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Performance of State-Owned Enterprises in Indonesia: The Impact of Government Involvement

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DECLARATION

To the best of my knowledge and belief this thesis contains no materials previously published by any other person except where due acknowledgement has been made. This thesis contains no materials which have been accepted for the award of any other degree or diploma in any university.

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Rahayu Puspasari
Date:

ABSTRACT

The purpose of this study is to investigate whether government intervention in Indonesian State Owned Enterprises (SOEs) governance, financial, and regulatory framework impact on performance. The SOEs studied are more than 50 per cent government-owned, which gives the Government ultimate control over all investigated variables. Agency theory is used as the basis to construct the hypotheses.

The entire 125 commercial listed and non-listed SOEs (*Persero Terbuka* and *Persero*) from nine major industry groups in Indonesia are examined using data from 2007-2009 SOE financial reports and government documents as the main sources. Government involvement in SOE has been classified into three areas (governance, financial, and regulatory framework) for the development of hypothesis.The thesis investigates ten independent variables where the government may through either its majority shareholding or control of the regulatory setting, influence SOE performance. Semi-structured interviews are conducted with thirteen respondents to corroborate findings of the main analysis.

The analysis concludes that external appointment of the Chairperson, establishment of board sub-committees and the dividend payout policy are positively related to SOE financial performance. In contrast, the acceptance of government subsidies or payments for public service obligation (PSO) decreases SOE financial performance. Externally appointed CEOs, Government related appointments to the Board of Directors and Commissioners, Government imposed asset transfers and legal cases initiated for non-compliance with regulation do not significantly affect SOE performance. The findings above were supported in small to medium size SOEs (equal to or less than 10 trillion rupiah of total assets) however were not broadly applicable to large SOEs (more than 10 trillion rupiah of total assets).

A number of the hypotheses were not supported. The reasons are articulted in the conclusion of the thesis. We speculate that this may be due to governance regulations in Indonesia not being properly enforced or implemented and hence not resulting in the improvement of profitability that normally be expected.

The interview results supported the quantitative findings noting strong government involvement in the operation of SOEs various governance, financial and regulatory activities.

This study contributes to the existing theory in several ways. It introduces an Indonesian specific definition of commercially oriented SOEs that differentiates them from other government owned enterprises. It also clearly defines the multiple ways in which the government actions impact on SOE performance. Several variables exploring government involvement are introduced in this study. These variables include *government transfer payments in the form of subsidy or public service obligation, dividend payout policy, asset transfer from the central government to SOEs and legal cases resulting from non-compliance with regulations.*

From a practical viewpoint, the interview results confirm that SOEs governance practice is highly influenced by government, primarily through the actions of the responsible minister. It further suggests that those actions are largely driven by a political agenda. Several mechanisms or regulations to resolve this political intervention could be applied, including open bidding and transparent recruitment processes.

Both the quantitative and semi-structured interview results point to government transfers to SOEs influencing performance negatively. The interview data suggests that effective communication with SOE management is needed to understand and accommodate their view of priorities before setting dividend payout and government transfer policies.

To my parents (Ayahanda H.R. Soemadji Soedjio Prawirohardjo and Ibunda Hj. Atik Soemadji) and my beloved children (Enggartyas Setyanto Mohammad and Luthfia Ilmi Setyaningtyas) to whom I dedicate this doctoral dissertation…

"Hard work will never betray you" (Kang Gary 2011)

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TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

CHAPTER 1: INTRODUCTION

1.1. Background

Indonesia's geographical position in South East Asia, its tropical climate and abundant natural resources has made it an attractive proposition for foreign investment, as its three and half centuries of colonisation testifies (Kementerian BUMN 2012). With the additional advantage of a younger rather than aging population and a strong fiscal base, it is predicted to become one of the rapidest emerging economies in the world along with Brazil, Russia, India and China (BRIC) (Indonesia's middle class 2011; Farrell 2012; Balakrishnan 2013). Despite the impact of the global financial crisis, Indonesia is well- placed to maintain its solid economic growth rate for years to come.

The literature draws attention to two key periods of economic downturn in Indonesian history from 1830-1860 and 1929-1967 that underlies the current economic position of the country (van Zanden and Marks 2012). Crop exportation dominated the economic activity in the first period, 1830-1860, overseen by the Colonial administration (Kementerian BUMN 2012). However, despite rapid export growth and economic openness in the market, the period was characterised by a collapse in productivity. The second downturn period, 1929-1967, were years that included the Great Depression, the Second World War and the transition of Indonesia to independence.

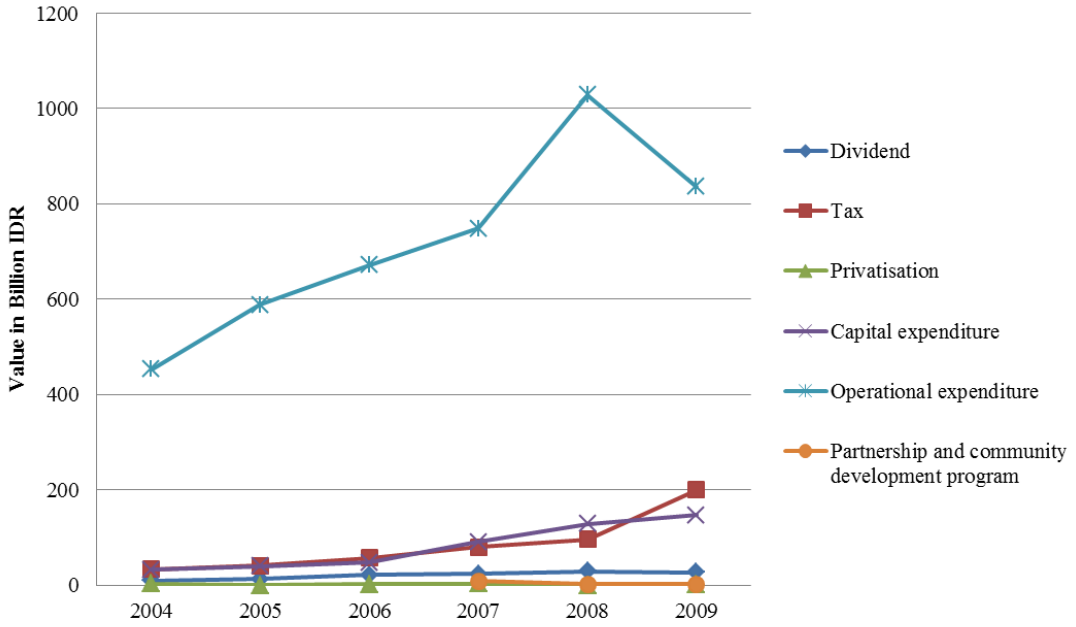
Nationalisation of Dutch companies and the establishment of state-owned companies to balance the dominance of Dutch owned companies took place in this period and became important milestones. Ironically, however, the economic problems peaked during this phase due to budget deficits, money supply and uncontrollable inflation.

Apart from these two periods, there are also periods of very rapid economic growth where productivity increased significantly, one of which was the period between 1968-1998. Known as the pro-growth era, the government opened the door to international competition during this time. Petroleum was in a booming market with

the state-owned energy sector as the most dominant player. Ironically, this did not prevent a bankruptcy in 1976 due to large-scale inefficiency and mismanagement (van Zanden and Marks 2012). Van Zanden and Marks also document growth in the agricultural sector, transportation sector, the industrial sector (in particular industries in natural resources such as oil, forests, and technology) during this period. It should also be noted, State Owned Enterprises (SOEs) were active in almost all industries.

The role of SOEs in the national economy can be identified in its contribution to the economy. The capital expenditure and operatioal expenditure of SOEs have been a significant portion to the GDP of the country over the years. Every year SOEs become one of the direct financial sources of Central Government's revenue generated from dividend, tax, and privatisation. Likewise, indirect contribution of SOEs to the overal economy of the state can be found in the form of partnership and community development program. Figure 1.1 illustrates the trend of SOE's contributions to the national economy in 2004- 2009.

Figure 1. 1: *SOE's contributions to the Indonesian Economy in 2004-2009*



From the description above, it can be concluded that in every stage of economic growth or decline, SOEs have played important roles in the country.

1.2. Indonesian State Owned Enterprise (SOEs)

SOEs have played a strategic role in laying the foundation of the national economy since Indonesian independence (Kementerian BUMN 2009; Rafick and Amir 2010). SOEs were originally a continuation of the Dutch private companies operating in Indonesia, most of which were public utility companies (Moeljono 2004). Their dominance continued until the 1950s and ended when the nationalisation program took place in 1967. In 1967, following the Dutch ending their occupation of Indonesia, all Dutch companies operating in Indonesia were nationalised and taken over by the Indonesian government. These companies, which became state-owned enterprises, have changed the Indonesian economy significantly. About 600 companies are nationalised, comprising the plantation, mining, commerce, banking, insurance, telecommunications and construction sectors (Kementerian BUMN 2012).

In addition to taking over the Dutch companies, the government also established public service companies, such as airlines, sea transportation, and banks, in order to offset the dominance of the former Dutch companies. This move was also aimed at pioneering new economic sectors that had not existed previously. In 1960, the government issued a presidential decree governing SOEs designed to expand its position in the national economy, Seven years later, the government issued another decree to reform SOEs institutionally. Profit-oriented companies were segregated from non-profit ones and known as *Perusahaan Jawatan (Perjan), Perusahaan Umum (Perum) and Perusahaan Perseroan (Persero)*. The position of the SOEs shifted to become the main driver of the national economy and social capital. SOEs contributed to government through taxes and dividends, as well as contributing directly to the economy in terms of capital expenditure (BUMN Track 2012; Muchayat 2010, 83; Sugiharto 2008, 178).

As in many other countries, Indonesian SOEs are considered vital to the national economy, contributing directly to GDP, employment, and market expansion. The collective total assets of the SOEs accounted for IDR 2,234 trillion in 2009 (Kementerian Keuangan 2010). Market capitalisation of 16 publicly listed SOEs (two of them minority owned by the Government) comprised nearly 31.57 per cent of total market capitalisation listed by the Indonesian Stock Exchange (Kementerian BUMN 2010a).

However, the long history of SOE performance suggests that the overall financial performance of SOEs has been very low (Nugroho and Wrihatnolo 2008; Rafick and Amir 2010). Unhealthy aggregate performance can be seen from the slow growth of overall Return on Assets from 1.6 per cent (1992) to 1.9 per cent (2009) suggesting a very low level of efficiency of asset utilisation to generate profits. Moeljono (2004, 6) describes this low SOE productivity as 'asset value destruction' (Moeljono 2004, 4). Likewise, the ROE trend has fluctuated in 18 years with the extreme drop at negative 16.4 per cent in 1998 and 6.5 per cent in 2009, post the global financial crisis.

There are some positive stories about SOE performance however, centring on the performance of 26 SOEs. According to the Ministry of State-Owned Enterprise (Ministry of SOE), the total net income of the 141 SOEs was equal to approximately US$ 10.83 billion, of which about US$ 10.05 billion (or 92.80 per cent) was generated by 26 SOEs (Kementerian BUMN 2011). The figure suggests another issue for SOEs, which is the large performance gap between 26 SOEs and the remaining 115 SOEs. Moreover, Muchayat (2010, 121) concludes that among those high performing SOEs, the level of competition in the industry still needs to be tested as their financial result is below that of the private sector.

The literature discusses many factors contributing to the low performance of Indonesian SOEs. Prior investigations have pinpointed Government control over the SOEs as one of the major causes of low performance (Hill 1982; Hamzah 2007; Laksanawan 2008). Bureaucratic interference, such as pricing policy and regulations on purchasing and contracting, planning and investment, could inhibit SOEs from operating independently and competitively. A study by the World Bank identifies poor business operation and management as the root of the issues. High employment, low productivity, and low quality of goods and service are aspects that have also contributed to poor execution (Nugroho and Wrihatnolo 2008). Habir, Sebastian, and William (2002) also add the mentality of corruption, collusion, and nepotism as a reason for poor management practices. Meanwhile, Rafick and Amir (2010) claim financial conditions have led many SOEs to suffer financially from illiquidity and insolvability.

Supporting the findings by the World Bank, Muchayat (2010) concludes that poor performance of SOEs is caused by three main reasons. First is the low level of productivity as a result of high fixed costs. According to Muchayat, SOEs have the tendency to explore all business sectors, rather than stay focussed on their core business. Secondly, the absence of effective research and development in SOEs has resulted in a lack of innovation in product and market opportunities. Thirdly, the inability to produce goods and service that meets high quality, low cost and time delivery in the market (p.68). Discussions and arguments on the factors causing low performance in SOEs have led to a better understanding of the multi-dimensional factors contributing to the success of this national economic icon. However, Muchayat claims that corporate problems can be resolved by creating synergy between management and stakeholders; this requires a foundation of good corporate governance.

1.3. SOEs, Government and Corporate Governance

The practice of corporate governance in Indonesia has been a great challenge. Wu (2005, 160) gathered ratings on corporate governance at country level measured by three international consulting companies, namely PricewaterhouseCoopers (PWC), McKinsey & Company and Credit Lyonnais Securities Asia (CLSA). First, according to PWC ratings, the level of Indonesian corporate governance equals to the 20th position among 35 countries with the rating (68) higher than the average rating (61.29). The higher rating represents lower corporate governance standard, thus it shows that Indonesia is still below the international standard. Second, the Mc Kinsey ratings signify the average premiums that an investor is willing to pay for a company that is well-governed in a specific country. The result also infers that Indonesia is far below the average (ranked as the 25th of the total 30 countries). Last, as for CLSA, the rating represents the weighted average on corporate governance key areas. According to the result comparison, Indonesia is positioned as the second lowest among 13 countries (37.3 far below the average of 51.76). Even though the ratings are constructed with certain perceptions by the surveyors, these are acceptable parameters to showcase corporate governance practice. Appendix A exhibits the Corporate Governance Ratings Comparison adopted from Wu.

More specifically, Muchayat (2010, 142) quotes from the Booz-Allen survey in 1998 that Indonesia has the lowest corporate governance index in the East Asia region. The low score also reflected poor corporate governance in SOEs in areas such as procurement, recruitment of directors, and integrity and transparency issues.

While an extensive literature review reveals a strong correlation between good corporate governance and successful business practice, it is interesting to examine the Indonesian experience and link it to the problems of low performing SOEs for the following reasons. First, from a business perspective, SOEs might be seen to be legally and financially overprotected by the Government. Highly inefficient SOEs have been maintained under special restructuring programs sustained by the Government. Second, although corporate governance regulations applying to SOEs have been introduced since 2002, studies continue to show that ineffective practice still exists (Syakhroza 2005). Didu (2011a) identifies that non-corporate intervention degrades the quality of SOE leadership due to outside intervention in the Board selection process. Third, one of the milestones of the SOE reform is the issuance of a Ministerial Decree on Good Corporate Governance[1] that marks the start of good corporate governance practices by SOEs in Indonesia. However, there is no study undertaken to evaluate the effectiveness of the regulation. The examination of SOE corporate governance practice is hence important.

The reform of SOEs commenced in 1998 and was executed in stages. The gist of the reform was to improve performance by relinquishing the Government's deep interference by means of introducing corporate governance practices (Laksanawan 2008; Rafick and Amir 2010). One substantial milestone of the reform was the issuance of Ministerial Decree No. KEP/-117/M-MBU/2002 on the implementation of good corporate governance for SOEs issued in 2002 (Kementerian BUMN 2002).

Under new legal arrangements, SOEs operations would be based mainly on three laws: the State-Owned Enterprise Law[2], the Limited Corporation Law[3], and the State Finance Law[4]. Based on these, the institutional relationship between SOEs and the Government can be described in at least three ways. First is the relationship of SOEs

[1] Implementation of Good Corporate Governance for State-Owned Enterprise Minister of SOE Decree (Number .*KEP-117/M-MBU/2002*).
[2] The State-Owned Enterprise Law (Number 19/2003).
[3] The Limited Corporation Law (Number 40 Year 2007).
[4] The State Finance Law (Number 17 Year 2003).

and the Ministry of SOE as proxy shareholder. The minister represents the Government's voting rights in the General Meeting of the Shareholder (GMS) with power to control and supervise management's strategy and operations. Therefore, corporate related issues such as privatisation and SOE restructuring to liquidation are under the coordination of the Ministry of SOE.

Second is the relationship between SOEs and the Ministry of Finance as ultimate shareholder and fiscal regulator or state treasurer. In this context, the Ministry of Finance as State Treasurer has the ultimate authority to determine measures such capital injection, privatisation, restructuring, and divestment as mentioned in the State Treasury Law[5]. Moreover, SOE and the Ministry of Finance also coordinate funding activities such as subsidy, public service obligation (PSO) funds, and dividend payouts (Sunarsip 2012a).

Third is the relationship between the SOE and the respective line ministry as the regulator in the related industry or economic sector. This consists of various sectoral ministries such as the Ministry of Energy; Ministry of Transportation; Ministry of Agriculture; and Ministry of Communication and Information Technology. According to Moeljono (2004), such coordination leads to many consequences, one of which weakens the SOEs due to high levels of intervention from the Government.

Moreover, in contrast with private companies, SOEs are bound to various regulations where private companies are not. Currently, the SOEs are bound to at least 22 laws (compared to eight laws for private firms). These laws, directly and indirectly, establish corridors that hinder the flexibility of SOEs to implement corporate strategy. Appendix B lists the 19 specific regulations for SOEs.

With this type of legal and institutional arrangement, the relationship between SOEs and Government becomes very bureaucratic (Sunarsip 2012b). For instance, the State-Owned Enterprise Law states that in relation to funding activity for capital injection, a long due process has to be undertaken, which involves several stages from different government departments.

[5] The State Treasury Law (Number 1 Year 2003).

Similar processes are found in the dividend payout policy area. Despite the reform, practice shows that government intervention still exists inhibiting competitiveness in the market (Hamzah 2007; Didu 2011b). For example, pressure from stakeholders such as politicians, bureaucrats, non-government organisations, local government, community leaders, press, or other power groups can be very difficult for SOEs to manage, particularly in the CEO and Chairperson selection process (Didu 2011a).

A review of the literature on SOEs shows an absence of study on the specific role of the Government in SOE governance practice. This thesis will therefore investigate the Government's various involvements in Indonesian SOEs.

1.4. Research questions

Governance of SOEs differs from that of the private sector. Boardman and Vining (1989) and Dewenter and Malatesta (2001) find the performance of publicly owned companies to be less profitable than that of private ones. Two plausible reasons are the social goals required of SOEs (Dornstein 1976; Lin, Cai and Li 1998; Chang 2007; Nugroho and Wrihatnolo 2008; Siqueira, Sandler and Cauley 2009; Lu, Tao, and Yang 2010; Zhang and Rasiah 2013; Xiongyuan and Shan 2013) and government interference in the SOE business process and management (Shleifer and Vishny 1997; Yuan, YongFeng, and Yi 2006; Ghosh and Whalley 2008; Lu, Tao, and Yang 2010; Hu and Leung 2012; Xiongyuan and Shan 2013). Nevertheless, the intervention of the Government in the governance system does not always result in negative consequence. Studies in Singapore (Feng, Sun, and Tong 2004; Chang 2007) and China (Sun, Tong, and Tong 2002; Lu, Tao, and Yang 2010) have demonstrated that government interference has led to better company performance.

The presence of corporate governance in improving corporate performance has been studied worldwide, yet there is no single uniformity (Solomon 2007) as countries throughout the world are distinguished by their respective governance system (Shleifer and Vishny 1997; Robertson, Gilley, and Street 2003). The practice of governance in Indonesian SOEs is unique with government involvement at many levels. First, the Government is the major shareholder, by means of controlling the

General Meeting of the Shareholder (GMS). Second, the Government engages with SOEs in the context of its representation on the supervisory board (known as the Board of Commissioner/BOC). Third, the Government is the regulator of fiscal policy as well as sector related policy.

This research will therefore investigate Government involvement in the SOE governance system. A specific question arising from this research is:

> *Does the governance, financial and regulatory measures controlled by government impact on performance in Indonesian SOEs?*

While Indonesian SOEs are corporate entities which are fully or more than 50 per cent government-owned (State-Owned Enterprise Law), it gives the Government ultimate control involvement or majority control/involvement over all measures.

1.5. Objectives of the study

Utilizing agency theory, this thesis provides insight into various types of government intervention, directly and indirectly, in the operations of SOEs in Indonesia. Specifically, the objectives of the research study are as follows:

1. *To analyse the level of government ownership and its relationship with SOE performance.*
2. *To examine the association between the General Meeting of Shareholders (GMS) attributes and SOE performance.*
3. *To investigate the association between the Boards of Commissioner (BOC) attributes and SOE performance.*
4. *To assess the association between the Central Government as financier and regulator and SOE performance.*

1.6. Significance of the Study

The potential contributions of this study are three fold. First, this study focuses on the impact of Government intervention on governance practice of SOEs. Most

previous studies investigating SOEs in Indonesia focus on privatisation (Siagian 2004; Laksanawan 2008; Sugiharto 2008), legal issues on corporate governance (Kamal 2008), BOC and corporate governance (Sari, Halligan, and Sutiyono 2010). Second, there is diversity among SOEs with regard to the company size, industry competitiveness, and economic sector. This calls for a more thorough analysis across SOEs. Previous studies on SOEs in Indonesia predominantly focussed on individual industries such as mining (Gillis 1982), 6 SOEs from textile (Hill 1982), 14 SOEs from construction (Pamulu 2010), and 8 SOEs from construction, energy, banking, and telecommunication and plantation industries (Sari, Halligan, and Sutiyono 2010). The fact that the SOEs range from very small to very large will limit the finding of those studies. This study examines 125 SOEs or the entire profit-oriented SOEs (SOE *Persero* and SOE *Persero Terbuka*) from all existing industrial sectors. Third, this study provides insight into government intervention in SOE governance practice through three different roles, namely the General Meeting of Shareholders (GMS), Board of Commissioners (BOC), and Board of Directors (BOD). The results will assist diverse stakeholders in obtaining a better understanding of the extent of good corporate governance practiced by SOEs and will contribute to the policy making process for continuing SOE governance reform in Indonesia.

Therefore, this research expects to make a significant contribution to scholars and to business practice as explained below.

1.6.1. Contribution to Theory

This study contributes to the corporate governance literature by examining whether the entrenchment hypothesis can explain the impact of Government involvement on SOE performance. Taking into account existing governance attributes from common international practice and bringing in new attributes of Government involvement variables to be tested, this study expects to provide comprehensive data on SOEs governance practice in Indonesia following the SOEs reform process.

In contrast, this study will take into account the full population of all industry type SOE *Persero* & *Persero Terbuka*.

Previous studies on SOEs in Indonesia have focused on SOE performance in specific industries (Hill 1982; Gillis 1982) and the impact of privatization on performance (Siagian 2004; Laksanawan 2008). They have also analysed legal aspects of SOEs with small samples using a qualitative case study approach (Setiawan 2007; Kamal 2008; Sari, Halligan, and Sutiyono 2010).

A gap in the literature exists in respect of non-privatised SOEs and the full extent of government involvement in these entities. Therefore, this study will be the first to examine non-privatized SOEs after the SOE reforms in Indonesia, with the full population of all industry type SOE *Persero* & *Persero Terbuka*. It will be the first study to include a number of governance attributes unique to Indonesia, including comprehensive measures of government involvement. The study further contributes to the corporate governance literature by examining whether the entrenchment hypothesis can explain the impact of Government involvement on SOE performance.

1.6.2. Contribution to Practice

This research provides insights into SOE governance practice. It will assist stakeholders, particularly the Government as the policy maker and the Parliament in obtaining a better understanding of the importance of good corporate governance for SOEs. It will allow stakeholders to understand the association between various governance related measures and performance of SOEs. Eventually, the outcome of this study will contribute to the policy making process for continuing SOE reform in Indonesia.

1.7. Structure of the thesis

Research into the Government's involvement in the business process as part of SOE governance is important, yet empirical evidence investigating this is extremely limited. This thesis attempts to fill this gap by investigating the involvement of the government in the operations of SOEs with regard to the governance, financial and regulatory framework.

This thesis is structured into seven chapters. **Chapter 1** begins with introducing the background of the research. The chapter then describes research questions, research objectives, significance of the study, and the thesis structure is presented.

Chapter 2 describes State-Owned Enterprises in the Indonesian context in depth. First, the definition and characteristics of Indonesian SOEs are presented. Following that, the SOEs financial performance and SOEs in industry competition are reviewed. The chapter also shows the chronology of SOE establishment in Indonesia and their governance structure. In addition, government involvement in the SOEs operation is also explained.

Chapter 3 details the theoretical backgrounds, starting with the core belief of agency theory and corporate governance. Then the discussion extends to government involvement, both in the international and Indonesian context. Following that, it advances hypotheses derived from the literature.

Chapter 4 illustrates in detail, sample selection followed by variable definition and measures.

Chapter 5 reports the research findings from univariate analysis. It starts with informing the approach for univariate analysis. Then it discusses the dependent variable (Return on Assets). The next section describes each independent variable that is grouped into governance related involvement, finance related involvement and regulatory related involvement. Finally, additional descriptive analysis on control variables is presented.

The analysis is followed by **Chapter 6** where findings from multivariate analysis are illustrated. To begin with, statistics for multivariate analysis and assumptions are reviewed. Then correlation analysis and multiple regression analysis are clarified. The next section analyses the semi-structured interview result. Detailed discussion on the three areas of government intervention is conducted followed by additional analysis on control variables. Lastly, sensitivity analysis to test the robustness is detailed.

Finally, the last part of this thesis, **Chapter 7**, concentrates on the implications and limitation of the research. Recommendations for future study conclude this thesis.

CHAPTER 2: STATE-OWNED ENTERPRISES IN INDONESIA

2.1. Introduction

This chapter describes SOEs in Indonesia. It begins with defining SOEs using the generally accepted legal context in Indonesia. It then discusses the establishment, history and progress of SOEs over time. The structure of this chapter is as follows: (1) defining state-owned enterprise; (2) SOE in industry competition; (3) history of establishment (4) the governance of SOE; (5) SOE and government; and (8) summary.

2.2. Defining State-Owned Enterprise (SOE)

The world has recognized the important role of SOEs in the economy of a country. Not only is an SOE one of the players in the competitive market, it can also function as an economy stabilizer. One of the most significant lessons from China's economic transition is that the reform of SOEs can have substantial effect on political and economic change in social welfare, financial institutions, and employment (Lin, Cai, and Li 1998, 422; OECD 2009, 3). This is explained by the domination of Chinese SOEs in every economic sector. With regard to privatising SOEs, empirical studies show that privatisation improves corporate efficiency and performance, leading to greater revenue collection by the government (OECD 2003). The OECD documents the success of privatisation programs across the majority of OECD member countries such as Australia, Poland, the Czech Republic, Hungary and Slovak Republic (p. 27).

The Indonesian Constitution stipulates that all economic sectors, which are important for prosperity, are to be controlled by the state. As this is the mandate, it is the duty of the government to control either through regulation or state ownership of certain businesses in order to build the wealth of the country. One of the policy measures taken to improve the economic control is to establish SOEs.

An SOE is characterised by at least two factors: it is owned by the state and the role it carries. According to the OECD (2009, 5), the term 'state-owned enterprises' is defined as "enterprises where the state has significant control, through full, majority, or significant minority ownership" (OECD 2005). Similar to the accepted international definition, SOEs in Indonesia are one of the economic entities in the national economic system, in addition to private businesses and cooperatives. The Indonesian definition of SOEs is described in the State-Owned Enterprise Law as "a business entity which is fully or majority owned by the state through government's permanent investments". By the State-Owned Enterprise Law, Indonesian SOEs fall into three categories: public corporation (*Perusahaan Umum* or *Perum* or SOE *Perum*), limited liability enterprises (*Perseroan Terbatas* or *Persero* or SOE *Persero*) and publicly listed limited liability enterprise (*Perseroan Terbatas Terbuka* or *Persero Tbk* or *SOE Persero Tbk*). The first category, SOE *Perum* is defined as fully owned by the Government whose operations are considered vital for the public. The SOE *Perum* is urged to make a profit even though the basis is not fully commercial. The latter two categories, SOE *Persero* and *Persero* Tbk are classified as fully (majority) owned by the Government whose capital is divided into shares and all (or at least 51 per cent) owned by the Republic of Indonesia. Majority owned SOEs means a publicly listed SOE (known as *Persero Terbuka* or *Persero Tbk*). Both non-publicly listed SOEs and publicly listed SOEs operate on a fully commercial basis with their main objective to pursue profit.

