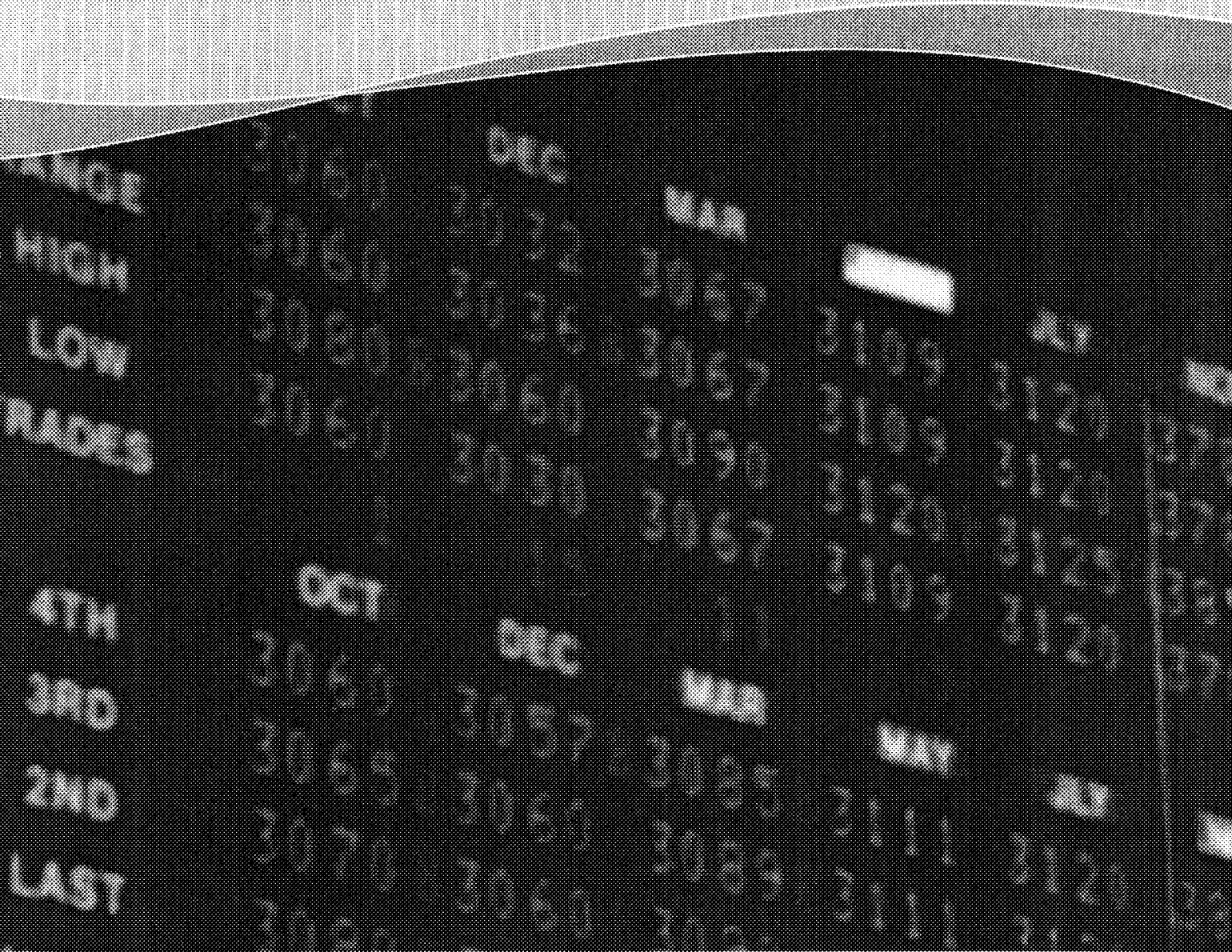


East Asia and Pacific Region
The World Bank

CORPORATE GOVERNANCE COUNTRY ASSESSMENT REPUBLIC OF INDONESIA



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CORPORATE GOVERNANCE COUNTRY ASSESSMENT
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Prepared by

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FOREWORD

Good corporate governance is essential for promoting healthy economic growth. Corporate governance is the set of relationships among a company's management, its board of directors, its shareholders and its other stakeholders that shape the company's direction and control. These relationships are determined in part by the laws and regulations, and the history and culture, of the country in which the company is located. Good corporate governance enhances the performance of companies, increasing their access to outside capital at lower costs. By adding value to companies and better managing risks, good corporate governance contributes to the promotion of sustainable investment and development.

This report provides a benchmark for Indonesia's observance of corporate governance practices against the OECD Principles of Corporate Governance. It describes current practice and provides policy recommendations in five areas: (i) rights of shareholders; (ii) equitable treatment of shareholders; (iii) role of stakeholders in corporate governance; (iv) disclosure and transparency; and (v) responsibilities of the Board.

The report shows that Indonesia has taken important steps since 2000 to address weaknesses in its corporate governance framework. But there remain some important challenges moving forward. These include strengthening the independence and enforcement capacity of the securities regulator (Bapepam), clarifying and reinforcing the legal responsibilities of directors and company managers, improving the transparency and reliability of annual reports and financial statements and the quality of public company audits, strengthening the process for appointing independent board members, and enhancing the rights of minority shareholders. The progress that has been made to date provides a strong foundation upon which these next steps in the reform agenda can be taken.

This report is based on the corporate governance assessment that the World Bank completed in Indonesia in late 2004. The assessment was undertaken by Behdad Nowroozi from the East Asia and Pacific Region of the World Bank. It is based on a template that was developed by the World Bank and completed by Emmy Yuhassarie. The assessment of practices is based on interviews with regulators, institutional investors, financial institutions, and reputational agents such as market analysts, lawyers, accountants and auditors, as well as shareholder activists.

