,736.89 trillion in 2007,\textsuperscript{22} Indonesia’s 139 SOEs are crucial for the Indonesian economy, acting both as taxpayers and contributors to the state budget through dividend contributions. In 2007, the 139 SOEs contributed Rp. 79.88 trillion of revenue and Rp. 23.80 trillion of dividends to the Indonesian national budget.\textsuperscript{23} However, the SOEs’ total contributions of tax revenue and dividends only comprised less than ten per cent of total assets. SOEs

\textsuperscript{19}Miko Kamal and Mia Mahmudur Rahim, ‘Changes in the Corporate Governance Patterns in Developing Countries: Guesses on Ideological Imbalance’ (2008) 2008-31 Macquarie Law Working Paper 2, 8.
\textsuperscript{20}Iman Sugema, Revrisond Baswir and M. Iqbal Irfany, ‘Penguatan Badan Usaha Milik Negara’ in Soegeng Sarjadi and Iman Sugema (eds), Ekonomi Konstitusi: Haluan Baru Kebangkitan Ekonomi Indonesia (Soegeng Sarjadi Syndicate, 2009).
\textsuperscript{21}Ibid.
\textsuperscript{23}Ibid.
could contribute more if they were better managed; SOE lawmakers recognised this fact, stating that SOEs contribute at this low level because companies are not yet run optimally in spite of the fact that the government has undertaken to introduce and implement the concept of corporate governance.  

This thesis will focus on Indonesian non-listed SOEs (pure SOEs) rather than listed ones. As stated by Law No. 19 of 2003 Concerning State-Owned Enterprises, Indonesian SOEs fall into two categories: limited liability companies and general companies (PERUM). The former includes listed limited liability companies (listed SOEs) and non-listed limited liability companies (pure SOEs). While listed SOE shares are widely dispersed, pure SOE and PERUM stocks are concentrated in the hands of the government, with the Minister for SOEs acting as the shareholder. The Minister for SOEs reports that 115 of 139 SOEs are pure SOEs. The remainder of the SOEs are listed companies (11) and PERUM (13). Figure 1 demonstrates the comparison of the number of Indonesian SOEs.

![Percentage of the Indonesian SOEs, 2007](chart.png)

**Figure 1: Percentage of Indonesian SOEs by Type**


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24 Point d of the consideration of Law No. 19 of 2003 Concerning State-Owned Enterprises.

25 The Government Regulation No. 41 of 2003 Concerning the Devolution of Position, Duties and Authority of Minister for Finance on Limited Liability SOEs (PERSERO), Public Companies (PERUM), and PERJAN to the Minister for SOEs.
The remainder of this introductory chapter proceeds as follows: Section 1.4 examines the study’s methods and data collection. Section 1.5 highlights the theoretical underpinning for the study. Section 1.6 provides the contributions this research makes on corporate governance. Finally, Section 1.7 outlines how the four self-contained journal articles contribute to addressing the overall research problem.

1.4 METHODS AND DATA COLLECTION

Methods are defined as the means used to collect and examine data.26 The social science approach offers several methods, including questionnaires, case studies, interviews, document analysis, narratives, interpretative methods and focus groups.27 This thesis uses a qualitative research approach (defined by Shank as a model of systematic empirical inquiry into meaning), using document analysis and interviews to gather data.28 This thesis draws on the opinions and experiences of twenty-seven interviewees as they relate to SOE boards of commissioners.

1.4.1 Document analysis and procedures

The document analysis was conducted by examining relevant laws for boards of commissioners and SOEs, such as Law No. 40 of 2007 on Company Limited Liability and Law No. 19 of 2003 on State-Owned Enterprises. In addition to these laws, relevant regulations were analysed, including the Government Regulation No. 45 of 2005 on the Establishment, Management, Supervision and Liquidation of State-owned Enterprises, Presidential Instruction of Republic of Indonesia; No. 8 of 2005 on the Appointment of Members of Board of Directors and Board of Commissioners of

27 Ibid 5.
28 Gary D. Shank, Qualitative Research: A Personal Skills Approach (Prentice Hall, 2002) 5.
State-Owned Enterprises (revised by the Presidential Instruction of Republic of Indonesia No. 9 of 2005); and the Decree of the Minister for State-Owned Enterprises No. KEP-117/M-MBU/2002 regarding the Implementation of Good Corporate Governance on State-Owned Enterprises.

