CORPORATE GOVERNANCE, DISCLOSURE AND ITS EVIDENCE IN INDONESIA

Siddharta Utama

PART I

Abstract

One principle of corporate governance is disclosure and transparency. This principle stipulates that relevant and reliable disclosure is made on all material matters regarding the corporation. By applying this principle, information asymmetry can be reduced and thus negative consequences of adverse selection and moral hazard problems can be minimized. This paper assesses the extent of regulation on disclosure in Indonesia and reviews the evidence on the disclosure level among publicly listed companies in Indonesia. In Indonesia, private mechanism to control the negative consequences of information asymmetry is not effective since the role of board of directors/ commissioners and banks/creditors is minimum in monitoring the firms' actions. Further, the capital and labor markets are not well developed. Without proper regulation, the amount of information produced by these companies, as expected, is inadequate. In recent years, there has been significant improvement in the regulation of disclosure in Indonesia. Badan Pengawas Pasar Modal (Capital Market Monitoring Agency) has issued a number of rules that enforce disclosure and that protect the interest of minority shareholders. The accounting standards are harmonized with the International Accounting Standards while the due process in preparing the standards has been intensified. Empirical evidences, however, find that in general the disclosure level among publicly listed companies in Indonesia is low. Even for mandatory disclosure, the compliance rate is not satisfactory. This low level of disclosure despite the enhancement of disclosure requirement by the regulating bodies suggests that the enforcement of the regulation needs to be improved. The paper concludes with some policy recommendations to improve the disclosure level in Indonesia.

Keywords: *Corporate Governance, Disclosure, Indonesia, Regulation, Financial Statements, Annual Report*

Introduction

The issue of corporate governance has come to the surface since the second half of 1997, after the economic turmoil that hit Indonesia. This is so since the lack of good corporate governance was partly blamed as one of the causes of the economic crisis that affected Indonesian economies since 1997.

Siddharta Utama, Ph.D, CFA,
Department of Accounting, Faculty of Economics University of Indonesia

According to the Indonesian Institute for Corporate Governance (2000), corporate governance refers to:

The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interests of other stakeholders.

It consists of a framework of rules and regulations that define the relationships between shareholders, managers, creditors, the government and other stakeholders and a set of mechanisms that help to enforce these rules.

Generally, the issue of corporate governance arises because of the separation of ownership from control. This separation of duties might result in conflict of interests between parties. For example, when a firm's management is separate and distinct from the providers of the firm's capital, managers, who have control of the firm's assets, have a responsibility to manage assets efficiently and effectively in order to maximize the firm's value. However, due to self-interest, managers might apply corporate assets for non-productive uses that are detrimental to capital providers. This agency problem can exist not just between shareholders and managers, but also between shareholders and creditors, and between controlling and minority shareholders. It can also exist whether the firm is publicly traded, privately held, family-controlled or state-owned. The fundamental concern of corporate governance is to control the possible conflict of interest between parties such that capital providers can assure themselves of getting a return on their investment.

The benefits obtained from implementing good corporate governance include:

- minimizing agency costs, by controlling possible conflict of interests between the principal and the agent;
- minimizing cost of capital, by creating a positive signal for the capital providers;
- increasing the company's image; and
- enhancing the value of the company, which results from lower cost of

capital, improved financial performance and better perception of stakeholders on the company's future performance.

Ultimately, sound corporate governance practices are vital to national economic welfare and essential to maintain a stable global economic environment.

Organization for Economic Co-operation and Development (OECD) has established five principles that can be employed as a reference point by corporations or market participants as they develop their own corporate governance practice, or by policy makers as they examine and develop their legal and regulatory frameworks for corporate governance suitable to their own environments. According to the AdHoc Task Force on Corporate Governance OECD (1999), the five principles are:

1. The rights of shareholders. The corporate governance framework should protect shareholders' rights.
2. The equitable treatment of shareholders. 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 effective redress for violation of their rights.
3. The role of stakeholders in corporate governance. The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
4. Disclosure and transparency. 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.
5. The responsibilities of the board. 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.