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EXECUTIVE SUMMARY¹

Indonesia has taken important steps since 2000 to address the weaknesses in its corporate governance framework, and now has in place an elaborate system of formal corporate governance rules, which in some respects do not differ substantially from those of OECD countries. However, the reform agenda remains unfinished as corporate governance practices in Indonesia often fall short of the requirements of OECD Principles of Corporate Governance. Improving corporate governance practices is a great challenge, however, particularly where, as in Indonesia, the corporate sector is characterized by companies with concentrated ownership, controlling shareholders, and a business culture that is known to be relationship-based rather than rule-based. In moving ahead with the reform agenda, Indonesia will need to address the following priorities:

- *The enforcement of laws and regulations needs to be strengthened.* Administrative sanctions for violation of securities or disclosure rules may not be adequate. Efforts should be expended to ensure that corporate officials in positions of trust will be held accountable if they violate the law. Sanctions should go beyond fines, and the incentive system should be changed so that violators are truly discouraged and good corporate behavior is promoted. This will require strengthening the enforcement capacity of the Bapepam, as well as its independence as the securities regulator.
- *The Company Law should explicitly refer to the fiduciary duties of directors and managers for violation of securities laws.* Current effort in amending the Company Law needs to be expedited. Further efforts should also be expended to develop alternative (non-judiciary) mechanisms, such as shareholder activism, for encouraging compliance.
- *Transparency and reliability of financial reports and adequacy of disclosures remain a major challenge.* Transparency is a prerequisite to accountability. While Indonesian accounting standards are largely consistent with international standards, a gap exists between those standards and actual practices. In the past, external auditors of public companies have not provided the expected assurance. There is a need for greater disclosure and transparency in annual reports and financial statements, as well as better quality audit of public companies. The way in which companies report income — and often avoid paying taxes — as well as the discretionary power of tax authorities in assessing taxes, are areas that require special attention.
- *The process for nomination and selection of independent commissioners needs to be strengthened.* The concept of independent commissioners has only recently been introduced for publicly listed companies and state-owned enterprises. The question remains whether these commissioners act independently from the controlling shareholders and exercise effective oversight. Requiring the use of nomination committees could help in this

1 The team is grateful for the guidance and advice provided by Andrew Steer, Country Director for Indonesia. We would like to express our gratitude to the Capital Market Supervisory Agency (Bapepam), the Jakarta Stock Exchange, and the National Committee for Corporate Governance for their significant cooperation and contributions. We also thank the private sector firms, accounting firms, experts on legal issues, investment bankers, and shareholder activists with whom we spoke. Colleagues from the Corporate Governance Unit of the Investment Climate Department (CICIC) and East Asia and Pacific Region provided comments and advice.

regard. Conducting training and promoting awareness among all stakeholders is critical to changing the business culture. Efforts to enhance the skills and knowledge of independent board members need to be expedited. Improving the roles and responsibilities of the audit committees should be a high priority. Separation of management from the owners and appointment of professional managers needs to be further promoted.

- If their rights are violated, the redress available to minority shareholders remains limited. While class actions and derivative actions are allowed, they are costly and have therefore been rarely used – and never successfully. Further improvements are required to enhance minority shareholder rights and the ease with which those rights can be exercised. These could include measures to allow minority shareholders a greater voice in the selection of commissioners (i.e., cumulative voting).

In implementing reform measures, including those outlined above, a significant challenge will be to raise awareness among all stakeholders of the importance of corporate governance, and to improve the corporate culture and practices. This will be necessary to enhance the effectiveness of the corporate governance framework that has been established.

CAPITAL MARKET OVERVIEW AND INSTITUTIONAL FRAMEWORK

Indonesia's equity markets grew significantly in 2003.² However, the equity markets relative to other East Asian countries remain small. As of December 2003, the total market capitalization on the Jakarta Stock Exchange (JSX) amounted to about USD 54.4 billion, approximately 25.8 percent of the country's GDP. As of April 2004, 335 companies were traded on the JSX. The turnover ratio in 2003 was 28 percent, up from 18 percent in 2002. In order to be listed on the JSX, a company is required to offer to the public 50 million shares or 35 percent of its share capital, whichever is lower (free float). In practice, however, free float estimates are believed to be less than 20 percent.

Indonesia has a second stock exchange, the Surabaya Stock Exchange (SSX), which is primarily designed for smaller firms, fixed income securities, and for trading over the counter. The SSX is much smaller than the JSX. As of April 2004, 211 companies were listed at SSX, most of which were also listed on the JSX.

The Capital Market Supervisory Agency, known as the Bapepam, is the securities regulator. The Bapepam is not a fully independent agency. It is accountable to the Minister of Finance, who also appoints the Bapepam chairman (no fixed term). The Bapepam's annual report is submitted to the Minister of Finance. It is publicly available at the Capital Market Reference Center. The JSX also plays a role in monitoring trading and disciplining its members.

The principal law governing stock corporations is the Company Law No. 1/1995, and the principal law governing the stock markets is the Capital Market Law (CML) No. 8/1995. The CML contains special rules applicable to listed firms; it is implemented by the Bapepam.

The National Committee on Corporate Governance (NCCG) was established in 1999 through a ministerial decree. The NCCG is responsible for strengthening, disseminating, and promoting good corporate governance principles in the private sector. Since its establishment, it has developed a code of good corporate governance.³ Institutional investors have not played a significant role in improving corporate governance in Indonesia, as they have in other developed markets.

² The market capitalization increased from IDR 268 trillion in 2002 to IDR 460 trillion in 2003.

³ Additionally, the NCCG has issued a code of good corporate governance for banks and guidance for audit committees and independent commissioners.



REVIEW OF COMPLIANCE WITH CORPORATE GOVERNANCE PRINCIPLES

This review assesses Indonesia's compliance with the OECD Corporate Governance Principles. For each Principle, Indonesia's level of observance was assessed as follows:

- *Observed.* All essential criteria are generally met without any significant deficiencies.
- *Largely observed.* Only minor shortcomings, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term.
- *Partially observed.* While the legal and regulatory framework complies with the OECD Principles, practices and enforcement diverge.
- *Materially not observed.* Despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.
- *Not observed.* No substantive progress toward observance has been achieved.

In addition to levels of observance, this section briefly assesses current practice and makes policy recommendations in each area. Annex A summarizes the key policy recommendations.

SECTION I: THE RIGHTS OF SHAREHOLDERS

Principle I (A) – Basic shareholder rights

The corporate governance framework should protect basic shareholders' rights. These include rights to: register ownership through secure methods, convey or transfer shares, obtain timely relevant information on a regular basis, participate and vote in general shareholder meetings, select members of the board, and share in the profits of the corporation.

Assessment

This principle is partially observed.