Analysis of the researched companies’ self-regulations (such as their annual reports, corporate governance codes, board manuals, codes of conduct and company by-laws) was also included in this study. This study also examines the curriculum vitae of members of the researched companies’ boards of commissioners. Finally, this study examines online documents of companies; the most recent analysed online document was downloaded on 11 December 2009.

1.4.2 Interview method and procedures

A series of interviews were conducted in Jakarta from February to May 2009. Each interview consisted of a list of open-ended questions that were used in all interviews to maintain consistency. The interviewees gave consent before the interview was conducted. All of the interviews were conducted in Indonesian and lasted approximately one-and-a-half to two hours each. A recorder was used to record each interview and the recordings were subsequently transcribed.

Twenty-seven participants were interviewed. Eighteen of the participants are from six Indonesian SOEs; they are members of the board of commissioners, board of directors and presidents of company trade unions. In order to meet the research ethics requirements of Macquarie University, the researched companies (all non-public Indonesian SOEs) are referred to by the codes M, A, C, Q, K and L, so that the
companies cannot not be publicly recognised. Profiles of participants and researched companies are provided in Article 3 (Chapter 5).

The remainder of the interviewees include an Indonesian corporate governance expert, an economic and political expert, a former member of an Indonesia SOE board of commissioners, a vice chairman of Corruption Eradication Commission of Indonesia, a chairman of the NCG, a coordinator of the Indonesian Corruption Watch, a politician, and a chief of a corporate governance institution. Unlike the interviewees from the researched companies, these interviewees were happy to be identified in the thesis.

1.5 THE THEORETICAL UNDERPINNING FOR THE STUDY

The central framework employed by the thesis is agency theory as articulated and developed by Candemir, Shankman, Adelopo and Arnold and Lange in the context of corporate governance. Agency theory is utilised in the course of assessing the extent to which the present laws and regulations effectively govern SOEs. Agency theory is used to analyse the effect of delegation of tasks and decision making by one party (principal) to another (agent) within the SOE structure, as well as the various interactions involving cooperative effort. Shankman's development agency theory, which focuses on the agency relationship in which agents (individuals or groups) have definite duties towards their principals (another individual or group) that are based on

33 Candemir, above n 29, 24
their economic connection, is also used to assess the effectiveness of the present laws relating to SOEs.\textsuperscript{34} Agency theory assumes that human beings are self-serving, individualistic and opportunistic and tend to maximise their own interests at the expense of owners. In a company a difference in aims between the agents and principals is almost always present.\textsuperscript{35} In the context of agency theory, it has been designed to ensure the harmonisation of the interests of the principals and agents, and lessen agency problems or principal-agent (abbreviated to PA) problems that result from friction in PA relationships.\textsuperscript{36} In other words, as Arnold and Lange explain, agency theory clarifies how best to organise PA relationships, with the intention of ensuring that the relationship is smooth.\textsuperscript{37}

The PA relationship is a significant component of the structure of SOEs and a variety of agency problems are prevalent. As with its counterpart private company, the separation between ownership and control is in existence. This is because the ordinary public is assumed to be the SOEs’ principals, while the government is the agent. The general public, the SOEs’ ultimate owners, are not able to control the agent – the government.

However, the PA relationship in SOEs is unique, which creates a variety of particular agency problems. Unlike their private company counterparts, the relationship exists not only between the SOEs acting shareholders (the government) and SOE management (agents), but also between the public as ultimate owners of SOEs and the government. This confirms Whincop's assertion quoted at the beginning of this

\begin{flushleft}
\textsuperscript{34} Adelopo, above n 31, 141.
\textsuperscript{35} Ibid.
\textsuperscript{36} Shankman, above n 29, 321.
\textsuperscript{37} Arnold and de Lange, above n 32, 753.
\end{flushleft}
introduction: 'the practice of corporate governance in private firms can only be applied to GOCs [SOEs] with care'.

1.6 THE CONTRIBUTIONS MADE BY THIS RESEARCH TO SCHOLARSHIP ON CORPORATE GOVERNANCE
The study contributes at both a theoretical and practical level to the fields of corporate governance, boards of commissioners and SOEs. Some key contributions of this research can be summarised as follows:

1.6.1 Contribution at the theoretical level
This thesis will contribute to research scholarship by offering a clarification of the SOEs’ Principal-Agent relationship and an analysis of the positioning the board of commissioners as the ultimate owners’ representative.