With regard to the fourth principle, the principle recently has become increasingly important in Asian countries, including Indonesia. According to Fujinuma (2000), the president of International Federation of Accountants, the driving factors for this development are:

1. Increased focus by regulators on audit quality. As a result of a number of high profile audit failures and Asian financial crisis in 1990s, public confidence in the accounting and auditing professions was hampered. This highlighted the need of ensuring transparent, comprehensive, reliable, high quality financial information.
2. Increased information demands from users. Stakeholders (e.g., investors, governments, business and commercial interests) need new and expanded information - not just in traditional areas of accountancy work, but also in areas that may not be primarily financial in nature (e.g., prospective financial information).
3. Increased expectation of the accountants' role in fighting corruption. The integrity of accountants/auditors plays a key role in reducing corruption since their access to privileged information allow them to detect the possibility of fraud or other irregularities.

Based on the foregoing discussion, this paper assesses the extent of regulation on disclosure in Indonesia and reviews the evidence on the disclosure level among public companies in Indonesia. The paper begins with an overview of the theoretical explanation on the importance of disclosure. A review on disclosure practices across East Asian countries follows afterward. The following section discusses the reason why regulation on disclosure is crucial in Indonesia. Next, it reviews the status and progress of regulation on disclosure in Indonesia. As an illustrative case, a more in-depth discussion is conducted on the banking industry. After that, it reviews some studies that investigate the extent of disclosure among publicly listed companies in Indonesia. Again, a more in-depth discussion is conducted on the banking industry. Finally, the paper provides conclusion and recommendations to improve disclosure practice in Indonesia.

Information asymmetry and the Importance of the Disclosure Principle

Good corporate governance is necessary when there is a potential conflict of interest among parties. This potential conflict of interest arises because the existence of information asymmetry, which results when one party has knowledge not possessed by the other.[1] There are two major types of information asymmetry. The first is adverse selection. Under this type, the party who has information disadvantage relative to the other may decide not to deal with the other party whatsoever, or if the deal is on, he or she may impose a highly stringent and costly condition to the other party. An example is the possible conflict of interest between insiders (i.e., managers) and outsiders, such as potential investors. There are various ways that managers can exploit their information advantage at the expense of outsiders, for example, by hiding, biasing, or managing the information released to investors. As a result, investors are unsure of the quality of the firm and are wary of buying the firm securities, or will only buy the firm securities at very low price. This condition causes the capital market not functioning as well as it should. Other examples of the existence of information asymmetry are: creditors and minority shareholders who possess less knowledge and information than managers and majority shareholders do.

The second type of information asymmetry is moral hazard. Under this type, information asymmetry arises because some parties cannot observe the actions of others when those actions affect

1 The discussion on the following four paragraphs is synthesized from William R. Scott, Financial Accounting Theory, Chapter 1, Prentice-Hall International, 1997.

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the interests of all parties to the transaction. The major case of moral hazard is the problem of motivating manager effort. In most large companies, it is common to have a separation of ownership and control. Since it is difficult for shareholders and creditors to observe the extent of the manager effort on their behalf, the manager may tend to shirk on effort. Moral hazard also hampers the efficient operation of the economy.

The adverse selection problem can be controlled with the use of the full-disclosure principle, by converting inside information into outside information. Accounting information such as financial statements plays a crucial role since it provides past financial performance of a firm. Based on the information, investors are able to distinguish 'high' quality firms from 'low' quality firms and thus can make a more efficient capital allocation accordingly. Obviously the information has to be credible to gain the trust and confidence of the investors. External auditors play an important role to add credibility of accounting information since as long as they can maintain their integrity and independence, outsiders can rely on their opinion with regard to the fair representation of the financial statements.

Financial statements and especially net income can also be useful to control moral hazard since accounting net income can be used as a proxy of managerial performance. Disclosing net income can inform the securities and managerial labor markets about the performance of a manager, so that the manager who shirks will suffer a decline in income, reputation, and market value over time.

Obviously there is cost of disclosure. This includes out of pocket costs (such as administration costs, raw materials, etc.) and indirect costs (such as cost of revealing propriety information to competitors / potential competitors). Firms will increase the amount of disclosure as long as the benefits from disclosure exceed the costs.

Some studies have investigated the impact of disclosure on cost of capital. These studies suggest a negative association between disclosure level and cost of equity capital. There are two explanations on this. The first is that increased disclosure improves stock market liquidity and thus reducing cost of equity capital either through reduced transactions costs or increased demand for a firm's securities (See for example Glosten and Milgrom 1985, Amihud and Mendelson 1986 and Diamond and Verrecchia 1991). The second explanation is that enhanced disclosure reduces estimation risk arising from investors' estimates of the parameters of an asset's return (See for example, Coles and Loewenstein 1988, Handa and Linn 1993, Coles *et al.* 1995, and Clarkson *et al.* 1996).