Description of practice

1. *Secure methods of ownership registration.* Under Indonesian law, ownership of a security is legally evidenced by registration in the company's Register of Shares (DPS). The DPS is maintained by each company's secretary. An investor registered in the company's DPS is a legal shareholder who is entitled to exercise shareholder rights. It is common practice in Indonesia for listed companies to appoint the Bureau of Share Registration to administer their DPS. The official central depository in Indonesia is the Indonesia Central Securities Depository (KSEI), which is responsible for providing a full range of custodial services. For deposited shares, KSEI is registered as a shareholder in DPS for the interest of investors. Participating

- securities firms or custodians are in turn registered with KSEI. Investors can register and deposit their securities in KSEI through participating securities firms or custodians. When registering with KSEI, all securities firms are required to open a sub-account in the name of their customers. If such a sub-account is opened, the customer becomes the beneficial and legal owner, and is then entitled to all the benefits of share ownership. The legal owner can also be whoever holds power of attorney from a principal or trustee of the beneficial owner. The latter is the common practice in Indonesia.
2. *Convey or transfer shares.* In principle, shares of listed companies are freely transferable, except for those of state-owned enterprises in strategic sectors and banks. In addition, the model Articles of Association issued by Bapepam does not allow restrictions on the free transferability of shares. However, the transferability of shares can be restrained by a shareholder agreement.
 3. *Obtain relevant information on the corporation on a timely and regular basis.* Information on the corporation can be obtained through various means. The Company Law requires a company to make annual reports available to shareholders.⁴ JSX also requires listed companies to hold public investors' meetings once a year. In practice, investors commonly make additional effort to obtain information beyond that which has been required for publication. The quality of information disclosed could be improved.
 4. *Participate and vote in general shareholder meetings.* Shareholders are entitled to attend General Shareholders Meetings (GSMs). In practice minority shareholders rarely attend GSMs. Under the Company Law, shareholders representing 10 percent of the total shares (or a lesser percent, as stipulated in the company's Articles of Association) may request the Board of Directors (BOD), or Board of Commissioners (BOC) to convene a GSM.⁵
 5. *Elect members of the board.* Under the Company Law, a limited liability company must have a two-tier board system composed of the BOD and the BOC. The BOD, which is analogous to a Management Board of a continental European company, is in charge of day-to-day management. The BOC, which is analogous to a Supervisory Board of a continental European company, has the duty of monitoring, overseeing, and advising the BOD. Members of the BOD and the BOC are both elected by the shareholders at the GSM. Each company's Articles of Association set forth procedures for nominating, appointing, and dismissing members of the BOD and the BOC. Only a few listed companies have established nomination committees for electing members of the BOD or BOC.⁶ In practice, nomination is usually made by management (or controlling shareholders, especially in state-owned enterprises). There is no clear mechanism for shareholders to nominate board members. The principle of one share, one vote applies in shareholder resolutions. Cumulative voting, which allows minority shareholders to cast all their votes for one candidate, and thereby can enhance their power to affect the decisions of the

4 Company Law, Article 62.

5 If the Board of Directors or the Board of Commissioners refuse to convene a GSM, the shareholders may take their request to the District Court (Company Law, Article 67).

6 Listed SOEs and large non-listed SOEs are required to have both nomination and remuneration committees.

BOD (or BOC), is neither expressly prohibited,⁷ nor permitted. At the GSM, voting is normally conducted for the entire slate of candidates, leaving shareholders no alternative other than to approve the whole package.

6. *Share in the profits of the corporation.* The GSM has the power to determine distribution of net profits. In the case of state-owned enterprises, -- which are under the control of the dominant shareholder, the government -- the government makes the decision on distribution of profit.

Policy recommendations

- Consider requiring all listed companies to establish nomination committees.
- Consider steps to allow minority shareholders a greater voice in the selection of directors and commissioners, including the introduction of cumulative voting.
- Consider steps to promote the interests of minority shareholders, such as support for shareholder activism and advocacy groups.

Principle I (B) – Right to participate in fundamental decisions

Shareholders should have the right to participate in and to be sufficiently informed on decisions concerning fundamental corporate changes – for example, amendments to the governing documents of the company, the authorization of additional shares, and extraordinary transactions in effect resulting in sale of the company.

Assessment

This principle is largely observed.

Description of practice

Revision of the Articles of Association, the company's principal governing document, is to be decided at the extraordinary GSM. The GSM has the power to decide on the issuance of shares. This power, however, can be delegated to the BOC for a maximum of five years, although such a delegation can be withdrawn any time. As noted above, the Articles of Association normally govern a company's voting requirements. Major corporate transactions that in effect result in the sale of the company are to be approved by the GSM. This requires a three-fourth majority votes. For other GSM decisions, a quorum is reached by a two-thirds majority. The Bapepam regulates these matters in more detail for listed companies.⁸

Principle I (C) – Shareholders' AGM rights

⁷ Company Law, Article 46 and Article 72, allow any kind of voting if agreed upon by shareholders and stipulated in AOA.

⁸ Bapepam Rules IX.E.1, IX.E.2, and IX.J.1.

Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings; and they should be informed of the rules, including the voting procedures, that govern them.

Assessment

This principle is largely observed.

Description of practice

There are two types of GSMs: annual and extraordinary GSMs. To convene a GSM under Bapepam rules, companies must submit a detailed agenda to the Bapepam seven days prior to a public announcement. The announcement and the public notice must appear in two daily newspapers at least 28 days before the date of the GSM. Therefore, it takes a minimum of 35 days to convene a GSM. A notice to shareholders advises on the place, time, and agenda of the GSM. Supporting materials are not published, but they are available to the shareholders at the company office or at the meeting place of the GSM.

Shareholders can introduce items into the GSM agenda.⁹ They can also raise an item in a meeting; however, this right is rarely exercised. Shareholders seldom place items on the agenda or participate actively in shareholders meetings.

Shareholders may exercise their voting rights by proxy. Under the Company Law, the BOD, BOC, and employees of the company are prohibited from acting as proxies of the shareholders in attending the GSM and exercising the shareholders' voting rights. Voting by mail is allowed if it is stipulated in the company's Articles of Association. There is no rule on how votes are to be cast. The vote may be by show of hand, or in the case of larger listed companies, by bar-code cards. In practice, voting is normally conducted by asking, "Is there anyone who disapproves?" A disapproving shareholder is often asked to explain why, which tends to discourage shareholders from voting against the majority. Although electronic voting is in theory permitted under the Company Law as voting by "other means," in practice, it is rare.