1.6.1.1 SOEs’ principal–agent relationship
Firstly, at the theoretical level, this thesis introduces the concept of an SOEs’ principal-agent relationship. This differs from the nature of the principal-agent relationship discussed in the context of private firms. In private firms, shareholders are assumed to be principals while company’s management members are considered agents. This pattern has been transferred by some scholars to the context of SOEs, with the government positioned as the principal and SOEs’ managers and board members categorised as agents. This thesis attempts to make clarify the roles of principal and agent in an SOE, identifying the general public as principal and the

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38 Whincup, above n 1, 5.
government as agent. This argument attempts to move the academic debate on the state ownership problem forward.

1.6.1.2 Positioning the board of commissioners as the ultimate owners’ representative

Secondly, this thesis recommends positioning the board of commissioners as representatives of the ultimate owners of SOEs. In the existing system of Indonesia’s SOEs, the board of commissioners and board of directors (company management) act as representatives of the government. This system gives the government full authority to direct and control SOEs. As seen from the agency theory standpoint, the government is principal and agent simultaneously. Under the current system, the roles of the public and SOE owners are blurred. Consequently, the public, which is entitled to control the SOEs, cannot fulfil its role properly. Positioning boards of commissioners as representatives of the ultimate shareholders of SOEs offers a legal solution to the problem of identifying principals and agents, both conceptually and practically. Therefore, this study can clarify the ambiguous roles of SOEs’ principals.

1.6.2 Contribution at the practical level

At the practical level, this thesis makes two contributions: recommending the creation of a board of trustees and identifying the type of Indonesian SOEs’ board of commissioners.

1.6.2.1 Introducing a board of trustees

The thesis explores the notion of positioning the board of commissioners as the public’s representative. A board of trustees will take on responsibilities of electing
and discharging members of the board of commissioners, as well as the responsibility of approving the board of commissioners’ dismissal of members of the board of directors.

1.6.2.2 Identifying five categories of SOEs’ commissioners

By means of empirical research, this thesis identifies five types of members of Indonesian SOEs’ boards of commissioners and outlines their characteristics. The five categories are as follows:

- Public servant commissioners refer to members of SOEs’ boards of commissioners whose primary role is a government official (for example, a high-ranking official in a government department).

- Businesspeople or skilled worker commissioners refer to commissioners who have their own business or undertake work other than serving a director or board of commissioners’ member.

- Academic commissioners refer to academics who serve as SOE commissioners.

- Pensioner commissioners refer to retired government officials who serve as commissioners of an SOE.

- Big fish commissioners refer to individuals who have influence in their limited community, and who are considered useful in securing company business through community pressure.

A significant message of the findings is that most of the members of boards of commissioners are busy people. At the practical level, the government can use these findings to improve SOEs’ boards of commissioners.
1.7 HOW THE FOUR SELF-CONTAINED JOURNAL ARTICLES CONTRIBUTE TO ADDRESSING THE OVERALL RESEARCH PROBLEMS

The thesis is organised into seven chapters. Chapter 1 forms an introductory chapter, including a consideration of the background and context of the research, the research questions, the methods and data collection, the contribution made by this research to corporate governance scholarship, and a self-contained journal article addressing the overall research problems. Chapter 2 examines the relevant literature on corporate governance and SOEs. Chapters 3–6 comprise a series of papers. Chapter 7 concludes the thesis. Below is the summary of the four papers that address the research questions:

