

**CORPORATE GOVERNANCE AND POLITICAL
CONNECTIONS ON WEALTH EXPROPRIATION
AMONG INDONESIAN BUSINESS GROUPS**

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CONNECTIONS ON WEALTH EXPROPRIATION
AMONG INDONESIAN BUSINESS GROUPS**

by

PUJI HARTO

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With my profound love to:

Solikhaton, my beloved wife and fellow companion in life
Thank you for your generous dedication and
unconditional support throughout our life together

Sajidah, Abid and Habibah, my brave and incomparable blessing of my life
Thank you for your patience, encouragement,
and all the joy and hope you have brought me

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**TADBIR URUS KORPORAT DAN HUBUNGAN POLITIK KE ATAS
EKSPROPRIASI KEKAYAAN DI KALANGAN KUMPULAN
PERNIAGAAN INDONEISA**

ABSTRAK

Satu dekad selepas krisis kewangan Asia 1997/98, Indonesia masih menghadapi tahap keberkesanan yang rendah dalam aspek penguatkuasaan tadbir urus korporat. Masalah ekspropriasi kekayaan masih berterusan atas sebab ketumpuan pemilikan yang tinggi, dominasi kumpulan perniagaan dan penguasaan syarikat-syarikat oleh keluarga. Tujuan keseluruhan kajian ini adalah untuk menyelidiki peranan mekanisme tadbir urus korporat dan hubungan politik untuk menjelaskan takat ekspropriasi kekayaan melalui urus niaga dengan pihak yang berkaitan. Urus niaga dengan pihak yang berkaitan berfungsi sebagai proksi ekspropriasi kekayaan yang boleh dibahagikan kepada piutang pihak berkaitan, hutang pihak berkaitan, jualan pihak yang berkaitan dan belian pihak berkaitan. Sampel kajian ini adalah 127 syarikat awam yang tersenarai di Bursa Saham Indonesia sepanjang tempoh 1999-2008 yang menghasilkan 1270 tahun-pemerhatian syarikat. Analisis kuantitatif dilakukan melalui regresi data panel dinamik. Keputusan kajian menunjukkan bahawa beberapa mekanisme dalaman tadbir urus korporat gagal untuk melaksanakan peranan pemantauan terhadap ekspropriasi kekayaan. Struktur pemilikan muktamad dan pengarah berganda cenderung untuk menyokong ekspropriasi kekayaan. Kompensasi pengarah dan penyelia berganda gagal untuk bertindak sebagai mekanisme pemantauan yang berkesan untuk mengekang ekspropriasi kekayaan. Pembolehubah hubungan politik cenderung pula untuk memudahkan ekspropriasi kekayaan yang sekaligus bertindak sebagai halangan atas keberkesanan mekanisme dalaman tadbir urus korporat. Penyelidikan ini berjaya menghasilkan beberapa sumbangan. Dari segi sumbangan secara teori, penyelidikan

ini telah mengkaji kepentingan masalah agensi di antara pemegang saham majoriti dan minoriti dalam menjelaskan peranan tadbir urus korporat atas ekspropriasi kekayaan. Kajian ini juga mendapati sokongan untuk model '*path dependence*' tadbir urus korporat, di mana keunikan faktor institusi suatu negara seperti sistem politik juga turut menyumbang ke arah proses pembentukan tadbir urus korporat. Kajian ini mendapati bahawa hubungan politik bertindak sebagai penhalang bagi pembangunan tadbir urus korporat yang baik. Dari segi sumbangan praktikal, kajian ini telah mengemukakan beberapa cadangan dasar untuk menjadikan fungsi lembaga penyeliaan lebih profesional dan penetapan peraturan mengenai bilangan maksimum pengarah berganda. Merujuk kepada transaksi dengan pihak berkaitan, kajian ini turut mencadangkan penambahan dalam keperluan pendedahan mengenai transaksi tersebut.

CORPORATE GOVERNANCE AND POLITICAL CONNECTIONS ON WEALTH EXPROPRIATION AMONG INDONESIAN BUSINESS GROUPS

ABSTRACT

A decade after the 1997/98 Asian Financial crisis, Indonesia is still experiencing a low score on the effectiveness of corporate governance enforcement. The problem of wealth expropriation still persists due to high ownership concentration, domination of business groups and predominantly family-controlled firms. The overall objective of this study is to examine the role of corporate governance mechanisms and political connections to explain the extent of wealth expropriation through related party transactions. Related party transactions serves as a proxy for wealth expropriation and is examined from related lending, related borrowing, related party sales and related party purchases perspectives. The sample of this study was 127 public listed companies in the Indonesian Stock Exchange during the period of 1999-2008, resulted in 1270 firm-year observations. Dynamic panel data regression was used to test the hypotheses. The results of this study show that several internal governance mechanisms fail to discharge their monitoring role to wealth expropriation. Ultimate ownership structures and multiple directorships are more likely to support wealth expropriation. Director compensation and multiple commissionerships fail to act as effective monitoring mechanisms to curb wealth expropriation. Political connections tends to facilitate wealth expropriation and also acts as an impediment to the effectiveness of internal governance mechanisms. This research highlighted several contributions. In terms of theoretical contribution, this study examines the importance of agency problems between the majority and minority shareholders in explaining the role of corporate governance on wealth