2.3. SOE History and the Picture of SOE Financial Performance

The dynamics of SOEs in Indonesia are marked by the number of SOEs that change from time to time in accordance with economic change and demands nationally and internationally. Based on the time period, SOEs can be categorized into three types i.e. (1) SOEs in the Colonial era up to post–Independence Day (up to 1960); (2) SOEs in the New Order era (1960-1998); and (3) SOEs in the reform era. A detailed description of the key events in each period is discussed in another section of this chapter.

The first era was the post-nationalisation of Dutch-owned companies up to 1960. After the Dutch occupation ended, the Dutch's companies were handed over to the Indonesian Government (Kementerian BUMN 2012, 27). In 1958, companies were nationalised, which meant the Dutch-owned companies located in the territory of Indonesia became the full property of the Republic of Indonesia by law. About 600 companies were nationalised, consisting of approximately 300 companies from the plantation sector, 100 companies from the mining sector, and the rest from trade, banking, insurance, communications, and construction (p.34). Laksanawan asserts that nationalisation was a blow for foreign capital investment in Indonesia and fundamental change in the structure of the economy (2008). Following the nationalisation policy, the government then began to establish some public corporations to overcome the dominance of the Dutch companies. Two years later, the issuance of a regulation[6] marked the initial establishment of public corporations or SOEs as one of the significant milestones of the Indonesian economy.

During the second era, the "New Order era"[7], there was a decline in the number of SOEs. As a result of the global financial crisis, the Indonesian economy was dependent upon the international financial or funding community such as the IMF, World Bank and foreign companies, which was interpreted as a doorway for a liberal economy. Then the government attempted to simplify the management of SOEs by issuing another law to restructure SOEs. Also, the new legal form of public corporations was introduced in 1969. The corporations were grouped into three, i.e. *Perjan*, *Perum*, and *Persero*, based on the different purpose of operations. The impact of these regulations was the restructuring of state enterprises to the total of 233 companies (Kementerian BUMN 2012, 36).

The third era, the "Reform era"[8], marks a new approach of SOE development particularly in response to the global financial crisis and political change in Indonesia. The government marked another milestone by issuing the new law on State-Owned Enterprises, reforming the legal form of SOEs by only *Perum, Persero* and *Persero Terbuka*. With improvements in the overall national economy, the

[6] Government Regulation as a Substitution of Law on Public Corporation (Number 19 Year 1960).
[7] The term "New Order era" is used to describe an era when Indonesian was led by the regime of President Suharto between 1966 to 1998.
[8] The term "Reform era", also known as Post-Suharto era, is used to explain the era after President Suharto stepped down in 1998.

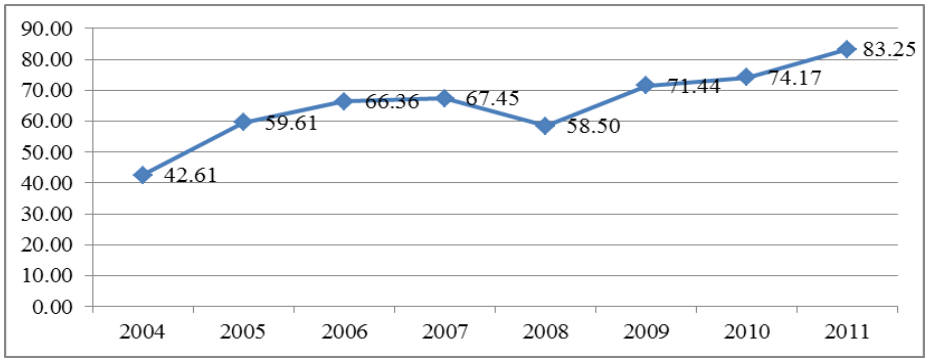
number of SOEs grew to 142 SOEs in 2011. Table 2.1 exhibits the growth on SOEs during the reform era.

A growing number of SOEs as described above indicates an increased amount of equity, of which the largest amount comes from the Central Government fund. It is recorded as government capital investment or posted in the Central Government's financial statement as a permanent investment. The value of this capital investment as well as the growth has been substantial over time. Overall, there has been a steady increase of the total amount of investment by 58.28 per cent in only three years (2004 to 2007). However, it experienced a collapse of 13.26 per cent reaching US$ 58.50 billion in 2008. The decline only occurred in one year as the trend gradually went up again until 2011 amounting US$ 83.24 billion. This value equals to 31.72 per cent of the Central Government total assets as shown in the 2011 Balance Sheet indicating that massive amounts of Central Government economic resources are allocated permanently in the SOEs. Figure 2.1 below presents the upward trend of the permanent investment whereas Table 2.2 describes how significant the investment is to the finances of the Central Government.

Table 2. 1: *Growth of SOEs for 2005-2011*

Type of SOE	2005	2006	2007	2008	2009	2010	2011
SOE *Perum*	13	13	14	14	14	14	14
SOE *Persero*	114	114	111	113	113	111	109
SOE *Persero Tbk.*	12	12	14	14	14	16	18
Total SOEs	139	139	139	141	141	142	142

Figure 2. 1: *Trend of permanent investment on SOEs by central government for 2004-2011 in US$ billion*



Source: Indonesian Central Government Financial Statements for 2004-2011 (Kementerian Keuangan 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012)

Table 2.2 exhibits the SOEs financial highlights from 1992 to 2009 showing that the value of total assets was in a steady upward trend over 8 years reaching almost up to eight times the size of total assets during the time. A dramatic fall of total equity occurred in 1998 due to the global financial crisis. However, the figure improved again afterwards. Total liabilities, on the other hand, experienced very steady growth over 18 years. This indicates the increasing performance of SOEs over time yet there is still a certain level of dependency due to a high level of leverage. It should be noted that the gradual increase of total assets over 8 years is consistent with the fast increase of total liabilities and slower increase of total equity suggesting that the SOEs overall performance was inefficient.

Table 2.2: *Permanent investment of central government in SOEs for 2004 – 2011*

Year	Total Permanent Investment (in billion US$)	Total Assets (in billion US$)	Total Permanent Investment Relative to Total Assets (in %)
2004	42.61	91.02	46.81%
2005	59.61	119.63	49.82%
2006	66.36	135.85	48.85%
2007	67.45	169.17	39.87%
2008	58.50	185.64	31.51%
2009	71.44	225.19	31.72%
2010	74.17	272.75	27.19%
2011	83.25	341.48	24.38%

Source: Compiled from Indonesian Central Government Financial Statements for 2004-2011 (Kementerian Keuangan, 2004, 2005, 2006, 2007, 2008, 2009, 2010, 2011).

Furthermore, Table 2.3 also presents the very low level of ROA and ROA growth from 1.6 per cent in 1992 to 1.9 per cent in 2009. The average ROA remains low every year (below 5%) suggesting that the level of efficiency of SOEs using its assets to generate profits was very low. Moreover, the ROE trend shows a higher rate yet increasing variability over 18 years. The most striking decline occurred in 1998 (at negative 16.4 per cent), which then skyrocketed in 1999 to 25.2%. One reason is the number of SOEs in plantation sectors experiencing windfall profits from rising commodities in US dollar (Nugroho and Wrihatnolo 2008, 26). This unstable figure reveals the low level of ability to generate profits with the money the Government has invested.

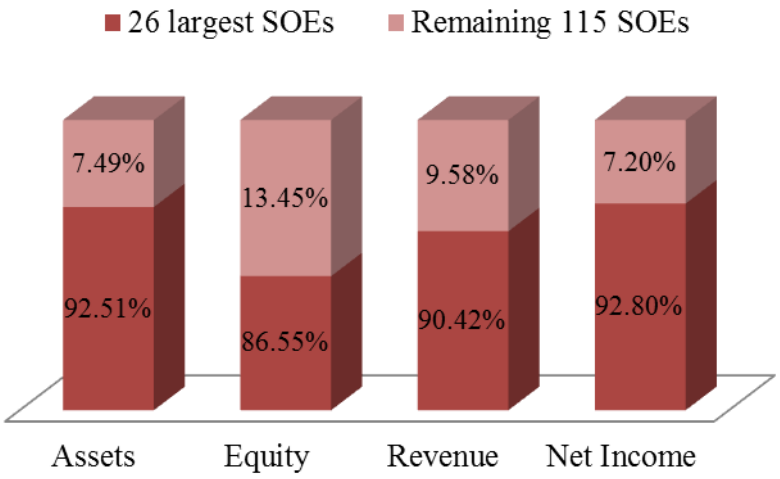
Table 2.3: *SOEs financial highlights, 1992-2009*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Number of SOEs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	139	139	139	141	141
Total Asset[a]	n.a.	129.79	132.31	142.99	143.73	147.03	42.95	77.35	102.63	78.99	100.55	135.78	132.44	135.11	158.95	188.89	202.24	214.64
Total Equity[a]	n.a.	33.5	38.29	44.2	42.91	35.52	-8.49	7.23	13.96	12.64	29	45.55	43.38	44.56	50.24	56.58	54.61	55.14
Total Liabilities[a]	n.a.	96.3	94.07	98.78	100.82	111.5	51.43	70.13	88.68	66.35	71.55	90.23	89.06	90.55	108.72	132.31	147.62	159.5
Profit After Tax[a]	n.a.	1.86	2.08	3.25	3.01	2.52	1.39	1.82	1.58	1.79	2.76	2.97	3.7	4.61	5.56	7.39	6.9	8.94
Dividend[a]	n.a.	0.62	0.51	0.45	1.2	1.48	0.46	0.88	1.05	0.96	1.35	1.14	1.1	2.16	2.51	3.18	2.69	n.a.
Sales[a]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	745	839	1.137.6	962.1
Capex[a]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	48	91	128.3	107.2
Opex[a]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	672.1	748	1.028.4	833
ROA (%)	1.60	1.40	1.60	2.30	2.10	1.70	3.20	2.40	1.50	2.30	2.70	2.20	2.80	3.40	3.50	3.90	3.40	4.20
ROE (%)	5.90	5.50	5.40	7.40	7.00	7.10	-16.40	25.20	11.30	14.20	9.50	6.50	8.50	10.40	11.10	13.10	12.60	16.20
Dividend Payout (%)	31.60	33.30	24.40	13.70	40.00	58.90	33.10	48.30	66.20	53.30	49.00	38.40	29.60	46.90	45.10	43.00	39.00	n.a.
Leverage(%)	27.10	25.80	28.90	30.90	29.90	24.20	-19.80	9.30	13.60	16.00	28.80	33.50	32.80	33.00	31.60	30.00	27.00	25.70

Note: [a] in US$ Billion.
Source: Kementerian BUMN (2010a) and Kementerian BUMN (2010b, xvi and 11).

With regard to SOE overall performance, the Ministry of SOE records that of the US$ 271.87 billion of the total asset value, US$ 251.50 billion or 92.51 per cent is owned by the 26 largest SOEs. Similarly, the total net income of all SOEs is worth US$ 10.05 billion, of which 92.80 per cent is generated from the 26 SOEs (Kementerian BUMN 2010a). The description suggests that approximately 17.73 per cent are categorized as highly performing SOEs while the remaining 115 SOEs are low or contributed less to the overall SOE performance. Table 2.4 below describes the gap of the two groups.

Table 2.4: *Contributions of 26 largest SOEs in 2011*



In US$ billion	Assets	Equity	Revenue	Net Income
26 largest SOEs	251.50	58.63	112.09	10.05
Remaining 115 SOEs	20.37	9.11	11.88	0.78
Total SOEs	271.87	67.75	123.97	10.83

Source: Kementerian BUMN (2011) and DJKN (2011).

Furthermore, as a reciprocal form of capital invested by Government to SOEs, SOEs contribute back to the state both directly to the Government and indirectly to the national economy. SOEs generate dividends, tax and cash flow as a result of privatisation, all of which are directly paid to the State Treasury accounts. Likewise, SOEs participate in driving the economy through the capital market, partnership in environmental conservation, funding for small to medium enterprises, public service

obligations, capital expenditure, and operating expenditure activities (Abubakar 2011, 4; Kementerian BUMN 2011, 16). Table 2.5 provides information on SOE contributions to the national economy. It should be noted that the impact of SOE capital expenditure on growth in the real economic sector is considerable, with the total amount of SOE capital expenditure in 2009 at US$ 11.40 Billion.

Table 2.5: *SOE contribution to the national economy (in 2008-2010) in US$ billion*

	Contribution	Fiscal Year		
		2008	2009	2010
Direct Contribution to the Government	Dividend	2.61	3.03	3.39
	Tax	8.64	9.72	11.33
	Privatisation	0.00	0.19	0.24
Contribution to the overall economy	Capital market capitalization	34.59	67.57	92.17
	Environmental conservation partnership	0.15	0.21	0.33
	Funding for small to medium enterprises	0.00	1.82	0.00
	Public service obligation	22.02	8.89	18.87
	Capital expenditure (CAPEX)	11.47	11.40	22.16
	Operating expenditure (OPEX)	92.11	88.35	104.91

Note: Adapted from SOE contribution to the 2010 Economy (BUMN Track 2011, 17; Kementerian Keuangan 2008, 2009, 2010).

2.4. SOEs in Industry Competition

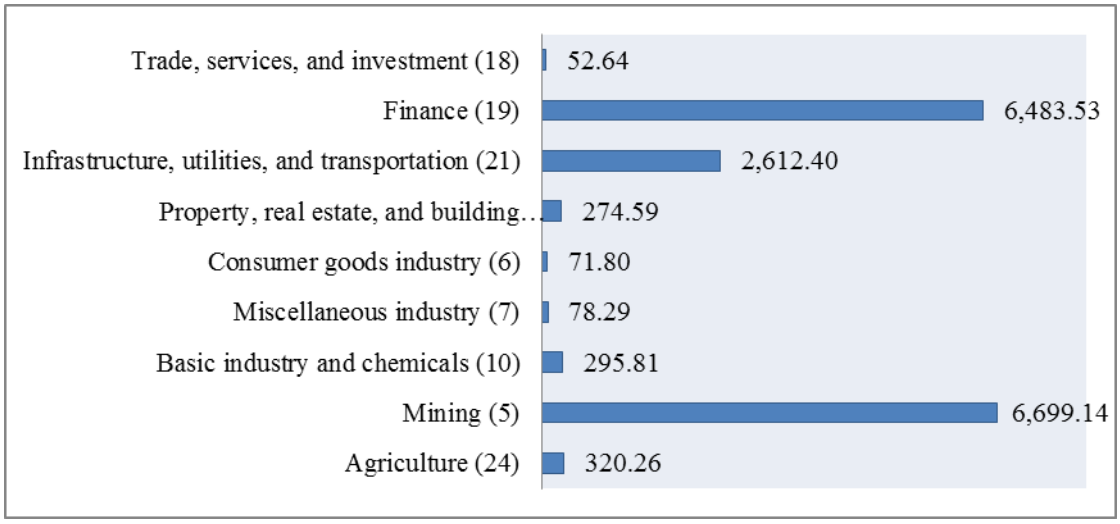
As a driver of the national economy, SOEs participate in almost every industry. In infrastructure, such as roads, transportation, seaports, airports and telecommunication, and public utilities and services, such as electricity, gas, fuel, water, SOEs have been the dominant player and investor (Laksanawan 2008).

The categorisation is regulated by a ministerial decree grouping the SOEs into 31 sectors (DJKN 2011) comprising plantation; forestry; fishery; supporting agriculture; fertilizer; irrigation services; mining; energy; cement; defence; steel, manufacturing and engineering; dock and shipping; miscellaneous industry; paper; printing and

publishing; pharmaceutical; telecommunications and media; electricity; ports; airport; transportation (land, air and sea); construction; construction consultants; region; warehousing; banking; insurance; financing; trade; certification; hospitality and tourism; and miscellaneous. The mapping of 31 categories into nine groups is presented in Appendix C.

In this study, the SOE categorisation is regrouped into nine industry categories based on the categorisation used in the publicly listed companies in the capital market or the Indonesian Stock Exchange (ISX). This category consists of nine groups i.e. agriculture; mining; basic industry and chemicals; miscellaneous industry; consumer goods industry; property, real estate, and building construction; infrastructure, utilities, and transportation; finance; and trade service and investment. The mapping of 31 categories into nine groups is as presented in Appendix C. The largest SOEs are distributed across the finance; infrastructure; utilities; and transportation; and mining sectors. Whereas the smallest SOEs are found in trade services. and the investment industry. The graph below depicts the mean of total assets by industry category.

Figure 2. 2: *Mean comparison of total assets of 125 SOEs[a] by industry group in 2009 (in US$ million)*



Note: [a] Based on 125 SOEs *Persero* and *Persero Terbuka* (Source: DJKN 2009)

The figure above describes the government as capital owners investing in all sectors of the economy but particular industries are more prioritised than others. For example, five companies in the mining and energy sector worth US$ 6,699 million

form the second largest group in terms of total assets while utilities and transportation infrastructure consisting of 21 companies worth US$ 2,612 billion, only one third the mining group in total assets, is almost 3 times smaller.

The participation of SOEs in the economy of the country also triggers, and enlivens, the market. Even though there are some SOEs with a monopolistic privilege, most SOEs participate in the competitive market. Table 2.6 below shows the industry group by competition level. According to the table, the majority of SOEs are in a highly competitive playing field.

Table 2.6: *Industry group by industry competition level in 2009*

	Industry Competition				
	Monopoly (0)	Low (1-5)	Moderate (6-20)	High (21-40)	Very High (>41)
Agriculture	0	0	6	0	18
Mining	0	0	0	1	4
Basic industry and chemicals	0	0	3	4	3
Miscellaneous industry	2	2	1	0	2
Consumer goods industry	0	0	0	0	6
Property, real estate and building construction	0	1	0	0	14
Infrastructure, utilities, and transportation	3	7	3	0	8
Finance	1	6	0	2	10
Trade, services, and investment	6	1	0	2	9
Total	12	17	13	9	74

According to the statistics released by the Bank of Indonesia (Kementerian BUMN 2010b), there are a total of 122 banks in Indonesia, five of which are SOEs. Total assets of the SOE banks are approximately 37 per cent, relative to total assets of the entire 122 banks. The Bank of Indonesia also notes that the SOE banks' assets have been among the slowest growing in Indonesia yet have a very rapid growth of office branches across the country. In the non-bank finance industry, i.e. financial institution, insurance and social security, there are 7, 7 and 3 SOEs, respectively.

The property, real estate and building construction industry is a very highly competitive and fast growing economic sector. According to Kementerian BUMN (2010b), approximately 120,000 construction companies collapsed in 2008 with the increasing growth each year. Eight were SOEs, two of which were the largest and dominated the sector. Moreover, there are 3000 companies within the construction consultancy sub-sector with only five SOEs. With a very high level of competition and less efficient operation, three out of the five SOEs in this area are under a merger scenario.

Within trade, services and investment, there are four SOEs in logistics trading and distribution, some categorised as monopolies. Likewise, there are 16 SOEs amongst 83 industrial estates in Indonesia with export processing and bonded zones. The volatility of Indonesian social politics creates a big challenge for developing this sub-industry due to the decreased level of foreign direct investment.

Infrastructure, utilities, and transportation and air transportation have experienced fast growth in both competition and passenger traffic. It should be noted that due to the deregulation policy on air transportation in 1999, many commercial airlines entered the market. The increase in service providers led to a drastic reduction in airfares. This resulted in not only air transportation becoming highly competitive, but has encroached on other markets, i.e. land and water transportation. Thus, the rapid growth in air transportation sector has had an inverse relationship with the land transportation and water transportation sector. In addition, some of them provide a public service. Such SOEs are characterised as monopolistic businesses with highly regulated government rules.

Moreover, transportation infrastructures such as airports and ports also have strategic functions such as opening up access to domestic and international travellers. Following on from the fast growth of airplane industries, there are 163 airports to date in Indonesia, 27 of which are operated by two SOEs. Both SOEs are the largest companies within the country taking care of almost 90 per cent of the total passenger traffic. Meantime, more than 2133 ports are operated across the country; with 4 SOEs operationalising about 111 of them (Kementerian BUMN 2010b, 141).

By contrast, the transportation support and shipyard sector (as part of the infrastructure, utilities and transportation industry), is much neglected. Currently, there are only 9 major companies (amongst the total of 240 transportation support and shipyard businesses that exist) and 2 of the 10 SOEs have the capacity to build and repair ships. It is difficult for new ship construction companies to enter the market due to high domestic interest rates and collateral problems.

In tourism, there are three SOEs operating in this sector. Despite the fact that tourism is one of the significant revenue generators offering wide opportunity for profit making, the presence of state companies does not really affect the industry.

In plantation, Indonesia has a leading position in the world market for several plantation commodities. The domestic market can produce over 22 million tons of commodities mainly palm oil (the largest in the world), rubber, coconut, tea, coffee and cocoa. There are 16 SOEs in the plantation sector whose production consists of palm oil, rubber, sugar and tea. This occupies only about 10 per cent of the total plantation area in Indonesia in 2008.

Similar to the importance of the plantation sector in the national market, the agriculture and agriculture support sector, such as the provision of seeds, pesticides and fertilizers, also have significant roles. Agriculture and agricultural support sectors play a significant part in the national economy that absorbs more than 40 per cent of the workforce. SOEs contribution is not large in terms of size, yet relatively influential (Kementerian BUMN 2010, 215).

Government investment in irrigation through SOEs has made a vital contribution to escalating rice prices. With fertilizer, SOEs have a virtual monopoly on its production. In forestry, the role of SOEs has declined for years despite the fact that forestry in Indonesia owns considerable forest area (133.1 million ha).

The paper industry, conversely, is a significant generator of foreign exchange for the Indonesian economy in the last twenty years. Among major players, there are two SOEs, one of which is the largest integrated pulp and paper manufacturer in the country.

As for mining, this business is in its growth stage. Unlike countries with a relatively mature mining sector, in Indonesia natural resources and reserves are still plentiful. Not just oil and gas, the country is rich in coal, nickel, tin, lead, gold and silver. Despite the massive opportunities, mining in Indonesia, especially by SOEs, is constrained by several important factors such as declining exploration activities and foreign investment, regulatory uncertainty, illegal mining, undiversified operations and a scale problem. State companies are big players in this industry, where three out of four SOEs are the largest publicly listed companies in the Indonesian Stock Exchange. In the energy sector, both oil and gas, and electricity are all dominated by SOEs and highly regulated by the government.

In the cement industry, both domestic and foreign companies have a large investment in the state. The growth of domestic demand has been increasing swiftly since 2004. Cement distribution is free from zone restriction.

As for energy, a range of segments in the energy industry comprises oil and gas extraction and transmission, electricity generation and production, and various related services. Indonesia's oil production has been continually decreasing. With domestic consumption increasing, Indonesia's export capacity has even further diminished. At current levels of consumption, Indonesia's potential reserves are predicted to be drained in 15 years. Consequently, Indonesia has started to utilize natural gas, coal, and geothermal and hydropower as alternative energies. It should be highlighted that the energy industry is highly regulated. Related SOEs remain as fully government-owned as it is Government policy to protect the energy reserves.

Telecommunication is a highly competitive industry in Indonesia. Since deregulation and restructuring was introduced in 2001, the practice of monopoly ceased and the market opened for competition.

With regard to steel manufacturing, Indonesia is the largest steel producer in the ASEAN (35 per cent of the region's output) with the total national capacity accounting for 6 million tons of steel. This need is fulfilled by 95 steel manufacturers with only one large SOE that produces approximately 3 million ton or half of the national output.

Conversely, in the pharmaceutical industry, there are 198 manufacturers in Indonesia with a market size of more than US$ 2.5 billion. The market is dominated by the largest 60 manufacturers (three of them are SOEs), which account for 80% of sales.

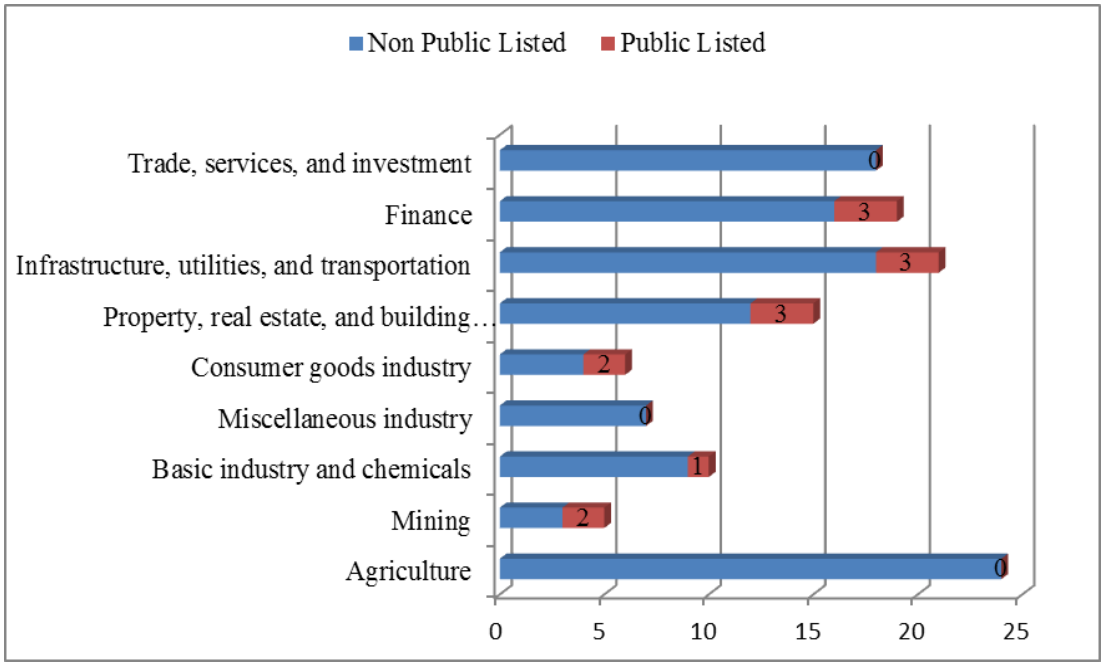
In the fishing industry, small-scale fishermen and commercial fisheries dominate the sector reaching only about 5% of the world's capacity. The market is particularly thriving as aquaculture has increased the production from 1.5 tons in 2004 to 3.5 tons in 2008. Conversely, the four SOEs in this industry suffered from large losses and financial difficulties, resulting in a merger of these four companies in 2005.

Based on the above description, it can be noted that as a player in the economy, SOEs rotate the wheels of the industrial sector. This affects opportunities for business expansion and employment (Simatupang 2005). Likewise, it stimulates the economy through capital and operational expenditure. In particular, the total capital expenditure of all SOEs was worth approximately US$ 246.000 billion in 2009, which is approaching 40 per cent of the GDP of the country (Kementerian BUMN 2010b).

Furthermore, SOEs play a very strategic role in the national economy. This is particularly relevant when the SOE is perceived as a pioneer in the business sector that private companies have no interest in. SOEs also have a strategic role as implementers of public services, balance the forces of large private capital and facilitate the development of small businesses. In addition, SOEs are substantial sources of revenue to the state from tax, dividend and privatisation (BUMN Track 2012; Kementerian BUMN 2012).

SOEs as one of the focal strengths of the national economy can also be seen in the capital market. To date, there are 14 publicly listed SOEs and more state enterprises in the privatisation process. The frequency distribution of publicly listed SOE based industries in 2009 can be seen in the figure 2.3 below. Market capitalisations of 16 publicly listed SOEs (two of them minority owned by the Government) comprise nearly 31.57 % of the total market capitalisation of the Indonesian Stock Exchange (Kementerian BUMN 2010b).