1.7.1 Chapter 3 (Paper 1): The New Indonesian Company Law: Does It Support Good Corporate Governance?


The two aims of Paper 1 are (1) to explore the new Indonesian company law, Law No. 40 of 2007 and (2) to critically analyse the concept of the board of commissioners under the new company law. The paper will strive to answer the following research questions: What are the legal roles of the SOEs’ board of commissioners? How do relevant laws, regulations and self-regulations of SOEs affect their governance and board practice?
This paper begins by discussing the nature of the two-tier board, its history and practices within countries that use the civil law system, such as the Netherlands, Germany and France. The establishment of the Committee of Nine in 1623, when the *Dutch Verenigde Oostindische Compagnie* (VOC) existed, is considered a landmark event in the development of the two-tier board across the world. The Committee of Nine had five primary duties: to provide advice to management, to approve the annual report, to control the directors’ competence and to present a board meeting as well as to inspect the premises and the documents of the company. This paper then examines the history of two-tier boards in France and Germany. The concept was first introduced to France in 1856, when a company was required to have a supervisory board in addition to a board of management. However, in 1940, the Vichy Regime of France abolished the two-tier board model. The regime imposed a new policy on corporate structures by enacting the Law of 16 November 1940. Twenty years later, the Commercial Code in 1966, known as the 1966 Reform, reintroduced the two-tier board model in France. The Commercial Code is a voluntary law that allows businesses to choose either a unitary or a two-tier board for their company operations. Like the rules prevailing in other civil law countries, the French law set up two boards in a company, namely the directorate (*directoire*) and the supervisory board (*council de surveillance*). The former is an executive management board responsible for running the company, while the *council de surveillance* is in charge of supervising the *directoire*. As a result, the 1966 Reforms ensured that the supervisory board undertook three primary tasks: First, authorising the directorate to make a certain decision; second, monitoring the activities of the directorate; and third, reporting its findings to the shareholders.
This paper also reveals that in Germany, the concept of the two-tier board was first introduced by the German Commercial Code in 1861. The German two-tier boards are characterised by two features: first, the management and supervisory boards perform tasks separately. Second, members of the supervisory board are elected by shareholders; in large companies up to half of the members are appointed by employees, as regulated by the Management Relation Act of 1952 and the Codetermination Act of 1976. There are three types of German codetermination: full parity codetermination, quasi-parity codetermination and one third codetermination.

Further, this paper examines the Indonesian two-tier boards. This paper explains that Indonesia initially employed the two-tier structure under the Dutch Commercial Code of 1847 because, as a colony of the Netherlands, Indonesia had to follow Dutch colonial laws, including company laws. Currently, Law No. 40 of 2007 regarding Limited Liability Companies regulates the two-tier boards in Indonesia (succeeding Law No. 1 of 1995). According to this law, the board of commissioners played eleven roles: (1) to receive, analyse and approve an annual plan; (2) to analyse and to sign an annual report; (3) to approve interim dividends; (4) to call shareholders for holding a general meeting; (5) to decide on the board of directors’ remuneration; (6) to represent the company in court; (7) to suspend members of the board of directors; (8) to give written approval or assistance to the board of directors; (9) to carry out a particular action to organise the company in a particular condition and time; (10) to approve drafts of the merger of company; and (11) to approve the takeover of the company.
This paper also discusses the following unique aspects of Indonesian two-tier board structure. First, under Law No. 40 of 2007, the two-tier board was compulsory for all companies in Indonesia, regardless of size, listing or type—a one-size-fits-all mandate. Indonesian SOEs are also subject to Law No. 19 of 2003, in addition to laws regulating SOEs. Second, both the board of commissioners and the board of directors represent the shareholders, and in the context of SOEs both the boards represent the government (the SOEs’ acting shareholders). Third, the board of commissioners has the right only to suspend the members of the management board, but not to discharge. This is a weakness of the board of commissioners and is a primary factor in preventing the board of commissioners from behaving professionally. Fourth, the Indonesian two-tier board employs independent commissioners. The elucidation of Article 120, Paragraph 1 of Law No. 40 of 2007 defines the independent commissioners as outside directors. The term ‘outside director’ is familiar in the one-tier board model countries such as Australia. In Anglo-Saxon countries, an independent director is crucial to the company’s structure because a company has only one board to undertake both management and supervisory tasks. This paper suggests that the role of independent commissioners was adopted from the Australian model. This connection can be traced by following the debate since 1999 surrounding the role of the independent commissioner, during which academics and corporate governance organisations proposed to define an independent commissioner. As stated in this paper, the FCGI proposed independent directors, a proposal which the National Committee for Corporate Governance adopted and which has now been incorporated into Law No. 40 of 2007. This paper also reveals that the law’s drafters adopted an incorrect method of legal transplantation; the law-makers never considered the prevalent legal system in Indonesia when adopting the outside director to act as an
independent commissioner. Finally, in addition to independent commissioners, Indonesian SOEs also employ delegated commissioners. However, the new law does not define the term delegated commissioner; rather, it states that the commissioner would be regulated by the articles of association of a particular company.

