KPMG

The Board Governance Forum

September 2015

Raising Corporate Governance Standards in Indonesia

Panel discussion: practical ways of improving CG in Indonesia. From left: KPMG partner and moderator Agung Nugroho Soedibyo, Universitas Indonesia's Professor Lindawati Gani, Bank Tabungan Pensiunan Nasional's Irwan Habsjah, Bank Mandiri's Aviliani and Universitas Indonesia's Sidharta Utama.

Tohana Widjaja, Managing Partner, KPMG Indonesia, delivering her opening remarks

3 key takeaways:

1. **Stronger CG needed.** Indonesia ranks 17th of 25 markets for its Corporate Governance, according to a 2014 KPMG-ACCA study. Recognizing the need for improvement, Indonesia's financial services authority, the OJK, released a roadmap outlining ways to better CG in Indonesia.

2. **Streamline requirements.** CG requirements are at times conflicting, leading to confusion in the market and making it harder for companies to implement them. Some consolidation may help.

3. **Enforce and integrate.** To improve Indonesia's CG systemically, regulations must be enforced. CG principles must also be integrated into company operations, and the informal sector must be brought into the fold.

The State of Corporate Governance in Indonesia

Indonesia was ranked 17th of 25 markets for its corporate governance, according to a 2014 study by KPMG and the Association of Chartered Certified Accountants (ACCA). The study, using the OECD CG Principles as a baseline, stacked up the 25 markets according to their use of CG instruments, the stringency of enforcement of CG Codes and the clarity and completeness of their CG Codes.

Ranking well in such studies is good for business, observed KPMG's Head of Risk Consulting in Indonesia and Singapore, Irving Low. "It tells the whole world that this country has good corporate governance, and that's a major draw for capital."

To help Indonesian companies raise their levels of corporate governance, KPMG Indonesia launched a dedicated corporate governance platform, the Board Governance Forum, in June 2015.

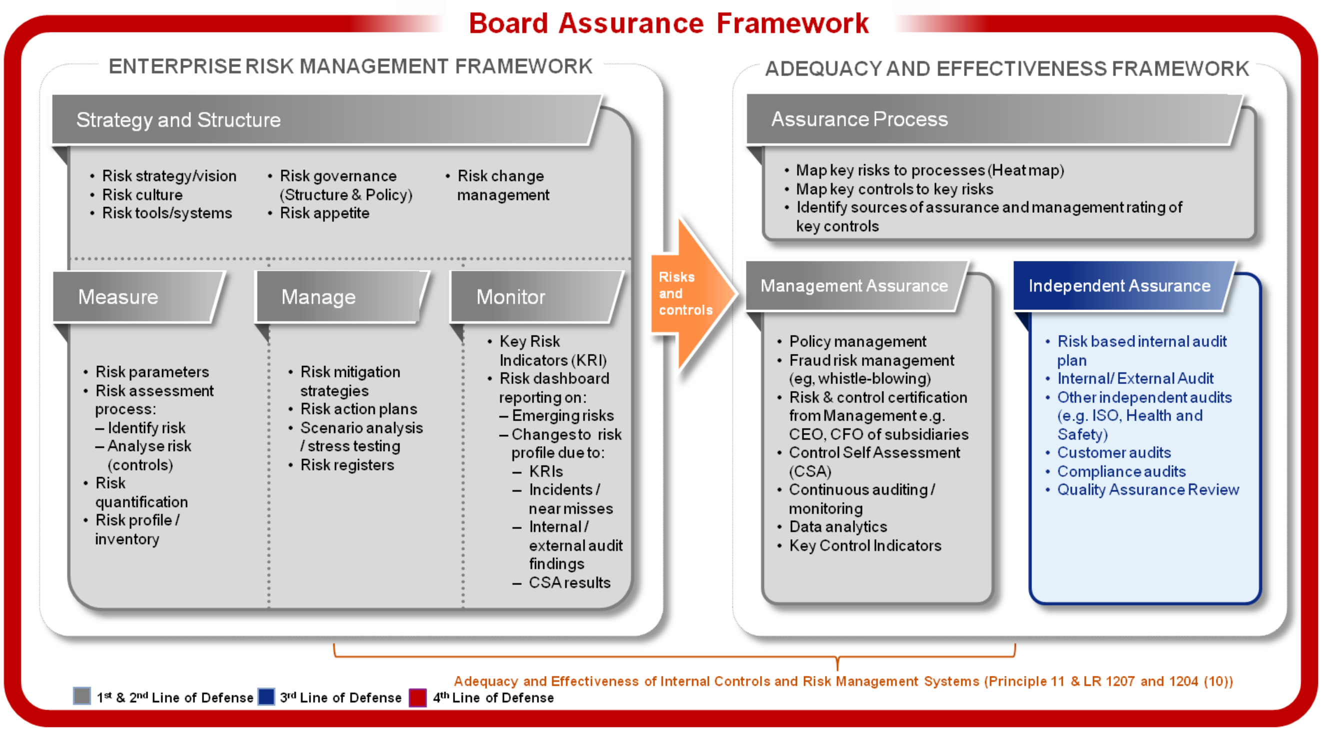
Confronted by a fast-changing risk and regulatory environment, and the formal creation of the ASEAN Economic Community by the end of 2015, corporate leaders in Indonesia are seeking help with their CG obligations.