expropriation. This study also supports the path dependence model of corporate governance, where the uniqueness of a country's characteristics such as institutional factor also shapes the direction of the governance process. This study finds that political connections acts as an impediment to the development of good corporate governance. As for the practical contribution, this research proposes some policy recommendations to make the board of commissioners function more professional and also calls on the use of regulation to limit the maximum number of directorships. Regarding related party transactions, this study suggests increased disclosure requirements concerning these transactions.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Studies on corporate governance have received great attention in recent years. In Asia, the issue of corporate governance has attracted significant consideration especially a decade after the Asian financial crisis which happened in 1997. Poor corporate governance is mentioned to be the cause of the significant woes toward the collapse of the banking and corporate sectors and the inability to attract investments. Therefore, the implementation of good corporate governance practices is regarded as the key to achieving sustainable growth; its accomplishment, however, requires the commitment from all countries, including Indonesia.

Following the above crisis, the Indonesian government has been promoting investment as the basis of economic growth. Consequently, the pursuits of good corporate governance to attract domestic and international investors have become a crucial priority.

On the contrary, empirical evidence generally reveals that the performance of Indonesian's corporate governance practice is still poor (ADB, 2004; Klapper & Love, 2004; Standard & Poors, 2004). According to Husnan (2001), the practice of corporate governance in Indonesia is highly influenced by its unique institutional context. The institutional settings for the majority companies in Indonesia among others are concentration of ownership in the hands of family business groups, the prevalence of pyramid structure, and the lack of shareholder protection (Husnan, 2001).

1.1.1 Indonesian Corporate Governance System: Development and Challenges

During a decade after the Asian Financial Crisis 1997, the government of Indonesia has been promoting and enforcing good governance practices among companies. In the year 2001, the National Committee on Corporate Governance (NCCG) established the code of conduct of good corporate governance. This code was adopted from corporate governance principles developed by the Organization for Economic Cooperation and Development (OECD). The code was revised in 2006 (KNKG, 2006). The country has also developed a plethora of codes of best practice for different sectors, companies and professions which include public governance (i.e., government), banks, state-owned enterprises and actuaries. The pursuit of the Indonesian code of corporate governance, however, is neither mandatory nor adhere to the principle of compliance. It is merely a set of principles and general guidelines recommended as best practices for a wide range of companies, including unlisted ones (ACGA, 2010).

While some corporate governance indicators have improved since the establishment of the code, the need to instill transparency and accountability are still very challenging. Among the main challenges of corporate governance in Indonesia are the weaknesses in its legal and judicial system, and poor protection of minority investors. The importance of minority investors' protection is highlighted by a survey conducted by Forum for Corporate Governance in Indonesia (FCGI) in 2004. According to the survey, investors were willing to pay up to 17% premium for investing in firms which have good corporate governance. On the other hand, a deep discount of 30% was imposed for firms controlled by a single or few domestic owners with poor governance (Nam and Nam, 2004).

A recent survey of corporate governance quality in Asia by Asian Corporate Governance Association in collaboration with Credit Lyonnais SA (CLSA) (2007, 2010) once again placed Indonesia at the bottom rank compared to its neighboring countries as presented in Table 1.1.

Table 1.1
Corporate governance quality score for Asian countries

Rank	Market	Rules & Practices		Enforce		IGAAP		Political & Regulatory		Culture		Total Score	
		'07	'10	'07	'10	'07	'10	'07	'10	'07	'10	'07	'10
1	Singapore	70	65	50	60	88	88	65	69	53	53	65	67
2	Hongkong	60	59	56	63	83	80	73	67	61	54	67	65
3	India	59	46	38	36	75	63	50	54	56	43	56	49
4	Japan	43	45	46	53	72	75	52	62	49	53	52	57
5	Taiwan	49	50	47	47	70	78	60	56	46	46	54	55
6	Thailand	58	56	36	42	70	73	31	54	39	49	47	55
7	Malaysia	44	49	35	38	78	80	56	60	33	32	49	52
8	China	43	47	33	36	73	75	52	56	25	30	45	49
9	Korea	45	43	39	28	68	78	48	44	43	33	49	45
10	Indonesia	39	39	22	28	65	67	35	33	25	32	37	40
11	Philippines	39	35	19	15	75	75	38	37	36	32	41	37

Source: Asian Corporate Governance Association (ACGA) and CLSA Asia-Pacific Markets (2007& 2010)

As depicted in Table 1.1, Indonesia was ranked at the 11th position in 2007 and 10th in 2010. Indonesia only beats Philippines but still lags behind Singapore, Malaysia, and Thailand. Further analysis indicates that the low total score on corporate governance was mainly contributed by the poor scores on the enforcement of good corporate governance practices, political and regulatory environment and the hindrance of business culture. These three categories are the key issues of concern in the development of Indonesian corporate governance. The result also indicates that the implementation of good corporate governance road map still faces critical challenges that need long-term commitment from the public and private parties.