1.7.2 Chapter 4 (Paper 2): Corporate Governance and SOEs: A Study of Indonesia’s Code of Corporate Governance

This paper has been published in the *Journal of International Commercial Law and Technology*: Kamal, Miko, ‘Corporate Governance and State-owned Enterprises: A Study of Indonesia’s Code of Corporate Governance’ (2010) 5(4) *Journal of International Commercial Law and Technology* 19.

The objectives of this paper are (1) to answer questions about the extent to which Indonesia’s concept of corporate governance conforms to the Anglo-American corporate governance regime and (2) to ascertain whether the Indonesia’s code of corporate governance is suitable for solving existing problems of SOEs, including those of pure SOEs. The first research question of this thesis, regarding the existing system in Indonesian corporate governance, is addressed in this paper.

The importance of corporate governance in Indonesia can be seen not only in the enactment of these laws and regulations, but also in the literature on the Indonesia’s code of corporate governance, created by the national committee on governance and discussed in this paper. The framers of the code clearly identify the code as a reference point for all companies in Indonesia, regardless of type, including SOEs. Corporate governance is an essential instrument for dealing with the companies’
problems, and the code emphasises that every Indonesian company should adopt its methods.

This paper unravels the universal features of codes of corporate governance, including compliance or principles, the soft-laws model, audit committees, remuneration committees, transparency issues, the role of the board, investor protection and deception prevention, as well as an atmosphere conducive to attracting foreign capital. These features are consistent with Indonesia’s code of corporate governance.

This paper also explains that the Indonesian code has not provided principles that clearly separate the social and business functions of SOEs. Within the code, we do not find any principles that expressly request a segregation of the SOEs’ objectives into business and social objectives. In addition, the code-makers do not express concern over the intermingling of business and political problems. On the contrary, the code grants permission to the SOEs to get involved in political activities through donations to political parties and nominations to legislatures and bureaucrats.

This paper also discloses that the code-makers presume that the Indonesian SOEs problems can be resolved by introducing professional commissioners with integrity and capability. The code explains that the principles of integrity and capability ensure that the supervisory and advisory roles of the board are of high quality, and it assumes that a professional commissioner who has capability and integrity will not utilise the company’s properties for personal advantage. Further, the creators of the code believe that a professional commissioner with capability and integrity will comply with the relevant deeds, laws and regulations. However, this does not take into account the fact
that existing problems in non-listed SOEs result not only from lack of integrity and capability but also from time constraints faced by commissioners (who are often busy in some other professional capacity). This paper maintains that the code’s notion of ‘professional’ commissioners is meaningless in this context.

Further, this paper explores the underlying assumption of the Indonesian code: Indonesian companies have agency problems similar to those experienced by privately listed companies. The code divides shareholders into two groups: controlling and minority shareholders. While this division is relevant to companies with dispersed shares (which can use the division to shield the minority shareholders’ money from possible abuse from the controlling shareholders), it is meaningless in pure SOEs where owners are the public, represented by the government.

This paper also highlights the unique agency problem of pure SOEs have a. In contrast to other listed companies, pure SOEs have four distinct agency problems: first, the tension between society as the SOEs’ ultimate owner and the government as the actual owner or society’s agent (ultimate principal-actual principal or ultimate PA relationship problem); second, the tension between the government and the board of commissioners (actual principal-board relationship problem); third, the tension between the government and the board of directors (actual principal-management relationship problem); and finally, the tension between the board of commissioners and the board of directors (board-management relationship problem).

This paper also examines agency problems of pure SOEs in greater detail. The ultimate principal-actual principal or ultimate PA relationship problem is bound to
occur since the government, as the society’s agent, tends to prevent society from exercising social control. Thus, the government is free to direct SOE management in accordance with its wishes; for example, the government may direct the management to undertake activities that benefit the government. The actual principal-board relationship problem exists as a consequence of both Indonesian company law and laws governing SOEs that position the board of commissioners as an actual principal’s agent in terms of overseeing and advising the SOEs’ management. The board of commissioners is considered an agent because the actual principal can dismiss and appoint its members. The problems of the actual principal versus management relationship result from the separation of ownership and control within SOEs. In pure SOEs, companies are run by managers or members of the board of directors who act as executive management. The actual principal-management relationship exists because the government, acting as the principal, appoints and dismisses members of the board of directors. The board-management relationship problems stem from the roles and responsibilities of each of these agencies. The board of directors is the company organ responsible for carrying out the company’s activities, whereas the board of commissioners is responsible for overseeing the company’s activities and advising the board of directors.

