GOVERNANCE

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RESEARCH POLICY BRIEF No. 8

Survey of Corporate Governance Practices in Indonesia, Thailand and Korea

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Based on ADB Institute country surveys supervised by Sang-Woo Nam
(June 2003 – February 2004)

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Corporate Governance Practices at the Firm Level

Poor corporate governance is viewed as one of the structural weaknesses responsible for the outbreak of the Asian crisis in late 1997. Controlling family owners could pursue private interests with relative ease often at the expense of minority shareholders and the profits of these firms. In order to address these problems, a high priority has been given to corporate governance reform in post-crisis policy packages. There is little doubt that the reform efforts should improve corporate governance by preventing outrageously abusive behavior by controlling owners.

Many, however, observe that the changes introduced are rather cosmetic, and embedded institutional or socio-cultural norms and values also limit the effectiveness of the newly instituted mechanisms. These critics believe that the corporate governance reform measures pushed largely along the Anglo-American model will take a long time, if at all, to take root in the local economies. Some also suggest that, though shareholders should have the strongest incentives to monitor their firms, other stakeholders — employees and creditor banks, particularly — can also play a useful role in corporate governance.

In spite of much effort to put the regulatory framework of corporate governance in place in many Asian countries, in-depth investigation of corporate governance practices at the firm level is largely lacking. In order to fill this gap in knowledge, a questionnaire survey was conducted at the end of 2003 by the ADB Institute and its local collaborating institutions in three countries that were strongly affected by the financial crisis of the late 1990s: Indonesia, Thailand and the Republic of Korea. The survey has three broad objectives.

First, investigation of corporate governance practices at the firm level as compared with the relevant regulatory framework. For a deeper understanding of corporate governance, the survey is based on both factual information and opinions of board members.

Second, evaluation of the relationship between corporate governance practices and firm performance. For this purpose, corporate governance practices obtained from the survey have to be scored and analyzed to see whether the scores have any positive association with firm performance.

Finally, assessing the potential roles in corporate governance by stakeholders other than shareholders (see also, Research Policy Brief No.7, *Potential Role in Corporate Governance by Employees of Asian Enterprises*, S-W Nam, Sept. 2003). This will be based on factual information on corporate human resources and opinions of corporate directors about the roles of employees and creditor banks.

Sample Firms and Respondents

The sample firms include those in seven selected industries (including food and beverages, textiles and clothes, chemicals, iron and metal products, electrical and electronics products, transport equipment, and commerce and trade) and whose shares are traded at the local exchanges. Factual information has been gathered from a total of 238 firms (61 in Thailand, 111 in Korea, and 66 in Indonesia). Also, 468 directors or commissioners mostly belonging to these companies joined the opinion survey: 224 executive directors and 244 independent directors (169 for Thailand, 214 for Korea, and 85 for Indonesia).

The survey shows that diffuse ownership is very rare in these economies, representing only 6% of the Korean and Indonesian firms and 15% of Thai firms. Not surprisingly, the CEOs of almost 60% of the Korean and Indonesian firms and about 40% of the Thai firms are either the founders or founder's family members. Over 30% of the Korean and Indonesian firms and 40% of the Thai firms say they are substantially owned by foreigners: they are mostly controlled by foreign shareholders in Indonesia, while there is virtually no management control in Korea.

Shareholder Rights and Equitable Treatment of Shareholders

The surveyed firms are doing relatively well in allowing shareholders effective participation in decision-making and exercising other shareholder rights. However, there are areas requiring further attention. Given high ownership concentration, it seems very difficult for minority shareholders to call a special shareholders' meeting or put issues on the agenda of a shareholders' meeting. Also, voting by mail is largely unavailable, and shareholders are inadequately protected with priority subscription rights, right to approve major related-party transactions, and dissenters' right.

Moreover, minority shareholders still seem to play little role in the process of nominating and electing directors (there is little use of cumulative voting, for instance). Sample firms are relatively poor in information disclosure and transparency. Disclosure is often inadequate as for information on matters potentially involving self-dealing or conflicts of interests and undermining the independence of external auditors. In Indonesia and Thailand, websites are not yet fully utilized as a means of timely disclosure of information and enhancing transparency.