Changing laws and other formal rules alone may fail to achieve the desired outcomes or alter the status quo when such changes face with a rather stagnant business culture. Despite the intensive implementation of regulations on good

corporate governance especially a decade after Asian Financial Crisis 1997, a skeptical view still comes into sight on the consequences of its accomplishment in the Asian context (Chen, Li, & Shapiro, 2011). Looking at the low score on Indonesian's business culture as well as poor political and regulatory environment, it seems to suggest that it is not only a good corporate governance implementation that matter, the reformation of the mindset of those actors behind the implementation process is also very much needed. In other words, good human governance, a term that refers to the values, attitudes and ways of thinking and doing that bend social forces toward the better life of society (Salleh and Ahmad, 2008) should be given due consideration as well.

One distinguishing feature of Indonesian corporate governance system is the two-tier corporate governance system derived from the civil law codification system. Within the system, there is an explicit separation between the monitoring function performed by the supervisory board and the operational function performed by the board of directors (La Porta, Lopez-de-Silanes, & Shleifer, 1998). Indonesian corporate law system explicitly states that in conducting their fiduciary duties, the supervisory board oversees the board of directors (UUPT, 2007). This governance structure differs from the U.S. and other developed countries which follow the common law system. For countries which draw on the common law system, the operation of the company is controlled by a single board of directors and it is called one tier corporate governance system.

As opposed to the single tier corporate governance system adopted by its neighbouring countries, the implementation of the two-tier system has made the Indonesian's governance system rather unique in the region. In particular, its legal origin has resulted in the adoption of a governance structure which separated the

monitoring and operational functions via the establishment of two independent boards. Judging from the two-tier structure, it creates the impression that an independent supervisory board appears to be more neutral and thus it is expected to be more effective in protecting minority shareholders' wealth. In contrast, La Porta et al. (1998) found that the common law system provides higher guarantees for shareholder rights and better enforceability of the rights. In addition, they also found that the lower degree of shareholders' protection is closely related to a higher control concentration and the lower occurrence of widely held firms (La Porta et al., 1998). This contrasting finding has motivated the present study to seek empirical evidence on the effectiveness of the two tier governance system in mitigating the problem of wealth expropriation in Indonesia, a developing country with a fast growing capital market.

1.1.2 Threat of Wealth Expropriation by Controlling Shareholders

A substantial body of empirical research shows that concentrated ownership prevails in most countries around the world (Anderson & Reeb, 2003; Claessens, Junco, & Lang, 2000, 2002; La Porta et al., 1998, 1999; Lemmon & Lines, 2003). The high concentration of ownership together with the domination of family business and weak investors' protection will potentially create problem of wealth expropriation (Wolfenzon, 1999). In this sense, controlling shareholders as the dominating party try to extract firms' wealth to gain the private benefits at the expense of the minority investors. The imbalance position of majority shareholders versus minority shareholders actually represents the agency problems between the two competing parties. This type of agency problem is the prevalent agency problem that exists across the world (La Porta et al., 1999; Shleifer & Vishny, 1997).

Along with the concentrated ownership, the domination of family business often facilitates pyramidal and cross-holding structures as the means to maintain and enhance control of the firm by its controlling shareholders. Pyramidal structure is defined as the ultimate ownership of a firm running through a chain of ownership of intermediate corporations. Cross-holding refers to horizontal and vertical ownership links among corporations that can enhance the control of a large, ultimate shareholder (Claessens et al., 2002).

The pyramidal and cross-holding structures allow the controlling shareholders to exert various self-dealing activities to expropriate firm's resources in ways that serve their own private interest at the expense of other stakeholders. This can be done by extracting resources from companies in which controlling shareholders have low cash flow rights to affiliated firms in which controlling shareholders have higher cash flow rights without bearing the full cost of the expropriation (Morck, 2003). Self-dealing activities through misappropriation of companies' assets, also known as tunneling, is a transfer of wealth from minority shareholders to insiders such as corporate owners, managers, or directors (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000; World Bank Group, 2006). Hence, ownership structure concentration provides incentives for wealth expropriation. These acts, in turn will have negative impact on firm performance and valuation (Leuz, Nanda, & Wysocki, 2003; Kim & Yi, 2005).

Empirical evidence thus far suggested that wealth expropriation has taken place in the form of related party transactions (Cheung, Rau, & Stouratis, 2006; Galerry, Gallery, & Supranowicz, 2008; Gordon, Henry & Palia, 2004; Henry, Gordon, Reed, & Louwers, 2007; Jian & Wong, 2006; Peng, Wei & Yang, 2006), dividend policy (Chen, Jian & Xu, 2009; Faccio, 2001; Lee & Xiao, 2004), debt

policy (Du & Dai, 2005; Faccio, Lang, & Young, 2003; La Porta et al., 1999; Nor & Ariffin, 2005), diversification policy (Claessens et al., 2000; Ishak & Napier, 2006; Khanna & Palepu, 2000), and even earnings management (Denis, 2001; Lo, Wong & Firth, 2009). Among the many ways to expropriate wealth, it is likely that related party transactions is one of the most common techniques employed by the owner manager (Nenova, 2005).