Given the uniqueness of agency problems in the case of the pure SOEs, this paper states that Anglo-American agency problems, such as the expropriation of minority shareholders’ assets by controlling shareholders, will not arise because shareholders are not divided into minority and majority groups. Thus, it is fair to say that in Indonesia the existing corporate governance model (the Anglo-American model) has overlooked the needs of Indonesia’s pure SOEs.
As a civil law country, Indonesia applies the two-tier structure model with the board of commissioners (supervisory board) and board of directors (management board) present as two compulsory organs in every company, including an SOE. However, Indonesia’s two-tier structure is not identical to the ones seen in other civil law countries, such as Germany. While Germany applies the codetermination concept, where employees are represented in the company’s supervisory board, Indonesia does not offer a place for employees on the board of commissioners. As a result, Indonesia has a range of unique problems in the implementation of corporate governance. With regard to the company structure, Indonesia partly follows the Continental Europe model where two organs (the board of commissioners and the board of directors) must exist in a company; however, unlike in the European model, workers in Indonesia are not given the chance to become members of the board of commissioners. In terms of its code of corporate governance principles, Indonesia tends to adopt the Anglo-American model, which is not appropriate for Indonesian companies, especially the pure SOEs. For instance, the code prescribes maximum protection to the minority shareholders when in fact there are no minority shareholders in pure SOEs.

1.7.3 Chapter 5 (Paper 3): Board of Commissioners in Indonesia: An Empirical Study of the Board of Commissioners in Indonesia’s SOEs

This paper has been submitted to Asian Journal of Comparative Law and is currently under review.

The objective of this paper is to examine features of boards of commissioners in Indonesian non-listed or pure SOEs. This paper will investigate the prevailing laws,
regulations, self-regulations and practices of commissioners in six selected SOEs, and will serve to answer the following research question: what factors contribute to the establishment of an SOE’s board of commissioners?

This paper begins by discussing the role of the company’s board as an internal control. Findings reveal that dispersed ownership is the main characteristic of a contemporary company. This characteristic can create problems for governance; because shareholders are dispersed, they are not able to directly control their assets in the company. This is a common example of an agency relationship within a company.

This paper also discusses external and internal control mechanisms for dealing with agency problems between the managers and the owners of corporations in a company. Examples of instruments of external control include the external labour market; financial analysts monitoring the capital market; institutional and block shareholders; and the takeover market. The instruments of internal control comprise a natural process of monitoring from the higher to the lower levels of management and include mutual monitoring among managers and the board of directors. In the context of a two-tier board in a company, the supervisory board acts as both the principal of the management board and an agent of the shareholders simultaneously. In other words, the supervisory board is considered the principal of the management board and the agent of the shareholders when undertaking actions representing the interests of the shareholders or when supervising company activities as carried out by the board and management.
This paper also finds that Indonesian company law stipulates that the appointment and dismissal of the members of the board of directors and the board of commissioners must be done by the company’s shareholders at a general meeting. Thus, from the perspective of the agency theory, the two boards can be considered shareholders’ agents. While a commissioner acts as an agent in terms of his monitoring function, a director is an agent because he directly runs the company. This situation occurs because the Indonesian two-tier board system does not recognise the codetermination concept.

Further, this paper compares the Indonesian and German supervisory boards and states that Indonesian company law may authorise a board of commissioners to suspend the management board. This right of suspension refers to the board of commissioners’ authority to fire directors temporarily by stating the reason for the suspension. The board also has the right to ensure that within 30 days of the suspension date, a general meeting of shareholders is held and a new management board is appointed. However, although the board of commissioners has the authority to suspend a member of the board of directors, the board of commissioners is not superior to the board of directors; rather, both boards hold equivalent positions. This stands in contrast to the German two-tier board. In Germany, the main task of the supervisory board is to appoint and dismiss the management board, in addition to executing other duties such as monitoring the work of the management, approving the annual report and intervening in the case of a serious company crisis. Therefore, because the board of commissioners does not have the right to elect and dismiss members of the board of directors, this power is placed in the hands of the shareholders (in the case of SOEs, the government); this stands in contrast to
Germany, where a company’s shareholders do not have direct authority over the board of directors. In Germany, the board of commissioners hold the shareholders’ power, as the appointment of members to the board of directors is part of the authority delegated by shareholders to the commissioners, acting as the shareholders’ agents.