Effectiveness of the Board of Directors or Commissioners

The median board size is around 12 in Thailand, 6 to 7 in Korea, and 4 in Indonesia. The boards in these countries typically have the share of independent directors or commissioners between 25% and 50%, though almost 40% of the Thai boards have independent directors below 25%. Thai boards seem to be too large and the share of independent directors too low, while the Indonesian boards are probably too small. It is notable that the CEO position and chair of the board post are separated in more than 80% of the Thai firms and in all Indonesian firms due to the two-tier board system.

The true independence of independent directors is rather doubtful, particularly in Korea as they play a limited role in setting board agendas, giving constructive criticism, and disapproving unreasonable agenda items. The fact that the CEO or controlling owner effectively selects directors seems to be the most critical factor behind the lack of independence. Even though many Thai directors indicate personal relationships with other directors as a reason for the lack of independence, such personal relationships or behavioral norms do not seem to play a major role, as best we can see.

The functions of the boards in these countries are generally weak, without active board committees. Audit and nomination committees are in place in only a little over 20% of the Korean firms, while most Thai and Indonesian firms have (only) an audit committee. While responding corporate directors generally agree that their boards are a forum for serious discussion of all significant corporate matters, almost 20% of the Korean directors say that their boards are rather perfunctory.

In all three countries, board function seems to be weak in selecting, monitoring, and replacing the CEO, and in reviewing the remuneration of key executives and directors. The sample firms appear to be particularly poor in supporting outside directors for their best contribution as board members and evaluating their performance. Outside or independent directors are often not adequately provided with necessary information, access to outside professional services, designation of contact person in the company, education and training, stock-based incentive compensation, and director insurance for personal liability.

Is There Any Role for Stakeholders?

When a corporation is in serious financial distress, not only shareholders but also all stakeholders are greatly affected. Thus, creditor banks and employees also have strong incentives to monitor the firms. Creditor banks have a natural comparative advantage in monitoring their corporate clients, and this advantage gets more pronounced where banks have a stable long-term relationship with their clients. Likewise, long-term employees often have invested heavily in firm-specific human capital that is of little value outside the firm, making them greatly interested in monitoring the health of their firms. Where innovative ideas and dedication of core employees are the key source of corporate competence, these employees may be encouraged to take part in corporate decision-making and governance.

Corporate directors and commissioners in the surveyed countries seem to be rather sympathetic with the roles of broader stakeholders. Fifty to sixty percent of them strongly agree that a corporation has the goal of enhancing the well being of various stakeholders in addition to making profits for shareholders. They also tend to acknowledge a potential corporate governance role by stakeholders. In Korea, for instance, employees are looked upon as a party that can most effectively prevent the abusive behavior of controlling families. And, firms in countries with a less-developed financial market, like Indonesia, seem to be very interested in relationship banking allowing banks a role for corporate governance.

Banks certainly have strengthened the monitoring of their corporate clients since the Asian crisis, and companies are interested in having a close, long-term relationship with their creditor banks particularly in Indonesia and Thailand. Such a relationship may lead to banks' holding equity shares of client firms and even being represented on their boards. Though the firms are aware of the associated potential burdens or risks, they seem to be more than offset by the expectation of better credit access, mitigation of temporary liquidity shortage, and avoidance of premature liquidation during serious financial distress.

The survey results show relatively high prevalence of joint labor-management committees (JLMCs): 84% for Korea, 73% for Indonesia, and 21% for Thailand. However, JLMCs in these countries seem to play only a limited role as a potential governance mechanism. Obviously, the management is not so willing to share information on business-related issues, and JLMCs are largely preoccupied with labor-related issues. Nevertheless, there seems to be a substantial corporate governance role for employees in the future.

Employees in these countries have fairly high education (particularly in Korea) and a relatively long tenure. In about a half of the surveyed firms, employees with 10 or more years of tenure account for at least 30% of total employees. Moreover, facilitating/complementary mechanisms for the enhanced role of employees are widespread. They include shop-floor participation and various schemes of financial participation, which make employees truly "stakeholders." Also, employees are likely to be increasingly treated as "partners," as corporate directors tend to believe the rising importance of human capital for enhanced performance. The respondents did not appear to be overly concerned about the downsides of increased employee voice/participation.