"As the corporate governance landscape continues to evolve globally and here in Indonesia, there is a real need to raise awareness of requirements, connect Commissioners and Directors and share insights, not only about what companies need to comply with, but how they can do so efficiently and effectively," said Tohana Widjaja, Managing Partner, KPMG Indonesia.

CG Changes in Indonesia

Recognizing the need to advance the state of play, Indonesia's financial services authority, the Otoritas Jasa Keuangan (OJK) in 2014 released a roadmap for the development of the CG landscape in Indonesia. It contains 33 recommendations to improve critical areas, with almost half targeting the roles and responsibilities of the Board of Commissioners and Board of Directors. Other changes include upgrading the CG code (last revised in 2006) to give it regulatory force by implementing the "comply or explain" approach for listed and public companies. The roadmap is meant to build investor and stakeholder confidence in Indonesian capital markets, and ideally to improve Indonesia's CG rankings in time for the AEC.

Figure 1: KPMG Board Assurance Framework



Source: KPMG Global Audit Committee Institute

Key challenges facing Indonesia Boards and Audit Committees

A recent global study by KPMG surveying over 1,550 Audit Committee members around the world reveals some of the areas where Indonesian Boards face the most difficulties.

Indonesian companies report that their greatest challenges are operational in nature rather than related to financial reporting, since the country's vast size often means that operations are spread across wide areas. Political, economic and regulatory uncertainties are other major challenges.

Unsurprisingly, Indonesian ACs are concerned primarily with oversight of the risk process and adequacy of internal controls around operational risk, more so than the global average. Financial reporting is also much more of a key concern than it is globally.

Indonesian ACs are also concerned about the new regulations aimed at financial conglomerates on integrated risk management (No. 17/POJK.03/2014) and integrated governance (No. 18/POJK.03/2014). Risk identification, measurement, assessment and monitoring are key to compliance with these requirements.

Overcoming the Challenges

Some practical ways for Boards to overcome the above challenges are: enhancing existing governance structures, establishing a robust enterprise risk management framework and establishing a process to check their adequacy and effectiveness. However, Mr. Low cautioned that Boards also need to determine what constitutes "adequacy" and "effectiveness".

Of these, a strong structure is particularly important because it determines how well a company is governed and makes it easier for the Board of Commissioners and Board of Directors to run the company. Companies need to be aware of what committees and key governance roles are available and relevant for the size and nature of their company.

Boards may wish to establish a board assurance framework to measure, manage and monitor risks and controls (Figure 1). This framework should include at least one source of independent assurance and needs to be able to drive results and performance.

In the Right Direction

Overall, Mr. Low sees the changes to Indonesia's CG landscape as heading in the right direction. Strengthening the OJK regulations and oversight will improve levels of compliance and help to prepare companies for the AEC.

"Improving corporate governance is really something that should be done for the good of the company, not just for the sake of complying with regulations," said Mr. Low. "So I find the upcoming changes very progressive and forward-looking. There is still work to do – greater clarity and awareness is needed, along with greater consistency in the approach. The Board Governance Forum will be here to help in the coming months and years, and I look forward to seeing the results."

The Value of Internal Audit

Internal audit is mandatory for listed companies in Indonesia. According to the results of the 2014 KPMG Global ACI survey, most companies are satisfied that their IA function is doing its job and delivering value. However, they also feel that IA should expand its role, and many believe that outsourcing or co-sourcing IA would be a more cost-efficient way of accessing talent than maintaining an in-house function.

Moving Forward: Expert Views

The launch of the Board Governance Forum incorporated a panel discussion facilitated by Agung Nugroho Soedibyo, Partner, KPMG Indonesia. Panel members included Dr. Aviliani, Independent Commissioner, Bank Mandiri; Irwan Habsjah, Independent Commissioner, BTPN; Prof. Dr. Lindawati Gani, Professor at the Faculty of Economics and Business, Universitas Indonesia; and Sidharta Utama, Professor at the Faculty of Economics, Universitas Indonesia.

The discussion's backdrop was the formal commencement of the ASEAN Economic Community in 2015. The AEC calls for 10 markets to be combined into a single market, which will require a substantial amount of funds, mostly from the capital market. To attract investors, the capital market will have to be efficient and transparent, and that will in turn require robust implementation of corporate governance.