Indonesian company law also regulates the commissioners’ liabilities, both internal and external. Internally, commissioners report their own activities by monitoring and advising the board of directors during the annual general meeting of the shareholders. Externally, commissioners are liable to third parties for negligence that causes the company to suffer losses. For instance, a commissioner could be externally liable for approving the board of directors’ decision to enter into a business contract that has caused losses for the company. Thus, commissioners are not free from legal liability when they approve directors.

The main findings of this paper are as follows: (1) The commissioners in the six studied companies are busy individuals who hold other positions in addition to their roles as commissioners. The paper describes these individuals as ‘public servant commissioners’, ‘businessmen or skilled worker commissioners’, ‘academic commissioners’, ‘pensioner commissioners’ and ‘big-fish commissioners’. Public servant commissioners refer to members of SOEs whose primary role is government official; for example, such an individual may be a high-ranking official in a government department. Businessmen or skilled worker commissioners are individuals who have their own businesses or undertake work separate from their roles as directors (executive management) or members of a board of commissioners. A university lecturer who serves as an SOE commissioner may be categorised as an
academic commissioner. Retired government officials who serve as commissioners of an SOE are labelled pensioner commissioners. A big-fish commissioner is an individual who exerts influence within his or her domain and is considered useful in securing business for the company through community pressure. (2) This paper found that existing laws and regulations allow an SOE’s commissioners to hold positions other than the ones they hold in the SOEs in other institutions. (3) Other findings of this study include the absence of fit-and-proper testing and the excessive influence of politics in appointing members to the SOEs’ board of commissioners. Whether or not a person can be elected commissioner is subject to the decision of the President of the Republic of Indonesia through the Final Assessment Team (TPA).

Further, this paper finds that existing laws grant the shareholders absolute power to elect and dismiss a board of commissioners and directors through a general meeting of shareholders. In the context of the pure SOEs, the government (represented by the Minister for SOEs) constitutes an SOE’s shareholder and can therefore constitute a general meeting of the shareholder. Consequently, because Indonesia’s two-tier board structure does not apply a codetermination concept as Germany does, pure SOEs operate under the control of one set of individuals. It can be argued that where absolute power prevails, political interference necessarily arises. Moreover, such political interference is authorised by the Presidential Instruction No. 8 of 2005 (amended under the Presidential Instruction No. 9 of 200), which states that all members of the SOEs’ board of commissioners are selected by the TPA chaired by the president, the vice president acting as the vice chairman, the cabinet secretary serving as the team secretary along with the minister for finance and the minister for SOEs as team members. All of the TPA’s members are politicians who, arguably, are
inclined to make decisions on the appointment and dismissal of members of the board of commissioners based on political rather than professional considerations.

1.7.4 Chapter 6 (Paper 4): Dealing with the Dilemma of the SOEs’ Principals: A Proposal for the Governance of Indonesia’s SOEs

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This paper aims (1) to discuss the dilemma of SOEs’ principals (2) and to propose measures to deal with it, which can be adopted by Indonesia’s SOEs. This paper attempts to answer the following research questions: what is the existing system of corporate governance in Indonesia, what are the legal roles of SOEs’ boards of commissioners and what factors contribute to the establishment of an SOE’s board of commissioners?

This paper argues that the intermingling of politics and business, rather than the dilemma of state ownership, principally determines the problems of Indonesia’s SOEs. This paper finds that the Presidential Instruction No. 8 of 2005 (which governs the appointment of members of boards of directors and boards of commissioners of SOEs, and which was amended under the Presidential Instruction No. 9 of 2005) legitimised the intermingling of business and politics in Indonesian SOEs. According to this presidential instruction, the government, through the TPA, undertakes the final decision in the election of an individual to a board of directors or commissioners. The president of the Republic of Indonesia chairs the TPA, with the vice president, the minister for finance, the minister for SOEs and the cabinet secretary acting as the
team’s vice chairman, members and secretary, respectively. There is therefore significant opportunity for the intermingling of business and politics and for the political interference in Indonesian SOEs. This explains why Indonesian SOEs have difficulty in competing against private companies. This paper then discusses the positioning of the board of commissioners as representatives of the ultimate owners of the SOEs. This positioning will undermine the government’s power in Indonesian SOEs and will position the government as an agent of the SOEs rather than of the principal. Therefore, this paper maintains that professional agents appointed to the SOEs will perform better if the separation of the principals and the agents results in effective control over SOEs’ management.