Figure 2. 3: *Public listed SOEs and non-public listed SOEs by industry group in 2009*



2.5. History of Establishment

The chronology described below gives an overview of the development of the SOE in Indonesia across time. The chronology is divided into three eras as earlier mentioned: (1) The SOE in the Dutch Colonial to post –Independence Day; (2) The SOE in the New Order era; and (3) The SOE in the reform era.

2.5.1. The Dutch Colonial – Post-Independence Day Era

The history of SOEs is inseparable from the history of Indonesia's independence. From the time of Dutch settlement, the Dutch Government invited the Dutch trading companies to unite and to form an alliance, which was named after *Vereenigde Oostindische Compagnie* or VOC. The VOC, established in 1602, was given exceptional monopoly rights and privileges such as forming the armed force and conducting direct commercial negotiations with other countries. It cannot be denied that the VOC in Indonesia had an ambiguous impact. On one hand, the VOC transformed a barren land into fertile land and created a new source of economic activity that attracted foreign investors to Indonesia. Yet, on the other hand, the VOC notoriously absorbed the natural resources of Indonesia, which resulted in

extraordinary losses for the country. The VOC was later declared bankrupt in 1799, leaving massive debt after handing over all assets and company operations to the Dutch government (Kementerian BUMN 2012).

When the independence of Indonesia was declared, the first agenda of the founding fathers was to formulate the constitution and to implement the vision and mission of Indonesia. According to the 1945 Constitution of the Republic of Indonesia,

> …sectors of production which are important for the country and affect the life of the people shall be under the powers of the State" (article 33 no.2) …. The land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people (The 1945 Constitution article 33 paragraph 3).

This embeds SOEs as a part of the Indonesian political system. This constitutional basis provides legitimacy for SOEs as a policy tool to promote society's welfare (Laksanawan 2008). The intention of "under the power of the state" set forth in the Constitution was to strengthen the economy after independence. This due to (1) the situation of the new state that required social overhead capital for capital development. (2) the great loss and damage on public utilities and (3) the practices of indigenous employers which were far behind those of employers from Europe, Arabia and China.

Based on the mandate of the Constitution, later on the government took two initial steps to strengthen the economy. First was to nationalise companies in key infrastructure industries. The issuance of Nationalisation of the Dutch-owned companies Law[9] was the milestone of the nationalisation of ex-Dutch companies in Indonesia. It signified that all the Dutch-owned companies located in the territory of the Republic of Indonesia were nationalised and declared the full property of the Republic of Indonesia. The nationalised companies comprised airlines, railroads, postal and telephone telegraph, shipping, mining and energy, printing, rubber processing, and so forth. Furthermore, of 600 nationalised companies, 300 came from plantation companies, more than 100 came from mining companies, and the remaining came from banking, insurance, communications, and construction (p. 14).

[9] Nationalisation of the Dutch owned companies Law (Number 86 Year 1958).

The second step was to strengthen the post-independence Indonesian economy by establishing several national public corporations. When the Declaration of Independence in 1945 took place, the local business sector was less developed and mostly dominated by foreign companies and small businesses. Moreover, there was only a small financial sector available for additional capital and limited opportunity for private funding. Subsequently, the central government became the main capital resource for speeding up Indonesia's economic development. Thus, the dominance of the former Dutch companies in Indonesia evaporated through newly-funded government held companies. This step underpinned the important role of SOEs in the development of the national economy through generating goods and services to the public, steering exports, creating employment as well as developing experts in the fields concerned.

By the end of the Sukarno presidency in 1967, public corporations dominated the Indonesian economy particularly in banking, commerce, plantation, mining, energy, manufacturing, capital, steel, shipping, electronics, and cement. The role of subsidy and government protection to the public corporations should be also highlighted as key factors in the rate of industrial growth.

2.5.2. The New Order Era

The transition of leadership from the first president (Sukarno) to the president of the New Order (Suharto) resulted in a turnaround in economic policy, which was marked by three milestones. The first milestone was the issuance of the Foreign Investment Law[10], which signified the opening of the door to foreign capital. Gradually and inevitably, Indonesia's economic strength began to depend upon foreign financial institutions, like the IMF, World Bank and other foreign institutions.

The second milestone of the new order era was the issuance of the Presidential Instruction for the Direction and Simplification of Public Corporations[11]. More importantly, the commencement new law[12], which governed the public corporation into three groups, namely covenants (*perusahaan jawatan*), public corporations (*perusahaan umum*) and the limited liability company (*perusahaan perseroan*). The

[10] Foreign Investment Law (Number 1 Year 1967).
[11] The direction and simplification of public corporations Presidential Instruction (Number 17 Year 1967).
[12] Determination of Government Regulation for State-Owned Enterprises Form Law (Number 9 Year 1969). (no. 9/1969).

implementation of the second milestone resulted in downsizing the number of firms to 233 companies (Kementerian BUMN 2012, 36; Laksanawan 2008).

The government declared under the New Order two clear objectives in the establishment of SOEs. First was to maintain economic and political stability; the second was to support national defence.

Unlike the former leadership, the New Order era supported the emergence of the private sector. To achieve this goal, the government targeted subsidies solely to strategic SOE industries. Moreover, the government limited its intervention by restraining bureaucratic procedure and regulations on SOEs. This allowed the board of directors to run the company with a full mandate and responsibilities.

However, through the 1970s SOEs and government bodies were still dominant in the economy. Only in the early 1980s, did that reverse with the role of the private sector elevating following a decline in the role of SOEs. As a comparison, the proportion of SOEs relative to the national economy was 70 per cent in 1970 and 23 per cent as of 2011. During this period of time, financial institutions, capital markets and debt were developed to fund newly emerging companies.

Later in 1998, Indonesian history recorded a striking period of economic downturn. This occurred when an economic crisis severely hit Southeast Asia countries including Indonesia. The monetary crisis in Indonesia was triggered by a domino effect of the absence of foreign exchange systems and hedging policies as well as the lack of debt management that went into domestic private sectors. All of these led to the uncontrollable declining value of the Indonesian currency against the dollar in mid-1997. The economy of the country started to improve slowly when the presidential successor, B.J. Habibie sharply boosted the Indonesian currency rate in 1998.

In addition, defence and military spending was relatively low in the Central Government budget, amounting to about 6 per cent of the total budget in 2009. Military spending was inadequate to safeguard national security as it consists of approximately 0.5% of GDP. This portion is very small in comparison to other Asian countries (3% to 5% of the GDP) (Kementerian BUMN 2010b, 299).

2.5.3. The Reform Era

A new paradigm of SOE management is marked by the publication of the State-Owned Enterprise Law[13]. There are three major changes introduced in this law. First, the law reinforced the relationship between SOEs as the operator with the government as the shareholder and the government as the regulator. This clarified the conflicting role of the government conducted by the Ministry of SOEs as the proxy shareholder and the line ministries as regulator.

Second, the new law incorporated the principles of good corporate governance in order to encourage efficient and productive SOEs. The governance structure introduced in the law is discussed later in this chapter.

Third, there was a confirmation of the position of state-owned enterprise as a business enterprise that aimed to generate income and provide maximum contribution to the national economy. SOEs were then transformed into three new classifications: public corporation (*perum*), limited company (*perusahaan persero*) and public listed limited company (*perusahaan perseroan terbuka*). The definition of each was discussed earlier in this chapter.

Based on the chronology outlined above, the commencement of SOEs in Indonesia can be defined into three groups based on the history of SOE establishment. First, SOEs came into existence as a result of legal transformation from Dutch companies known as nationalisation. Second, SOEs were formed to balance the dominance of nationalised SOEs as well as maintaining national economic and political interests. Third, SOEs were also established to protect national security.

2.6. Governance Structure of SOE

Corporate governance should be understood as operating in a particular environment (Kim and Hoskisson 1997, 11-13; Lukviarman 2001). Relevant to the Indonesian context, Lukviarman suggests that the uniqueness of corporate governance practice in Indonesia requires certain emphasis. Corporate governance of SOEs is regulated

[13] State-Owned Enterprise Law (Number 19 Year 2003).

by the State-Owned Enterprise Law and is defined in the Good Corporate Governance Ministerial Decree[14] as:

> …a process and structure used by an organ of SOE to enhance the success of the business and corporate accountability in order to create shareholder value over the long term by taking into account the interests of other stakeholders, based on the law and ethical values (the State-Owned Enterprise Law article 1 paragraph a).

On one hand, the practice of corporate governance of SOEs is reflected in the principles of good corporate governance as stipulated in five aspects in the law (article 3). First is transparency, which refers to openness in processes and in disclosing material and relevant information about enterprises. Second is independence, which means ensuring that enterprises are managed professionally without influence being exerted by any party contrary to applicable laws and regulations. The next aspect is accountability, which emphasizes the clarity in the functions and responsibilities of corporate structures so that the company management is carried out effectively. The fourth aspect is responsibility, a way of managing compliance with applicable laws and regulations and adherence to good corporate principles. The last aspect is fairness, which describes equity in upholding the rights of shareholders under agreements and applicable laws and regulations.

On the other hand, corporate governance as a structure reveals the governance structure of the SOE organ. For the SOE *Persero*, it consists of the General Meeting of the Shareholders (GMS), Board of Commissioners (BOC) and Board of Directors (BOD) (article 13). Each role is explained as follows. First, the General Meeting of Shareholders (GMS) is the supreme organ of the SOE who holds the highest authority. The Minister of SOEs acts as the GMS in respect to all shares owned by SOE *Persero*; and acts as shareholders in partially owned SOEs. Moreover, the Minister may delegate this responsibility to individuals or a legal entity. The GMS appoints and dismisses the BOC and the BOD. When the Minister acts as the GMS, then appointment and replacement of BOD is his sole prerogative right.

Second, the Board of Commissioners (BOC) is appointed and dismissed by the GMS. An individual who is legally competent and has no record of bankruptcy or

[14] Implementation on Good Corporate Governance for State-Owned Enterprise Minister of SOE Decree (Number KEP-117/M-MBU/2002).

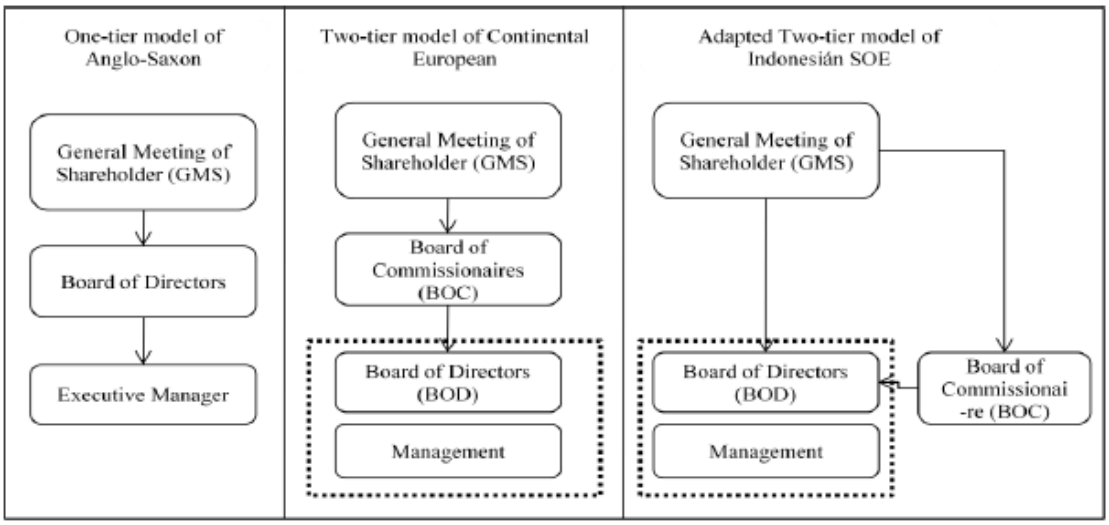
found guilty of causing bankruptcy, or convicted of a criminal offence that causes a loss to the state, can be appointed as a BOC member. Their role and responsibility is to monitor the company's funds and other special purposes as well as advising the BOD, in accordance with the corporate charter. The BOC configuration should be arranged to meet the effectiveness and independency in making decision. Likewise, the BOC is required to establish an audit committee to work collectively in assisting it to carry out the BOC task. The audit committee is chaired by a chairperson who is responsible to the BOC.

Third, the Board of Directors (BOD) is an organ of the company whose members are authorized and fully responsible for running the business on a daily basis and in accordance with the aims and objectives of the company. The BOD also represents the company both inside and outside the court. A person who is legally competent and has no record of bankruptcy, or found guilty of causing bankruptcy, or convicted of a criminal offence that causes a loss to the state can be appointed to the BOD. The GMS assigns the BOD and may dismiss them at any time by the GMS's decision stating the reasons. A dismissal decision can be made after listening to the defence of the GMS.

In addition, the State-Owned Enterprise Law also regulates that members of the BOD and the BOC are prohibited from holding double positions as members of the BOD, local public enterprises, private companies and other positions that may cause a conflict of interest, structural and functional positions at institutions/agencies and local governments; and/or any other office in accordance with the legislation (article 25). Tenure of the BOD and BOC is a 5 (five) year term. Both may be reappointed once for another term (article 28(3) and article 45 (5)).

In international practice, there are two common models of governance structure. These models are adopted by many companies, both private and government-owned, and by many countries. The first model is the Anglo-Saxon model where a Board of Directors provides the supervisory function. It is, therefore, known as a one-tier model. The second model, the Continental Europe model, has separate boards for supervisory functions and management functions. Each board is occupied by different people. Figure 2.4 illustrates this difference between the two models.

Figure 2. 4: *Diagram of three models of governance structures*



Source: Adopted from Cernat (2004), Syakhroza (2005), and Sari, Halligan, and Sutiyono (2010).

Meanwhile, the governance structure of the Indonesian SOE model is unique. Like the two-tier model, the GMS takes on a supervisory function (namely as BOC) and the management function (namely as BOD). Interestingly, the position of the BOC and BOD is not hierarchal yet equal. As a consequence, the role of the BOC is limited to monitoring and advising the operational performance of the BOD. The BOC is given a right to propose candidates to the BOD but they cannot appoint or dismiss the BOD. The figure 2.4 also shows the Indonesian SOE model in comparison with the two other models.

As depicted in the illustration, the governance structure for Indonesian SOEs is distinct from the two other models. The most significant difference is the position of the BOD and the BOC as equals, because they are directly elected by the shareholders. This is in contrast to the Anglo-Saxon model, where shareholders also elect the BOD and the BOC. In the Continental Europe model, shareholders elect the BOC. Then, the BOC appoints the BOD. As mentioned earlier, the appointment and dismissal of the BOC and BOD is conducted by the GMS. The BOC composition in this model should be arranged to ensure that decision-making can be done effectively and independently.

2.7. SOE and Government

As a business entity, SOEs in Indonesia were used to operating under two equally controlling drivers. i.e. first, the Ministry of Finance as the representative of the government and as the ultimate shareholder; and second, line ministries that regulated SOE technical matters (Laksanawan 2008). For instance, SOEs from the energy industry are under the Ministry of Energy and Natural Resources and SOEs in the plantation business are under the Ministry of Agriculture. However, since the State-Owned Enterprise Law was introduced, the relationship between the government and SOEs has shifted. The law gives a mandate to the Minister of SOEs to act as the proxy shareholder. Thus, the Ministry of Finance is positioned as the State Treasurer and fiscal regulator. Similarly, line ministries are regulators in each related sector.

Therefore, since 2003, the relationship between government and SOEs can be described by three involvements. First is the involvement of Ministry of Finance as the fiscal regulator. Second is the association with the Ministry of State-Owned Enterprise as the proxy shareholder to SOEs of which the Minister of SOEs represents the government as shareholder in the General Meeting of the Shareholders. Third is the intervention of line ministries as the industry regulator. Descriptions about each ministry and their involvement areas are as detailed below.

To start with, the Ministry of Finance (MOF) operates as the State Treasurer. According to the Ministerial Decree on Organisation and Work Procedures of Ministry of Finance[15], as the State Treasurer, the MOF has a duty to formulate and implement policies and technical standardisations in the field of the SOEs. In carrying out this duty, the MOF determines policy, norms, standards and procedures, policy implementation, as well as evaluation of the provision of technical assistance in the areas of SOEs (Kementerian Keuangan, 2010a). Likewise, the MOF handles administration that requires government regulation for every financial activity that involves government share equity changes including capital injection, restructuring, divestment, or privatisation.

[15] Organisation and Work Procedures for Ministry of Finance Ministerial Decree (Number PMK 184/PMK.01/2010).

Furthermore, the MOF controls the SOEs funding allocation from the annual budget. This funding includes revenue activities such as tax and dividend payout policy, and expenditure activities, such as loan (known as subsidiary loan agreements), public service obligations, subsidy, and asset transfer.

In addition, as part of governance practice, the State Treasurer is obliged to disclose the SOE's financial position in the Central Government Financial Statements following SOEs submitting financial statements to the Ministry of Finance. This is stipulated in the State Finance Law[16]. Second is the Ministry of SOE. The shift of government representation of SOE ownership has given the Ministry of SOE a mandate as a proxy shareholder due to the Ministry of Finance's delegation of its mandate. This is stated in the State-Owned Enterprise Law[17] and Delegation of Authority Regulation[18]. Accordingly, the Minister of SOEs thenceforth represents the Government voting rights in the GMS. All rights of the GMS, such as the appointment and dismissal of the BOC and BOD and the approval of the annual budget and work plan, are part of the Ministry of SOE's job description. In carrying out this function, the Minister may authorize the substitution rights to an individual or legal entity to represent the GMS (article 14 of the State-Owned Enterprise Law).

Furthermore, as part of the bureaucratic structure of government, the Ministry of SOEs formulates and determines policies related to the SOEs. Ministerial decree is often issued for SOEs as guidelines for operations. The Ministry of SOEs also coordinates and synchronizes the implementation of SOE policy in the field, such as synergizing business processes of SOEs within a similar industry.

Third are line ministries, which in general are regulators in their sector. Even though there is no specific technical rule governing the relationship between SOEs and line ministries, there are conventions that line ministries are to be directly involved in decision-making related to SOEs that are within the ministry's coordination.

[16] The State Finance Law (Number 17 Year 2003) article 30 (2) states that "the financial statements at least cover Budget Realization Report, Balance Sheet, Statement of Cash Flows, and Notes to the Financial Statements, which is attached with the financial statements of state-owned enterprises and other entities."

[17] State-Owned Enterprise Law (Number 19 Year 2003) article 1 (5) states that "Minister refers to the Minister who is appointed and/or authorized to represent the government in the state-owned enterprise (*Persero*) as shareholder and in the public company (*Perum*) as capital owners with regard to legislation."

[18] Devolution of position, duties and authority of Minister of Finance to Minister of State-Owned Enterprise on state-owned enterprise (*Persero*), public company (*Perum*) and bureau company (*Perjan*) Government Regulation (Number 41 Year 2003).

Technical ministries involved in each state are distinguished according to the characteristics, type of business and the field of industry where SOEs operate. For example, the Ministry of Energy is the regulator in the exploration of petroleum and natural gas. Therefore, all SOEs in the energy business are under the Ministry of Energy coordination. The Ministry of Agriculture is to coordinate regulation in agriculture, including fertilizer, rice fields and plantations. The Ministry of Forestry is a regulator of forest management. Ministry of Transportation is the transportation industry regulator in land, sea and air transportation. The Ministry of Telecommunications oversees the telecom industry. The Ministry of Commerce and Ministry of Trade regulate various manufacturing industries. The Ministry of Health supervises the pharmaceutical field. In addition, the banking financial services are under the coordination of the Bank of Indonesia (Central Bank), while the non-bank financial services such as insurance and securities are under the Ministry of Finance.

2.8. Summary of the Chapter

Chapter Two describes Indonesian SOEs in detail. It introduces the distinctive definition of SOEs that are categorised into three groups, each of which represent different characteristics and business orientation. The history of SOE establishment in Indonesia is then discussed describing the erratic economic situation and impact on SOEs. The considerable amount of investment value by the Government to SOEs remains consistent over periods despite SOE performance fluctuation caused by financial crises in 1997 and 2008. This unstable figure reveals the inability of SOEs to generate profits with the money the Government has invested.

As a driver of the national economy, SOEs participate in almost every industry. Initiated from the time the Dutch occupied, Indonesian SOEs grew in certain ways under the Government's control. After the issuance of the Law on SOEs, SOEs were officially introduced to so-called corporate governance, through five pillars, namely transparency, independence, accountability, responsibility, and fairness. It was then followed by the reform or governance structure of the SOE organ.

The three organs of SOE organisation comprise the General Meeting of Shareholders (GMS), the Board of Commissioners (BOC), and the Board of Directors (BOD). The

governance structure of these three organs has been adapted from the two-tier model of Continental Europe with customisation where the BOC operates on equal terms to the BOD (Figure 2.4).

Lastly, with regard to the SOE relationship with government, SOEs are under three controlling agencies, i.e. the Ministry of SOEs, the Ministry of Finance and line ministries. The Ministry of SOEs coordinates and synchronizes the implementation of SOE policy and acts as the GMS. The Ministry of Finance is the representative of the Central Government and, hence, has duty to formulate and implement policies and technical standardisation in the field of SOEs. Finally, line ministries regulate the industrial sector.

CHAPTER 3: AGENCY THEORY AND HYPOTHESIS DEVELOPMENT

3.1. Introduction

This chapter provides the literature review of the thesis. It presents key aspects of existing literature relevant to agency theory as the basis for the discussion of relationships between principal and agent. Guided by this principle, a review of the entrenchment effect as a consequence of the ownership structure is conducted and is used as a foundation to develop the hypotheses.

The organisation of this chapter is presented into the major sections with the following subheadings: Theoretical Background, Agency Theory and Corporate Governance, Corporate Governance Model, Government Involvement in the SOE Business Practice, Hypothesis Development, and Concluding Remarks. The hypothesis development is discussed in relation to three groups of government intervention being Governance Intervention, Financial Intervention and Regulatory Intervention.

3.2. Theoretical Background

Over decades, study on state-owned enterprises took place across the world, investigating a wide range of issues, of which the most researched are privatisation, corporatisation, and corporate governance. The study of SOEs also involves diverse disciplines such as accounting and finance, management, law, and organisational behaviour and, consequently, a variety of theoretical frameworks.

Agency theory is the most frequently used by researchers in examining the competing interests of owners and managers. The theory acknowledges the relationship between the two main parties, the principal (owner) who delegates work, and the agent (manager) to whom the principal delegates the work; and the problems that emerge from such a relationship (Jensen and Meckling 1976; Fama and Jensen

1983). It is often used as a basis to examine cases related to agency problems such as voluntary disclosure, board size and composition, remuneration, turnover and CEO duality and their impact on performance.

In much of the literature, the theory of property rights is also used as a theoretical base to build the case of comparing private and state-owned enterprises (Boardman and Vinning 1989; Al-Obaidan and Scully 1992; Bozec, Breton, and Cote 2002; Marra 2007). Property rights studies generally focus on the efficiency of private ownership over public emphasising the discipline brought by the market and threat of bankruptcy (Ramamuriti 2000).

However, the emphasis for this study is not a comparative of SOE versus private performance, but rather performance within a group of SOEs, which have been challenged to maximise profit. The focus is on the effectiveness of a number of measures in disciplining the behaviour of the managers within these firms.

As this study focused on the performance of SOEs, with a specific emphasis on the (agency) costs arising through their (largely government) ownership structure, agency theory is selected to underpin the study.

Another theory that is commonly used in examining SOEs is stakeholder theory. Instead of merely concentration on shareholders, this theory takes into consideration stakeholders from a larger community (Mallin 2004; Tosi et al. 2003). Consequently, a governance structure of a company shall accommodate more direct representation from all stakeholder groups. There are also a number of studies into SOEs testing institutional theory. This theory concerns more in-depth and more resistant aspects of social structure by taking into account the processes by which establishing structures as authoritative guidelines for social behaviour (Scott 2004). Researchers use this theory to test, for example, environmental issues (Chen 2011; Zeng, Yin, and Tam 2012), housing and other social infrastructure (Abdul-Azis et al. 2010) and other social political issues (Clark and Soulsby 1999; Giacobbe-Miller, Miller and Victorov 2003; Li, YongFeng, and Liu 2006; Weng 2008).

The purpose of this study is to investigate the government's relationship with SOEs, especially linking the relationship between government intervention and its impact on the performance of Indonesian SOEs. It becomes the main concern of this

research to examine the role of government intervention in SOEs' business process. It investigates three areas of government intervention: governance, financial and regulatory.

Based on the research objectives, agency theory is the best fit for constructing and testing the hypotheses in this study. Agency theory accommodates the approach of this study, i.e. the investigation of the relationship between the government (principal) and SOEs (agent) and the presence of vertical agency problems. In contrast to previous studies that focussed on examining the opportunistic behaviour of the agent, this study focusses on the principal (government) as the dominant party and how it impacts on the performance of SOEs.

3.2.1. Agency Theory

Agency theory, proposed by Jensen and Meckling, is extensively acknowledged as an important justification of the relationship under contract between principal (or owner) and agent (or manager). It identifies a relationship where one party, the principal, under which the principal(s) delegates work to another party (the agent) to perform services including making decisions on their behalf (Jensen and Meckling 1976; Fama and Jensen 1983; Tosi, Katz, and Gomez-Mejia 1997; Mallin 2004; Wasserman 2006; Nicholson and Kiel 2007; Lambright 2009).

The premise of the theory is "if both parties to the relationship are utility maximisers, then there is good reason to believe that the agent will not always act in the best interest of the principal" (Jensen and Meckling 1976, 308). Based on McGregor's Theory X who claims that individuals are lazy, passive, not intrinsically motivated to work and need to be controlled by management or they will not act in the best interest of the organisation (Davis, Schoorman, and Donaldson 1997, 20; McGregor as quoted by Tosi, Katz, and Gomez-Mejia 2003, 2054). The principals then seek to motivate the agents to act in the principal's interest through monitoring and incentive arrangements (Fama and Jensen 1983). Under this situation, managers acquire better knowledge and expertise than the firm's owners and thereby are in a position to pursue their own agenda at the cost of the owners (Jensen and Meckling 1976; Hart 1995). The agents can misuse their power over the management advantage and they do not take appropriate risks in the interest of the principals. Such abuse of power

can exist in the form of fraud, misreporting of financial statements, failure to undertake external audits, and unethical behaviour by the management.

Agency problems can be found in any type of organisation, both private and public sectors. When a conflict of interest of the principal and the agent emerges, particularly in monitoring the behaviours of the agent (Eisenhardt 1989), it initiates the principal-agent type of problem. Costs incurred as a consequence of resolving this conflict is known as agency cost. Jensen and Meckling measure this as the sum of the monitoring cost, bonding cost and residual loss (the cost of implementation by the agent surpass the benefits) (Jensen and Meckling 1976, 308; Fama and Jensen 1983). Agency cost decreases when the financial interest of corporate insiders and shareholders converge. Cost arising due to the conflicts between owners and managers is more specifically called "vertical agency cost" (Hope 2013).

3.2.2. Controlling Shareholder and the Entrenchment Effect

In a case where there is more than one principal, all shareholders are obliged to monitor management. This causes difficulty if the ownership is dispersed or if there is a different interest amongst owners especially between majority shareholders and minority shareholders. Theoretically, the larger the investment of the largest shareholder, the greater their incentive to make the company more profitable. However, as ownership gets beyond a certain point, large owners gain almost full control of the company. At some point, controlling shareholders are influential if they favour to use companies generate personal benefits that are not shared by minority shareholders (Shleifer and Vishny 1997). The more dominant group might possess conflicting interests and trigger principal-principal agency problems (Ali, Chen, and Radhakrishnan 2007; Memili, Misra, and Chrisman 2012). Such circumstances are risky to overall company performance and long-term shareholder wealth. This type of situation is specifically known as 'horizontal agency cost' (Hope 2012).