The empirical evidence appears to support the negative association between disclosure level and cost of equity. By measuring disclosure level as the amount of voluntary disclosure provided in the annual reports, Botosan (1997) finds that for firms that attract a low analyst following, greater disclosure is associated with a lower cost of equity capital. The negative association between disclosure level and cost of debt has also been documented. The reason is that lenders and underwriters consider a firm's disclosure policy in their estimate of default risk. Sengupta (1998) finds that firms with high disclosure quality ratings from financial analysts have a lower effective interest cost of debt. He further provides evidence that the relative importance of disclosures is greater in situations where there is greater market uncertainty about the firm.

Andrew Sheng (2000), Chairman of the Securities and Futures Commission Hong Kong, summarized the benefits of disclosure as follows:

To maintain integrity and to function fairly and efficiently, the market needs high quality information, timely disclosures and efficient access to such information. Investors need this information to make investment decisions and to trade. When relevant information is not properly disclosed in a timely fashion, when insiders abuse their positions and misuse information, or when misleading information is given, this will destroy market fairness and integrity, and the level playing field.

The foregoing discussion suggests that disclosing relevant information benefits not only outsiders but also the firm and the economy; therefore firms should generate an optimal amount of information to the benefit all parties. The question is whether firms do that or whether there is a failure in producing adequate information such that regulation of disclosing information is needed.

Indeed, without any regulation, firms actually have private incentives to produce information about them.[2] First, firms generate contracts with various parties that they deal with. These contracts typically require information to monitor whether the rights and duties of each party are fulfilled or not. The parties to a contract can agree on the type and amount of information to be produced and thus, there is little need for regulation to drive information production. Second, market pressure (capital and labor markets) can also be the second source of private incentives for information production. Managers who perform well will be highly valued by the managerial labor market and they are highly valued if they can increase firm value. As discussed ear-

2 The discussion in the following two paragraph is excerpt from Scott (1997), chapter 12.

tier, to enhance firm value the cost of capital has to be minimized and thus a full disclosure policy is warranted.

Unfortunately, because of information asymmetry, capital and labor markets may not operate properly. Problems of moral hazard and adverse selections remain and indicate that managers and other insiders possess private information that they can use to their advantage. Further, producing information to outsiders is like public goods and thus is characterized by externalities and free riding. These problems can result in under produce of information and thus justify central authority intervention.

Disclosure Practices Across East Asian Countries

To provide general view on disclosure practices across Asian countries, the following section reviews two studies that have investigated disclosure practices across Asian countries, especially those that were most affected by the Asian financial crisis.

OECD conducts the first study and it examines corporate governance practices in selected developing countries. Countries included in this study are Indonesia, Republic of Korea, Malaysia, the Philippines and Thailand.[3] The objective of the study is to evaluate the role of corporate governance in the five countries most affected by the Asian financial crisis. The findings of the study that are related to the issue of disclosure and transparency can be summarized as follows. The study finds that countries studied have poor transparency and inadequate disclosure practices. It cites a number of factors that may explain these findings. The factors include little tradition of disclosure among corporate insiders, who mainly consist of families and family groups. Other factors that contribute to findings are inadequate accounting standards and weak implementation of these standards, including failure to impose penalties for fraudulent financial reporting. To substantially improve the quality of accounting, auditing and financial reporting, the study provides some recommendations that include: establishing a supervisory entity to regulate accounting, auditing and financial reporting practices and to enforce the standards; requiring that all publicly listed companies appoint independent directors and external audit subcommittees and mandate their functions an responsibilities to public investors; and the imposition of sufficiently severe penalties for fraudulent financial reporting.

The second study provides a comparison of the current disclosure practices of some of the largest banks and corporations in the Republic of Korea, Thailand, Indonesia, Malaysia, Philippines, and Japan with internationally accepted accounting practices.[4] The study reviews published financial statements of each of the sample companies and identified actual accounting and disclosure practices in the following areas: related party lending and borrowing; foreign currency debt; derivative financial instruments; segment information; contingent liabilities; and additional disclosures in bank financial statements. These areas were chosen since they provide useful information regarding financial transactions that contributed to the Asian financial crisis.

The results indicate that most of the corporations and banks in the five East Asian countries (except Japan) did not follow International Accounting Standards (IAS) in disclosing the areas investigated. The average compliance scores of all areas are less than 40% and they range from less than 20% for disclosure on Derivative Financial Instruments to about 35% for disclosure on Foreign Currency Debt. This lack of compliance with IAS affects transparency in the financial statements and hinders dissemination of useful financial information through financial statements. The study argues that the lack of disclosure prevents the users of financial statements to detect the worsening financial condition of the companies well in advance of the outbreak of financial crisis in the affected countries.