Many corporate scandals that arise in the recent decade show evidence of self-dealing, including those that happened in the developed countries (McCahery & Vermeulen, 2005). In the U.S., Enron was accused of being heavily involved in related party transactions. A similar scandal also happened in Italy where Parmalat tried to hide enormous amount of debts through complicated inter-companies transfer. In India, companies that have unexpected high earnings have been found to channel extra cash disproportionately to the controlling family (Bertrand, Mehta, & Mullainathan, 2002).

As self dealing problem gains attention all over the world, evolving efforts have been taken to curb the problem. At the international scene, the World Bank has been conducting the assessment of investors' protection in addressing corporate governance issues. A series of reports such as the observance standards and codes (ROSC) and "*doing business report*" have been published. The reports attempted to review the progress of corporate governance development in various countries by benchmarking it with code of good corporate governance of OECD (World Bank, 2004).

In emerging markets, the issues of self-dealing become more pressing in view of problems such as concentrated ownership, weaker regulation, and thin market which are notably absent in the developed countries. Since expropriation of minority

shareholders is so prevalent in developing countries, it is very important to know how and why it occurs. La Porta et al. (1999) suggested that the theory of corporate finance should also focus on the topics of expropriation in the context of agency relationship between controlling and minority shareholders as these are relevant to most countries. The majority literatures on agency theory, for instance, emphasize on the context of developed countries. This situation motivates the present study to intensively embark on the role of corporate governance in mitigating the problem of wealth expropriation in a developing country like Indonesia as an attempt to gain a clear picture on the issues and challenges facing the development of good corporate governance practices.

The rising trends in research on connected transactions in recent years have exacerbated the concern of these transactions on the potential abuse and their impact on economy (See for example: Baek, Kang & Lee, 2006; Berkman, Cole, & Fu, 2009; Cheung et al., 2006, 2008, 2009a, 2009b; Gallery et al., 2008; Gao & Kling, 2008; Gordon et al., 2004; Jian & Wong, 2003, 2006; Jie, 2008; La Porta et al., 2003; Peng et al., 2006). While not all related party transactions are abusive for business operations (Henry et al., 2007), a scrutiny on these transactions induce a high risk factor that investors would consider before investment decision is made (Cheung, et al., 2006). The abusive transactions may lead to the national discount to the country's market as a whole (OECD, 2009).

1.1.3 Self-dealings Transactions among Indonesian Business Groups

The complexity of business groups in Indonesia has given rise to the extensive related party transactions among affiliated firms within the group. The main benefit of performing these transactions is that it can provide efficient resources allocation

among the connected parties as suggested by the efficient contracting view (Kohlbeck & Mayhew, 2010). However, looking at the low level of political and regulatory environment in Indonesia, exploiting those prevailing transactions potentially create the conflict of interest toward the benefit of controlling shareholders (Pizzo, 2011). In Indonesia, related party transactions is one area that is still largely unexplored although there are some anecdotal evidence indicating its pervasive abuse.

Due to high ownership concentration in Indonesia, related party transactions are not given the due and necessary attention and are not sufficiently regulated (Nenova, 2005). A sound regulation dealing with related party transactions is normally required as those transactions typically engaged at market price, approved by board committees and should be approved by general shareholders' meeting for material transactions. In reality, however, the disclosure of related party transactions is still not adequate while the enforcement is still weak (Nenova & Hickey, 2006).

One key finding of the Report on the Observance of Standards and Code (ROSC) from corporate governance country assessment project by a joint committee of World Bank and International Monetary Fund (IMF) (2004) stated that related party transactions among Indonesian companies are still subject to high uncertainty due to unclear regulation. It is recommended that Indonesia strengthen its regulation further. Moreover, the definition of related party transactions by BAPEPAM-LK (*Badan Pengawas Pasar Modal dan Lembaga Keuangan*) or the Capital Market and Financial Institution Supervisory Agency is still confusing as BAPEPAM-LK allow companies to rely on lawyer's opinion in deciding the need for disclosure on these transactions (Nenova, 2005). Consequently, it makes the compliance of disclosure

regulation on related party transactions more arbitrary in practice, allowing greater chances of potential abuse.

The monitoring of related party transactions becomes more difficult as many companies in Indonesia are under the control of family business groups with complex pyramidal ownership structures. In fact, the prevalence of business groups in Indonesia has facilitated and encouraged more of these kinds of transaction. Related party transactions at Gajah Tunggal Group (See section 2.4.2 in chapter 2 for details), for instance, reflect the common practice of self-dealing activities prior to the 1997 economic crisis by business groups in Indonesia.

Existing cross-country evidence also supported the predominance of business groups in emerging markets in Asia (Claessens et al., 1999; 2000) as well as in Continental European countries (Barca & Becht, 2001). Therefore, a study on business groups would be useful to shed more light about the benefits and costs of group affiliations since previous studies still report mixed results and are still far from conclusive (See for example: Claessens et al., 2002; Haidar & Khan, 2003; Khanna & Palepu, 2000; Sato, 2004; Wiwattakanang, 1999). As such, studying related party transactions in the context of firms affiliated to business groups opens up opportunities to examine the subject matter more closely at the heart of the business dealings (Chang, 2006). Therefore, unraveling related party transactions as a means of wealth expropriation becoming a pillar of motivation of this study.