Moreover, the largest controlling shareholder with the extended power can expropriate firm resources to get what they want at the expense of other shareholders (Lin, Chiou, and Chen 2010). The pyramidal structure, cross-holding structure or dual-class shares are applied to expand control of the company (La Porta, Lopez-de-Silanes, and Shleifer 1999). In Taiwan, controlling shareholders expand their control

rights by choosing family members or trusted people for director and supervisor positions (Yeh and Woidtke 2005). Consequently, the discrepancy of ownership and control takes place giving incentives for entrenchment. This effect is known as ‘‘entrenchment effects’’ or “negative entrenchment effects of large ownership” (Claessens et al. 2002). The negative entrenchment effect is disadvantageous for minority shareholders. Control by dominant shareholders can take many forms, such as gaining positions on the board. Being in this role, they can directly monitor and even control operations by having regular meetings with management and becoming involved in strategic decision making in areas such as investment and dividend payout policy.

Family run firms are the most common types of corporation in Asia and are an example where shareholders can become a controlling bloc (La Porta, Lopez-de-Silanes 1999, 511; Bunkanwanicha 2008, 1579). A traditional viewpoint believes that in family businesses, agency problems occur less due to unified ownership and management (Jensen and Meckling 1976; Chrisman, Chua, and Litz 2004). However, in publicly listed family firms, the agency problem performs differently. When the family owner dominates the management and board positions, they act for the controlling owner (the family) to pursue the interests of the family, not that of non-controlling owners (Morck and Yeung 2003). Hence the focus of the agency problem shifts from principal-agent conflict to principal-principal conflict, that is minority shareholders versus majority shareholders (Berglöf and Claessens 2004; Memili, Misra, and Chrisman 2012). Morck and Yeung argue that the principal-principal agency problem caused by this multiple principal-agent relationship is a form of expropriation of non-controlling shareholder’s wealth.

Despite the above, dominant shareholders are commonplace in many economies. La Porta, Lopez-de-Silanes, and Shleifer (1999) discovered that among 27 wealthy economies the company is generally controlled either by the family or by the state. This finding contradicts Berle and Means’ (1932) who earlier claimed dispersed ownership structures were more common across the world. Over time, a growing number of studies have confirmed the finding that the majority of publicly listed companies in most observed countries experienced a concentrated ownership (La Porta, Lopez-de-Silanes, and Shleifer 1999; Claessens, Djankov, and Lang 2002). In Asia (eg Hong Kong, Indonesia, Japan, South Korea and Thailand), Claessens,

Djankov, and Lang discovered that more than two-thirds of East Asian companies were owned by a single largest controlling shareholder. In Indonesia, high ownership concentration is the norm (Husnan 2001; Bunkanwanicha 2008, 1579). Sanjaya (2009) also observed that principal-principal agency problems (between controlling shareholder and non-controlling shareholders) were more common in his research involving publicly listed manufacturing companies in Indonesia. He also points out that family-owned private companies are dominant where the founding family members were appointed to be part of management (Board of Directors) and the supervisory board (Board of Commissioners).

State-owned enterprise is defined by the OECD as an enterprise where the state has control over full, majority or substantial minority of share ownership (2004). However, SOEs in Indonesia are defined as the Government having at least 51 per cent of shares. The State-Owned Enterprise Law states:

> …State-Owned Enterprises is a business entity that all or most of the capital owned by the state through direct investment from wealth separated state (article 1 paragraph 1)... limited company, hereinafter referred to *Persero*, is a state-owned enterprise in the form of a limited liability company whose capital is divided into shares that all or at least 51% (fifty one percent) owned by the Republic of Indonesia, with main objective of pursuing profit (Article 2 paragraph 2).

This high level of government ownership (at least 51%), opens the opportunity for the negative entrenchment effect. Thus, for Indonesian SOEs, government intervention as the ful or majority owner is the main element of the principal-agent problem in this thesis.

3.3. Agency Theory and Corporate Governance

The term ‘corporate governance’ has emerged since the early 19th century, but gained currency in the wake of the bankruptcy of some of the world's business giants in the 21st century. For instance, the 1997 financial crisis in Asia severely hit the economies of most East Asia countries causing a sudden withdrawal of foreign capital after property assets collapsed. During that time, economists around the world observed that the absence of proper ‘corporate governance’ in these nations explained the weaknesses of the institutions in their economies. In the early 2000s,

the world economy was again confronted with the news of massive bankruptcies at a number of giant US firms such as Enron Corporation, MCI Inc. (Worldcom), and Arthur Andersen and noted this as one of the blackest periods in American business history. A number of scandals behind the collapse were uncovered, due to criminal malfeasance found in corporate accounting, leading to bankruptcy and the loss of public trust in financial markets. As a reaction, in 2002, the US government passed the Sarbanes-Oxley Act with the aim of addressing inadequacies and restoring public confidence in 'corporate governance'. Many flaws in corporate governance also exist in other parts of the world, causing a severe impact on the business and economies of those countries (Bank 2004).

For a long time, 'corporate governance' also has been the subject of a long and multi-disciplinary academic discussion. Scholars have very different views about the concept of corporate governance. Bank (2004, 3) simply defines corporate governance as the company's structure and function with regard to its stakeholders in general, and its shareholders in particular. Monks and Minow (2003) characterise corporate governance as diverse participants of shareholders, directors and the management in navigating the direction and achievement of the corporation. Meantime, Berglöf and Von Thadden (1999, 21) refer to corporate governance as being "the mechanism translating signals from product and input markets into corporate behaviour" and the mechanism includes all stakeholders (investor, employee, supplier, competitor, corporate networks and the government). Berglöf and Von Thadden's definition is constructed based on their observation on the paradigm shift of corporate governance in transition and developing countries. Moreover, in a broader perspective, the OECD defines corporate governance as

> ...the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs ('corporate insiders') on one hand, and those who invest resources in corporations, on the other (Oman 2001, 13).

The World Bank specifically defines corporate governance in two ways. From a social perspective, corporate governance is an orientation towards a company's sustainability, growth, and development in concurrent ways through corporate

control. From a corporate perspective, corporate governance is about the relationship between the owner, manager and other stakeholders (Monks and Minow 2003).

While the discussion continues to evolve, there seems no agreement reached on the definition of corporate governance, except that no single universally acceptable definition of corporate governance exists (Turnbull 1997, 200; Monks and Minow 2003, 537; Babic 2003, 4; Solomon 2007, 12) which the OECD refers to as a "no-one-size-fits-all-approach" (1999). However, all definitions suggest that corporate governance is about a set of relationships among participants aiming to achieve the company's objective. This also suggests that corporate governance is multidimensional which gives each country the latitude to develop a specific approach to practice.

The development of corporate governance is influenced by global dynamics. Many factors contribute to the adoption and implementation of corporate governance (Mallin 2004, 16). One very influential aspect is the legal system. Research by La Porta, Lopez de Silanes, and Shleifer (LLSV) in 27 countries concluded that the legal system in one nation affected how corporate governance was exercised (1999, 511). La Porta, Lopez-de-Silanes, and Shleifer identified the presence of controlling shareholders in the companies in countries with weak shareholder protection. These controlling shareholders, usually in family firm or state-owned companies, had the power to implement a management structure, which may include taking the most senior position. Meantime, bigger and more effective equity markets are found in common law countries (eg the United States) with sound legal protection for minority shareholders. In such practice, regulations governing the composition of the board, appointment of CEO and so forth become a crucial instrument of good corporate governance.

Another aspect that has impacted on how the corporate governance system is built, among others, is culture (Turnbull 1997; Kuada and Gullestrup 1998; Licht, Goldschmidt, and Schwartz 2001; Tabalujan 2002). Following up LLSV's findings, Licht, Goldschmidt, and Schwartz (2005, 2004) tested the relationship between national cultural and legal rights' of investors, including anti-director rights, creditor rights, and legal families. They found evidence that corporate governance laws have a systematic relationship to the existing culture of one nation.

Furthermore, the country's economic development is another aspect that influences the practice of corporate governance. In the investigation held in transition and developing countries, Berglöf and Von Thadden (1999, 24) assert that LLSV's findings are more suited to widely held firms where strong managers and weak owners exist. However, they claim that it does not fit to closely held firms in developing countries. An important role of an investor can only be played if they are in the position of strategic investor.

Another investigation, conducted by Babic (2003, 1) highlights the difference between the corporate governance system of developed market economies and ones in transition. While in the developed countries the system is pictured as a multiplex of law, regulation, politics, public organisation, and codes of ethics, in countries with transition economies the issues are corporate ownership, government, fiscal, regulatory, legal, institutional and human capital related problems.

Furthermore, Denis and McConnell (2003) explain that the development of the concept of corporate governance occurs over two generations. The first, initiated by Berle and Means (1932), focuses on the shareholder and the concept of separation of ownership and control in a company. This is introduced by Jensen and Meckling (1976) in their well-known "agency theory". This shareholder viewpoint is used to develop the governance model system. However, corporate governance is not only dominated by law and economics researchers, but also other disciplines such as sociology, strategic management, finance, accounting, and others. In fact, corporate governance is more approachable and easily understood after the introduction of agency theory.

The second generation of corporate governance is characterized by the introduction of the concept stakeholder theory by Freeman (Syakhroza 2005). From this perspective, the company is seen as an entity associated with many interested parties who are both inside and outside the company. The second generation of corporate governance is marked by the findings of La-Porta et al or known as LLVS (1998) who found that the implementation of corporate governance across countries was different and greatly influenced by the legal instruments in force. Also they identified the presence of ownership concentration that resulted in the entrenchment between majority owner and minority owner (Denis and McConnell, 2003).

3.4. Corporate Governance Model

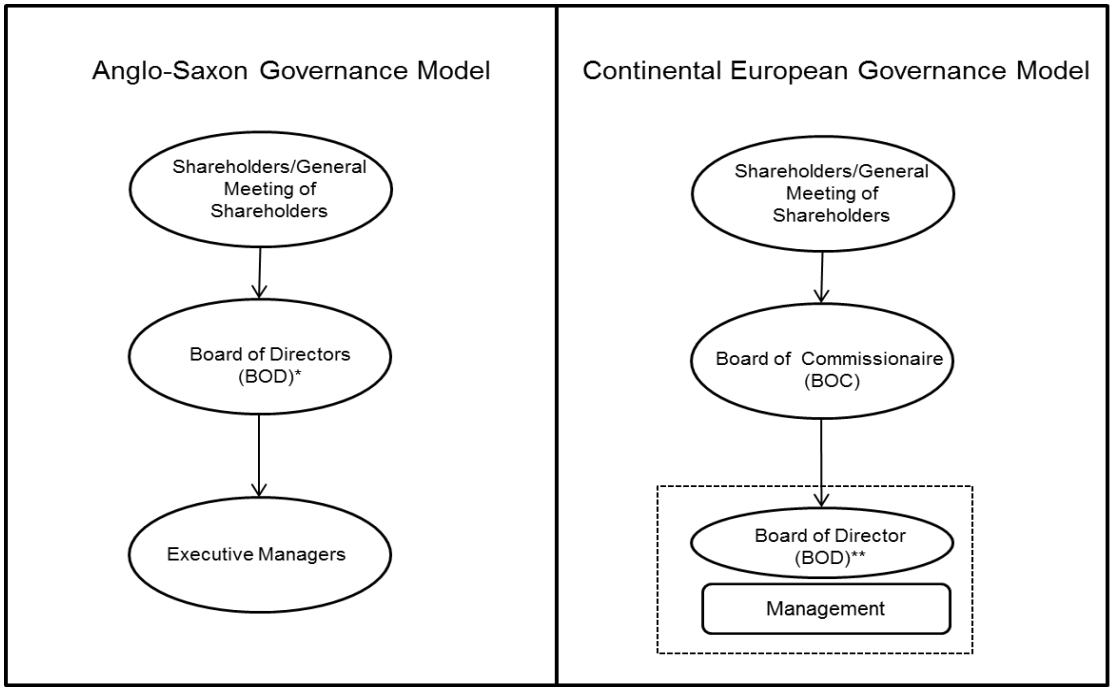
The basis of agency theory as proposed by Jensen and Meckling (1976) addresses the separation of ownership and control. To enable a control mechanism to work, a governance system is required. The OECD (2011) further delineates corporate governance as a system representing a set of interrelations among shareholder, management board and supervisory board. Meanwhile, the World Bank defines corporate governance as

> "the structures and processes for thedirection and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders." (The World Bank 2009, 2).

The first generation of corporate governance introduced two models of governance, i.e. the Anglo-Saxon model and the Continental European model (Syakhroza 2005; Millet-Reyes and Zhao 2010; Bohinc 2011; Nikolić and Eric 2011). Both models aim to describe how the concept of ownership and control separation is implemented. The difference is in the composition and leadership structure, which characterises the way the board functions (Nikolić and Eric 2011). Figure 3.1 below illustrates both models.

First, the Anglo-Saxon model is initially built based on the common-law system. The structure of this model consists of one board only (Board of Directors). The Board is appointed by the General Meeting of Shareholders (GMS). The figure implies that the member of the BOD is also the member of the supervisory board suggesting that a similar person is responsible for two functions: management and control. Meantime, ownership and control is clearly dispersed. Furthermore, the highest position in the structure is the GMS. It has the authority to appoint and dismiss the BOD. The BOD is a representation of the shareholders / owners, who collectively have direct responsibility to the GMS (Syakhroza 2005). The BOD should comprise a large number of outside members that are independent of the management and have no conflict of interest with the shareholders. The main tasks of the BOD, among others, include defining the corporate goals, strategies, and work plans; appointing and replacing the CEO and executive managers; and proposing potential BOD candidates (Nikolić and Eric 2011).

Figure 3. 1: *Governance model comparison: Anglo-Saxon versus Continental European*



Note: It should be noted that the term 'Board of Directors* ' on the Anglo-Saxon model is not similar to the Board of Directors** on the Continental European model. The Anglo-Saxon's BOD* has the function of supervisory management, while the Continental European's BOD** has a purely management function. Since the sample used in this study adopts a dual board system, the use of the term 'Board of Directors' in this context refers to CEO and executive managers with management function, except when the context refers to the Anglo-Saxon model, when the term 'Board of Commissioner' refers to Chairperson and BOC members with supervisory function. Source: Syakhroza (2005) and Nikolić and Eric (2011).

Second, the Continental European model is characterized by two boards: the supervisory board (or so-called Board of Commissioners) and management board (or so-called Board of Directors). The model is very clear about integrating ownership and control (Nikolić and Eric 2011) and vividly separating management and supervisory functions. The supervisory board is selected by the GMS. It has three important functions, i.e. (1) as counsellor to the management board, (2) as authoriser of important decisions made by the management board and (3) to monitor the management performance (Douma 1997, 613). The last role is the most important one as the supervisory board is given the mandate to appoint and replace the BOD members. As for the BOD, it is headed by a director, who is in charge of carrying out the day-to-day corporate operations (Syakhroza 2005).

The Anglo-Saxon model has only one board (i.e. BOD) with a Chairman responsible for two functions, in management (as the CEO) and in supervision, while these two functions are run by different persons in the Continental European model. The Anglo-Saxon model is also known as a "one-tier board", and the Continental European model as a "two-tier board". While the one-tier board exhibits separation of ownership and control, the two-tier model integrates both. The table 3.1 below presents differences between both models as proposed by Nikolić and Eric.

Table 3. 1: *Difference between one-tier and two-tier board model*

One-tier Board	Two-tier Board
Dispersion of ownership and control	Concentration of ownership
Integration of management and control	Integration of ownership and control
Poor incentive for investors to be involved in the control process	Control from the part of banks, partners and employees
Climate for hostile takeovers are not unusual	Aversion towards hostile takeovers which are rather rare
Other stakeholders' interests are not taken into account	Other stakeholders' interests are taken into account
Investor engagement is regulated by law and is related to formulating long-term strategies of the company	Investor engagement is allowed only in case of obvious financial failures
Takeovers may lead to the forming of monopolies	Insider system may lead to secret agreements

Source: Nikolić and Eric (2011, 73)

The literature has discussed the advantages of each system. To start with, the basic benefit of the two-tier model is that there is a balance or clear separation between the power of management and control (Aste 1999; Jungmann 2006; Nikolić and Eric 2011) as well as a division of responsibilities between the supervisory board and the BOD. The minimal number of members on the BOC of the two-tier model can speed up the decision-making process. Aste also argues that this model encourages non-traditional candidates to take up a BOD position. This model also accommodates the interests of foreign capital. Finally, the two-tier model gives merging companies an opportunity to sit in a position on the supervisory board.

However, there are criticisms of the two-tier models. Firstly, the supervisory board in this model is prone to influence the decisions of the management board (Douma 1997). With the power, it can promote interlocking directorships. It can be easily be misused for political rather than economic interests. For example, a director who has resigned could be appointed to the supervisory board. This model also has the potential to accommodate the hidden interests of the supervisory board that is not necessarily an advantage for the company (Aste 1999). Secondly, ratification of management decisions by the supervisory board may cause delays leading to potential waste of management time and business opportunity.

As for the one-tier model, the key advantage is the structural strength. The fact that the board leads as well as controls the firm gives the firm benefits that its entrusted board members have similar responsibilities for supervising and setting strategy. Since all of the board members have direct access to the information, there is no information asymmetry. In addition, with one board, the meeting frequency is higher, the decision making process is therefore quicker (Jungmann 2006, 459).

Nonetheless, the one-tier model also has drawbacks. The main weakness of this model is the high risk of having great concentration of power in the CEO's hand since the function of the supervisory board is limited to administration (Nikolić and Eric 2011, 71). Also, there is a potential of abuse by BOD members of the one-tier model as they may seek personal benefits through share issuance at discount value, sale of property to targeted parties that is not necessarily beneficial to the firm and invite consultants to award BOD member's an extra personal bonus. The BOD members can also interfere with financial reports and issue biased information.

A country decides on a governance system model based on the legal system applied in the country. The one-tier of the Anglo-Saxon model is adopted by countries including the US, UK, Australia, Finland, Spain, Sweden, Greece, Cyprus, Turkey and Canada; whereas the two-tier of Continental European system is used in countries such as Germany, France, the Netherlands and Japan (Syakhzora 2005). In addition, some countries leave the company to select one of the two systems as in France and Slovenia. Others decide not to follow the mainstream models and apply their own types of governance system with different kinds of the supervisory board (Bohinc 2011), like Serbia and Indonesia.

3.5. Indonesian Corporate Governance Model

The Indonesian governance system is influenced substantially by the historic Dutch system in the era prior to Indonesian independence (Husnan 2001). As a follower of the two-tier board system, the governing body in an organisation consists of the General Meeting of the Shareholders (GMS), with the Board of Commissioners (BOC) as supervisory board and the Board of Directors (BOD) as management board. As such, the governance structure is greatly affected by the power of the controlling owners represented by the General Meeting of the Shareholders.

Company Law defines the General Meeting of Shareholders (GMS) as

> … the organ of the Company that has authority not given to the Board of Directors or the Board of Commissioners, within limits as stipulated in this Law, and/or the articles of association (Article 1 number 4).

This signifies the supreme power of the GMS to control both boards. Company Law also regulates that the GMS appoints both the BOD[19] and BOC[20]. Even though the BOC is given rights to temporarily suspend BOD members, the final decision for permanent suspension is the GMS prerogative[21].

More specifically, the National Committee on Governance describes the duty, function and authority of the GMS in the Indonesian's code of good corporate governance. The code emphasises the role of the GMS to facilitate shareholders to make substantial judgements regarding shareholders' investment in the company (KNKG 2006, 11). The code makes very clear the rights and limitations of the GMS.

Decisions taken in the General Meeting of Shareholders must be based on the long-term interests of a company. The General Meeting of Shareholders and/or shareholders cannot intervene in the exercise of the duty, function and authority of the Board of Commissioners and the Board of Directors, without curtailing the authority of the General Meeting of Shareholders to carry out its rights in accordance with the articles of association and laws and regulations, including the replacement

[19]Members of Board of Directors shall be appointed by the GMS (article 94 (1)).
[20] Members of Boards of Commissioners shall be appointed by GMS (article 111 (1)).
[21] Members of Boards of Directors may be dismissed at any time by virtue of GMS resolutions stating the reason therefor (Article 105 (1)). A member of a Board of Directors may be temporarily suspended by a Board of Commissioners, giving the reasons therefor (Article 106 (1)). In the event that the GMS confirms the resolution for suspension, the member of the Board of Directors shall be dismissed (Article 106 (7)).

or termination of the members of the Board of Commissioners and or the Board of Directors (KNKG 2006, 11).

Meantime, the two boards under the GMS, the Board of Commissioners (BOC) and the Board of Directors (BOD), have each respective authority and tasks but for similar vision, mission and values of the company (KNKG 2006). Company Law defines "Board of Commissioners" as the Company Organ with the task of general and/or specific supervision in accordance with the articles of association and giving advice to the Board of Directors (Article 1 number 6).

The BOC consists of a Chairperson and members of BOC whose positions are equal. As the board responsibility is limited to overseeing and offering advice to the BOD, the BOC is prohibited from any activity that signifies participation in any operational decision of the BOD (KNKG 2006).

As for the BOD, it consists of the Chief of Executive Office and the BOD members to manage the company on a daily basis. The code defines the role of the BOD to "function and be responsible collegially for the management of the company as each member" performs their duty based on their respective tasks and responsibilities (KNKG 2006, 17).

By structure, the governance model of Indonesia and that of the European system seem identical since both are two-tier/dual model. However, both are conceptually different. The major difference is that the function of ownership and control is integrated under the GMS, while it is cascaded in the original two-tier Continental European system. This means the GMS is in full control over the BOC and the BOD (Syakhroza 2005, 13). The second difference is in the supervisory function, as the BOC has only limited authority in carrying out the function of monitoring the BOD. With no power to enforce and discipline the BOD, the BOD is able to overlook the BOC rendering it ineffective in performing its monitoring function (Kamal 2008). This is different from the Continental European model where the supervisory board is given a mandate by the GMS to implement strategic decisions on behalf of the GMS, including appointment and dismissal of the CEO and the BOC members. As such, the supervisory board may use their power to enforce and discipline the management board allowing them to perform their function of counselling, ratifying

and monitoring more effectively. In addition, Kamal describes the German model, which is one of the followers of the Continental Europe model, as a model that accommodates the representation of the employees as members of the BOC (2010, 222), which, in contrast, is disallowed in the Indonesian model.

Meanwhile, Indonesia's state-owned enterprises are tied up by a specific rule. The State-Owned Enterprises Law stipulates that the governance model for SOEs is more likely similar to those of private companies with several distinctions. First, SOEs are government owned companies therefore the Minister of SOEs is the government's representative in state ownership. The Law stipulates that:

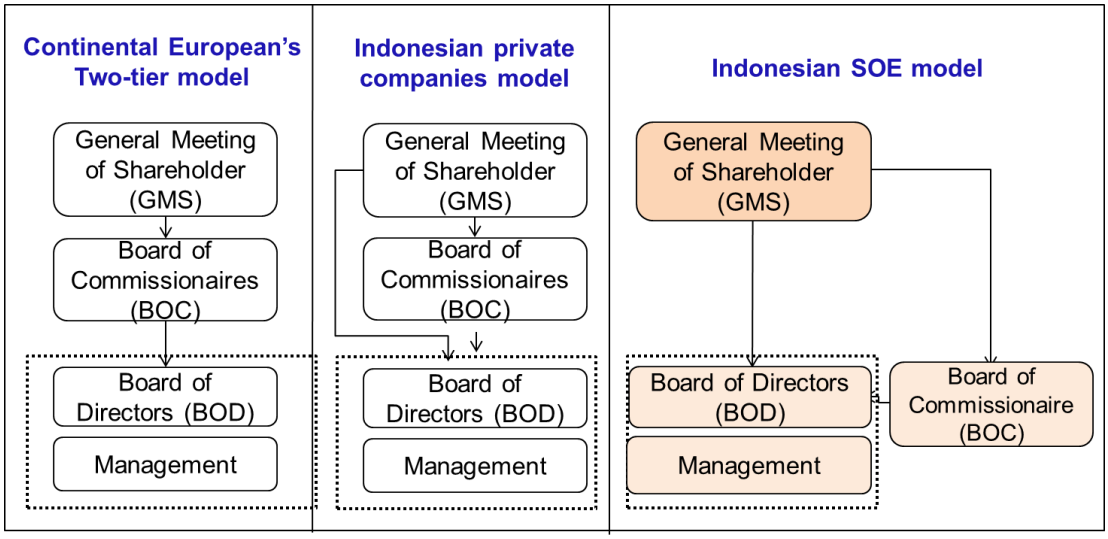
> The Minister acts as the General Meeting of Shareholder for the SOE which is fully owned by the government and acts as a shareholder in a limited liability company which is partially owned by the government (Article 14 paragraph 1).

Secondly, the GMS (the Minister) appoints a chairperson and members of the BOC as well as a CEO and BOD members. The GSM also has the power to dismiss the BOC and BOD (Sari, Halligan and Sutiyono 2010, 11). The BOC is only given authority to propose a candidate for CEO or BOD members who come from inside the current company (insider) as prospective candidates from outside can only be nominated and selected by the Minister. With regard to BOD dismissal and replacement, the law does not regulate the BOC's rights to replace or even temporarily suspend the CEO or BOD members. Thus, the BOCs oversight function can be said to be very weak because it does not have the power to drive performance and discipline the BOD (Kamal 2008). Figure 3.2 presents a comparison of the two-tier model, Indonesian private companies and Indonesian SOE s model.

On the other hand, the position of the GMS remains very strong and controlling. Because the ownership of SOEs are under the coordination of the Ministry of SOEs, the Minister becomes very controlling and influential as many strategic decisions rely on the Minister's decision, such as the appointment and turnover of a CEO; dividend and investment strategy and other strategic decisions that have direct impact on the performance and the sustainability of the SOEs. Since, Government interference has commonly been seen as a negative influence that inhibits SOEs performance (Boardman and Vining 1989; Boycko, Shleifer, and Vishny 1996;

Shleifer and Vishny 1997; Dewenter and Malatesta 2001), it then becomes important to highlight Government intervention in SOEs.

Figure 3. 2: *Comparison of two-tier model, Indonesian privates company's and Indonesian SOE' s model*



Source: Adopted from Cernat (2004), Syakhroza(2005), and Sari, Halligan, and Sutiyono (2010).

3.6. Government Involvement in the SOEs Business Practice

3.6.1. Government Involvement in International Practice

Government involvement in a company is identical with political connectedness. A study by Faccio, Masulis, and McConnell (2006) investigating 43 countries concluded that companies with political connectedness, private or SOEs, underperform their non-connected peers on an ex ante basis regardless of the given benefit. Later studies (eg Fan, Lau, and Young 2007; Kamal 2010; Chen et al. 2005) indicated similar results, that strong connections with political or government reduce performance.

The power of control depends on whether the shareholder is the sole owner or a dominant shareholder. A study by La Porta, Lopez-de-Salines, and Shleifer (1999) across 27 nations found that the majority of firms have had a controlling shareholder for some period of time, largely controlled by the family or the state (government). In companies with 100% government ownership, the government possesses single

voting rights in the General Meeting of the Shareholders. If the government does not fully own the SOEs, then the government is the controlling shareholder. The dominating power is unique in that the government is not merely a shareholder, but also a fiscal and industry regulator (Muchayat 2010).

Government intervention in SOEs is discussed widely in the literature by presenting distinctive case studies, as different countries have different forms of government involvement and its impact. To begin with, Polsiri and Jiraporn (2012) tested financial companies in Thailand during the 1997 financial crisis. They found that the ownership structure and government (in this case is the Crown Property Bureau/CPB) played a significant role in the emerging market economy in the country, characterised by a concentration of ownership and political links. Polisiri and Jiraporn further identified that the institutions with dominant foreign investors in the ownership structure were likely to be shut down. Conversely, financial firms with connections with the CPB were likely to remain open. In addition, the study also revealed that connections in politics are not important factors that contribute to the collapse of the company.

In Canada, Boardman, Freedman, and Eckel (1986) outlined how the Canadian government, by intervening in SOEs, caused an immediate reaction in the market. Their evidence is based on the take-over action of a private Canadian pulp and paper firm by two government owned companies known as Quebec Crown Corporation. The acquisition occurred unexpectedly without insider trading early information and a tender procedure. This led to a strong negative reaction from the investors. Besides the poor financial position of the Canadian pulp and paper industry, Boardman, Freedman and Eckel believed that the loss was caused by the hostile takeover by the government which was motivated by socio-political goals rather than the pursuit of non-profit objectives (1986, 270).