Scoring Corporate Governance Practices

We made a preliminary attempt to score corporate governance practices on the basis of the questionnaire survey. The scoring, though based on existing empirical evidence and the wisdom of practitioners, is nevertheless subjective. It is based only on factual information (28 questions related to shareholder rights, and 31 questions on the effectiveness of boards), not including any roles of stakeholders. Scores are given by six components of corporate governance including three components related to shareholder rights and another three components related to the effectiveness of the board (see the table below for these components and the scores).

The scoring results show that there is relatively little difference among the surveyed countries in shareholder rights and equitable treatment of shareholders. On the other hand, the scores for the effectiveness of the board show a larger dispersion among the countries, as well as among firms within a country. Those practices that are tightly restricted by laws and regulations, leaving little room for variation among different firms of a country (thus, not included in the survey), have been excluded in the scoring.

The Thai firms generally do better than those in Korea and Indonesia particularly in board effectiveness. Korea's scores turn out to be the poorest, which is consistent with the fact that the Korean firms are mostly controlled by a single largest owner and the majority of CEOs are family members. Across the countries, information access by outside directors and other support for directors is very poor. Although independent directors might have been well represented on the board, a more important task seems to be how to adequately support them for their best contribution to the company.

Table 1. Corporate Governance Score by Components and Country

	Indonesia	Korea	Thailand
Overall Score (CGS)	**52.5**	**50.2**	**59.1**
1. Shareholder Rights (SGR)	**66.2**	**63.9**	**66.8**
Effective Participation in Decision-making (EP)	65.2	70.0	73.2
Other Shareholder Rights (OR)	72.8	63.2	66.6
Information Disclosure and Transparency (DT)	60.5	58.5	60.5
2. Effectiveness of the Board (BE)	**38.8**	**36.6**	**51.4**
Board Composition and Independency (CI)	51.3	47.4	64.1
Board Function and Committees (BF)	48.5	33.3	58.2
Information and Support for Directors (IS)	16.7	29.1	31.9

Note: The overall score (CGS) and scores for shareholder rights and the effectiveness of the board are, respectively, the average score of its subcomponents.

What Determines the Quality of Corporate Governance?

Our analysis shows that large firms have better corporate governance. This indicates that formal governance mechanisms are typically called for when firms get larger making the problem of information asymmetry substantial. Firms substantially foreign owned or with a professional manager as CEO have a more effective board of directors. Fixed capital intensity (negatively) and group affiliation also tend to be associated with high corporate governance score. Information asymmetry is likely to be more serious where a firm's assets are largely non-fixed assets or affiliated with a business group. As a way of mitigating this, the firm may put better corporate governance mechanisms in place. Both the Thai and Indonesian firms, other things being equal, have higher scores than the Korean firms.

Corporate Governance Scores and Firm Performance: Does Corporate Governance Matter?

For the whole sample firms, the survey results provide evidence that corporate governance matters significantly for firm performance. Performance is measured by Tobin's q, which is the ratio of a firm's market value to its book value. To the extent that all available corporate information (including the quality of corporate governance) is instantaneously reflected in a firm's market value, a strong link between the quality of corporate governance and the firm's performance may indicate a causal relationship running from corporate governance to performance.

Indeed, the corporate governance score is strongly associated with the firm's performance measured by Tobin's q. For the Thai sample firms, however, any such evidence cannot be found. Although the score for shareholder rights (SHR) alone does not show any significant association with firm performance, scores for board effectiveness (BE) and overall scores (CGS) turn out to be significantly associated with firm performance. For instance, improving the scores for board effectiveness (BE) or overall corporate governance scores (CGS) from the median to the highest 25% of the sample firms is associated with a 13–15% increase in a firm's market value or Tobin's q. Firm performance is also affected (negatively) by firm size and control of firms by a single domestic private owner or by a non-family group (see Table 2 for the estimated equations).

Table 2. Estimated Equations for Tobin's q (Ratio of Market Value to Book Value)[1]

Factors Affecting Tobin's q	(1)	(2)	(3)
Corporate Governance Score/100[2]	**BE** **0.826 ****	**CGS** **1.137 *****	**CGSw** **1.100 *****
Debt Dependence (Debt / Total Assets)	0.269 *	0.271 *	0.245 *
Firm Size: Ln (Total Assets)	–0.060 **	–0.063 **	–0.056 **
Sales Growth: Ln (2002 Sales / 1997 Sales)	0.167 ***	0.172 ***	0.167 ***
Firms Controlled by a Single Domestic Private Owner	–0.148 *	–0.164 **	–0.170 **
Firms Belonging to a Non-Family Group	–0.289 ***	–0.289 ***	–0.280 ***
Thai Firms	0.094	0.110	0.165 *
Indonesian Firms	0.252 ***	0.238 **	0.245 ***
R^2 (Number of Observation)	0.176 (223)	0.177 (223)	0.187 (223)