Policy recommendation

- Consider strengthening shareholders' access to information on the items on the GSM agenda. Minority shareholders should have the right to make proposals in connection with a GSM.
- It is recommended that the use of technology be promoted to facilitate shareholder participation in the GSM. Shareholders should be allowed to cast votes electronically.

Principle I (D) – Disproportionate control disclosure

Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Assessment

⁹ Company Law, Article 70.

This principle is materially not observed.

Description of practice

Any person acquiring more than 5 percent of the paid-in capital of a company must report their ownership to the Bapepam (and any change of ownership thereafter) within a period of no more than 10 working days from the transaction date. However, in practice, it is not easy to find out who the ultimate owner is, and the 5 percent rule can be circumvented. The 10-day reporting period is far too long. The identity of a majority owner of a listed company must be disclosed in the annual report; however, the disclosure does not go beyond direct ownership. The name and address of shareholders and the number of shares can be found in the DPS, and, under the Company Law,¹⁰ the BOD must permit shareholders to conduct an inspection of the DPS upon their written request. However, the BOD may reject the shareholders' request due to considerations of confidentiality and competition. The Company Law restricts cross-shareholding. However, cross-shareholding of listed companies is prohibited by the listing rules. In addition, shareholders agreements normally are not disclosed.

Policy recommendation

- Consider requiring adequate disclosure of affiliated corporations.

Principle I (E) – Control arrangements should be allowed to function

Markets for corporate control should be allowed to function in an efficient and transparent manner.

Assessment

This principle is materially not observed.

Description of practice

Under the Company law, a public company can be acquired through a tender offer, a debt to equity swap, or a so-called "creeping takeover" through secondary market transactions.¹¹ However, transactions resulting in control changes are rare, as the rule is considered to be cumbersome. Anti-takeover devices are not generally available in Indonesia. They are not regulated by Bapepam, but could be permitted by a company's Articles of Association.

Policy recommendation

It is recommended that a study be conducted on how to make the market for corporate control work more effectively.

Principle I (F) – Cost/benefit to voting

¹⁰ Company Law, Article 86.

¹¹ Company Law, Article 102-109 and Bapepam Rules (IX.H.1, IX.F.1, IX.F.2, IX.F.3).

Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

Assessment

This principle is materially not observed

Description of practice

Institutional investors have the power to vote their shares. In practice, most institutional investors seldom attend GSM. There is no requirement for institutional investors to disclose their voting policy to the public. Such disclosure can prevent abuse of voting rights in exchange for private benefit from management can prevent abuse of voting rights in exchange for private benefit from the management.

Policy recommendation

It is recommended that institutional investors acting in fiduciary capacity be required to disclose their voting policy.

SECTION II: EQUITABLE TREATMENT OF SHAREHOLDERS

Principle II (A) – All shareholders should be treated equally

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain redress for violation of their rights. All shareholders of the same class should be treated equally. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

Assessment

This principle is partially observed.

Description of practice

Under the Company Law, each individual shareholder has the right to file a lawsuit against the company to compensate for loss arising from unjust and unreasonable acts of the company, the GSM,¹² the BOD, or the BOC. Shareholders holding at least 10 percent of the total voting shares can file a lawsuit on behalf of the company's shareholders (derivative action) against members of BOD or BOC for the company's losses caused by their negligence. The 10 percent threshold seems too high compared with other

12 The right to file a lawsuit against GSM is not intended to obtain financial redress directly, rather, indirectly through a request that the company put an end to the detrimental actions and take steps to overcome the consequences resulting from those actions.

countries.¹³ While class action suits are allowed, thus far there have been only a few cases related to the capital market law. The cost of initiating a suit and the lack of understanding of class action suits are considered to be major obstacles. To minimize cost and shorten the dispute resolution process, the Indonesian Capital Market Arbitration Board was set up as an alternative to court settlement in 2002. The Supreme Court Regulation issued in 2002 provides guidance on procedures.

Non-common shares with special voting rights have to be specially provided for in a company's Articles of Association. Listed companies must issue common shares with one vote each¹⁴ In state-owned enterprises, the government holds a "golden share." Custodian banks may vote the shares in custody if the beneficial owners permit. This is common. When an investor opens an account in a securities company, the investor can determine whether or not to delegate the voting right to the security company. Although the CL or the Bapepam rules do not explicitly recognize the principle that shareholders must be treated equally in proportion to their shareholding, the equality principle is recognized in various specific contexts. For example, the Bapepam rule on tender offers prevents different treatment of the shareholders of the same class.

Policy recommendation

It is recommended that steps be taken to make it easier for shareholders to file class action suits against directors and managers for breaches of duty and violations of the law – for example, by lowering the threshold for filing lawsuits against members of the BOD or BOC.

Principle II (B) – Prohibit insider trading

Insider trading and abusive self-dealing should be prohibited.

Assessment

This principle is partially observed.

Description of practice

Insider trading. Securities trading based on material non-public information is strictly prohibited under the Capital Market Law and Bapepam rules. The Bapepam is responsible for closely monitoring insider trading and market manipulation. Enforcement of insider trading rules, however, could be improved. The Bapepam can impose administrative sanctions such as fines. However, public perception is that the level of administrative sanction is not sufficiently high to deter violations. Violators are also subject to criminal sanctions, including imprisonment for up to 10 years. However, during the past 5 years, only two cases have been filed in connection with insider trading violations.

Self-dealing. The Bapepam sets forth a detailed set of rules on related party transactions. Related party transactions create potential conflicts of

¹³ In Korea, the threshold holding for shareholders to file a derivative action against directors, statutory auditors, and controlling shareholders has been reduced from 5 to 1 percent for non-listed firms. It is as low as 0.01 percent for listed firms.

¹⁴ Company Law, Article 46.

interest as they consist of transactions between the company and entities that control or are under common control with the company, or between the company and significant shareholders or key managers (or their relatives). The rules require certain related party transactions to be approved by independent shareholders other than the controlling shareholder.¹⁵ The rules however, are not well understood, and in practice a certain degree of legal uncertainty exists in this area.