Challenges to Adopting Good CG

Mr. Irwan pointed out that in Indonesia, the commitment to adopt CG is mostly viewed as a mere formality. This is due to the very high proportion of family-owned businesses, many of which have no structure or process in place and no way to ensure adequate or effective controls. Based on historical events, this is dangerous: the Asian financial crisis in 1998 was caused partly by weak CG, especially in the banking sector.

Agreeing, Dr. Aviliani said that unclear ownership of a company leads to weak control, which increases the chance of CG lapses. Regulation is also important: today, the banking sector has good CG due to stronger regulation and oversight, and a better corporate culture that places more importance on compliance. However, other sectors also need supervision so as to minimize uncertainty and risk.

At the same time, regulation has to be balanced with business needs, cautioned Prof. Dr. Lindawati. Overly stringent regulation, especially in enterprise sectors where risk is embedded in operations and necessary for the company's growth, can cause a business to collapse. The best way of establishing good CG is through strong leadership with a commitment to good practices.

The importance of tone from the top extends to the relationship between holding companies and their subsidiaries. With good two-way communications and strong CG policies in the holding company, the entire group will be able to establish a positive cycle of best practices.

One key change set out in OJK's roadmap is to enhance the transparency of Commissioner independence criteria. Under current regulations, it is mandatory for listed companies to have independent Commissioners. The definition and criteria of independence, and the duties of the independent Commissioner, are clearly set out. However, Mr. Sidharta pointed out that, despite the stringency of the requirements, independent Commissioners are in practice usually chosen by majority shareholders. They often exist only to comply with the regulation, and their independence hinges on the attitude of the majority shareholders. Furthermore, if the majority of shares are family-owned, even if the company is listed, the Directors will not be independent.

To make the regulation more effective, companies need to be more transparent about how they nominate Board members. Awareness among top management is also critical: it must see the value of CG and be able to accept its cost.

Mr. Irwan added that there is also often confusion between the multiple instruments employed by different institutions. For example, listing regulations require companies to have independent Directors, but this is not stipulated in the CG code. He added that if non-banking sectors were subjected to the same level of regulation as the banking sector, the Indonesia Stock Exchange would find it challenging to draw new listings.

Speakers and panel discussion members at the launch of the KPMG Indonesia Board Governance Forum

Practical Implementation

Several questions on implementing the new regulations were raised during the discussion. One regarded the integration and combination of risk in a group whose companies had multiple different structures and risk types, and the segregation of confidential information for each company.

Dr. Aviliani shared that in Bank Mandiri, the group would first decide on committee members and unite IT systems. The culture of the different companies then needs to be harmonized to ensure that they place the same value on CG. Finally, the best Director would be appointed to lead the subsidiaries, as the holding company already has a good system of its own. The issue of confidential information would be resolved by asking customers whether they consent to having their information shared across subsidiary companies.

Another question regarded how to select independent Commissioners in the presence of an "invisible hand". Dr. Aviliani advised that the independent Commissioner must be from the nomination committee, or if the influence of the "invisible hand" cannot be prevented, then the independent Commissioner should not be someone who will negatively affect the company's operations.

Diversity of Boards was also brought up as a key focus area that can be challenging. Mr. Irwan advised that companies seeking diversity must first develop a strong corporate culture that supports their vision and mission.

Improving Indonesia's Global CG Ranking

To improve Indonesia's CG ranking, three things are required: first, regulations must be enforced.

According to Mr. Sidharta, at present, companies only comply with around 70 percent of mandatory regulations, and it is unclear what consequences there are for companies of non-compliance. To address this, all stakeholders must take a part in improving CG, rather than leaving it to the regulators.

Secondly, business leaders need to socialize and embed CG in the company, so that it becomes an integral part of the company's operations and not merely a compliance duty. This requires awareness among leaders and a strong tone from the top.

Finally, regulators need to consider the needs of companies that operate in the informal sector. This group of companies makes up 70 percent of all businesses in Indonesia, and, while they should not be exempt from CG, they should not be subject to overly onerous requirements either. Regulators need to create a simple version of the requirements for these companies and ensure that they are implemented.

Contact us

Kusumaningsih Angkawidjaja
Partner in-charge, Audit Services, KPMG Indonesia
T: +62 (0) 21 574 2333
E: kusumaningsih.angkawidjaja@kpmg.co.id

Irving Low
Head of Risk Consulting, KPMG Singapore and Indonesia
T: +65 6411 8888
E: irvinglow@kpmg.com.sg

KPMG
35th Floor Wisma GKBI
28, Jl. Jend. Sudirman
Jakarta 10210
T: +62 (0) 21 574 0877
F: +62 (0) 21 574 0313

Find out more about our services at **kpmg.co.id**