Finally, Saudagaran and Diga analyze the characteristics of financial reporting in "Emerging Capital Markets" (ECMs), which refer to capital markets in less-developed and transitional economies.[5] They employ information availability, reliability and comparability as the criteria for evaluating and comparing the state of financial reporting in ECMs. The analysis reveals significant financial reporting diversity in ECMs, but generally ECMs are lack behind their more developed counterparts with respect to these criteria.

In summary, these studies find that all East Asian countries (including Indonesia) have poor disclosure practices.

The Effectiveness of Private and Marketi Incentive Mechanisms to Reduce Information Asymmetry in Indonesia

In Indonesia, it is common to find companies whose ownership structure is controlled or concentrated by limited number of shareholders or family ownership. Claessens *et al* (2000) show that 67.3% of the publicly listed companies were family held while only 6.6% were widely held. This concentration in ownership and control exacerbates the extent of information asymmetry between majority stockholders and minority stockholders. Due to their weak ownership position, it is difficult for minority stockholders to impose a contract that requires the firm to provide adequate disclosure to them or to involve them in key corporate decision-making. The mechanisms for participation by minority shareholder in corporate decision-making are generally weak, shareholder participation is passive and legal protection for shareholders is inadequate. Further, OECD (2000) reports that because of dominance of family-based controlling shareholders and because of the lack of effective mechanisms that could provide checks and balances, boards of directors are ineffective oversight mechanism in serving interests of all shareholders. The effectiveness of boards of directors

3 OECD, *op. cit.*

4 M. Zubaidur Rahman, *The Role of Accounting Disclosure in the East Asian Financial Crisis: Lessons Learned?, The Second Asian Roundtable on Corporate Governance*, Hong Kong, May 31 - June 2, 2000.

5 S. M. Saudegaran and J. G. Diga, Financial Reporting in Emerging Capital Markets: Characteristics and Policy Issues, *Accounting Horizons*, June 1997. p. 41-64.

may also have been undermined by the fact that the chairman of boards of directors often being the top management team. A study by Ikatan Akuntan Indonesia (2000), the Indonesian Accounting Association, finds that in Indonesia, since families typically control firms, there is often no separation between ownership and management and this may result in management acting in the best interest of the majority shareholders rather than the best interest of all shareholders.

Debt and especially bank loans provides the major source of financing among companies in Indonesia. Therefore, ideally banks should have the power to require their clients to produce information necessary for monitoring their clients' performance. Unfortunately, this situation fails to be met. OECD (2000) finds that in Indonesia creditors in general provide little input and feedback into companies' management and decision, and their role in monitoring is weak. First, creditors are poorly governed, as explained by weak internal control and inadequate regulatory frameworks for financial institutions. Secondly, there is a lack of competition among creditors and further many of them are parts of conglomerates or owned by the same families who own the borrowing firms. Thirdly, implicit and explicit government guarantees of loans may have further weakened creditors' incentives to monitor and discipline bad borrowers and to recognize non-performing loans.

The above discussion indicates that relying on private incentive to produce information through contracting fails to generate adequate disclosures necessary to control the negative impact of information asymmetry (i.e., adverse selection and moral hazard). The following analysis discusses the market role in improving disclosure in Indonesia.

Capital markets are not well developed in most East Asia countries, including Indonesia. This lack of a well-developed capital market may also be one of the reasons that in some countries (including Indonesia) have relied mainly on bank finance. Further, the capital market in Indonesia is less efficient than more developed markets in term of the degree of relevant information reflected in security prices.[6] Managerial labor market is also not well developed in Indonesia. Moreover, it is ineffective to monitor the performance of managers since the managers belong to the family who has controlling interest. This creates disincentive for managers to be properly valued by the labor market. Finally, the market for corporate control has been largely inactive in Indonesia. This is partly a function of government policy but it also reflects the difficulties to take over when ownership is so concentrated. All of these conditions hamper the effectiveness of market mechanisms in providing incentives for firms to generate adequate disclosure.

Since these imperfections are sufficiently serious, the central authority needs to step in and regulate firms' information production decisions. ■

6 For empirical evidence regarding the market efficiency in the Jakarta Stock Exchange, as an example see Utama and Afandi 1998.

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