Policy recommendation

It is recommended that market surveillance on the part of Bapepam and JSX be strengthened, including with regard to insider trading. Special training programs should be provided on a regular basis to enhance the understanding of insider trading rules on the part of those who enforce the law. To minimize legal uncertainty, it is also recommended that related party transactions be further defined and clarified.

Principle II (C) – Board and managers disclose interests

Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

Assessment

This principle is partially observed.

Description of practice

There is no specific requirement in the Company Law for disclosure of conflicts of interest on the part of directors or managers. Since the Bapepam rules require independent shareholder approval of certain related party transactions, however,¹⁶ the directors and commissioners of a listed company are likely to be required to disclose any potential conflict with the company. Indonesian GAAP also has a detailed set of rules requiring disclosure of certain related party transactions.

Policy recommendation

Bapepam rules, or the Company Law, should make more explicit that directors, controlling shareholders, and other related parties must fully disclose conflicts of interest and related party transactions.

SECTION III: THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

Principle III (A) – Stakeholder rights respected

The corporate governance framework should recognize the rights of the stakeholders as established by law and should encourage active

¹⁵ Bapepam Rule 1X.E.1

¹⁶ Bapepam Rule 1X.E.1.



cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The corporate governance framework should assure the legally protected rights of stakeholders are respected.

Assessment

This principle is partially observed

Description of practice

Indonesia is a civil law country. Although it does not recognize the right of employees in the company decision-making process, the company must consider the interest of its employees.¹⁷ The basic rights of employees are provided under the Company Law. The labor law provides for a “collective labor agreement” for settling labor disputes, for which the company must establish a three-party body consisting of representatives from government, labor unions, and work providers. Under the recent Labor/Manpower Law, provisions related to severance payment and terminations are also provided.

During the process of restructuring a company, creditors can file a petition to the Commercial Court, negotiate by themselves, or seek out-of-court settlements. Since accurate information on secured assets is not available, the rights of creditors are not well protected. There is no centralized database where creditors can verify whether a movable or immovable asset has been placed as collateral or pledged. In case of pledged shares, KSEI does not have access to underlying agreements but must rely on the good faith of both the pledgor and the pledgee.

Policy recommendation

It is recommended that pledged shares of both debtors and creditors be reported to and registered in the DPS. It is important that the same information also be provided to the KSEI.

Principle III (B) – Redress for violation of rights

Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

Assessment

This principle is partially observed.

Description of practice

No mechanism provides for an efficient, transparent, and predictable method of assessing the status of assets recovered, including seizure and sale of immovable and movable assets. Under the Company Law, creditors have the right to liquidate the collateral for redress. For stakeholders such as employees and for environmental issues, the media serves in practice as the main channel for expressing grievances. Alerting non-governmental organizations is currently the prevalent mechanism.

¹⁷ Company Law, Article 36 and 104.

Principle III (C) – Performance enhancement

The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

Assessment

This principle is partially observed.

Description of practice

Unless otherwise stipulated in a company's Articles of Association, under the Company Law, a company issuing new capital should offer preemptive rights to the existing shareholders.¹⁸ Since 1999, publicly listed companies have been able to offer share options.¹⁹

Principle III (D) – Access to information

Where stakeholders participate in the corporate governance process, they should have access to relevant information.

Assessment

This principle is partially observed.

Description of practice

Creditors have the right to access company information, yet these rights are limited. Stakeholders' access to company information is not adequate.

Policy recommendation

It is recommended that adequate company information be made accessible to all stakeholders by making the annual reports and other company information accessible publicly on the company website or on a public website.

SECTION IV: DISCLOSURE AND TRANSPARENCY

Principle IV (A) – Disclosure standards

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. Disclosure should include, but not be limited

¹⁸ Pre-emptive rights give existing shareholders a chance to purchase shares of a new issue before it is offered to others. These rights protect shareholders from dilution of value and control when new shares are issued.

¹⁹ Bapepam has prepared a draft of Employee Stock Options Plan scheduled to be released in the near future.

to, material information on: (1) The financial and operating results of the company, (2) Company objectives, (3) Major share ownership and voting rights, (4) Members of the board and key executives, and their remuneration, (5) Material foreseeable risk factors,; (6) Material issues regarding employees and other stakeholders, and (7) Governance structures and policies.

Assessment

This principle is partially observed.

Description of practice

Public companies must submit to the Bapepam their annual (audited) and semi-annual (reviewed) financial statements prepared in accordance with generally accepted accounting principles in Indonesia. Each public company must publish its annual financial statements in the newspapers in the Indonesian language.²⁰ In addition, the JSX and SSX require publicly listed companies to submit quarterly financial statements. Under the Company Law, the Board of Directors must submit the Annual Report, including the audited financial statements, to the GSM.²¹ In addition to their annual and periodic reporting requirements, companies must announce to the public any material information or events affecting the price of securities or investors' decisions, no later than two working days after the event. Such events include mergers and changes in control or significant change in management.²² Omission of disclosure or failure to report and disclose in a timely manner can lead to imposition of administrative sanctions.²³ In practice, minority shareholders often lack access to minutes of directors' meetings.

Company objectives are stated in the articles of incorporation, prospectus and/or in the Registration Statement. Companies are required to include in their annual reports information concerning future objectives, development of the company, material changes since registration, and business activities.²⁴

Information on share ownership and voting rights is recorded in the company's DPS and Special Share Register, which is a list of shares owned by directors, commissioners, and the family members or affiliates. All listed companies are now scripless. For scripless trading, the DPS is automatically updated. Directors, commissioners, and shareholders with ownership in excess of 5 percent of paid-in capital are required to report their ownership details to the Bapepam and to disclose the detail in the financial statements.²⁵ Information on preferential rights and privileges and special limitations for each type of share should be disclosed separately in the notes to the financial statements.²⁶ There is no requirement to disclose the identity of the ultimate beneficial owners of the shares. In practice, companies identified with certain major

20 Bapepam Rule X.K.2.

21 Law 1/1995, Article 56 and Bapepam Rule VIII.G.2.

22 Bapepam Rule X.K.1.

23 Number of companies fined for violation of disclosure requirements have varied between 295 in 1999 and 186 in 2002.

24 Bapepam Rule VIII.G.2.

25 Bapepam Rules X.M.1, VIII.G.7 and Circular Letter SE-02/FM/2002.

26 SFAS 21.

conglomerates and majority shareholders disclose the names of the first-level shareholders, the group affiliation, and related parties. These may include the names of the ultimate beneficial owners, but there is no requirement for the members of the BOD or BOC to report on their families' shareholding in the company.²⁷