1.1.4 Political Economy of Corporate Governance in Indonesia

The characteristics of ownership and control concentration in East Asian corporate system tend to be highly related to the preferential treatment to the family members by government. This is what Rajan and Zingales (1998) defines as “*crony*

capitalism". In this environment, business is conducted in a system involving close relationship among companies, banks, and the government through ownership, family affiliation and political connections. In a broad sense, crony capitalism falls under relational-based corporate governance, the opposite of a market-based corporate governance (Rajan & Zingales, 1998). Since crony capitalism has led to little incentive for an elaborate system of good corporate governance, it may even reduce the ability of the legal system to protect minority shareholders effectively.

Prior to the Asian financial crisis 1997, developing political connection is the viable way to secure business groups' interest in the centralized power of former President Suharto and his family circle. The patronage connections between politician and rent seeking interest groups have led to collusive behaviors that cause the inequality of wealth distribution in the national economy. Fisman (2001) pointed out that the value of some firms in Indonesia might have been highly dependent on the extent of their political connections. The disproportionate economic success of business groups through alliances with political regime was highlighted by Husnan (2001):

"Some of the groups related to government officials have a unique share ownership. The officials (or their family members) often own a small portion of shares given to them freely as token from the controlling shareholders. By doing this, the controlling shareholders could maintain the special relationship with the officials, and hence, enjoy some kind of protection and special treatments. However, the control of the company is still in the hand of the founder or their family". (Husnan, p. 28).

Corporate governance reform in the aftermath of Asian crisis has become a crucial agenda to restore investor confidence as well as promoting growth and development. It is worthy to note that the success of corporate governance reform requires a prior shift in the balance of power away from coalitions that oppose to corporate governance reform towards coalitions that support the reform (Rosser, 2003).

While some progress have been made since the pursuit of Indonesian corporate governance reform, it has not been eradicated completely the practice of crony capitalism. Indonesia has no clear legal regulations in barring government officials from having business interest when they hold position in public offices. In the recent political power under President Susilo Bambang Yudoyono (SBY), there has been a tendency of the growing mix between business and politics. During the first term of SBY's administration, some top officials like Vice President Jusuf Kalla and Minister Aburizal Bakri are also the owners of leading business groups in the country (Guerin, 2006). Therefore, this research makes an attempt to examine the political economy aspect of corporate governance in Indonesia.

With the reshuffling of the business groups and the change in the ownership structure of public listed companies in the post-crisis period, it is still unclear as to what are the impacts of current situation on the protection of minority shareholders. Little is known whether business groups still play prominent roles in recent Indonesian business activities. Previous research on ownership structure in Indonesia were conducted as part of cross-country setting, mostly dealing with data prior to Asian economic crisis of 1998 (Claessens et al., 1999; 2000; 2002; La Porta et al., 1999; Fan & Wong, 2002), while only a few studies focus specifically on Indonesia (Achmad et al., 2008; Lukviarman, 2004; Sato, 2003, 2004).

1.2 Research Problem

In managing the transition after the 1997 Asian Financial Crisis, the efforts of the government to restore investors' confidence and to uphold good corporate governance image in the Indonesian business sector has yet to yield desire outcomes. Despite serious commitment and effort taken by the Indonesian government to

restore investors' confidence by enforcing good corporate governance practices among Indonesian companies, discussions presented in section 1.1 generally suggested that the outcomes of the government's effort are still far from satisfactory. Lack of accountability, transparency mechanisms and poor protection of minority shareholders are among the agendas that need crucial attention.

One important aspect in promoting minority shareholders' protection is corporate transparency when engaging with self-dealing activities through related party transactions (Young, 2005). The OECD through its Corporate Governance Principle (OECD, 2004, 2009) has mandated the protection of the minority shareholders:

“Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.”

Nevertheless, the low score on the enforcement of good corporate governance regulation and the hindrance of business culture in Indonesia based on recent surveys (CLSA, 2007, 2010) indicate that the evolving efforts to strengthen the protection of minority shareholders is still questionable. The presence of business groups' affiliation in Indonesia with their pyramidal structure and concentrated ownership will induce controlling shareholders to behave opportunistically. As suggested by La Porta et al., (2009), pyramidal ownership structures are much more prevalent in countries that provide investors the weakest protections. These circumstances allow controlling shareholders to expropriate the companies' wealth at the cost of minority shareholders. The inefficient group affiliation can inflict a loss if there is less effective implementation of good corporate governance.