Among discussions on state-owned enterprises, China has the most literature presenting this case. The economic downturn in the 1970s caused substantial economic reform in China in 1978, including the reform of SOEs. According to Li and Xia (2008), the government firmly focussed on retaining the larger strategic SOEs and releasing or privatising the small non-strategic sector SOEs. Li and Xia also highlighted that SOEs tend to formulate strategies that favour long-term

investment (as compared to non-SOEs that prefer short-term). They document, from the national Bureau of Statistics of China, the significant decline of SOE production from 81 percent of Chinese industry output before the reform took place to 35 percent after the reform. Also, Li and Xia argue that the figure represents the emergence of new players into the market as a consequence of the Government's policy on allowing a free market.

A later study by Bajona and Chu (2010) observes in more detail the impact of China joining the WTO. The result shows that by joining the WTO, China was obliged to follow WTO protocols, one of which was to reduce Government subsidies to its state-owned companies. Surprisingly, the impact of reducing capital subsidy to SOEs by 2 percent led to the improvement of the welfare gain to 5.4 percent (2010, 822). Bajona and Chu concludes that the action of reducing SOE subsidy funding and the reallocation of funds to other more efficient private firms explain the source of the increase of welfare benefit.

In contrast to most SOE examples in the world, Singapore provides an interesting case study of SOEs and government control. Based on the study by Feng, Sung and Tong (2004) and Chang (2007), it demonstrates that SOEs (known as government link companies or GLCs) are as efficient as private companies in doing business. When comparing private firms and GLCs on each accounting measure, before and after listing, no evidence shows that the performance of GLCs is worse than that of private firms. Using comprehensive data from the period of 1964-1998, the study also indicates that the high performance of GLCs existed from the very beginning of their establishment. Feng, Sung, and Tong conclude that the efficient operating GLCs have been a result of the Singapore government's policy of creating an open economy to stimulate foreign competition as well as establishing a well-functioning workforce, goods and services, and capital markets (p.2462-2464).

Economic elites view countries with free trade competition and a minimum level of government regulation as more efficient than those of government ownership. Sikora (2005) arrives at this conclusion after extensive research using massive data from four countries, Australia, Finland, Poland, and Bulgaria. He confirms the fact that private companies are much more efficient than state owned companies with Eastern countries more tolerant to government ownership than Western countries. In all four countries, Sikora observes that the government supports the SOEs through

maintaining their economic efficiency, providing subsidies to consumers and protecting jobs.

Furthermore, Sikora also documents the strong support of subsidies in Finland, Poland and Bulgaria, particularly during the time of the financial crisis (p.260) Researchers pay serious attention to government control as the major difference between private companies and SOEs. A state-owned enterprise is normally characterised as a business entity that carries a social goal or mission (Peng and Luo 2000; Tan and Peng 2003; Nugroho and Wrihatnolo 2008; Li and Xia 2008). Often this non-financial goal limits their opportunity to play competitively and perform well in the market.

SOEs around the world have a high level of government intervention particularly through the application of regulations (Shleifer and Vishny 1997; Child and Tsai 2005; Yuan YongFeng and Yi 2006). Government, which own the SOEs, have highly concentrated control rights. When making decisions, Government often prioritises political objectives over profit maximization. For example, SOEs have a tendency to create more leverage and labour intensity compared to private firms (Dewenter and Malatesta 2001). Also SOEs tend to have easier access to political elites than private ones (Child and Tsai 2005), which opens an opportunity for corrupt practices such as hiring employees with political connections and for favourable deals with connected suppliers and customers (Boardman and Vining 1989; Boycko, Shleifer, and Vishny 1996; Shleifer and Vishny 1997; and Dewenter and Malatesta 2001. All of these actions lead to inefficiency.

The findings of Dinç (2005) concluded that SOEs have better access to government-allocated resources such as bank loans and that non-state firms outperform SOEs in labour, productivity, cost control and profitability. Dinç studied the behaviour of government owned banks and private banks across 43 countries to determine whether they behaved differently in election years. Dinç found that government-owned banks increased their lending in election years relative to private banks. These effects were robust even controlling for macroeconomic and bank-specific factors. The results indicated that political motivations influenced the actions taken by government-owned banks and could not be attributed to other differences between private and government-owned banks in efficiency and objective.

Moreover, in explaining inefficiency, Dewenter and Malatesta (2001) argue that SOEs often adopt strategies which are more conducive to fulfilling administrative work rather than pursuing profits. In China, for instance, SOEs tend to adopt strategies to gain support from government (Fung, Kummer, and Shen 2006). They infer that from 1998 to 2002, around 50 percent of capital investments in the country were generated by SOEs. However, these heavy investments by SOEs did not result in output proportional to their investment, unlike investments by non-state firms (Li and Xia 2008, 46). Li attributes the results to the differing aims of non-SOEs in seeking market return and efficiency, while at the same time lessening policy uncertainty and legal risks.

Li and Xia futher explain that if an SOE wishes to persistently getting government funding, the SOE should in return support government in meeting their objectives and program instead of concentrating on the profit motive goal. A potential agency problem can emerge in this situation, as the managers are the investor agents as well as the government officers. This eventually leads to inefficiency of resource usage. .

A study conducted by Yuan, YongFeng, and Yi (2006) highlighted that SOEs' market orientation in transitional stage can be stimulated by "market competitive pressure", "formalized corporate governance" and "less government control". This suggests that government intervention in SOEs affects the degree of market orientation. The formulation of the SOE development plan and performance target will determine the SOEs' orientation in the market. Likewise, the government's involvement in resource allocation (such as labour/capital/technology) is also an important factor in market competition. Yuan, YongFeng, and Yi also concluded that there is a strong positive relationship between market orientation and SOE performance.

3.6.2. Government Involvement in Indonesian State-Owned Enterprises

The law relating to SOEs outlines five functions - namely to provide a foundation for national economic growth; to promote commercial profit; as a source of revenue; as the executor of public service obligation; and as a driver of small and medium enterprises and cooperatives (small medium enterprise) (Muchayat 2010; Sembodo

2012). The first two functions relate to a corporate/commercial agenda while the other three serve as methods for achieving government policy initiatives.

Under new legal arrangements, Indonesian SOEs follow a unique model of governance and recognise a high degree of Government involvement. First, the presence of the Ministry of State-Owned Enterprises (MSOE) which plays the role of proxy shareholder on behalf of the Ministry of Finance. This position executes the function of the General Meeting of the Shareholders (GMS). Having this supreme position, the Government as the shareholder controls the appointment of the Board of Directors (management board) and Board of Commissioners (supervisory board) (Sari, Halligan, and Sutiyono 2010) with the strategic capability to appoint and dismiss both the BOC and BOD. According to the Ministerial Decree on Good Corporate Governance[22], this includes determining the composition of ordinary and independent commissioners on the BOC, and the composition of outside and internal directors on the BOD.

Second, the Government is the regulator with the main mission of protecting the national economy and state finances. The Ministry of Finance is involved in SOE financial activity in many ways. According to Government Accounting Standards[23], Government capital injection (in the form of permanent investment) is the main source of equity of non-listed SOEs. SOEs with a cashflow problem, a market expansion plan or a program to restructure can request additional capital to the Ministry of Finance via the Ministry of SOE. The Government also injects money in the form of subsidies or from a public service obligation fund (Kementerian Keuangan 2010). This allocated budget is dedicated to SOEs with a heavy social burden, such as energy, railway transportation, fertilizer, and the agriculture industry. In addition, the Government earns dividends from profitable SOEs. By law, the GMS decide the amount of retained earnings and dividends from the net income of the corresponding year. However, in practice, the Government demands the contribution of dividends as a part of non-tax income revenue to finance its activity. This situation often leads to conflict for internal SOEs since it will affect their business decisions (Hamzah 2007; Nugroho and Wrihatnolo 2008).

[22] Implementation of Good Corporate Governance for State-Owned Enterprise Minister of SOE Decree (Number *KEP-117/M-MBU/2002*).
[23] Government Accounting Standards Goverment Regulation (Number 24 Year 2005).

Third, SOEs are managed via state finance (State Finance Law), therefore, the Government including the Supreme Audit Institution compels SOEs to follow a set of regulations related to state finance, state treasury, state audit, and anti-corruption. This positions the SOE as a highly regulated business entity which is under bureaucratic control.

Fourth, the government is the regulator that coordinates all business activities for the sake of national economic stability. Each corresponding line ministry, such as the Ministry of Energy, the Ministry of Industry, the Ministry of Trade, the Ministry of Housing, the Ministry of Agriculture and the Ministry of Transportation, plays a significant role in formulating regulations or policies to support corresponding industries (Puspasari and Evans, 2012a). In this context, SOEs are set up to accomplish a particular goal of the government with the line ministry overseeing this.

For example, in navigating the national transportation policy, the Ministry of Transportation decides to build a new railway to attract investors and support economic activity in remote areas. Since there is only one company in this business, the government can enforce the new route including the cost of the service so that it is affordable for people to use. This policy is based on a social motive since it is not necessarily profit making for the company.

To conclude, SOEs are likely to follow government policy and are more protected by the state as compared to private enterprises. In ongoing debate, government interference has commonly been seen as a negative influence that inhibits SOEs performance (Shleifer and Vishny 1997; Dewenter and Malatesta 2001), even though Sun, Tong, and Tong (2002) and Feng, Sun, and Tong (2004) oppose this argument as they found that the governments of China and Singapore with their SOEs/GLCs were a positive catalyst in the country's economic development. In the Indonesian context, government involvement can be found in many policies that regulate SOEs as the agent of economic development and as the operator of the government's social agenda.

3.7. Hypothesis Development

Government involvement in SOE has commonly been seen as a negative influence that inhibits SOEs performance (eg Shleifer and Vishny 1997; Dewenter and Malatesta 2001) even though study has also found that the involvement can be positive to SOE performance (Feng, Sun, and Tong 2004). The purpose of this study is to investigate the relationship between government involvement in SOEs and SOE performance. To facilitate this, government involvement in SOE has been classified into three areas as described below. These are government intervention in the SOE's governance, financial, and regulatory framework.

3.7.1. Governance Related Government Involvement

The Indonesian government intervenes in the governance of SOEs in a number of ways. This includes through the direct ownership of state-owned enterprises and also in the appointment of members of the Boards of Directors and Boards of Commissioners. The influence of intervention in these variables on SOE performance is discussed below.

***Government Ownership* (H_1)**

One of the major principles of corporate governance underpinning the OECD Guidelines is the 'equitable treatment of shareholders' (OECD 2005). All shareholders should have fair and equal treatment and access to corporate information. Accordingly, the practice must include the presence of a high level of transparency across majority and minority shareholders, rules for communication and consultation with all shareholders, and the proper provisions for minority shareholders to be involved in fundamental decision-making processes and in shareholder meetings. Moreover, equal treatment signifies that heterogeneous shareholders are more likely to have access to a richer decision- making process and outcome.

Characteristically, majority shareholders have strong control over the firm under heterogeneous ownership conditions. This allows them to control decisions in relation to monitoring activities that minority shareholders cannot. The most common methods are to be a member of the BOC, to conduct regular meetings with management teams, to participating in the company's daily operation (Fama and

Jensen 1983; Adams, Hermalin, and Weisbach 2010). As the ownership increases, the majority owners are more advantaged, particularly when the ownership reaches a certain level (Sheifer and Vishny 1997, 759).

A study by Hope (2013) claims that there is diversity among different groups of majority shareholders: family ownership, institutional ownership, state ownership and employees. Companies with family ownership as the controlling shareholders demand power through appointing a CEO who comes from the family. As also studied by La Porta, Lopex-De-Silanes and Shleifer (1999), one typical action of a controlling shareholder is to use pyramids and be involved in management. This is, however, found to improve the company performance (Anderson and Reeb 2003). Agency problems as an impact of management and ownership separation were found to be less exposed in family firms (Ali, Chen, and Radhakrishnan 2007). This may explain the positive value of family ownership. Meantime, institutional ownership (eg pension fund and mutual fund) is argued to be more passive. Their core business is portfolio investment and therefore, is more focussed to succeed in absolute money terms. On the other hand, state ownership is more sophisticated since the government desires to control SOEs through becoming a majority shareholder. This results in state owned companies receiving considerable political intervention (Schmidt 1996; Kamal 2010). As for employee ownership, being dominant shareholders leads them to increasing employee-manager goal alignment and productivity. Both result in better returns (Hope cited from Kruse, Blasi and Park 2009[24]). To conclude, as observed by Sheifer and Vishny (1997) and Hope (2013), majority shareholders or highly concentrated owners prefer to control for their own benefit, where minority shareholders do not have such control.

Examples of a majority shareholder or high concentrated ownership are found in both developed and developing economies worldwide. Research across the world finds evidence of large shareholders or controlling shareholders, including some OECD countries (European Corporate Governance Network 1997), European countries (Borisova et al. 2012), and Asian countries (La Porta et al. 1998; Xu and

[24] Kruse, Douglas L., Joshph R. Blasi, and Rokeun Park. 2009. Shared Capitalism in the US Economy: Prevalence, Characteristics, and Employee Views of Financial Participation in Enterprises. Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options, University of Chicago Press (Chapter 1).

Wang 1999; Lukviarman 2004; Yi-Hua, Jeng-Ren, and Yenn-Ru 2010). La Porta et al. specify controlling shareholders exist in countries with weak shareholder legal protection.

Furthermore, La Porta, Lopex-De-Silanes and Shleifer (1999, 511) looked at the ownership structures of large companies in 27 countries and discovered that in instances of family or state ownership, the founder of the companies or their successors, were the majority owners. Not only did the controlling shareholders monitor management, there are cases where they were part of the top management.

The proportion of Government ownership in state-owned companies varies across nations. A study by Borisova et al. of the European Union community, notes that government owned is 11.8 per cent on average of 133 SOEs from 14 EU countries (2012, 2920). This level of ownership has substantial increased since 2008 as an impact of the global financial crisis. In China, publicly listed companies have more government dominance in ownership. According to a China Securities and Futures Statistics result summarized by Qiang (2003, 774), state shares account for 41.31 per cent among two other groups (legal personnel or organisation shares and tradable A-shares) in 1994. The figure fluctuates over the years with 38.90 per cent in 2000. Between these years, specifically by the end of 1995, Xu and Wang (1999, 76) demonstrate that government has been one of the main shareholders controlling approximately 30 per cent of shares.

Furthermore, investigations into four Arab countries by Omran, Bolbol, and Fatheldin (2008) concluded that Egypt had the highest government ownership at 34 per cent, whereas Jordan and Oman documented the lowest level of government ownership (9 per cent and 6 per cent respectively) and the largest level of private ownership at 80 per cent.

Research on the effect of government ownership on performance suggests different kinds of results. In China's privatized SOEs, a number of researchers found a negative association between government ownership and company performance (Xu and Wang 1999; Sun, Tong, and Tong 2002; Chen et al. 2005; Gunasekarage, Hess, and Hu 2007; Chen et al. 2011). Dewenter and Malatesta (2001) and Boycko et al. (1996) claim that government controlled SOEs made decisions by prioritising

political objectives over profit maximization. This policy creates a conflict between a social welfare agenda and political interest and explains why SOEs with a controlling ownership by government do not serve the public interest better than private ones. Employment of political connections (Chen et al. 2011) and favourable deals with connected suppliers and customers, over-employment and transfer of resources to supporters (Shleifer 1998) are instances that demonstrate how SOEs are rarely conducive to efficiency (Boycko, Shleifer, and Vishny 1996; Shleifer and Vishny 1997; Dewenter and Malatesta 2001). More specifically, Xu and Wang (1999, 93) tested government's ownership over employment policy as the source of inefficiency in SOEs. They demonstrated a decrease of labour productivity as the ratio of government ownership increased. As increased employment is one of the government's objectives; the inefficiency may have been created as a consequence.

Considerable research on government ownership in the banking industry has been conducted worldwide to see the level of government intervention in bank operations (eg La Porta, Lopez-de-Silanes, and Shleifer 1998; La Porta, Lopex-De-Silanes and Shleifer 2000; Tabalujan 2002; Dinç 2005; Prabowo and Soegiono 2010). La Porta, Lopezde-Silanes, and Shleifer (2000) investigated banks from 49 countries and documented that government owned banks were large and common around the world and particularly significant in poor and underdeveloped countries with low income, weak financial systems, highly involved government yet low protection of property rights (2000, 290). They assert that such ownership politicises the process of resource allocation and efficiency reduction, leading to lower profitability and productivity growth of government owned banks compared to private owned banks. Meantime, Dinç asserts further that the lending level of government banks escalates during election time in comparison to private banks. It reveals that political influence is driving these government companies and macroeconomic factors before the election takes place (p.20). Similarly, Indonesia SOEs, particularly banks are known to have a higher level of political exposure that potentially harms SOE performance (Basri 2009; Rafick and Amir 2010). Despite the high intervention, Probowo and Soegiono report that their study could not find enough evidence that the intervention led to performance decline (Prabowo and Soegiono 2010).

On balance the literature supports the proposition that government ownership is negatively related with performance. However, this is not consistent across all levels

of ownership. Some studies report a non-linear relationship with the negative relationship evident at differing (generally higher) levels of ownership (McConnell and Servaes, 1990; de Miguel, 2004; Dhnadirek and Tang, 2003).

Contrary to the above findings, Sun, Tong, and Tong (2002, 22-3) reveal that a positive impact on SOE performance occurs when partial government ownership takes place. While too few shares owned by government implies too little involvement from government, conversely a high level of share ownership means a high degree of control or intervention of government in SOE operations. This benefits SOEs with financial difficulties such as insolvency since the government can release the SOEs from such trouble. However, this pattern is found to be an inverted U-shape indicating that a positive association works only at a certain level of share ownership.

Feng, Sun, and Tong (2004) also found that having government ownership can have corporate value. Their research in Singapore found that a high level of government involvement has been a positive catalyst in Singapore. SOEs or so-called 'Government-linked companies (GLCs)' have gained a strategic role in the country's economic development due to the government's full involvement in planning, paving, and managing Singapore's development pathway. Ang and Ding support this finding as they contrast the GLCs' and non-GLCs' financial and market performance and evidence that GLCs show higher financial performance and more sound corporate governance than those of non-GLCs. The Singaporean government control GLCs through a holding company named Temasek Holdings, by monitoring and partaking as board members of the company (Ang and Ding 2006, 85-86).

Later study by Tian and Estrin (2008, 85), however, presents new evidence. Their investigation of Chinese publicly listed companies finds that there is a U-shaped relationship between government ownership and company value. The finding suggests a negative association initially when the value drops as the level of government ownership increases. However, the value goes up after reaching a certain level of shareholding (25 per cent), and the relationship becomes positive. They explain the additional shareholders create a positive incremental effect when the government becomes a large shareholder (with more than 25 per cent of stock

ownership). This finding concludes that Chinese' state ownership can associate positively with company performance only at high levels of ownership.

Similarly, Tian and Estrin (2008), Yi-Hua, Jeng-Ren, and Yenn-Ru (2010, 69) also demonstrate a positive relationship in China between government ownership and SOE performance in the case of dividend preference when the proportion of shares reaches a certain level. Interestingly, a later study by Wu, Wu, and Rui (2012) used different approaches by investigating private companies with and without political connectedness. They found that companies whose managers have political connection experienced higher value and attained more subsidies than those without politically connected managers.

The Indonesian legal framework determines that to be recognized as a SOE, a minimum of 51 per cent of SOE's shares should be possessed by the government. SOEs are intended to be majority owned by government yet open for privatisation opportunities. Earlier research has shared a one directional perspective on SOE privatisation in Indonesia that it leads to better performance (ADB 2001; Nugroho 2003; Laksanawan 2008; Nugroho and Wrihatnolo 2008; Sugiharto 2008; Siagian 2004; Astami et al. 2010). While statistically there is a gradual increase in the number of privatized SOEs since 1998, it indirectly implies that the privatisation policy is preferable because it invigorates SOEs. However, reducing the proportion of government ownership of the SOEs believing this will lead to better performance is not always correct. For instance, the privatisation of several Indonesian SOEs' has not always been successful (Kementerian BUMN 2002; Sutianto 2012; Metrotvnews.com 2013). Taking into consideration the above discussion, this thesis posits that government ownership is a determinant factor explaining SOE financial performance. Thus, it is hypothesised that:

> *H1: Government ownership is negatively associated with SOE financial performance.*

CEO External Appointment (H_2)

There has been extensive discussion in the literature about the preference of CEO background. That is whether the new CEO should be appointed from inside -

someone inside the organisation, or outside -someone who does not work for the organisation before succession takes place. Diacon and O'Sullivan (1995) and Jiang, Huang, and Kim (2013) argue the advantages and disadvantages of each type. The successful appointment of a new CEO relies heavily not only on the selection process but also the basis for setting up such a process like the motive and preference to select candidates from inside or outside.

Conventional wisdom says that a company elects an insider that they trust for having a proven track- record in the company. In this case, the insider is believed to be more likely to have better knowledge about the company. His/her involvement starts earlier thus they are more familiar with the goals and strategies of the company. He/she also has established relationships with the top executive and the board early. Because of this, the insider candidate requires a shorter time to adapt than outsider candidates (Schnatterly and Johnson 2008, 133). This argument is supported by Harris and Helfat (1997) who claim that the outsider is less knowledgeable about the company and possibly less skilful within the industry. This leads to a longer learning curve for an outsider (Lauterbach, Vu, and Weisberg 1999) compared to an insider who is more likely to be familiar with the characteristics of the company.

The appointment of an inside CEO candidate is also found to be more efficient. An established company ought to maintain data about prospective human resources from their achievements in the company. This motivates qualified people to stay in the company and promotes trustworthiness and confidence (Friedman and Saul 1991). Hence having an insider choice for CEO diminishes various recruitment, replacement and compensation expenses. In addition, observations by Schnatterly and Johnson (2008, 141) found that a significant turnover of CEOs was more likely to happen in technology-based firms due to rapid changes in technology. Such firms invest human capital for firm-specific knowledge, industry and networking. From this perspective, the company can minimize costs if they appoint an insider CEO. An outside successor means more expensive operational costs (Naveen 2006, 665).

Another reason of favouring insiders over outsiders is that insiders can reduce risks to the company. As pointed by Harris and Helfat (1997, 899), outsiders represent a higher risk to the company. Incorrect judgement and decision making in selecting a CEO from outside can happen because of a lack of information about the candidate. Particularly, the outsider is more likely to make a rash move that can extend the

company risk Gabarro (1987). Consequently, having an insider CEO candidate minimises the risk by reducing a possible information asymmetry between managers and board members (Schnatterly and Johnson 2008, 134).

Despite the arguments that value insider CEOs as a more preferable option, researchers who have investigated outsider CEOs have come up with opposing arguments about the strengths of outsiders CEOs (Tibau and Debackere 2008, 224). Firstly, a CEO invited from outside the organisation may provide independent leadership that creates value (Said, Zainuddin, and Haron 2009). The company presumes that an outsider will convey new information, competence and insight into the company (Karaevli 2007, 700). Thus, they have a higher ability to make changes in the organisation than insiders since their presence is expected to also influence and improve the managerial quality (Huson, Malatesta, and Parrino 2004, 273), whereas long-tenured insiders might have narrower viewpoints, and a psychological commitment to the existing situation (Hambrick, Geletkanycz, and Fredrickson 1993, 412).

Secondly, researchers have shown that the selection committee (the board) actually benefits from the beginning of the selection process. Westphal and Fredrickson (2001, 1127) assert that the selection committee can use the opportunity during the process of selection to align the outside candidates' successful achievements in their past work with the company's future strategic direction. They also emphasize that the board can place expectations on the appointed outsider to encourage them to obtain similar achievements. This assists the new CEO because they are aware from the beginning what the expectations on them are (Finklstein and Hambrick, 1996, 192).
Thirdly, another advantage of a CEO with an outside background is that the presence of new outsiders increases the prospect for a substantial system transformation in the company. The leader succession in conjunction with a strategic reorientation can be a sign of the end of the old order. It also gives legitimacy for new system (Virany, Tushman, and Romanelli 1992, 88). This is particularly relevant to companies in turbulent situations. In their observation of 59 minicomputer (technology based) firms, CEO turnover impacted positively on firm performance. Virany, Tushman, and Romanelli also found that both a newly selected CEO and a change in the executive team can significantly but impartially improve firm performance. The new

formation of a team allows for greater diversity in skills, experience and other factors that may benefit the company, which may not be the case with insiders.

What drives the selection of CEOs given that both insiders and outsiders have their own positive and negative values? Past research has identified various factors that influence the decision of CEO succession and the preferred background. First, Jalal and Prezas (2012, 425) find the level of players within the firm's industry influences the choice. Companies with more firms in a similar business category have a tendency to pick up candidates from a similar industry.

Second, the characteristic of the business is also a factor to consider. For instance, a high technology-based company will desire insiders since the human investment for specific expertise or know-how, market knowledge and relationships take time to acquire and is normally invested in people who already work for the company (Harris and Helfat 1997; Schnatterly and Johnson 2008, 134).

Third, the type of company also tends to show different preferences on CEO background. For instance, private companies are predominantly family owned businesses and therefore have a typical preference of having relatives or friends as top executives. They also note that the presence of an heir-apparent significantly affects the preference of an insider while the non-insider board member reduces the preference of having outsider candidate (Jiang, Huang, and Kim 2013, 50). In contrast, Jiang, Huang, and Kim find that SOEs decide the CEO background by taking into account the firm-specific reasons. High risk SOEs are more likely to appoint outsider CEOs. Likewise, SOEs with high market-to-book value also prefer outsiders to insiders. Schnatterly and Johnson argue that the decision of inviting outsider candidates only occurs when the board believes there is no candidate from inside (2008, 140).

Other considerations in the selection of a successor CEO, such as firm performance, growth, size, firm age (Schnatterly and Johnson 2008, 140), organisation similarity with industry norms (Kesner and Sebora, 1994) and the composition of Board of Directors (Jalal and Prezas 2012, 425) also enrich the literature about the CEO selection process.

Empirical findings document numerous descriptive statistics of insider and outsider successors where the portion of insiders is likely to be larger than outsiders. Recent finding by Jiang, Huang, and Him (2013) document among 1484 CEO turnover in China during 2002-2008, 41.4 per cent are made to outsiders (67.7 per cent of the samples are Chinese SOEs). By contrast, Schnatterly and Johnson (2008, 136) highlight that 30 out of 64 CEO successions (sample taken from 700 observations) are insiders; 24 are outsiders, and the remaining 10 are outsiders from board members. Jiang, and Huang, and Him found that appointed outsider CEOs associate positively with the firm performance only when SOEs hire outsiders due to specific reasons such as high risk in the company (p.60).

A study by Jalal and Prezas (2012) specifically examines outsider CEO turnover. Instead of comparing insider CEOs with outsider CEOs, they assess two groups of incoming outsider CEOs, i.e. from within similar industry and outside industry. The study points out two important facts. First, it reveals the fact that among 528 outsider CEO samples during the period of study in 1993-2009, 40.91% are appointed from within similar industries indicating that outside industry CEOs are preferred (p.403). Second, companies with outsider CEO successors from similar industries enjoy an increase in stock performance as an impact of the market reaction in the following year after succession than those from outside industries (p.409). However, after a number of years, their performance is overtaken. The company with outside industry originated CEOs perform better financially by having lower levels of financial leverage and greater amounts of dividend, capital expenditure, profitability and growth (p.418-423). Unlike the succession of other management team members, the CEO turnover has a direct and immediate impact on the company. As evidenced by Kesner and Sebora (1994, 329), the company can experience an increase in performance following CEO succession. More specifically, Jiang, Huang, and Kim document that firms experience risk reduction and are economically justified (2013, 58-62).