Companies are required to include in their annual reports the names of the members of the BOD and BOC, and their salaries and other allowances.²⁸ Salaries and compensation to directors, commissioners, and majority shareholders who are also employees are treated as a matter of conflict of interest if the overall amount of the compensation is not disclosed in the periodic financial statements and thus requires approval of the shareholders in general meetings.²⁹ In practice, remuneration is usually disclosed in the aggregate. Companies are required to include in their annual reports (as part of management's discussion and analysis³⁰), a discussion of, among other things, the risks to which the company is exposed as a result of competition, supply of raw materials, foreign currency exchange rates or interest rates and any measures it has taken to hedge risks resulting from foreign currency exposures.³¹ There is no discussion of risks related to internal controls. Companies should disclose the number of employees at the end of the period. Matters and transactions affecting employees must also be disclosed in the notes to the financial statements. In practice, not all companies willingly disclose such information.

The Registration Statement, Prospectus, and Articles of Association of the companies include discussion about the division of responsibilities among shareholders, the BOD, and the BOC, as well as the qualifications, duties and responsibilities, and meetings of the members of the BOD, BOC, and the meetings of the shareholders.³² There is no requirement for companies to disclose their compliance with the Code of Good Corporate Governance. However, the principles of good corporate governance have been adopted in the Bapepam rules. There is a new requirement that a company's President Director and the Finance Director attest to the accuracy of the financial reports submitted to the Bapepam.³³

Policy recommendation

For listed firms, additional steps should be taken to facilitate investors' access to company information, including making annual reports available to the shareholders through the Internet. It is recommended that consideration be given to requiring listed companies to report on their state of internal controls, and also, that external auditors in the future be required to render an opinion on such reporting. It is recommended that disclosures relating to companies' governance structure be improved, particularly with respect to the responsibilities and the independence of members of the BOD and BOC, and the rights of minority shareholders.

27 Company Law 1/1995.

28 Company Law, Article 56.

29 Bapepam Rule IX.E.1.

30 Management's discussion and analysis is the section of the Annual Report that reports on the company's operations and interprets the financial statements from management's perspective.

31 Bapepam Rules IX.B.1, IX.C.2 and VIII.G.2.

32 Bapepam Rules IX.B.1 and IX.C.2.

33 Bapepam Rule VIII.G.11 issued in December 2003.

Principle IV (B) – Standards of accounting and audit

Information should be prepared, audited, and disclosed in accordance with high-quality standards of accounting, financial and non-financial disclosure, and audit.

Assessment

This principle is partially observed.

Description of practice

Annual financial statements must be prepared in accordance with Indonesian Financial Reporting Standards (PSAK), which are largely adapted from International Accounting Standards (IAS) and issued by the Indonesian Institute of Accountants (IIA). Where a particular accounting standard has not been issued, IAS or US Generally Accepted Accounting Principles (US GAAP) is followed. The IIA is primarily responsible for issuing accounting standards and rules. Since 1994, the IIA has followed a program to harmonize Indonesia standards with international accounting standards. There are, however, inconsistencies between the Indonesian accounting standards and IAS, particularly for those standards that have been modified to suit local requirements. The Central Bank and Bapepam also issue accounting standards and principles for the banking sector and the capital market. In conducting audits of listed companies, the auditors have to follow the Indonesian Generally Accepted Auditing Standards (GAAS) issued by the Public Accountants' Compartment of. These standards are said to be materially in conformity with International Standards on Auditing.³⁴ While the Bapepam has issued guidance on the preparation of financial statements,³⁵ in practice the quality of financial statements is not fully consistent with international standards and practices.

Policy recommendation

It is recommended that Indonesia improve its national accounting standards and practices by fully adopting IAS, issuing related guidelines and providing training.

Principle IV (C) – Independent audit annually

An annual audit should be conducted by an independent auditor in order to provide external and objective assurance on the way in which financial statements have been prepared and presented.

Assessment

This principle is partially observed.

Description of practice

34 An Accounting and Auditing ROSC is underway.

35 Bapepam Rule V111.G.7.

Appointment and dismissal of auditors, as proposed by the BOD, is subject to confirmation by the GSM. Ethics and standards of auditors are regulated by the Public Accountants Compartment (PAC) of IIA. One of the sections of the Code of Ethics and Public Accountants Professional Standards (SPAP), revised in 2001, consists of integrity, independence and objectivity. The SPAP defines what constitutes “independence of auditors” and in order to ensure objectivity, elaborates on several aspects of professional standards to be observed in undertaking an audit. To enhance independence, listed companies and non listed companies, are required to change auditors every three years and auditing firms every five years. Auditors of a company are prohibited from providing it with non-audit services. Non-audit services are clearly defined and include, bookkeeping, internal audit, consulting for management, valuations, human resources and investment advisory.³⁶ The SPAP is based on Professional Standards of the American Institute of Certified Public Accountants (AICPA). However, given the changes in international auditing standards, the Indonesian SPAP needs further revisions. In practice, the quality of audit of public companies varies.

While there are elaborate reporting requirements, the weak enforcement environment undermines the production of sound and reliable financial reports. Under the Civil Code and in conjunction with various company, capital market, and banking laws and regulations, parties that suffer losses due to audit failures may sue auditors. However, shareholders have never filed a class action lawsuit against a public accounting firm. The Bank of Indonesia (which has wide-ranging authority to impose sanctions and fines) has removed auditors from the Bank of Indonesia’s auditors list; but it has not recommended revoking their licenses due to ethics violations. A recent Ministry of Finance Decree regulates the performance and liability of public accountants.³⁷ The authority to appoint the independent auditor rests with the GSM. However, the GSM may delegate the authority for appointment of the independent auditor to the audit committee. In order to strengthen the independence of the external auditor, the audit committee’s role in the appointment of the auditor must be strengthened.³⁸

Policy recommendation

It is recommended that the draft Public Accountant Law adequately strengthen accountants’ legal liability, particularly with respect to third parties and with respect to the ease with which legal suits can be filed against accountants in cases of fraud and gross negligence. It is recommended that International Standards of Auditing and related pronouncements be fully adopted and that adequate training be provided.