While the struggle for enforcing good corporate governance principles has been continuing since its inception in combating expropriation of minority investors,

its effectiveness is still a matter of concern. Despite anecdotal evidence showing the detrimental effect of self-dealing activities, academic research concerning the potential entrenchment of related party transactions is still lacking, especially in the case of Indonesia. Therefore, this study intends to fill the gap by seeking evidence on the effectiveness of corporate governance mechanisms in protecting minority shareholders from the potential abuse of wealth expropriation through related party transactions. Hence, the underlying question is: what is the role of corporate governance mechanisms in resolving wealth expropriation problem?

As highlighted in section 1.1.1 and 1.1.4, the policy decision regarding corporate governance cannot be separated from the country's legal and political system. The enforcement of corporate governance must also include the role of political and legal system in order to effectively protect the interest of minority shareholders (La Porta et al., 1998). The recent situation in Indonesian political economy, however, still points out the significance of family based system with political connection, a condition known as crony capitalism (Rajan & Zingales, 1998). Leuz and Gee (2006) contended that politically connected firms are unwilling to share the benefits of political patronage with the minority shareholders. If this is the case, it can be argued that political connection is one of the primary ways to maintain the practice of wealth expropriation. Therefore, political connection would not contribute in promoting the protection of minority shareholders as mandated by corporate governance. To better understand this issue, the role of political connection to the extent of wealth expropriation will also be investigated in this research.

1.3 Research Questions

The research questions are listed as follows:

1. What is the nature and type of the related party transactions among Indonesian companies?
2. What is the relationship between corporate governance mechanisms and the extent of wealth expropriation through related party transactions?
3. What is the relationship between political connection and the extent of wealth expropriation through related party transactions?

1.4 Research Objectives

The overall objective of this study is to examine whether corporate governance mechanisms and political connection have explanatory power to influence the extent of wealth expropriation through related party transactions. The following are the specific research objectives of this study:

1. To determine the nature and type of wealth expropriation via related party transactions among Indonesian companies.
2. To examine the influence of corporate governance mechanisms on wealth expropriation.
3. To examine the influence of political connection on wealth expropriation.

1.5 Significance of the Study

This research provides contribution both theoretically and practically in several ways. First, it provides empirical evidence on the agency theory literature with the test on the effect of corporate governance mechanisms based on agency conflict between controlling shareholders and minority shareholders in the post economic

crisis 1997. The original agency literature based on the conflict between manager and shareholders (Jensen & Meckling, 1976) might not capture the essence of this conflict in the Indonesian context which is characterized by concentrated ownership and weak investor protection. Therefore, this study provides empirical evidence by extending the agency theory explanation in the context of a developing country like Indonesia. A few prior researches in Indonesian only focused on a limited time span (Achmad et al., 2008, Niki, 2004), while this study intend to cover a more comprehensive period that cover up a decade time after the Asian Economic Crisis 1997.

Secondly, this study will explore the agency relationship of controlling shareholder through control rights and cash-flow rights of ultimate owners. Tracing control chains along pyramidal structure of business groups will provide a better explanation for the role of ownership structure in corporate governance research. La Porta et al. (1999) documented ways of calculating control rights and cash-flow rights through tracing the control chains and it has since become a widely-used methodology. The use of immediate or direct ownership as carried out by previous research is not suitable to identify the exact controlling party in the context of concentrated ownership. This plan is however, to some extent hampered by problems with data availability and reliability in documenting the corporate control structure in Indonesia. Some data used by researchers in cross country setting were taken before the 1997 economic crisis (La Porta et al., 1999; Claessens et al., 2000, 2002), while this study will take the recent position in the aftermath of the Asian financial crisis. With the dynamic shifting on the business group structure during and after the crisis, it is not an easy task to observe their recent position. There is an indication that the

owners have incentives to intentionally split their blocks and mask their identities by using foreign offshore holding companies and other mechanisms (Suk, 2008).

Thirdly, this study tries to accommodate the political economy aspect into the research framework. In the relationship based model of corporate governance, the mutual symbiosis between political power and business actors play an important role in determining the effectiveness of corporate governance. When such relationship is made through preferential access to corporate policies in favor of majority shareholders, then the interest of minority shareholders will be marginalized. Although consideration of political economy is important especially in the context of a developing country like Indonesia, this issue is still not much explored in the study of corporate governance, especially in the aftermath of the 1997 economic crisis. Thus, this represents another contribution of this study.

Fourth, this study will provide further explanation about the current conditions of business groups as dominant players in Indonesia, both in the period of prior and post establishment of Indonesian Code of Corporate Governance (ICCG) in year 2001. By providing empirical evidence on the expropriation risk in pyramidal business groups, it is expected to give useful information to investors. For example, it is valuable for investors to consider expropriation risk through various corporate policies in making their investment decision.

Lastly, this research will give contribution to the policy makers and regulators concerning the effectiveness of the rules and regulations enforcement. The potential conflict of interests between large shareholders versus minority shareholders should become a major agenda to regulators in the effort to protect minority shareholder interests. The relevant regulators such as BAPEPAM-LK as the security market regulator and the Indonesian Accountant Association or *Ikatan*

Akuntan Indonesia (IAI) as accounting standard regulator will benefit from the policy recommendations of this research. For BAPEPAM-LK which is related to the capital market policies, market regulation dealing with company policies should be directed to protecting minority shareholder interests. The current regulations on transaction that potentially leads to conflict of interests such as related party transactions must be strengthened and properly enforced.