In the Indonesian SOE context, CEO turnover is stipulated in the legislation. The appointment and dismissal of directors – including the CEO- is conducted by the General Meeting of the Shareholders. It is a five year-term for each tenure and for a maximum two terms. For nationally strategic SOEs, the CEO turnover is at the discretion of the top government group, which is chaired by the President

(Presidential Instruction for the Appointment of Directors and or Commissioners/Supervisory Board Members)[25]. The presidential instruction, however, does not specify CEO background. As such, the selection process becomes highly influenced by the government since SOEs are fully or majority owned by the state.

As discussed earlier, government involvement in the SOE might carry multipurpose motives and agenda. This includes top management appointment of which the preference of outsider or insider SOEs might be determined depending upon this exclusive agenda. Chen et al. (2011) assert that top executives with a government background or political connection with government is found to have an impact in the decline of investment efficiency.

Regardless, the most common type of turnover is by internal appointment (Lauterbach, Vu, and Weisberg 1999; Ocasio, 1999; Naveen 2006; Schnatterly and Johnson 2008; Puspasari and Evans 2012a) even though diverse studies promote outsiders because the evidence supports a positive influence after outsider CEO succession. With this regard, this study hypothesises:

H2: CEO external appointment relates positively to the SOE financial performance.

Chairperson' s External Experience **(H_3)**

The BOC is a vital element of governance. Under the two-tier board system, its main function is as a supervisory board and signifies a formal connection between shareholder and management. The initial concept is that a supervisory board is formed as an extension of shareholders to represent and defend their rights against the executive or management board (Baums 2003). It has the potential to function as an effective disciplining mechanism to guarantee a successful alignment between the interest of shareholders and the accomplishment of management. This is the core of agency theory, which concentrates on the emergence of conflict of interest between

[25] Presidential Instruction for the Appointment of Directors and or Commissioners/Supervisory Board Members on State Owned Enterprise (No. 8/2005).

principals and agents and how to overcome such conflict (Jensen and Meckling 1976).

One of the major concerns about the effectiveness of the BOC is the appointment of a chairperson. It should be noted that the chairperson hereafter in this thesis, is a person chairing the BOC who can be a former officer of the company or from outside the company. This should be differentiated from the chairperson of the BOD in the Anglo-Saxon or one-tier model who has two functions: supervisory and executor, therefore having one person being a chairperson as well as the Chief of Executive Officer. In this context, a chairperson can be someone from the executive or an outsider (non-executive). Meanwhile, the term "Chairperson" used in this thesis uses the context of the two-tier Indonesian model, which means a double position of CEO and Chairperson is impossible.

Previously, it was discussed that a CEO could come from outside the company (outsider) or from within the company (insider). The main advantage of hiring a CEO from outside is the technical competence they have (such as specialisation or expertise, including leadership and corporate culture that is expected to increase the firm value), which may be absent in current management or insider candidates. Meantime, a CEO appointed from within the company is more appreciated for his/her experience working in the company as he/she has a better understanding about the company's history and business processes, so it does not need long to adapt.

As a BOC coordinator, a chairperson conducts supervisory functions on behalf of the General Meeting of Shareholders (GMS) or shareholders. Therefore, the background of the Chairperson is different from the CEO and should align more closely to shareholders or management. Therefore, the role of an independent chairperson becomes very crucial to ensure the BOC performs its function effectively (Syakhroza 2005). An independent chairperson is exceptionally useful in companies where the CEO chases a brave and risky approach to secure the company (Campbell 1995, 108). In the context of a family firm and a publicly listed company, an independent chairperson can be those from professions with specific expertise. In the context of government owned companies (SOEs), there are independent commissioners and ordinary commissioners (Kamal 2008). As such, those who originate from outside

the government or SOEs are called independent chairpersons. The majority of them are professionals with specific expertise, for example financial experts and other technical experts. Others can be from academia to community leaders. Other than as an independent chairperson (from the group of so-called "ordinary members") is a chairperson appointed from the government office or those whose office is affiliated with government. A senior government office is the most common one. Others are from senior management from other SOEs, retired senior government officer/SOE/army or police or other legal enforcement officer (Puspasari and Evans 2012a).

If an appointed chairperson comes from the Government, it has the main impact of having a close linkage to the government bureaucracy. Wu, Wu, and Rui (2012, 697) reveal that a chairperson from a government office leads to better relationships with the authorities. This benefits the company for instance, by paying less tax, and giving them more opportunity to access debt financing (Johnson and Mitton 2003; Claessens, Feijen, and Laeven 2008). However, others argue that having government people in the BOC can also invite further intervention. According to Booth and Deli (1996), as adviser, he/she can be less objective compared to an independent commissioner. His/her political link can affect how the company is steered (Ferris and Yan 2007; Fan, Lau, and Young 2007). The government controls SOEs in making decisions by prioritizing political objectives over profit maximization. For instance, the Chairperson can influence the team by insisting on the employment of people by political connection (Shleifer and Vishny 1997; Dewenter and Malatesta 2001; Xiongyung and Shan 2013). According to Dewenter and Malatesta, this can cause inefficiency as it creates more leverage and labour intensity.

If an independent candidate (outsider) is appointed as chairperson, he/she generally has strong experience or a career background that is relevant to the company (Sari, Halligan, and Sutiyono 2010). This type of chairperson is likely to contribute objectively with the expertise that he/she brought from their business experience (Booth and Deli 1996).

Coles and Hesterly (2000) found another possibility, i.e. the appointment of a person to be a chairperson from an independent category but with early past experience working in the company, such as a former CEO. In this case, even though he/she is

an independent commissioner, he/she is equipped with good experience and knowledge about the company, its business processes as well as human resources. Intuitively, this is an advantage for the company due to the individual's shorter learning curve. However, Coles and Hesterly learn that because the chairperson still has strong ties with the company due to the relationship that has existed in the past, the chairperson is likely to be closer to the company's management rather than to the shareholders who has assigned him/her. If this is the case, then the role of chairperson as an independent commissioner is not optimal.

Studies on independent chairpersons have mixed results. For instance, Chau and Gray (2010) document a positive relationship between the assignment of independent chairpersons and the voluntary disclosure level. They argue that the appointment seems to alleviate the family ownership influence as the controlling shareholder. On the other hand, a study by Ferris and Yan (2007) evidenced differently. In response to trading scandal and abuse cases in the US, the Securities and Exchange Commission (SEC) requested a change to improve governance practice for companies by filling their mutual fund boards with an independent chairperson and at least 75 per cent independent directors. Ferris and Yan investigated the impact of this new arrangement and discovered that there was no adequate evidence to show that independent chairperson succession improved the value of the fund management (p. 416-7).

From the opposite viewpoint, examination of the insider chairperson conversely evidences a positive impact on the effectiveness of the board in performing their monitoring function (Uzun, Szewczyk, and Varma 2004).

With regard to SOEs in Indonesia, the BOC members consist of independent members and ordinary members (Kamal 2008). As specified by the State-Owned Enterprise Law, a chairperson of the BOC can be appointed from either independent (outside government or SOE environment) or ordinary members. The Government (Ministry of SOE), who acts as the General Meeting of Shareholders in fully owned SOE or as a majority shareholder in partially owned SOEs, has full control over the appointment of a chairperson.

Having a chairperson with government links can be an entrance point for political interference and influence the performance of the SOE (Fan, Lau, and Young 2007).

For Indonesia, historically, in the early stages of transformation from Dutch companies being nationalised as SOEs in the late 1950s to early 1960s, SOEs were under the leadership of the military (Hill 2000; Rafick and Amir 2010) with strong patronage and unofficial finance (Abeng 2001). The military and senior officers resisted reforms to improve corporate governance. Even though there has been positive progress on the SOE governance practice, a long tradition of business approach, such as lobbying and wait-for-instruction instead of take initiative, still leaves room for the SOE bureaucracy and the leadership practice to be politically and financially oriented (Abeng 2001; Rafick and Amir 2010). Kamal (2008) emphasizes that the BOC in Indonesia is in a weak position to ensure professionalism in performing its role as they are not a purely independent company organ.

To conclude, as the chairperson of the BOC is a vital element of governance in SOEs, the appointment of a chairperson has a direct impact in promoting an effective disciplining mechanism and to guarantee a successful alignment between the interest of shareholders (the GMS) and the accomplishment of management (the BOD). Jensen (1993) argues that chairperson independence can properly improve the supervisory function. Based on the review above, this study will test whether a chairperson of the BOC having external experience is associated with SOE financial performance, as proposed in the following hypothesis.

H3: Chairperson's external experience is related positively to the SOE financial performance.

***The Proportion of Government Related Directors on the BOD* (H_4)**

In general, an agency problem arises because of the separation of ownership and management functions. As a utility maximiser, managers can potentially take advantage of their expertise and accessibility to internal information for personal use, but at the cost charged to the owner (Jensen and Meckling 1976; Shleifer and Vishny 1997). In the case of SOEs, such relationships can get worse as the government (the owner) has very limited ability to monitor the company. According to Li and Xia, this lack of ability gives managers greater opportunity to perform opportunistic actions that benefit themselves. Likewise, managers must enact administrative procedures and government policies, which can lead to inefficiency in resources and

indiscretion of management (2008, 42). Such agency problems may disappear by effective monitoring, one of which is through having a combination of inside and outside directors in a company (Byrd and Hickman 1992; Erickson et al. 2005; Le, Kroll, and Walters 2012). Erickson et al. claim that board composition influences the management of board monitoring regardless of its level of ownership concentration (2005, 389).

A composition of the Board of Directors (management board) comprises inside directors (insider) and outside directors (outsider). Inside directors are those who come from within the company. In a company with diverse shareholders, insiders are usually considered representative of the controlling shareholder. The main reason that a company favours insiders is because they have knowledge about the company's day-to-day operations and regulations built from their experience working in the company, thus they have valuable information and know the company better than outsiders (Bryd and Hickman 1992). Meantime, outside directors are desirable because of their expertise, knowledge or experience in certain areas (Palmieri 1979; Erickson et al. 2005). Outsiders are competitive in the labour market. As such, ability and expertise become a way to build reputations (Fama 1980; Fama and Jensen, 1983). Erickson et al. showed that financial experts who were recruited from financial institutions increase the performance of the company after they joined.

Furthermore, there is the assumption that poor performance in a company is caused by poor management. As such, a higher level of supervision of management (agency theory) is required. That is when outsiders are often brought into the company (Hermalin and Weisbach 1988). Outsiders are expected to create value to the company they join (Said, Zainuddin, and Haron 2009). However, outsiders are criticised for their lack of knowledge as opposed to insiders (Baysinger and Hoskisson 1990).

In the instance of SOEs, the insider does not just mean someone from inside the company. In Indonesian SOE practice, as a government owned company, an insider of an SOE may also come from someone inside a government office or be a military officer or from other SOEs (Puspasari and Evans 2012a). For instance, if a senior officer from the Ministry of SOE happens to meet the criteria of the BOD member's fit and proper test, he or she may be invited to join one of SOEs. Military officers can also be categorised as insiders. The Indonesian government has entrusted and

appointed military officers to lead and manage SOEs (Rosser 2003; Rafick and Amir 2010). This occurred in 1966 when an 'entrepreneurial military officer', which is the empowerment of military officers in managing SOEs, took roles as SOE managers after the restructuring of nationalised companies took place. Military officers were known for their loyalty and discipline; thus this was considered necessary in order to secure the SOEs. Likewise, a reshuffling of BOD members among SOEs from the construction sector took place in 2008 (Nuria 2008).

The role of independent directors is very important. Studies (such Bathala and Rao, 1995; Xie, Davidson Lii, and DaDalt 2003) promote the importance of outsiders to increase firm value. However, a number of investigations on board independence and firm value result in different conclusions. For instance, Merhran (1995) and Klein (1998) have proved that no significant relationship is found between board independence and firm value. Later on, Erickson et al confirm a contrasting result of their investigation that board independence associates negatively with corporate value (2005). It should be noted, however, that Erickson et al. also have conflicting results when examining the relation between board composition and firm value in highly concentrated public listed companies in Canada. The period of 1993–1997 is used. They document there is a rise in the outside directors proportion in the succeeding year. However, the growth of independent board members does not improve the firm value, except that directors with financial background can contribute to the monitoring benefits.

In the context of SOEs, BOD independence is an important aspect of governance. Distinctively, the SOE board is characterized by state representation, the presence and number of employee representatives and the degree of independence (OECD, 2005). The OECD observed that the composition varies across countries depending upon the influence of the government, the employee representation, and the importance of independent members. It can be a zero state representation (eg in Denmark, Norway, the Netherlands, and the US), proportional to their ownership (eg Austria, the Czech Republic, New Zealand), the fix percentage (eg a one third in France and 50 per cent in Mexico) to full members from insiders (Turkey).

While, the BOD is viewed as the most important internal control mechanism responsible for disciplining the actions of insiders (Fama and Jensen 1983) and board structure determines the effectiveness of the BOD in monitoring the firm's insiders, a

BOD with more government representation might lead to less effective management and thus a decrease of performance. Cheung et al. (2011) suggest a negative corporate governance practice emerged when close connections between the BOD and the controlling shareholder exist and leads to decreasing market value for the firm. This assumes the more government representation on the BOD as one form of insiderness, the more likely the SOE is to have poor corporate governance practice. Conversely, effective monitoring through the presence of outsiders on the board, as recognised by agency theory (Fama 1980; Fama and Jensen 1983), is believed to promote an increase of firm value. Therefore, it is hypothesised in this study that:

> *H4: The proportion of government related Directors on the BOD will be positively related to the SOE financial performance.*

***The Proportion of Government Related Commissioners on the BOC* (H_5)**

In agency theory, the disjoint of decision management, i.e. initiating and executing decisions, and decision control, i.e. endorsing and supervising decisions, is important for an effective decision process (Fama and Jensen 1983, 304). The rationale relies on the fact that top managers, who make important decisions, yet not the most affected party of their decisions, are not the equity holders who are largely diffused by those decisions. In doing so, Bathala and Rao (1995, 59) argue that the most important organisational control, among others, is the presence of the Board of Directors, which in this thesis is labelled as the BOC. Regardless of the scale of the company, the shareholders authorise power to this board with its supervisory function to control crucial decisions related to the top-level manager, including their appointment, dismissal, and remuneration. Likewise, the board is given power to endorse and supervise vital decisions (Fama and Jensen 1983, 311).

To ensure its supervisory function, the board composition (refers to BOC composition) becomes focal by balancing board members from outside or outsiders or non-executive directors and those from inside or executive directors. The agency literature identifies this board composition as one of the enabling mechanisms that alleviate agency conflicts in the company as the background of each group member offers certain benefits but the debate on which type of board member is more effective is still going on. Researchers have found that board members from outside

shelter shareholders in certain ways because their major function is to assure that board members from inside engage in and are consistent with the best interests of the shareholders (Fama 1980). The importance of inviting independent directors into the board can also be seen as a balance of members from outside and inside as a way to provide adequate and effective checks and balances (Bain and Band 1996), to moderate a dispute among inside board members (Fama and Jensen 1983, 315) and to prevent earnings management (Xie, Davidson Iii, and DaDalt 2003, 314). Outside members can be effective monitors of the boards' decisions due to their independence, reputation and value in the market that is associated with their company's performance (Fama 1980; Fama and Jensen 1983; Kaplan and Reishus 1990).

The literature also presents a perspective on the presence of outside board members and on which inside board members have the advantage. Bathala and Rao (1995, 60) assess the lack of inside information as the less favourable side of outside members compared to inside members. Correspondingly, Raheja (2005, 285) concludes his investigation showing that those with low verification costs to outside board members and low private benefits to inside board members are the most effective boards. Raheja also emphasized that inside board members benefit the company because of their particular knowledge about the company.

Several prior studies have identified a positive association between board composition and company performance. Hossain, Prevost, and Rao (2001, 143) reviewed the implementation of the Companies and Financial Reporting Acts of 1993 in New Zealand and found that the legislation has a positive influence on company performance. Moreover, an important role of outside board members in corporate governance as they tend to represent the interests of shareholders in control contests, is proven in anti-takeover action too. Investigation by Brickley, Coles and Terry (1994, 388) found that the average stock-price reacts significantly positively to the adoption of a poison pill announcement if the board is dominated by outside board members and significantly negatively otherwise. Another study, conducted by McWilliams and Sen (1997, 504), investigated 265 firms proposing an anti-takeover amendment in the US in the period of 1980-1990. They found that the stock price reaction appeared more negative. They found that a negative association between stock price reaction in the market and the proportion of

inside and affiliated outside board members and the increase of shareholdings from the board members.

On the contrary, a study by Erickson et al. (2005, 409) using data on publicly listed Canadian companies over 1993-1997 presented evidence that the independence of the board was negatively related to firm value. Erickson et al explained that using investor demand as a reason for adding outside members does not contribute to positive company value. This finding seems inconsistent with the notion that the independence of the board provides greater benefit in terms of supervision. Yet, Erickson et al. found that the reason was that the action was more to appease unsatisfied investors than to fill the expertise gap that existed. Agrawal and Knoeber (1996, 394) examined various mechanisms to mitigate agency problems using an extensive sample of 400 firms. The result from empirical evidence suggests a negatively significant association between outside board directors and firm performance. Agrawal and Knoeber explain the underlying political constraints that affect their being given board member positions as the reason for this puzzle. Similar results have been reported by Bhagat and Black (2002, 263) on their investigation of American public companies which are dominated by outside board members. Using a variety of performance measures over a long period of observation, the evidence shows that the increased number of outside board members in low-profit firms did not increase the company performance.

In a legal context, SOEs in Indonesia follow the two-tier model with a Board of Commissioners (BOC) comprising independent board members and ordinary board members. The presence of these two types of board members demonstrates the level of independency of the members (Kamal 2008). Independent members of the BOC are those who have no financial, management, ownership ties or family relationships with a member of the BOC, the BOD or the controlling shareholder or the government that may affect its ability to act independently (Kementerian BUMN 2002; Kementerian BUMN 2011). Examples of independent members comprise professionals, experts, academics, and local community representatives. These independent members can be equivalent to outside members in the western context as they share similar characteristics. The ordinary board members, on the other hand, are different from the context of insider or inside board member in the western approach. While insiders refers to board members from executive/management, the

ordinary members are members appointed from the government office, military office (including Police Department and Ministry of Defence) and retired senior officers from government, the military and SOEs.

An advantage of having ordinary board members on the board is a way to synergise the government mission with company strategy. Sari, Halligan, and Sutiyono (2010) argue that there is a presence for close linkage to the government bureaucracy in their own department when the government representative sits as the board member. It benefits SOEs by gaining accessibility to the authority inside the government.

There are, of course, critiques on having government officers on the board. Greater government proportion is considered to inhibit SOEs from operating independently and competitively (Hamzah 2007). One of the reasons, as criticized by Didu (2011a) is the presence of non-corporate interventions by bureaucrats. The form of intervention can be for oneself or group interests. Intervention can occur at the beginning when the decisions about board composition and board size as well as the appointment of board members is associated with the political elite and national figures. Bureaucratic intervention can also occur in the membership of the board such as in applying the fit and proper test for directors, in the preparation of criteria or job requirements or in the goods and service procurement (Didu 2011a).

Similar to common governance practice, the composition of the BOC or the proportion of independent or ordinary board members to the total of BOC members is at the discretion of the the GMS, i.e. the Minister of SOEs (The Implementation of Good Corporate Government for State-Owned Enterprise Ministerial Decree[26]), The GMS must follow the regulations within the specific industry to which the SOE belongs or the regulations of the capital market to determine the composition of the BOC. A minimum of 20% independent members of the total board is set. However, if non-corporate intervention exists, it can jeopardize the quality of the independence of the BOC since the appointed member may not act in the best interests of the company but to their personal agenda (Didu 2011a).

Based on the above arguments, the BOC representation is likely to have a strong influence on governance practice in the SOEs. Consistent with the principle of

[26] Implementation of Good Corporate Governance for State-Owned Enterprise Ministerial Decree (Minister of SOE' Decree No. KEP-117/M-MBU/2002).

agency theory, which suggests that BOC composition has been linked to the reduction of agency problems though effective monitoring, it seems likely that the more independent board members sitting on the BOC, the more effective monitoring is exercised. Conversely, the more government representation on the BOC, the more unlikely performance improvements will be achieved. The hypothesis is therefore,

> *H5: The proportion of government related Commissioners on the BOC will be positively related to the SOE financial performance.*

***The Number of Board Sub-Committees* (H_6)**

In agency theory, corporate governance is regarded as a vital tool for monitoring agency problems that occur due to principal-agent relationships, such as abuse of power by managers (Mallin 2004). In supervising managers (agent), check and balance mechanisms should be applied. One of many ways to address this issue is to form a committee or a number of committees (also referred as "board committee" or "sub-committee" in the literature) to help the supervisory board in firms (Weir, Laing, and McKnight 2001, 9).

The formation of committees varies across countries depending upon the company law applied and the need for governance in each country (OECD 2005). The practice is mandatory in some, in others it is not. The number of specialized committees and the members of the committees are set by the Board of Directors (in one-tier models) or the Board of Commissioners (in two-tier models). In the UK, all SOEs establish a remuneration committee, an audit subcommittee, a risk and nomination subcommittee, as they are mandatory according to the Government-Owned Company Act, whereas in Spain, the Netherlands and Korea, the three types of committees are found in almost all SOEs. Moreover, the OECD also reports that among others, audit committees and remuneration committees are the most commonly found in a company.

A board can establish committees based on the need. Different types of committee, for example, the audit, nomination, remuneration, insurance, strategy and risk management committees, have specific functions assigned to them. An audit committee has duties to assign auditors from outside the firm to review the financial

statement and to address any major findings by internal auditors (Cadbury Policy; OECD 2005). A remuneration committee or compensation committee have tasks to formulate the remuneration for directors. This committee is established mainly to prevent a conflict of interest by executive directors in setting their own remuneration rate. Klein (1998) suggests that the presence of this committee can relieve agency problems through a better designed scheme for incentive and bonus that satisfies both managers and shareholders. A nomination committee oversees the recruitment process for directors. The presence of this committee can avoid personal interests in selecting directors based on connections. A risk committee is the committee with members that are highly qualified financial experts. A risk committee is usually established in particularly large companies. The main mission of this committee is to avoid wrong decisions that relate to risky transactions in the business (Mallin 2004).

A committee is established by the Board of Directors (in a one-tier model) or the Board of Commissioners (in two-tier model). In the one-tier, e.g. in the US, members of committees are usually independent non-executive directors with particular expertise (Knapp (1987) as quoted from AICPA 1978[a]), whereas in the two-tier model, members are independent BOC and external members. The number of people assigned in one committee also varies. However, according to Cadbury's recommendation, an audit committee should have at least three members, and should be only non-executive directors or an independent supervisory board (Weir, Laing, and McKight 2001, 8).

The benefit of having committees to assist the board has been discussed extensively. The audit committee is the most frequently investigated in the literature. The audit committee is viewed as the critically important since it mediates between the internal auditor, external auditor and the board and management (Klein 1998; Saibaba and Ansari 2011, 53). The committee plays a significant role in monitoring the internal control system, reviewing the financial report and external audit process, and making sure the information flow to the board and management is proper and unbiased. This can alleviate agency conflicts by minimizing information asymmetry. In addition, Dey (2008) evidences that a company with larger agency problems is likely to have greater governance mechanisms, one of which is the presence of an audit committee.

Moreover, study on the impact of audit committees on firm performance has suggested mixed results. Wild (1994) reports that the market responds more positively to earnings reports after the establishment of an audit committee in the firm. Klein (1998) and Anderson, Mansi, and Reeb (2004) support Wild's findings that an audit committee and firm performance associate positively. However, other researchers have found that the presence of audit committees has no impact on the performance (Vafeas and Theodorou 1998) or even a negative impact to the firm value (Rouf 2011).

These diverse and inconsistent findings are further explained. According to the OECD (2005), the impact of having a committee depends on whether the committee is independent and able to exercise their task with a clear mandate. This conclusion is consistent with other investigations, indicating that the background of committee members is important to support the outcome of the committee. Independent audit committees increase firm value (Knapp 1987; Saibaba and Ansari 2011). Moreover, Klein (1998) also finds a positive relationship between the percentage of inside directors on finance and investment committees and accounting and stock market performance measures.

As far as the SOE is concerned, the OECD's recommendation states that an SOE board should establish a specialised committee to support the board in performing its respective functions (2005). It suggests that to increase transparency and disclosure the presence of an audit committee is imperative. In order to search for good candidates for CEO and directors and to ensure the independence of the nomination process, the establishment of a nomination committee may be effective and beneficial. While audit committees are widely investigated, there is limited research on other specialised committees. The adoption of specialised committees in SOEs has increased (Maassen and van de Bosch 1999; OECD 2005) suggesting an SOE may establish an audit committee, nomination committee, remuneration committee, risk committee or other type of committee depending upon the need.

In the Indonesian SOE setting, the law stipulates that the establishment of the audit committee is mandatory, while other types of committees are voluntarily based on the need of each company. The number and types of committees varies according to BOC discretion. Despite mixed results, the committee, as a tool of corporate

governance, is expected to work effectively to reduce agency problems and eventually increase the company's value. Therefore, this study predicts the larger the number of specialized board committees will lead to an increase in firm performance. The hypothesis is then:

> *H6: The number of Board Sub-committees relates positively to SOE financial performance.*

3.7.2. Financial Related Government Involvement

Another way for governments to exercise control over SOEs is through financial mechanisms. There are a number of financial or funding activities, two of which are attracting attention in the political debate and media: government transfer and asset dividend payout policy. The influence of intervention in these two variables on SOE performance is discussed below.

***Government Transfer Payment in the Form of Subsidies or PSO* (H_7)**

One type of government involvement in SOEs is government transfer where government money is transferred to SOEs for special purposes other than capital investment. Two types of legally recognised government transfer are subsidy and public service obligation (PSO). The first type of transfer, subsidy, is defined as the government's efforts to maintain stability of the selling price of goods and services that help people to buy/afford them. According to the annual budget laws, a subsidy is a budget allocation provided to companies/institutions that produce, sell, export or import goods and services, which meet the people's need in such a way that the selling price can be afforded by the public. It is determined by the line ministry and channelled through the state or private companies.

Typically, a subsidy, is recorded as expenditure in the government budget, of which the purposes are varied in each country. For Indonesia, as mentioned in the Annual Budget Law[27], economic efficiency is the reason why subsidies are provided for many strategic economic sectors in Indonesia, such as fuel oil, electricity, food, fertilizer, seeds, interest loan and tax. Meanwhile healthcare, housing, food and job

[27] The 2012 Annual Budget Law (Number 22 Year 2011).

protection are the main targets for subsidy in Poland, Bulgaria, Finland and Australia (Sikora 2005, 245), mass transportation in Japan (Sakai and Shoji 2010) and energy in the US (Ritschel and Smestad 2003).

The second type of government transfer is public service obligation (PSO). According to the Public Service Law[28], PSO is an activity or a series of activities/projects by the Government in order to fulfill goods or services or administrative services to every citizen and resident as part of the Government's obligation as a public service provider in accordance with laws and regulations. Unlike a subsidy, a PSO emerges because the government has a duty to provide public services with the purpose of eliminating the disparity of infrastructure provided to the community (Priatna 2005). The State-Owned Enterprise[29] stipulates that a PSO is mostly 'subcontracted' to SOEs. If the SOEs get the task of implementing the PSO, the government may provide financial compensation for the assignment.

Government transfer as one type of government intervention, in this thesis, refers to both subsidy and PSO for at least three considerations. Both involve a government transfer from the State Treasurer to the SOEs account despite having different purposes. A subsidy is given to the operator to cover the disparity between production costs and the selling price to the public, a PSO is paid to operators in order for them to do what the government assigns them in providing a public service.

However, both share similar goals in providing goods and services to the public. Since both originate from the government, they become highly regulated because government control over the tasks is very strong. This raises a question of whether government transfer of money to the SOEs gives them more advantage or, conversely, disadvantage?

Researchers have been studying the practice of government subsidisation worldwide. Sikora highlights difference in the level of magnitude of subsidy across countries and finds that support for subsidy is high in transforming countries (Poland and Bulgaria) and in crisis-survived countries (Finland), while much lower in steady developed countries (Australia). He also notes that among those four countries, healthcare is the

[28] The Public Service Law (Number 25 Year 2009).
[29] The State-Owned Enterprise Law (Number 19 Year 2003) article 66.

object with the highest allocation of subsidy, following subsidies for housing, food and job protection (Sikora 2005, 254).