Principle IV (D) – Fair and timely dissemination

Channels for disseminating information should provide for fair, timely, and cost-efficient access to relevant information by users.

Assessment

36 Bapepam Rule VIII.A.2/2002.

37 Ministry of Finance Decree 359/2003.

38 The Sarbaes Oxly Act in the U.S. provides an example of good practices for audit committees.

This principle is partially observed.

Description of practice

Companies are required to publish their annual financial statements (including the public accountant's opinion) in local newspapers, in the Indonesian language, no later than the end of the third month after the date of the financial statements. Under the Company Law, companies' annual reports are required to be submitted to the GSM no later than five months after the end of the fiscal year. Companies issuing shares should submit their annual reports 14 days prior to the GSM.³⁹ The public is allowed access at the Capital Markets Reference Center to documents related to the capital market, including annual reports, periodic financial statements, registration statements, prospectuses, business license applications, and a whole range of documents filed by companies with Bapepam.⁴⁰ No fees are charged for access other than the cost of photocopying. In practice, companies engage in selective disclosure. Public companies tend to provide some groups, such as fund managers and analysts, additional information beyond that which is publicly available. However, this is considered inside information.⁴¹ While an abbreviated version is published in the newspapers, full financial statements are made available with the corporate secretary of the company. There is no requirement that annual reports be posted on the company's website.

Policy recommendation

It is recommended that consideration be given to reducing the five-month period for submission of annual reports to three months and that annual report be sent to all shareholders and posted on the company website.

SECTION V: RESPONSIBILITIES OF THE BOARD

Principle V (A) – Board acts with due diligence and care

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and the shareholders.

Assessment

This principle is partially observed.

Description of practice

39 Company Law, Article 56 and Bapepam Rule VIII.G.2.

40 Bapepam Rule III.A.I.

41 Company Law, Article 96.

Under the Company Law,⁴² a limited liability company must have a two-tier board system composed of the BOD and the BOC. The BOD is in charge of day-to-day management of the company, while the BOC has the duty of monitoring, overseeing, and advising the BOD. The BOD's authority includes authority to act, enter into a transaction on behalf of the company, and represent the company in and out of court proceedings. The average size of the BOD is four to seven board members and of the BOC is three to five commissioners. While the Company Law is silent, JSX regulations require that 30 percent of the commissioners must be independent of the company. The chair of the audit committee is required to be an independent commissioner.⁴³ The Company Law also does not include detailed provisions on fiduciary duties such as the duty of care and the duty of loyalty. As the BOC is to monitor the performance of the BOD, the members of the BOC should be independent from the BOD.

Policy recommendation

It is recommended that the duties and accountabilities of independent commissioners be further clarified under the Company Law and the Capital Market Law. It is also recommended that current efforts to amend the Company Law be expedited.

Principle V (B) – Treats all shareholders fairly

Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

Assessment

This principle is partially observed.

Description of practice

The BOD is not allowed to discriminate among shareholders of the same class. Under the Company Law, shareholders may challenge the BOD's decisions, even those that are made in the best interest of the company, on the grounds that a decision affects them unfairly.⁴⁴

Policy recommendation

It is recommended that the Company Law explicitly require that the BOD treat all shareholders fairly. Under such a provision, it will be easier for the shareholders who are affected unfairly by a corporate decision to file a suit against management.

Principle V (C) – Ensures compliance with law

The board should ensure compliance with applicable law and take into account the interests of stakeholders.

42 Company Law, Article 79.

43 Bapepam Rule 1X.15.

44 Company Law, Articles 56, 85, 98.



Assessment

This principle is partially observed.

Description of practice

Under the Company Law, there is no explicit reference to the responsibility of directors and commissioners for compliance with laws and regulations. The Bapepam rule requires listed companies to have a Corporate Secretary or assign the function to a member of the BOD or an officer under the BOD.⁴⁵ The duties of the Corporate Secretary are similar to the duties of a compliance officer. The Corporate Secretary is accountable to the BOD. The JSX regulation⁴⁶ requires activities of the audit committee to be disclosed in the annual report. The audit committee is to oversee the company decisions and actions to ensure that it does not violate the existing regulations. Regarding stakeholder interests, the Company Law does not impose any duty on the BOD or BOC. In practice, however, banks, listed companies, and state-owned enterprises are expected to comply with the Code on Good Corporate Governance.

Policy recommendation

It is recommended that consideration be given to requiring the BOD and BOC of listed companies to include in their annual reports a statement of their responsibilities for establishing and maintaining adequate internal controls over financial reporting and compliance with applicable laws and regulations. They should also assess the effectiveness of their internal control system consistent with international best practices. Such an assertion should be certified by the external auditor.⁴⁷

Principle V (D) – Board should fulfill certain key functions

The board should fulfill certain key functions, including the following: (1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures; (2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning; (3) Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process; (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions; (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law; (6) Monitoring the effectiveness of the governance practices under which it operates and

45 Bapepam Rule 1X 1.4 (1996).

46 JSX Rule 10-1-A/2001.

47 An example of good practice is the recent Sarbanes-Oxley Act of 2002 in the U.S. that requires each annual report of an issuer to contain an "internal control report". Each issuer's auditor needs to attest to and report on the assertion made by the management of the issuer.

making changes as needed; and (7) Overseeing the process of disclosure and communications.

Assessment

This principle is partially observed.

Description of practice

Due to the two tier system, the above functions are carried out by either the BOD or BOC. The relevant governing body in this context is largely the BOC. The Company Law is not specific as to the functions of the BOC. The JSX rules, however, require that the BOC be in charge of the above functions, except that the BOC does not appoint the members of the BOD. The JSX rules specifically require listed companies to establish audit committees. Establishment of remuneration and nomination committees is not mandatory. It is within the authority of the BOD and BOC to decide whether such a committee should be established. The audit committee is established by, and accountable to, the BOC. Audit committees consist of, at least, one independent commissioner and at least two outsiders, who are not members of the BOC. The concept of the audit committee is new and audit committees are generally perceived to be neither effective nor adequately equipped to discharge their responsibilities.