Ikatan Akuntan Indonesia (IAI) as the accounting standard body also can improve disclosure of related party transactions in financial reporting. The disclosure should be strengthened in order to lessen the information asymmetry as a response to the investors' need of transparency. Based on the initiative of IAI to take a full adoption of International financial reporting standard (IFRS) as of 2012, it is a good opportunity to have some improvements on current Indonesian accounting standards. In line with the spirit to comply globally, improvement of disclosure about related party transactions should clearly cover the identification and definition of related parties as well as the transactions conducted in order to meet the needs of transparency.

1.6 Definition of Key Terms

The following sub-section contains definitions and descriptions of terminology used in this study:

- **Business group:** a number of firms owned by the same or related persons or family in which the member firms are tied together by stock-pyramids and cross-ownership.

- **Corporate Governance:** The process and structure used to manage the company towards realizing long-term shareholder value, whilst taking into account the interests of other stakeholders.
- **Related Party Transactions:** transfer of resources or obligations between related parties, involving transaction between parent company and subsidiary, subsidiaries of common parent, an enterprise and its principal owners, management or members of their immediate families, and affiliates.
- **Ownership and Control:**
 - *Ownership* is defined as the cash flow rights of the controlling shareholders.
 - *Control* is defined as the voting rights of the controlling shareholders.
 - *Wedge Control* is defined as the unequal proportion of control rights in excess of cash flow rights possessed by the ultimate controlling shareholders.
- **Pyramidal Holding:** an entity where its ownership structure displays a top-down chain of control with an ultimate owner (at the apex) and followed by the successive lower layers of firms.
- **Two-tier board system:** a system where there is an explicit separation in a company between operational roles as carried out by the management board and monitoring roles as represented by the supervisory board.
- **Multiple directorships:** any individuals holding multiple board positions in different companies. The board can be divided to board of commissioners and board of directors.
- **Board of commissioner:** part of corporate structure with the primary task to supervise and advise the board of directors in accordance with the company's article of association.

- Director Compensation: the total annual remuneration given to board of directors. It consists of salary and bonus.
- Political Connection: the extent of closeness between companies and the political power through various channels.

1.7 Summary

This chapter discusses the background of the study. In the introduction section, some issues regarding the weaknesses of Indonesian corporate governance system draw attention to the importance of the present study. The high level of ownership concentration accompanied by the domination of family business groups and the hindrance of business culture are some of the important aspects that cause Indonesia in attaining low corporate governance score in the region. These issues magnify the question about the effectiveness of two-tier corporate governance system in dealing with the problem of wealth expropriation. Another issue centered on the role of political connection as the weakening factor in the enforcement of good corporate governance. These concerns portrayed the background of the present study. They are then promulgated into problem statement and followed by the objectives of the study. The next section explains significance of the study from theoretical as well as practical perspectives. In the last section, the chapter provides a brief definition of some key terms that are relevant to the study.

CHAPTER 2

OVERVIEW OF BUSINESS GROUPS IN INDONESIA

2.1. Introduction

This chapter presents the essential explanation about the history and development of Indonesian business groups. The first section describes the origin and development of business groups. The second section explains the characteristics of business groups regarding the ownership structure, separation of ownership and control, dividend payout and financing policy. The third section deals with the overview of related party transactions coupled with an example on a case of these transactions.

2.2. Origin and Development of Indonesian Business Groups

The term business groups in Indonesia are generally used synonymously with conglomerates group. Chinese business groups are the majority group of conglomerates followed by several business groups developed by indigenous or *bumiputera* people (Chua, 2005).

The emergence of business groups in Indonesia was rooted back to the period of colonialism. During nineteenth century, many Chinese immigrants who came to Indonesia turned into traders and their existence was regarded as minority entrepreneurs (Chua, 2008). In the post independence era, their existence were marginal since the government through its economic policies tends to ignore them. Having obtained sovereignty from the Dutch, the Indonesian government has attempted to support and enhance indigenous businesses with the *Benteng* program in the 1950's. Through this program, the government tried to cut down the domination of Chinese capital with the reinforcement of the nationalization policy and put the priority on *pribumi* or indigenous capital. However, the *benteng* program

failed to generate strong *pribumi* entrepreneurs and Chinese capital further expanded its influence (Sato, 2003).

The new order regime under President Suharto in the beginning of 1970s began to promote economic development as a core policy in the Indonesian economic system. The government developed strategies to fuel rapid economic growth by allowing the entry of foreign capital and enhancing the existence of business groups. These groups trickled down the chain effect and created more employment opportunities, greater economies of scales and act as import substituted industries. The government allocated the scarce capital to targeted firms to develop labor-intensive industries in the 1970's and heavy and chemical industries in the 1980s. The government effectively controlled major businesses by providing subsidized loans to large firms through nationalized banks.