Apart from the fact that the level of importance varies across nations, subsidy is found to encourage inefficiency. Tye (1980) examines the deregulation policy on international air transport in the US. He found that subsidised SOEs experienced great losses in efficiency despite an increase of efficiency elsewhere in the industry. As Tye explained, SOEs enjoy the subsidy to enable them to be competitive yet end up with anti-competitive behaviour and high cost operationalised state carriers. SOEs have no immediate demand for profit compared to private companies (p. 204).

Comparable with Tye's finding, Sakai and Shoji (2010) and Sidak (2002) also concluded that subsidy policy works against efficiency. Sakai and Shoji's study on subsidies for public bus operators in Japan discovered that even though statistically about 30% of the total revenues were generated through subsidies, their empirical result confirmed a negative association between subsidy and the cost structure of the publicly owned bus companies. This comprises the increase of employment, capital expenditure and maintenance costs indicating that the presence of subsidies leads to technical disadvantages on the cost of increased capital by the operator. As such, it eventually discourages the overall efficiency (p.69). Meantime, Sidak's examination on telecommunication policy addressing a partly privatized firm (specifically referring to Deutsche Telekom) finds inconsistency between the bond ratings, weighted- average cost of capital and the capital subsidy and suggests that the reason lies with the fact that the company's obligation to maximize profit acts against the ability of this partially government owned company to perform competitively.

The result above is consistent when the adverse situation occurs. Bajona and Chu (2010) investigated the impact of direct subsidy reduction to capital in China. As a result of China joining the World Trade Organisation (WTO), the government was obliged to sign accession protocols and, accordingly, China reduced the capital subsidy rates. The result demonstrated that small reductions in capital subsidy rates can produce significant welfare effects in China. Bajona and Chu argue that the subsidy cut substantially affected the decline of the rate of capital accumulation as a result of changing their strategy in favouring more labour (p.821). This opens wider employment opportunities.

A number of findings reveal the fact that subsidies involve strong political motivation. Ritschel and Smestad (2003) investigated the effect of government intervention in providing energy subsidies following energy deregulation in California, USA that lead to a failure in the electricity market. They observed that the presence of an electricity subsidy to consumers as a response to the deregulated wholesale price and regulated retail prices demotivated consumers from saving energy. Consumers took advantage of disproportionately subsidised goods and increased their electricity consumption, degrading the energy saving faster (p.1389). It also triggered rigorous financial difficulties and environmental issues.

The impact of government interference through subsidisation is also studied by Chen, Lee, and Li (2008, 273) in China as they found that collusions existed between local government and listed firms in earning management. In the capital market, the Central Government sets rules for IPO and right offering procedures. When listed firms were having problems meeting the requirement for right offerings, the concerned local governments were willing to help these listed firms' earning problems through subsidy, causing the ROE to rise.

Study on non-oil subsidy policy in Indonesia by Handoko and Patriadi (2005, 61) pinpoint issues experienced from SOEs managing government transfers. The subsidy provided to SOEs is usually less than the cost of production/service delivery. Accordingly, one way to cover this cost gap is by cross-subsidy from other profitable business units within the company. This means that the subsidy not only does not lead to profit generation, it creates a cost for the company. Furthermore, Handoko and Patriadi also emphasize the lag time between the subsidy projects (at the beginning of the fiscal year) and the subsidy fund that is ready for disbursement (by the mid or end of fiscal year). Such a time gap will affect the company's cash flow situation.

With regard to PSO, funding is based on the financial condition of the government rather than the nominal need of SOEs as the operator of PSOs. In practice, there are discrepancies between the execution time of PSOs and the availability of funds. While the payment system follows the disbursement procedure of the government, the funding is not always available any time soon (Handoko and Patriadi 2005, 61). As such, the project handled by the SOEs does not necessarily generate sufficient

profit for the SOEs although technically, in administrating the PSO it is difficult to differentiate between revenues which are from PSO activities and those which are not. Likewise, misallocation of funds, (such as when funds intended to subsidise economy class train tickets are allocated to those of a higher grade type), can be caused by the absence of proper guidelines accompanying the PSO arrangement.

On the other hand, if the PSO project assigned to SOEs is already in financial distress, undoubtedly the SOEs need financial or funding support from the government for covering the cost of production of goods or service, tax, and permanent investment to support the capital structure (Evaluasi Risiko Fiskal 2013). Government transfers can be seen as two sides of one coin. On one hand, government transfer is seen as a political due to government control over providing goods and services for public welfare. On the other, the legislation still gives an opportunity for SOEs to take advantage and make a profit. Priatna (2005) points out that while the regulations allows SOEs to earn profits from subsidy or PSO related output, in practice, subsidy and PSO have unclear targets and are misdirected due to inaccuracies in economic resource allocation. Priatna observes that, in fact, allocated funds for subsidy and PSO are not all disbursed indicating the SOEs did not fully utilize the money for subsidy and/or PSO.

Researchers view subsidy as a way of government controlling SOEs financially (such as Tye 1980; Fiskal 2009). They find a reverse association between subsidy as a proxy of government intervention and company efficiency or company performance (Tye 1980; Sidak 2002; Xiongyuan and Shan 2013). Given the importance of the government's subsidy and PSO policy, the financial impact of this intervention for SOEs on their ability to make a profit should be also taken into account. Based on the discussion above, this thesis hypothesises:

> *H7: Government transfer payments to SOEs in the form of subsidies or PSO are negatively associated with the financial performance of SOEs.*

***Dividend Payout Policy* (H_8)**

Dividend payout policy is a fundamental signal of company performance. It signifies the capability of a company to generate profit. Stable dividend payment is likely to reduce the uncertainty of investors. Conversely, if the dividend amount declines or is even unpaid, the level of investor uncertainty increases following the decline of the stock value (Muhayatsyah 2005).

The dividend payout policy of a company also represents the company's reputation in the market. According to Bernstein Quantitative Research, firms with increased or initiated dividends generally outperform the market (Corporate Policy 1999, 51). Levy and Sarnat (1990) describe the dividend decision a company takes in allocating the portion of profits for shareholder dividend and the portion to be retained. Likewise, dividend payout policy resolves the disagreement over the payout ratio between large and small shareholders (Aggrawal and Kyaw 2010, 337; Khan et al. 2011).

There are a number of factors to be considered when the decision on dividend is made. Ownership is one of the very important factors. A study using four dividend models of 211 listed firms in the UK discovers a positive link between dividend payout policy and institutional ownership (Short, Zhang, and Keasey 2002, 118). They argue that the UK tax system, which provides tax exemption for particular institutions, is a possible explanation for the effect of institutional ownership on the dividend payout ratio (p.107). Using different predictors, Aggarwal and Kyaw (2010) also examine institutional ownership and its impact on the dividend payout policy. They evidence that capital structure and the presence of multinational firms in the company interrelate with the dividend payout policy. In China, an investigation using a large sample of 1024 listed companies by Wang, Manry, and Wandler (2011, 370) found that state ownership is more likely to pay a dividend compared to private ones.

Furthermore, the development strategy of a company is another substantial factor that navigates the dividend payout policy. An investigation of emerging markets in Tehran, Kangarlouei et al. (2012, 180) revealed that dividend payout policy correlates negatively with investment opportunity. This indicates that if a company

has an investment plan that requires big fund or capital expenditure, one way to finance it is to retain earnings. A reduction of dividend payout leads to an increase of the level of retained earnings. Other researchers, for example Gugler (2003), Truong and Heaney (2007), Liang, Moreau, and Park (2011), and Kangarlouei et al. (2012) have similar findings about the magnitude of investment on dividend distribution.

In addition, Kangarlouei et al. also found that cash flow uncertainty is a significant contributor to the dividend payout policy. They identify the negative association between indicating a high degree of uncertainly in cashflow leading to a low payout ratio of dividend. Similar to this finding, Wang, Manry, and Wandler (2011) investigated the Chinese corporate's dividend payout policy that had government in the ownership structure and discovered that the companies' dividend payout ratio reacted responsively to the change in earnings. It implied that a larger amount of earnings and previous dividend payments improves the likeness of a current dividend (p. 370).

More specifically, Wang, Manry and Wandler (p. 370) found that state ownership related positively to the dividend payout policy in cash dividend payouts. As the amount of state ownership decreased, the regular cash payouts also diminished at a similar rate. A cash dividend is a reflection of the controlling shareholder using its power and position to control the corporate economy from individual investors. Roberts (2012, 17) strengthened this argument later, on his discovery that about 100,000 SOEs in China were required to pay larger dividends to the Government.

Resembling China, Indonesia's SOE dividend payout policy is reflective of the unique intervention of the government. According to the regulation, the government treats SOE dividends not only as a portion of profits paid regularly by an SOE, but also is one of the main sources of non-tax revenue for the government. Consequently, as regulated under ministerial decree on the payment mechanism of the dividend sourced non-tax revenue,[30] the practice of direct intervention by the Government (i.e. Ministry of Finance) can be observed in the dividend formulation, payment procedure and penalty for late payment.

[30] Payment Mechanism of the Dividend Sourced Non-Tax Revenue Minister of Finance Decree (Number 5/PMK.02/2013).

The ministerial decree also describes government involvement in policy dividend as below. Dividend payout policy formulation starts when the Ministry of Finance sets the non-tax revenue of the state budget and formulates a dividend annual target. To target the non-tax revenue, the dividend payout ratio is set high in the budget document and is detailed in the State Budget Law. Then financial audits of SOEs are conducted ahead of schedule to determine the interim dividend (Kementerian BUMN 2008, 2010b). Separately, the Ministry of SOEs develops the analysis and justifies the dividend payout ratio for each SOE, whereas SOEs set up their own target based on their financial position and investment strategy. These procedures then converge in the Parliament, which determines the final targets for the dividend and payout ratios of individual SOEs as ruled by the State Budget Law[31]. This nature of activity is "transactional" between the SOE, Ministry of SOE, Ministry of Finance and the legislature (BUMN Track 2012, 28).

Furthermore, dividend payout ratio formulation is determined without a fixed standard. The current financial circumstances and political policy are often the deciding factors (Sunarsip 2012a, 30). The formulation adjusts the government policy on SOEs and national development plan every year. Then, the Ministry of SOE sets the priority for SOEs. Not all profitable SOEs are obliged to pay dividends to the government. Those with accumulated losses or under restructuring programs are exempt. For instance, SOEs from energy, telecommunications and banks, are set with very high payout ratios, whereas SOEs from the forestry industry are exempt from paying dividends due to their obligations towards environmental sustainability (Kementerian BUMN 2008, 2010b).

The main challenge in the formulation setting occurs every time the government sets up the annual budget. It undermines the SOE's ability to reinvest for maintenance and growth. This means less opportunity for the SOEs to build infrastructure and to stimulate economic development (Hamzah 2007; Nugroho and Wrihatnolo 2008; BUMN Track 2012). The absence of an adequate legal basis for determining the dividend is an indication that the Government can intervene very deeply in the development of state-owned enterprises.

[31] Eg. The 2009 State Budget Law (Number 4 Year 2012).

With regard to financial performance, high dividend payouts are presumed to be an indicator of the financial success of SOEs. The rationale is because only companies with a high level of earnings can pay greater dividends. Often, the dividend or tax paid by the SOE to the state indicates a strong financial performance (BUMN Track Number 57 Year VI April 2012, 24; Kinerja Pertamina 2013). While, a low rate of dividend payout can improve the company performance since the investor has confidence in the SOEs to develop the company with a capital gain arising from the retained earnings (Kementerian BUMN 2008, 2010a).

The practice of strong government controls over the SOEs' dividend payout policy shows certain characteristics. An examination of around 100,000 state owned companies in China demonstrated that SOEs were required to pay larger dividends to the Government as the owner (Roberts 2012, 17). Subsequently, they provided funding for indispensable government programs. With the Government's need for cash flow, the method of cash dividend was more preferable (Wang, Manry, and Wandler 2011).

While government control of SOEs over dividend payout policy provides funding for indispensable government programs as explained above, this is different from the common approach of a dividend payout policy (Levy and Sarnat, 1990). Dividend payout ratios set by the government that characteristically prioritises the need of government, conflicts with the need of SOEs to expand the business. As discussed above, government intervention may inhibit SOEs from retaining funds which could be used efficiently in the business and therefore, over time, inhibits the returns to the business. However, in the short term it is likely that governments seeking to maximise revenue will target those companies with high returns, with the highest payout ratio.

As a result it is hypothesised that dividend payout ratio will be positively related to the financial performance of the SOE.

> *H_8: The dividend payout policy relates positively with SOE financial performance.*

3.7.3. Regulatory Framework Related Government Involvement

Government involvement in SOEs is frequently conveyed through policies providing legal boundaries. In previous hypotheses, government involvement cascaded into governance and financially related measures and impacted on how these types of involvement contributed to the financial performance of SOEs. For the following hypotheses, government involvements are proxies of the regulatory framework set by the government. There are a number of ways, two of which are the variables in this thesis: asset transfer and legal cases resulting from non-compliance with regulation.

***Asset Transfer* (H_9)**

Government intervention in the SOEs as the full or majority owner is the main concern of the principal-agent problem in government-owned company practice. This is because the government is not only in a position as the shareholder of a business entity, but also a regulator. As an owner of SOEs (shareholder), the government pushes the SOEs to focus on adding economic value (profit maximization), whereas as a regulator, the government also possesses social goals to target public welfare so that the economic sector is regulated to be in the best interest of the people (Peng and Luo 2000; Tan and Peng 2003). However, often when these two goals collide, the government controls the decision to prioritise social and political objectives over profit maximisation (Shleifer and Vishny 1994; Sapienza 2004).

One of the direct interventions by the Government in the SOE to prioritise social objectives over profit making is through "asset transfer". The government (executed by the technical ministry) has obligations to provide public facilities, such as transportation. Often, the assets acquired by the government are transferred to SOEs without following legal procedures. This type of transfer is known as "Government unassigned status assistance" (*Bantuan Pemerintah yang Belum Ditetapkan Statusnya* or BPYBDS). The State Budget Law[32] defines it as:

> ….a government project funded by the State Budget (Revenue and Expenditure) who had been handed over to the State Owned Enterprises to support operational activities SOEs based on the letter of acceptance of the

[32] The 2013 State Budget Law (Number 19 Year 2012).

> goods, and recorded in the balance sheet of line ministry or of State Owned Enterprises (Article 1 paragraph 28).

Based on the definition, it shows that the transferred asset has not been entitled as a "permanent investment of the government". According to the State Budget Law[33], to legalise it as equity, a government regulation should be issued. The delay of legalising this asset causes problems in determining whether it should be recognised as an asset or a liability in the financial statements. A disclosure issue arises due to the unclear status of the transferred asset. It is administratively unclear because both parties record them in their financial reports (Avianti 2011). The presence of unclear transferred assets in the face of the financial statements and Notes to the Financial Statements indicates a legal and accounting issue. This suggests the potential emergence of audit findings that leads to an obligation for legal administration and accounting recognition in the near future.

Currently there is no standard or uniform accounting policy on how the unclear transferred asset should be presented in the financial statements. This opens up room for different reporting and audit treatment (Avianti 2011, 8). It is because the line minister recognises and reports the assets in the balance sheet that may be overvalued or undervalued. The asset is recognised as the government asset until the regulation on government capital investment on SOEs is issued. On the other hand, the transferred assets have been handed over and been used for SOE operations even though they have not been recognised and recorded as SOE's assets. Thus, there are irregularities in the SOE financial reports as the asset utilisation is not accepted by legal formalities. This leads to the second problem, where the evaluation of the SOEs efficiency in asset utilisation is difficult to measure (Hadiyanto 2012). Such practice is categorised as non-compliance to the regulation and becomes audit findings (Sukamto 2012; Biro Humas dan Luar Negeri 2013). Asset transfer activity has been part of audit findings by the Supreme Audit Institutions since 2004. Thus the presence of an asset transfer represents a non-governance practice.

[33] The 2013 State Budget (Number 19 Year 2012) article 23 paragraph 1: "assets derived from or line ministry's budget, which are used and / or operated by the SOEs and have been recorded in the financial statement of SOEs as BPYBDS or similar accounts, are set to be state permanent investment at the SOEs concerned". Paragraph 2: "assets as a result of government capital are to be used by the SOEs since the acquisition of those assets, are set as the state permanent investment in the SOE whose utilise the asset." Paragraph 3 "Execution of the state permanen investment at SOE as referred to paragraph (1) and paragraph (2) is set by a Government Regulation.

Moreover, the presence of asset transfer brings another disadvantage to the SOE. While it is not yet entitled as a state permanent investment, the asset is still "unclear" since it is recorded as fixed assets but not fully recognised as equity. This creates a polemic in the taxation perspective. First, if it is not yet an asset, the amount of asset cannot be part of non-taxable income even though the asset has already generated revenue resulting in a gap between the cost and revenue recognition (Hadiyanto 2012). Second, if government regulation has already been issued, but there is disagreement over the amount of deductable tax due to different treatment of fiscal correction (Ikbal 2013).

Furthermore, when the project is executed, the government intentionally acts as an operator without a profit orientation. This does not fit in the context of government as a regulator as well as the SOE as a business operator. It gives rise to a conflict of interest and leads to unequal treatment since as a regulator, the government should overshadow all the players in an industry (Muchayat 2010). For example, the Ministry of Transportation is the regulator for land, sea and air transportation. When they execute the project and spend the budget for capital expenditure to build new railways tracks, they also have set the location. The reason for selecting a location might be for social or economy motives, which may not be for a sound business decision.

Asset transfer is another form of political interference. Based on their function, the government allocates the budget, purchases goods or services 'sub-contracts' those to the SOEs to do all the work. An official handover of assets is marked by an acceptance letter (Avianti 2011). Moreover, the government's decision to spend money to acquire an asset is a legal act. This is stipulated under the State Finance Law[34] and the State Treasury Law[35] that the money spent for asset purchase is obtained from the government budget. To be included in the budget document, it would require a long process of budget planning that involves Ministry of Finance, the line ministry and parliament. Hence, if a line ministry executes the asset purchase, this suggests that there has been a level of political consensus from the beginning. The asset transfer is not based on a profit-motive. This regulatory intervention affects work plans and performance indicators of an SOE. According to jpnn.com, unless the work plan was prepared based on the results of consultation

[34] The State Finance Law (Number 17 Year 2003).
[35] The State Treasury Law (Number 1 Year 2004).

with the SOE, the asset transfer may be less beneficial if the project is not aligned with the annual work plan of the SOE. When the government insists on the project, it may end up with inefficiency issues (jpnn.com 2011). Likewise, an SOE is exposed to the burden of recognising additional amounts of equity and additional asset capitalisation based on the value of assets purchased by the government's money. This allows discrepancy in the fair value of the assets to be more expensive than if the SOEs purchased the assets. Once the asset is recorded, SOEs are also burdened with the obligation of recognising asset depreciation, which depresses the financial performance and does not add profit to the company.

Studies in SOEs indicate no early investigation on the asset transfer. Therefore, there is very limited discussion on the impact of asset transfer to the SOE as one of type of intervention by the government. However, the presence of an asset transfer is most likely recognised when the Supreme Audit Institution announces the audit findings related to the transfer of assets in the Central Government Financial Statements (23 BUMN 2011; Sukamto 2012; Biro Humas dan Luar Negeri 2013). Therefore, intuitively, it is speculated that asset transfer has a negative impact on the financial performance of an SOE. Taking into account the above discussion, this thesis hypothesises:

> *H_9: Asset transfers from Central Government to SOEs are negatively related to the SOE financial performance.*

Legal Case Resulting From Non-compliance Regulation (H_{10})

The OECD Guidelines require the assurance of an effective legal and regulatory framework for SOEs to encourage fair competition in the market (OECD 2005). This means the government should encourage a situation where there is equality in treatment of market regulation implementation. Rules that private companies are obliged to follow should also be complied with by SOEs. Correspondingly, regulations that bind SOE operation should be also applied to non-SOEs.

What happens with SOEs in Indonesia is strikingly different. SOEs are subjected to more regulations than private ones. Currently, there are many regulations that every business entity has to follow, including the Limited Liability Company Law, the

Capital Market Law, the Public Information and other economic regulations law. However, in addition to the law listed in the table (see Appendix B), there are at least 13 other regulations that are specific to SOEs, such as the State-Owned Enterprise Law, the State Finance Law, the Corruption, Collusion and Nepotism- Clean and Free State Governance Law.

According to Muchayat (2010), the different legal treatment occurs because the establishment of SOEs is aimed not merely to make profit. The State-Owned Enterprise Law specifies the five purposes of SOEs. These include (1) to contribute to the development of the national economy, in general, and state revenues, in particular; (2) to pursue profits; (3) to organize public goods and services of a high quality and adequate to meet the needs of the people; (4) to pioneer business activities that cannot be implemented by the private sector and cooperatives, (5) to actively provide guidance and assistance to small-medium enterprises, cooperatives and communities. Therefore, regardless of their profit-oriented characteristic, SOEs are also expected to carry out a social function. Likewise, the Government is not only a shareholder, but also a regulator. Because of this, the management of SOEs cannot be separated from the bureaucracy. Muchayat suggests that one of the obstacles in the SOEs' operation is the length of the process taken by the SOEs in implementing corporate action, which is longer compared to private firms because of the bureaucracy involved. By looking at the position of SOEs as government and businesses entities under the regulations that encapsulate them, the SOEs may spend more time to take action (2010, 128). In this case, bureaucratic procedures may hamper business particularly when a guarantee letter from the minister or a regulation is required to be issued as evidence of approval. Such a delay is highly risky and may result in lost business opportunities (p.132).

The regulatory framework for SOEs is not limited to business aspects, but also to the function of providing public welfare which is mandated to the SOEs by the government. In addition, publicly listed SOEs shall comply with the mandate of the State-Owned Enterprise Law, the Limited Liability Company Law and the Capital Market Law[36]. The highly regulated business environment of SOEs affects the way they do business. Because the SOEs must adapt to a variety of binding regulations,

[36] The Capital Market Law (Number 8 Year 1995).

businesses are stuck in bureaucratic processes that must be faced before the company can take action. For instance, procurement policy requires SOEs to follow certain procedures that takes longer or is non-transparent and less accountable or results in high cost/low quality production (Muchayat 2009, 128). Another frequently practiced example is to maintain bank accounts to accommodate revenues that are not reported as part of the company's earnings. However, highly regulated environments can also trigger the managers to abuse their power or authority (opportunistic behaviour of managers in the agency theory). Among these are the emergence of acts in violation of the laws and regulations. Violation of rules, either fraud or negligence, that leads to enriching themselves is called corruption. Corruption is defined as an unlawful act by any person who intends to enrich themselves or someone else or a corporation that could hurt the economy or harm the state finances; or any person to benefit themselves or another person; or a corporation, abusing the authority of opportunity or advice available because of their position or the financial position that could harm the economy of the country or countries (Sulaiman 2011, 15).

According to Wang and You (2012), the presence of widespread corruption decelerates economic growth and investment in the majority of developing countries. Dal Bó and Rossi postulate that corruption is strongly related to an increase in inefficient firms in a country as that they employ more inputs to generate a certain amount of output (2007, 959).

However, empirical evidence presents a striking fact that not all countries suffer from corruption. In fact, some countries in East Asia have experienced an increase in growth in spite of corruption practice. Wedeman (2002) labels this as the "East Asian paradox" referring to some East Asian countries, including China, Indonesia, South Korea and Thailand, that cope well in the corrupt environment. A later study by Rock and Bonnett (2004) supports Wedeman's argument about the country that experiences both corruption and economic growth at the same time, which seems to be less harmful to the county's economic development. They find that corruption and investment relate positively in the large East Asian industrialised countries like China, Japan, South Korea, Thailand and Indonesia. Among others, China is the most striking example as it has had nearly 10% of annual growth in the economic reform era since the early 1980s (Rock and Bonnett 2004) while being one of the most corrupt countries, ranking 71 of 145 on the Transparency International's Corruption

Perception Index (La Porta, et. al. 2004). A more recent finding by Fan, Rui and Zhao (2008) also underpins the paradox of corruption in China. They investigated 23 Chinese listed companies involved in scandals of bribing senior bureaucrats, or senior managers abusing past job relationships. They found that companies that have relationships with corrupt government officials enjoy the benefit of debt accessibility, especially for long-term loans. This benefit, however only remains as long as the corrupt officers are available to help. Once they are arrested, the benefit of this debt-financing advantage vanishes.

Another example of the East Asian Paradox can be found in Vietnam. Nguyen and van Dijk (2012) observed around 900 Vietnamese companies (public and private) and discovered that the level of corruption varies throughout Vietnam subject to the quality of governance (such as the cost of entering a new business, access to land, and changes to regulations applied to each industry). More interestingly, they document that the corruption negatively affects the growth of private firms, yet relates positively to that of SOEs.

Researchers, such as Shleifer and Vishny (1994) and Edgardo Campos, Lien and Pradhan (1999), claim that the presence of corruption is less destructive if the practice is more coordinated. Likewise, well-organized corruption creates a network that can shrink uncertainty and limit damage. This argument is used by Rock and Bonnett to further explain their findings on how corruption is treated as an alternative to rigid regulations, which eventually leads to an increase in efficiency and economic growth. Similarly, it can also justify Nguyen and van Dijk's finding that the relationship between SOEs and government officers can give SOE's management more chance to negotiate or lobby government officers to achieve the targeted growth (Nguyen 2006).

However, it is worth stressing that "the corrupt but growing regime" works only in the transition stage of development and cannot remain in the long run (Rock and Bonnett 2012). When there is institutional reform to build well-functioning institutions, corruption cannot survive. Likewise, corruption may work in low technological industries with a low labour intensity environment. They argue that with a corrupt government, it is difficult to move to technological learning and skill-intensive industries (p.1010). Nguyen and van Dijk (2012) suggest that improvement

in the quality of public governance alleviates corruption and promotes economic development.

Corruption seems to have similar patterns in international practice. In the US, as Glaeser observes, American utility and public transportation moved from private to public ownership as a result of corruption. Private firms bribed government officers in exchange for lower input prices of buying or higher output prices of selling (Glaeser 2001).

Glaeser examined large-scale corruption and found corrupt dealings between the high-level officials or politicians and utility managers. The practice of corruption exists when government overpays for goods/services that private firms sell or, conversely, under-charge for goods/services the private companies buy. Cases of inflated salaries are the most frequent ones. Glaeser and Shleifer (2001) argue that the increased number of corruption cases in the 19th century follows the growth in business scale. Thus, as the private companies improve their purchase capacity from the government, it stimulates more bribery cases. In contrast to Glaeser's result, Clarke and Xu (2004) investigated small-scale bribery cases in 21 transition countries in Central Asia and Eastern Europe. They documented that most bribe-takers (employees) are those who are in many utility sectors in SOEs with a low level of labour competition. Meanwhile, bribe-payers (service-using companies) usually induce them with money for the sake of greater profits or to resolve debt maturity problems. Clarke and Xu also generated robust evidence that bribery in utilities were lower if the countries had larger capacity and were more competitive within the industry. Also, less bribery is found in privatised utility companies. Clarke and Xu are also convinced that macroeconomic policy and politics are two factors that enable the level of corruption to increase in the country (p.2093-4).

Corruption practices in Indonesian SOEs can be seen in many forms. Nirwanto (2012) illustrates how the Supreme Court documented the typology of corruption in the SOEs. He identified that there is a common practice of conspiracy between the SOE Board (directors, commissioners and employees of state-owned) with third parties. The conspiracy leads to unlawful acts or abuses of power associated with the implementation of the SOEs. The form includes, among others, the procurement of goods and services of SOEs, SOE investment activity, SOE's fixed assets for sale

below the market price, misuse of funds relating to corporate social responsibility, bribery to speed up the business process or approval, embezzlement of state property, falsification of transaction records of SOEs for the purpose of fake receipts of fictitious activity (Muchayat 2010; Nirwanto 2012).