This paper also recommends strengthening the role of the board of commissioners in order to undermine the power of the government over SOEs and recommends positioning of the board of commissioners as the representative of the ultimate owners of the SOEs. This paper points out that the board of commissioners, as one of the major players in Indonesian two-tier boards, should be given due attention since the board’s supervisory and advisory roles can be used to improve a company. Moreover, the board of commissioners can strategically represent the general public as the SOEs’ ultimate owners, and can scrutinise the SOEs to ensure they maximise profits and contribute more to society at large. This paper suggests that positioning the board of commissioners as the public’s representative will work in practice when a board of trustees holds the responsibilities of electing and discharging members of the SOEs’ board of commissioners.
This paper discloses that countless scholars have misguidedely discussed the corporate governance of SOEs from in the context of privately-owned firms (the division of ownership and control, large companies or listed companies, institutional investors and the stock market); in fact, scholars tend to discuss SOEs’ governance as if SOEs are privately-owned and listed firms. Thus, most scholarly discussions on corporate governance have cynically criticised the state ownership of SOEs. These scholars maintain that since the SOEs are owned by the state, they cannot outperform their privately-owned-enterprise counterparts in terms of efficiency. In other words, scholars believe that the archetypal issues associated with SOEs, such as multiple goals and principals, political interference and a lack of transparency, have led to SOE inefficiency—all of which is assumed to be a result of state ownership. Based on the above discussion, this paper argues that when discussing the governance of SOEs, scholars have reached the narrow conclusion that so-called state ownership equals government ownership. The paper argues that this is a misguided discussion on SOEs governance, a point that will be discussed in greater detail in the next section.

Further, this paper finds that there are two layers in the structure of SOE ownership. In the first layer, the ordinary public is assumed to be the SOEs’ principal, while in the second layer, the government is deemed the SOEs’ principal. In the context of the former layer, the government, including cabinet ministers and/or members of parliament, acts as the agents of the public and the SOE. Accordingly, the government acts as the agent of its citizens in looking after the SOEs and has a responsibility to run the SOEs in accordance with the interests of the public. In practice, the government is not only the citizens’ agent but also the owner of the SOEs, since it acts on behalf of the country’s citizens when running SOEs. In other words, as an
agent, the government runs the day-to-day activities of the SOEs, while, as a principal stakeholder, it is also under an obligation to perform in the best interests of the ultimate owners. Given that the government has two roles to play with regard to the SOEs (that of agent and owner), two types of owners can be seen to exist with regard to the SOEs; the actual owners (the government) and the ultimate owners (public at large).

This paper finds that the PA relationship in SOEs is unique. Unlike in private companies, in SOEs the PA relationship exists not only between the government and SOE managements (agents), but also between the public and the government. Thus, the uniqueness of the SOE’s PA relationship creates certain agency problems. Further, this paper points to two relationships that create agency problems within SOEs: the relationship between the ordinary public as the principal and the government as the agents, and the relationship between the government as the principal and the public servants as the agents. The first relationship results in an agency problem when a conflict of interests arises between the public and the government, which can occur when public interest is difficult to ascertain. The agency problem in the second relationship results from the incompleteness of the contract between public servants and the government (the SOE’s actual owner).

In addition, this paper views the prevailing issues in SOEs as derived from the absence of a clear and conceptual approach to identifying the SOEs’ ultimate principals. Due to the absence of such an approach, business and politics intermingle; since the government feels entitled to govern all aspects of an SOE, it puts the right of appointment of the SOEs’ commissioners and directors into the hands of the TPA.
This paper also attributes the strong desire to privatise all SOEs to the blurred relationship between the principals of the SOEs. This obscurity has led to frustration within the government, which in turn has transferred the blame to the issue of state ownership. Moreover, as a result of the problem among principals, the role of the board of commissioners in supervising and advising the board of directors has been neglected, leading to a weakening of the board of commissioners.

As mentioned, the thesis considers the extent to which the relevant laws, regulations and modes of self-regulation relating to SOE governance, (including the board of commissioners) affect the effectiveness of SOE governance. The thesis concludes that the quality of the governance of a company, including SOEs, depends upon the quality of the regulatory framework.