Notes: [1] The equations also include the constant term and a dummy variable for firms established after 1997, but are not shown in this table. ***, **, and * indicate that the coefficients are statistically significant at 1%, 5%, and 10% level, respectively.
[2] CGS = 1/6 (EP + OR + DT + CI + BF + IS), and CGSw = 0.22 EP + 0.19 DT + 0.10 CI + 0.49 IS, where the weights were obtained from the relative size of estimated coefficients when the equation was run with all components of corporate governance (after excluding those with a very small or negative coefficients). See Table 1 for the notations.

The analyses also reveal some other interesting evidence. First, the market seems to discount, by about 30%, the quality of corporate governance in the case of firms controlled by a single domestic owner. Investors seem to demand higher quality of corporate governance for firms controlled by a family obviously for fear of expropriation. Second, as expected, the evidence supports the view that corporate governance matters more in countries where the legal and judicial system for investor protection is weak. Corporate governance score exerts the smallest impact on firm's market value in Korea, while its impact is the largest in Indonesia (where investor protection is generally viewed as poorer than the other two countries). Third, employee participation practices (self-directed teams, quality circles, job rotation or cross training, employee stock ownership or stock option plans, and profit sharing) also matter in the market valuation of companies.

Finally, the components of corporate governance practices that a market pays its main attention appear to be different across countries. For instance, among practices related to shareholder rights, Korean investors tend to appreciate information disclosure and transparency (DT) more highly, while it is effective participation in corporate decision-making (EP) for Indonesian investors. Among the various components of corporate governance practices, most significant for the whole sample seems to be information access and other support for (and evaluation of) directors (IS). This is the area where the sample firms score most poorly for all the countries (see Equation (3) in Table 2, where the overall corporate governance score, CGSw, is a weighted average of the scores of individual components). This finding is consistent with the respondents' view that the highest priority for a more effective board is timely provision of relevant information to directors, followed by promotion of a boardroom culture encouraging constructive criticism and alternative views.

Survey Conclusions

The survey results indicate that there is probably not a big gap between the regulatory framework and actual corporate governance practices in form, but a substantial gap in substance or spirit. The exchange-listed companies are doing rather well in complying with the relevant rules and regulations in such areas as ensuring the effective participation of shareholders in corporate decision-making and other rights of shareholders. There are, however, larger gaps and variations in areas where regulations/guidelines are less demanding or enforcement is difficult, such as support for, and evaluation of, directors, and the functions/activities of the board or board committees.

The respondent corporate directors believe that the most important tasks for better corporate governance in their countries are making internal corporate governance mechanisms work better and enhancing the standards of information disclosure, accounting and audit. For these tasks, the roles of financial supervisory agencies (and fair trade commissions), outside or independent directors and professional societies are viewed as most important.

For the sample firms as a whole, there is clear evidence that corporate governance matters. And, the market seems smart in evaluating the quality of a firm's corporate governance. It differentiates firms more on the basis of substance such as their practices of supporting and evaluating directors. In the case of firms controlled by families, the market discounts the observed quality of corporate governance. In countries where the legal and judicial system for investor protection is weak, the market more highly appreciates good corporate governance.

The above findings indicate that Anglo-American corporate governance frameworks generally work. True, firms in these countries are far from embracing the model in a wholehearted way. Nevertheless, the market obviously discriminates among firms according to the standards of the model, indicating that firms will have to move towards meeting more of these standards.

However, that does not necessarily mean that there is no room for employees and stakeholders other than shareholders, although they play little of such a role at present. Corporate directors in these countries (champions of the Anglo-American model in a sense) are rather sympathetic with the interests of broader stakeholders as well as their participation in corporate decision-making. Given that a large portion of workers in these countries are highly educated, long-term employees and that human capital is an increasingly critical factor for corporate success, the room for an employee's role seems large. Nevertheless, we now believe that the stakeholder model is more likely to be a complement, rather than any alternative to the well-known Anglo-American shareholder model.

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