Policy recommendation

It is recommended that listed companies be required to establish remuneration and nomination committees. It is recommended that the effectiveness of audit committees be improved, including measures to clarify and strengthen the role and function of audit committees, consistent with international best practices.⁴⁸ The audit committee members should continuously upgrade their knowledge and skills, e.g., through one of the institutions that provide directors' training.

Principle V (E) – Exercise of objective judgment

The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.

Assessment

This principle is partially observed.

Description of practice

The Company Law does not require that members of the BOC be independent. The JSX regulations, however, now require that at least one-third of the members of the BOC be independent. The audit committee is to be chaired by an independent commissioner. In practice, there is no mechanism available to shareholders to select/nominate independent commissioners. The GSM normally approves of the BOD's proposal for independent commissioner. The Company Law and the JSX Rules define

48 Examples of good practices are the Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees and the recent recommendations of the NYSE Listing Committee issued in 2002.

the qualifications of commissioners. In practice, the BOC is often not independent from the BOD. Attendance records at board meetings are kept by the BOD, but attendance lists are not disclosed even to the regulatory bodies. Under the law, there is no specific requirement related to the time to be spent by the members of the BOD or BOC in discharging their responsibilities. For directors in the banking sector, however, members of the BOD are not allowed to serve on more than one board of directors, fill more than one position as commissioner, or serve on an executive level in other banks, companies, or financial institutions. In practice, the maximum term allowed for a director varies from three to five years as stipulated in a company's Articles of Association. It can, however, be renewed for another term. It may be better for the BOC to have the power to fire members of BOD. Without such power, it would be difficult for the BOC to exercise effective control.

Policy recommendation

It is recommended that independence of the commissioners be further defined under the Code of Good Corporate Governance. In order to ensure that the BOC functions independently of the BOD, consider expanding the role and responsibility of the BOC and improving the process for nomination and selection of independent commissioners.

Principle V (F) – Access to information

In order to fulfill their responsibilities, board members should have access to accurate, relevant, and timely information.

Assessment

This principle is partially observed.

Description of practice

The Company Law is not explicit as to the BOC's access to corporate information. However, under the Company Law, the BOC is empowered to supervise and advise the BOD. This implies that the BOC can request and access any corporate information to fulfill those responsibilities.⁴⁹ In practice, however, members of the BOC are not aware of their rights and responsibilities.

Policy recommendation

It is recommended that the Company Law be revised to give BOC members the express right to access relevant corporate information. Additionally, further efforts should be expended to intensify the training of commissioners on their rights and responsibilities.

⁴⁹ Company Law, Article 97 and 98.

ANNEX A: SUMMARY OF KEY POLICY RECOMMENDATIONS

Principle	Key Policy Recommendations
I. THE RIGHTS OF SHAREHOLDERS	
I (A) – Basic shareholder rights	<ul style="list-style-type: none"> • Allow minority shareholders greater voice in director selection, e.g. cumulative voting. • Require listed companies to establish nomination and remuneration committees. • Consider steps to promote the interest of minority shareholders, e.g. shareholder activism
I (B) – Rights to participate in fundamental decisions	None.
I (C) – Shareholders AGM rights	<ul style="list-style-type: none"> • Strengthen shareholder access to information on the items on the GSM agenda. • Provide minority shareholders the right to make proposals in connection with a GSM. • Promote use of technology to further facilitate shareholder participation in GSM.
I (D) – Disproportionate control disclosure	Consider requiring adequate disclosure of the discrepancy between cash flow rights and voting rights of the controlling shareholders, and cross ownership of affiliated corporations.
I (E) – Control arrangements should be allowed to function	Conduct a study on how to make the market for corporate control work more effectively.
I (F) – Cost/benefit to voting	Require institutional investors to disclose their voting policy.
II. EQUITABLE TREATMENT OF SHAREHOLDERS	
II (A) – All shareholders should be treated equally	Take steps to make it easier for shareholders and investors to file class action suits, including lowering the threshold for filing lawsuits.
II (B) –Prohibit insider trading	<ul style="list-style-type: none"> • Strengthen market surveillance on the part of Bapepam and JSX. • Provide special training on insider trading rules and further clarify definition of related party transactions.
II (C) – Board/managers disclose interests	Make explicit under Bapepam or the Company Law that directors and related parties have the duty to make full disclosure to the company on the conflict of interest or related party transactions.
III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE	
III (A) – Stakeholder rights respected	Require that pledged shares are reported and registered in the Company Share Register.
III (B) – Redress for violation of rights	None.
III (C) – Performance enhancement	None.
III (D) –Access to information	Make adequate company information accessible to all stakeholders by making annual reports and other company information available on the company or on a public website.
IV. DISCLOSURE AND TRANSPARENCY	

IV (A) – Disclosure standards	<ul style="list-style-type: none"> • Require listed companies to make their annual reports available to shareholders through the internet. • Require listed companies to report on their state of internal control. • Improve disclosure relating to companies' governance structure.
IV (B) – Standards of accounting and audit	Adopt international accounting standards fully.
IV (C) – Independent audit annually	<ul style="list-style-type: none"> • Adopt international auditing standards fully and related pronouncements. • Strengthen accountants' legal liability particularly with respect to third parties. • Consider appointing external auditors by the audit committee • Strengthen quality review of auditors
IV (D) – Fair and timely dissemination	Consider reducing the period for submission of annual reports from five months to three months.
V. RESPONSIBILITIES OF THE BOARD	
V (A) – Acts with due diligence, care	Further clarify the duties and accountabilities of independent commissioners.
V (B) – Treat all shareholders fairly	Explicitly require under the Capital Market Law that the boards treat all shareholders fairly.
V (C) – Ensure compliance with law	<ul style="list-style-type: none"> • Require BODs and BOCs to include in their annual reports a statement on their responsibilities for establishing and maintaining adequate internal control over financial reporting. • Request that management assertions and remuneration be certified by the external auditor
V (D) – The board should fulfill certain key functions	<ul style="list-style-type: none"> • Improve duties and effectiveness of audit committee consistent with international best practice. • Require establishment of nomination committees for listed companies.
V (E) – The board should be able to exercise objective judgment	Consider expanding the role and responsibilities of BOCs.
V (F) – Access to information	Revise the Capital Market Law to explicitly entitle the BOC to have access to relevant corporate information.