With regard to business groups in Indonesia, generally there are two major types of business groups, namely established group and fast growth group (Sato, 2004). The former group refers to companies that were created before 1970s, the time when President Suharto came to power and established a new order regime. This group was developed and controlled mostly by Sino-Indonesians (Chinese ethnic). The founders of these business groups were usually known as tough entrepreneurs and they had been running their businesses for a long period of time before they became big conglomerates. The latter group (fast growth) emerged in the early 1980s and 1990s, mostly established out of government policies to create and develop indigenous entrepreneurs. Some of these groups were instantaneously grown up by facilitation and protection from political patronage. In fact, some companies like Humpuss, Bimantara, Citra Lamtoro, and Texmaco belong to patrons or close friends of President Suharto.

It is worthy to note that all business groups have connections with the new order regime under President Suharto. As noted earlier, during the first decade of his leadership, President Suharto strongly encouraged the establishment of large business groups to anchor economic growth. Therefore, the majority of business groups are in one way or another under the influence of political power during that time.

The degree of linkage with political power among business groups is however, different. The relationship under patron-client network between political bureaucrats and conglomerates has resulted in collusive behavior (Chua, 2005). The bureaucrats provided some facilities in terms of industry protection, import licensing, preference of credit financing from state banks, and even a monopolies market. In return for this win-win relationship, business conglomerates would offer business partnerships or channel back profits to their political patrons.

Business groups that are more intensively involved in collusive behavior are referred to as fast growth groups. While still maintaining political ties with the political power at that time, some established groups engage in less collusive behavior compared to fast growth group in the way that they emphasize more on fundamental firm performance. This strategy allowed them to survive even when external shock strikes the group during the economic crisis.

The spread of monetary crisis throughout East Asian countries in 1997 severely dented Indonesia's economy. Many banks faced serious liquidity crises and the corporate sector was experiencing high foreign debts. This condition brought the banking sector to collapse which led to structural break of the ownership structure in the private sector. In response to the crisis, the government under the monitoring eye of International Monetary Fund (IMF) program formed the Indonesian Banking

Restructuring Agency (IBRA) in January 1998. By the end of that year, IBRA closed 66 banks, took over 11, merged 14, pushed 9 others into recapitalization program (IBRA, 1999). In the private sector, two institutions were established, namely the Indonesian Debt Restructuring Agency (INDRA) and the Jakarta Initiative. Their primary tasks were to coordinate the negotiation between corporate debtors and their creditors in restructuring debt.

During its five years in operation until its dissolution 2004, IBRA has targeted the recovery rate of 28 percent of the 650 trillion rupiah (US\$ 72 billion). In 1998, the government issued 650 trillion rupiah worth of bonds, of which around 425 trillion was earmarked for recapitalizing banks, with the rest used to repay customers of banks, which had been closed down. In order to achieve this target, IBRA had to sell the bank's assets as the main way to resolve the debt problem of the business groups. Other methods included debt rescheduling, swap of debt to bond through convertible bond, and swap of debt to equity (Sato, 2003). The process of banking and private sector restructuring has a significant impact on the major changes in the ownership structure.

IBRA sold off stakes in the domestic banks it took over to raise funds, and allowed the entry of foreign investors to bring about better bank management practices in the future. For examples, the Singapore government's investment arm, Temasek Holdings, bought PT Bank Danamon; a consortium which includes South Korea's Kookmin Bank acquired PT Bank International Indonesia; while Malaysia's Commerce Asset-Holding Berhad gained control of PT Bank Niaga (Bhui, 2004).

Among those holding bad debts with IBRA were the Salim Group with total debts of 52 trillion rupiah (US\$ 6 billion) arising from the takeover of PT Bank Central Asia; Syamsul Nursalim of Gajah Tunggal Group, the owner of liquidated

PT Bank Dagang Nasional Indonesia (BDNI) with debts of 28 trillion rupiah (US\$ 3.1 billion); former president Suharto's business crony Mohammad 'Bob' Hasan with debts of 5.4 trillion (US\$ 600 million); Usman Admadjaja of Danamon Group with total debts of 12.7 trillion (US\$ 1.4 billion); and the Ongko Group with debts of 7.8 trillion rupiah (US\$ 860 million) (Tempo, 2002).

As a powerful government agency, IBRA was set up to acquire and manage the assets from insolvent corporations. During the process of selling the assets of the insolvent corporations, there were criticisms that the sale decision was merely based on political rather than economic criteria, including pressure by former owners who enthusiastically wish to repurchase their assets. Through their offshore companies, former controlling owners bought back the assets at deep discounted prices. It is conjectured that such unfair connected transactions were accompanied by corrupt practice (payments or promises). Without these political ties, it would have been impossible for the former controlling owners to buy back their assets at discounted prices (Bhui, 2004).

2.3 Characteristics of Business Groups

2.3.1 Ownership Structure of Business Groups

The study on business groups may be useful to shed more light about the benefits and costs of group affiliation as previous studies reported mixed results and are far from conclusive (Claessens et al., 2002; Khan, 2003; Khanna and Palepu, 2000; Sato, 2004; Wiwattakantang, 2001).

It has been documented that ownership concentration among Indonesian's business group is one the highest in the East Asian Countries (Claessens et al.,