A clear separation of function between Government as the owner and Government as regulator should be made (OECD 2004, 2006). Otherwise, Government intervention (the principal) to the SOEs (agent) becomes domineering and the SOEs become highly regulated. When agency problems arise (managers, as economic maximisers, look for opportunities to pursue personal interests rather than the interests of the company) (Jensen and Meckling 1976), it triggers various legal incompliance actions, both fraud or negligence, which eventually affects the company's overall performance. This study found that a highly regulated environment and violations against those regulations are a burden to sound governance practice. Good corporate governance regulations were introduced from 2002 (Ministerial Decree on Good Corporate Governance for SOE[37]), therefore it is hypothesised that violations of regulations by SOEs will lead to a negative impact on their financial performance.

> *H_{10}: Legal cases resulting from non-complience regulation is negatively related to the SOE financial performance.*

3.8. Summary of the Chapter

Despite the ongoing debate on the impact of government intervention in various international practices, the Indonesian government (i.e. Ministry of SOEs, Ministry of Finance, line ministries, legal enforcement institutions) is involved in many ways in regulating SOEs as an agent of economic development and as the operator of the government's role in delivering public service. The law gives an exclusive mandate to SOEs to perform five main functions (the foundation of national economic growth, the institution for commercial profit, the source of revenue, the executor of public service obligations and the driver of small and medium enterprises (Muchayat 2009; Sembodo 2012).

[37] Good Corporate Governance for SOE Minister of SOE decree (No. KEP-117/-MBU/2002).

By structure, the governance model of Indonesia applies a unique concept from the international practice of two-tier models with the emphasis in the Indonesian model of the BOC being less powerful than the European Continental model. The Indonesian model suggests that the GMS is in full control over the BOC and BOD. With the level of ownership at least (51%), the government holds the highest voting rights in the GMS which opens the opportunity for a negative entrenchment effect. This is the main concern of the principal-agent problem in this thesis.

Hence, this study aims at investigating the government's relationship with SOEs, especially linking the relationship between government intervention and its impact on the performance of Indonesian SOEs. Based on the research objectives and direction of the models, this study adopts agency theory as a basis for constructing and testing the hypotheses. Agency theory accommodates the approach of this study, i.e. investigation of the relationship between the government (principal) and SOEs (agent) due to the presence of vertical agency problems (opportunistic behaviour of the agent (Jensen and Meckling 1976) and the dominating role of the controlling shareholder).

This research extends the study of agency theory to test the entrenchment effect in the context of the high degree of control of the Government as the majority shareholder in the governance system of SOEs. It follows positivist ontology since it uses quantitative methods to measure the constructs and to identify latent variables and causal relationships to validate the theory (Neuman 2006). The proposed conceptual framework of this study is developed based on the entrenchment hypothesis (Wright et al. 1996; Oswald, Muse, and Rutherford 2009) within agency theory (Jensen and Meckling 1976; Zhou and Wang 2000). The hypotheses are constructed based on three areas of intervention: governance intervention by the Government in the General Meeting of the Shareholders (representing the Ministry of SOE), Government financial intervention (representing the Ministry of Finance) and Government regulatory intervention (representing the entire legal system in the country) as presented in the summary of hypothesis (Table 3.2) below.

Table 3. 2: *Summary of Hypotheses*

No.	Hypothesis
H1:	Government ownership is negatively associated with the SOE financial performance.
H2:	CEO external appointment relates positively to the SOE financial performance.
H3:	Chairperson's external experience relates positively to the SOE financial performance.
H4:	The proportion of government related Directors on the BOD will be negatively related to the SOE financial performance.
H5:	The proportion of government related Commissioners on the BOC will be negatively related to the SOE financial performance.
H6:	The number of Board sub-committees relates positively to the SOE financial performance.
H7:	Government transfer of payment in the form of subsidies or PSO is negatively associated with the SOE financial performance.
H8:	Dividend payout policy relates positively to the SOE financial performance.
H9:	Asset transfer from central government to SOEs is negatively related to the SOE financial performance.
H10:	Legal cases resulting from non-compliance regulation is negatively related to the SOE financial performance.

CHAPTER 4: SAMPLE SELECTION AND VARIABLE DEFINITIONS AND MEASURES

4.1. Introduction

The previous chapter developed specific hypotheses constructed from agency theory. The premise underpinning them proposed that government involvement in the controlling of SOEs leads to either performance growth or decline. This chapter describes how the sample for the proposed hypotheses was selected and data collected. Then it discusses how individual variables are defined and measured. The structure of this chapter is as follows: sample selection and data sources, variable definition and summary.

4.2. Sample Selection and Data Sources

As mentioned in Chapter 3, this research extends the study of agency theory to test the entrenchment effect in the context of a high degree of government intervention as controlling shareholder in the governance system of SOEs. Following a positivist ontology, this study applies quantitative method to measure the hypothesis as well as identifying underlying variables and causal relationships for theory validation (Neuman 2006). In developing the analysis of government intervention, the years 2007-2009 were selected. Some considerations for the selection of these years were as follows: first, these are important years because they were the first three consecutive years following the requirement of the SOEs to disclose a summary of their financial statements as a part of the Notes to the Financial Statements of Central Government. This is stipulated in the State Finance Law. Even though the obligation for preparing the financial reports based on Indonesian Financial Accounting Standards was introduced earlier in 2002, SOEs were still in the implementation stage at this time, and not all were available to issue their financial statements. As a consequence of state finance reform, the Ministries of Finance and SOE, agreed to enforce transparency and accountability as part of the good corporate governance

practice of the state, by requiring SOEs to submit their Summary of Financial Statements at the end of every financial year; second, five years from the 2002 commencement date of the introduction of the Indonesian Financial Accounting Standards should have given the SOEs transition time to fully implement the concept of good corporate governance; third, this thesis commenced in mid-2009, therefore, using the year 2009 as the end date for the research data timeline was the most optimal.

Furthermore, all SOEs were initially included in the sample selection in this thesis. There were 141 SOEs falling into three categories: SOE *Perum* (public corporation), SOE *Persero* (limited liability corporation) and SOE *Persero Terbuka* (publicly listed SOEs). These SOEs represented 9 available industry groups based on Indonesian Stock Exchange categories, namely agriculture; mining; basic industry and chemicals; miscellaneous industry; consumer goods industry; property, real estate, and building construction; infrastructure, utilities, and transportation; finance; and trade, services, and investment. The selection of all industry group categories in the sample will also test whether industry group is a significant factor contributing to government intervention in SOEs.

While there are five-fold objectives of establishing SOEs in Indonesia, for this thesis, however, the focus is on those established with a primary profit maximising objective. Hence the sample group covers only the "SOE under Persero" and "SOE under Persero Terbuka" types, namely profit maximising SOEs, both publicly listed and non-listed. This group is required by government to maximise profits and hence the key success measure is financial performance.

To meet the criteria that only profit-oriented SOEs would be considered in the sample, SOE *Perum* was then excluded. This left 125 SOEs remaining. It is worth stressing that the use of an entire population of profit orientated SOEs has never been attempted before in a study. This approach allows a deeper analysis to understand whether there is a consistency in the characteristic of profit-oriented SOEs that are diverse in size, industry type and level of competition. Overall, this research uses 375 annual reports as the sample set, coming from 125 SOEs (*Persero and Persero Terbuka).*

The data for dependent, independent and control variables were collected from a number of sources. Firstly, the annual reports and Central Government Financial Statements were used as the main source of financial and non- financial information. Secondly, additional sources such as SOE performance reports and government documents were used. The definition, measurement type and detail sources of each variable are presented in the following section.

4.3. Variable Definition

4.3.1. Dependent Variable: SOE Financial Performance

In the study of social science, corporate financial performance is often used as an indicator of success or failure of a business entity, for example in the implementation of corporate governance, investment decisions, capital structure and policy on the company's board of directors. In the study related to state-owned enterprises, SOE financial performance is also assessed to gauge the impact of government ownership, government intervention and other practices of governance.

There are two commonly researched methods of measuring financial performance, namely accounting based performance and stock market based performance (Lukviarman 2004). Accounting based financial performance is measured using a variety of figures to illustrate profitability, effectiveness, efficiency, and financial leverage. The indicators vary including revenue, net profit, leverage, growth, production and revenue. There are also ratio measures including the current ratio, quick ratio, inventory turnover, dividend yield, return on assets (ROA), return on equity (ROE), and return of sales (ROS).

Meanwhile, researchers who adopt stock market based performance to measure financial performance tend to use rate of return, the weighted average cost of capital, earning per shares or EPS, market to book equity and Tobin's Q (Salim and Yadav 2012; Liao and Young 2012; Park and Jang 2013). More comprehensive research has involved a group of financial indicators from both accounting and stock market value. Feng, Sun, and Tong (2004) examine the relationship between government ownership and GDP growth with various indicators of performance before and after

privatisation and applies more than one proxy for each factor of profitability, efficiency, output and leverage. Meantime, Salim and Yadav (2012) investigate the relationship between capital structure and corporate performance using indicators of ROA, ROE, earnings per shares and Tobin's Q all together. Similar to Salim and Yadav's approach, Yu (2013) examines state ownership and its association with firm performance using ROA, ROE and Tobin's Q as proxy variables.

This study will apply accounting based performance to measure the variable of financial performance. As discussed in Chapter 2, Indonesian SOEs consist of non-listed and listed SOEs. Since this study accommodates both groups of SOEs in the sample, it is preferable to use indicators that do not involve stock market data.

Alternatives to ROA as a financial performance measure were considered, however only ROA was finally chosen. Return on equity (ROE) was not adopted as the dependent variable representing performance for two reasons. First, in the case of SOEs, government injection of equity is a politically motivated decision made by the Government and approved by the Parliament which would potentially distort any performance measure. Second, a number of SOEs have negative equity. In commercial situations, these companies would cease to exist, however for this sample they survive through government subsidies, distorting the ROE performance measure.

Return on sales (ROS) was also excluded as the measure of performance. The vast majority of SOE are capital intensive where the use of ROS (predominately a retail based performance measure) would be distorting.

The ROA was selected as the measure of SOE's financial performance. This view follows the argument of Goel, He, and Karri (2011) that firm performance is best measured using the traditional measure of ROA if the context is set in the developing economies. They specifically stress that the use of capital market measures such as market-to-book or Tobin's Q to assess the company performance is not appropriate (Joh 2003; Goel, He, and Karri 2011), especially in Indonesia where the number of companies issuing debt and the securities market is still small (Lukviarman 2004).

Furthermore, among the accounting profit based measures, this thesis will utilize a financial ratio of Return on Assets (ROA) to gauge SOE's financial performance.

ROA quantifies the capacity of a company's assets to generate profits (Arosa, Iturralde, and Maseda 2010). It underlines the overall performance of the company and presents the annual measured return to the historical value of investments the company has achieved (The Government Regulation on Government Investment[38]). ROA is referred to as an indicator of a company's profitability and therefore a key determinant for the future investment in the company.

In this thesis, ROA is selected as the most representative indicator of SOE financial performance for several reasons. To begin with, ROA is widely used to measure a firm's profitability. According to Jewell and Mankin (2011), ROA is one of the most frequently referred to financial ratios, the third after current ratio and inventory turnover ratio. They calculate that ROA is referred to in 70 of the 77 business textbooks (Mankin and Jewell 2010). Also, ROA is frequently adopted by researchers including those who investigate government intervention and its impact on SOE financial performance (Eisenberg, Sundgren, and Wells 1998; Li et al. 2008; Goel, He, and Karri 2011). The same is true in the Indonesian context in this study, as ROA is also used in much of the literature to describe the financial performance figures of SOEs (eg Rafick and Amir 2010; Laksanawan 2008; Nugroho 2008; Muchayat 2011). This indicates the reliability of ROA as a tool to represent the financial profitability of a company.

Most importantly, ROA has been selected as it is used by Indonesian authorities to measure SOE success, including the revitalisation program (Muchayat 2011, 145) and the privatisation program (Laksanawan 2008; Nugroho 2008). For this reason, most of the Government's documents, including the Government's report on SOEs to the public, the SOE performance report by the Ministry of SOEs and the SOE administration report by the Ministry of Finance uses ROA to illustrate the increase or decrease of overall performance.

It should also be noted that the selection of ROA as a measure of SOE financial performance also faces a main drawback. Morman et al. (1998) argue the proper use of ROA as a measure can only be achieved if the presentation of accounting data is adequate and is supported by sound application of accounting standards. Since 1994, all limited liability companies are obliged to issue and present financial reports based

[38] The Government Regulation on Government Investment (Number 8 Year 2007).

on the Indonesian Accounting Standards. Therefore, it can be assumed that the use of financial data in this case is less of a problem.

While there are many variations of the formula used in accounting ratios (Mankin and Jewell 2010), this thesis measures ROA as a fiscal year's earning profit before tax, interest, and extraordinary items (EBIT) divided by its total book value of assets and expressed as a percentage. The selection of EBIT among other many possible numerators is based on avoiding the influence of debt, tax and dividend in the formula. According to Jewell and Mankin, this approach is useful, particularly in comparing the pre-tax return of companies with different capital structures (2011, 89). In other words, EBIT excludes capital cost as it only consists of operating margins and operating incomes (Arosa, Iturralde, and Maseda 2010). Moreover, Jewel and Mankin also argue that the use of EBIT as a numerator in the ROA formula is useful for predicting failure as they point out Altman's Z-Score who used EBIT to Total Assets (EBIT/TA) to forecast business failure forecast study (2011, 81). In addition, the use of total asset (as opposed to Average Total Assets) as a dominator is aimed for simplicity as it needs less data for ROA calculation (p. 85). With regard to the diversity of the tax situation in the SOE samples as well as availability of data, the formula of ROA as EBIT/TA is considered the best fit for the needs of this analysis.

To measure ROA, annual reports and financial statements of 125 SOEs were collected over a 3-year period from 2007 to 2009. This includes 14 publicly listed SOEs and 111 non-public listed SOEs.

4.3.2. Independent variables

This thesis tests three areas of government intervention (in governance, in finance and in the regulatory framework) and develops these into ten independent variables. As defined, all SOEs are more than 50 per cent government-owned. This gives the Government ultimate control over all investigated variables. Six variables represent the governance related government intervention. These include ***Government Ownership (OWN)***, which is also frequently called state ownership. Government ownership has been consistently studied in research (for instance Gunasekarage et al. 2007; Li, Yue, and Zhao 2009; Borisova et al. 2012; Yu 2013). In this study,

Government ownership is defined as the total proportion of shares owned by the central government in the SOE to the total share ownership and is expressed in percentage. Government ownership represents the government's voting rights in the General Meeting of Shareholder (GMS). The data is collected from the Central Government Accounting System (SAIP) database maintained by the Ministry of Finance.

The second governance related variable is ***CEO external appointment (CEO),*** which is defined as an appointment of a CEO from outside the company or a government or political appointment. Previous studies refer to government or politically connected CEOs as a CEO who has special links with presently serving bureaucrats due to the friendship, collegial or family relationships (Johnson and Mitton 2003); similar regional background (Siegel 2007) or prior experience at a government office (Xiongyuan and Shan 2013). This thesis takes into consideration all contexts of government or political connections as specified above, indicating that an external or outsider CEO is someone who is really independent from any formal and informal links to incumbent bureaucrats, whereas an internal CEO is an individual whose career background prior to his or her appointment as the CEO is from the government office or SOEs or politically connected as specified above. It is expressed as 1 for outsider CEO or 0 otherwise. This measure has been adopted in prior studies, e.g. Xiongyuan and Shan (2013).

The next variable, ***Chairperson External Appointment (CHAIR)***, is defined as an appointment of a Chairperson of the BOC from outside the government or from political connections. Similar to the context of a CEO external appointment, a Chairperson from outside indicates the presence of an independent board. Meantime, the Chairperson from inside the government or from political connections can be a government officer, or retired government officers including former ministers, those from the military, policy and other law enforcement units. Taking up from the study conducted by Ferris and Yan (2007), this is a dummy variable, assuming a value of 1 if the assigned chairperson is from external appointment or otherwise 0.

The fourth independent variable is ***the Proportion of Government Related Directors on the BOD (BOD).*** Studies regarding the BOD focus more on the outsiderness of a board composition and try to infer the impact of having outsider directors on

company improvement. For instance, a study by Arosa, Iturralde, and Maseda (2010) using a two-tier approach categorises outside directors on the board as independent and affiliated directors. The former, independent director is characterised as a person who has no prior business links with the company other than being their director, whereas the latter, affiliated director is described as a director with potential or current business links but not on a full-time basis with the company. Or, if it is reserved-interpreted, then an inside Director can be a person with prior or current business links with the SOEs. Taking into consideration Arosa, Iturralde, and Maseda's approach, this thesis defines a government related director on the BOD as a director who is a government or SOE connected individual or who has prior working experience with the SOE. Therefore, in this thesis, the proportion of government related Directors on the BOD, is defined as the total proportion of non-outside directors assigned as management board members (BOD member) divided by the total number of BODs.

Moreover, unlike conventional supervisory boards in the Continental European system whose every member of the BOC is independent, Indonesian SOEs recognize two types of BOC memberships: ordinary commissioners and independent commissioners[39] (Kamal 2008). Due to the uniqueness of the Indonesian system, there is no exact study found applying similar approaches, yet some former studies using a Western context can be used as a comparison with caution. For example, a study by Pombo and Gutiérrez (2011) specified an outsider director as a member of the supervisory board who had no working experience in the company or any related companies with similar scope as either management or supervisory board members, had no family links with controlling shareholders or the CEO and had no more than 10 percent of share ownership in the company. Therefore, referring to the Indonesian SOE model of BOC membership, this thesis extends the definition of outside commissioners or so-called independent commissioners in the SOE to individuals who are from non-government or are non-politically connected or have no business link or previous experience working with the SOE. Or in other words, an ordinary commissioner is an individual from a government office or is politically connected (for instance a former government officer, ex-military or people from policy or law

[39] The term 'independent commissioner', which was adopted from the practice of outside directors in the one-tier board system in Australia, refers to outside commissioners in the BOC as opposed to ordinary commissioners (Kamal 2008).

enforcement units) or has a business link or previous experience working with SOEs. The next variable, ***the Proportion of Government Related Commissioners in the BOC (BOC)***, is defined as the total proportion of ordinary commissioners assigned in the BOC within the total BOC.

Data on 125 SOEs collected over three years (2007-2009) on the background of CEOs, chairpersons and members of the Board of Directors as well as members of the Board of Commissioners were mainly collected from government documents produced by the Ministry of SOEs. This includes the ministerial decrees, the BOC and BOD database and SOE performance reports from 2007 and 2009. It is worth emphasising that, the source of this data is considered valid and reliable because the government documents sourced are legal documents. In addition, information on organizational structure and biography of the BODs and BOC from the SOE annual reports and SOE formal websites are also used to complete the missing data.

The last governance related government intervention variable, ***the Number of Board Sub-Committees***, refers to the number of Board sub-committees established or appointed by the BOC. The majority of prior studies using this variable focus on the relationship between the presence of specific sub-committees (most frequently, the audit committee) and its impact on the firm performance. This study, however, investigates the number of Board sub-committees that were established. It is measured by the total number of Board sub-committees formed by the BOC.

The data regarding the total number of Board sub-committees for 125 SOEs is gathered from the Ministry of SOE database. Since the database does not present each year of information, additional information from the three consecutive years of annual reports (2007-2009) was also used.

The next two variables relate to financial related government intervention. To start with, ***Government transfer payments in the form of subsidies or PSO (TF)***, is defined as money transferred from the central government to the SOEs in the form of subsidies or public service obligations (PSO). This variable is particularly important to investigate as one of the financially related government interventions because of the large amount of the central government budget that is allocated to this funding activity each year (Puspasari and Rob 2012b). While the nature of subsidy and PSO

is unique to the Indonesian context (subsidy is meant to close the gap between a determined selling price of a product to the public and the SOE's production cost; PSO achieves the government's function in delivering goods and services to the public), the use of similar characteristics in variables in other samples cannot be found in past studies.

The government transfer payment in the form of subsidies or PSO is a dummy variable and measured as 1 if the company receives a subsidy or PSO or both and 0 if the company does not obtain any of the two. The data set for the year of observation is gathered from the Central Government Financial Statement for 2007 to 2009.

The second financially related government intervention variable is ***Dividend Payout Policy***. It is defined as the payout ratio of the dividend paid to the Government on a yearly basis. This thesis seeks a different approach towards dividend payout policy and investigates the power of government in enforcing the company to allocate money to pay non-tax revenue to itself while other priorities, such as investment, come after. Despite having a different purpose, prior studies apply dividend payout policy in a number of ways. For instance, Chen et al. (2005) measures dividend policy proxy as the total dividend divided by net profit. Deng et al. (2013) refers to dividend policy as dividends per share divided by lagged total assets per share. Meantime, Wang (2010) measures dividend policy as the value of cash dividend per share over earnings per share. As for this thesis, dividend policy is expressed in percentage as a result of the total value of the dividend divided by the total net income (Puspasari and Evans 2012b). Data on dividend payout is collected from the Central Government Financial Statement for 2007 to 2009 while total net income is collected from the SOE's financial statement for corresponding years.

The next variable, ***Asset Transfer from the Central Government to SOEs (AT)***, is one of a regulatory framework related government intervention variables. It is defined as assets that are acquired or generated from a government project and handed over or granted to an SOE by the Central Government with the purpose of achieving the government's social agenda. Due to the nature of government control enforcing this responsibility onto SOEs, this variable is considered as one of the substantial examples of government control over SOEs and therefore should be included in the analysis.

The asset transfer from Central Government to SOEs is measured as a dummy variable and is stated as 1 if the SOE receives any transferred asset and 0 otherwise. The data on the three years succeeding asset transfer activities for each SOE is collected from the Central Government Financial Statement for 2007-2009.

The second and last regulatory related government intervention variable is the ***Legal Case Resulting from Non-Compliance with regulation (LEG)***. It is a dummy variable for the presence of legal cases related to any violation against the law or regulation that is bound to the SOEs operations. It is expressed as 1 if there is one or more legal case(s), or 0 otherwise. Like asset transfer, this variable is considered specific to the characteristic of SOEs and the legal environment in Indonesia, therefore this variable is considered another newly used in research.

The dummy variable is constructed using data gathered from various government documents from the Supreme Audit Institution (BPK), the Agency for Financial and Development Supervision (BPKP) and the Commission for Anti-Corruption (KPK). Another important source of data utilized for this variable is pulled from the LKBN ANTARA database.

4.3.3. Control variables

This study considers other specific characteristics or factors of the SOEs as a form of government intervention that potentially affects SOE financial performance. Those factors are treated as control variables, consisting of history of establishment, size, capital intensity, industry competition, leverage, year 2008 and year 2009. History of establishment is one control variable which has been utilized for the first time, while the others are frequently used in many studies.

The first control variable, the ***History of Establishment (HIST)***, provides a background of initial establishment of SOEs in Indonesia. It is a dummy variable representing 1 if the SOE is originally set up from a previous Dutch company and handed over to the Indonesian government as a nationalised company, or 0 otherwise. Data related to SOE history is captured from the SOE performance report 2009.

Secondly, ***Size (SIZ)*** is a natural log of total assets. This variable has been adopted by many researchers (eg Chen et al, 2005; Gunasekarage at al., 2007; Arosa, Iturralde, and Maseda 2010; Jiang, Huang, and Kim 2013). The data on total assets for three years of observation is captured from SOE financial reports (2007-2009).

Thirdly, ***Capital Intensity (CI)*** refers to dummy variables characterising the level of capital intensity of a company. It is measured as 1 if it is a high capital intensive company, or 0 if it is low capital intensive company. A company is categorised as high capital intensive if it has a capital expenditure greater than 5 per cent to total assets in any year between 2007-2009.

Fourth, ***Industry Competition (IC)*** is another dummy variable for expressing the level of competition of an SOE in the corresponding industry. It is measured as 1 if the level of competition is medium to high, identified by more than 5 competitors within the industry, or otherwise. The data set of this variable comes from various sources including Industry Sector Summary Reports from the Ministry of Industry (2010), a list of banks from the Bank of Indonesia, a list of insurance companies and financial institutions from the Ministry of Finance.

Fifth, ***Leverage*** is measured as total debt scaled by total assets. Various studies utilizing leverage as a control variable include, for example, Chen et al. (2005), Akhigbe and Martin (2008), Jiang, Huang, and Kim (2013) and Gunasekarage, Hess, and Hu (2007). The data element for leverage is obtained from the SOE financial statement for 2007-2009.

The last two control variables are dummy variables of ***Years 2008*** and ***2009.***

4.4. Summary of the Chapter

This thesis broadens the research of agency theory to examine the entrenchment effect in the context of government as a controlling shareholder of SOEs in Indonesia. Following a positivist ontology, this thesis tests three areas of government intervention – in governance, financial and regulatory framework; and relates the impact of the interventions to SOE financial performance. Using Return on Assets as

the dependent variable, this thesis investigates 10 predictors of independent variables and 7 control variables. The summary of variables is presented in the Table 4.1 below.

The next two chapters present statistical analysis (Chapter 5 for univariate analysis and Chapter 6 for multivariate analysis) for testing samples.

Table 4. 1: *Summary of Variables*

Variables	**Measurement Type**	**Data Type**	**Data Source**
Dependent variable: SOE financial performance			
Return on Assets (ROA)	A fiscal year' EBIT (earning profit before tax, interest, and extraordinary item) divided by its total assets, expressed as a percentage.	Continuous	SOE Annual Report and/or SOE Financial Report for 2007-2009
Independent variables			
Government ownership (OWN)	Total proportion of shares owned by the Central Government in the company to the total share ownership, expressed as a percentage	Continuous	Central Government Accounting System Database (SAIP)
CEO external appointments (CEO)	Dummy variable for career or professional experience or background of a person prior to his or her appointment as the CEO. It is expressed as 1 for external or outsider CEO or 0 otherwise.	Categorical	Government documents (ministerial decree, BOC and BOD database), SOE performance report, SOE annual reports, SOE formal websites.
Chairperson external appointment (CHAIR)	Dummy variable for independence of career or professional background of the Chairperson of the Board of Commissioners.	Categorical	As above

Table 4.1: *Summary of variables (continued)*

Variables	Measurement Type	Data Type	Data Source
Chairperson external appointment (CHAIR) *(continued)*	It is expressed as 1 if the Chairperson is independent from the Government and political connection or 0 otherwise. Internal or insider Chairpersons can be from the government officer/retired government officer including those from military, policy and law enforcement unit.		
CEO external appointments (CEO)	Dummy variable for career or professional experience or background of a person prior to his or her appointment as the CEO. It is expressed as 1 for external or outsider CEO or 0 otherwise.	Categorical	Government documents (ministerial decree, BOC and BOD database), SOE performance report, SOE annual reports, SOE formal websites.
Chairperson external appointment (CHAIR)	Dummy variable for independence of career or professional background of the Chairperson of the Board of Commissioners. It is expressed as 1 if the Chairperson is independent from the Government and political connection or 0 otherwise. Internal or insider Chairpersons can be from the government officer/retired government officer including those from military, policy and law enforcement unit.	Categorical	As above
The proportion of government related directors on the BOD (BOD)	The proportion of directors from inside (internal SOE or Government assigned as the BOD) within the total BOD.	Continuous	As above

Table 4.1: *Summary of variables (continued)*

Variables	**Measurement Type**	**Data Type**	**Data Source**
The proportion of government related commissioners in the BOC (BOC)	The proportion of ordinary commissioners assigned in the BOC within the total BOC.	Continuous	As above
The number of Board sub-committees (SC)	The number of board sub-committees established or appointed by the BOC.	Continuous	Ministry of SOE database, SOE annual reports for 2007-2009
Government transfer payment in the form of subsidies or PSO or Government transfer (TF)	Dummy variable for SOE receiving government transfer payment for subsidy or PSO, measured as 1 if the company receives subsidy or PSO or both; 0 if the company does not obtain any of the two.	Categorical	Central Government Financial Statements for 2007-2009
Dividend policy (DIV)	Refers to the dividend payout ratio of an SOE to be paid to Government, measured in percentage as result of total value of dividend by the total net income.	Continuous	Central Government Financial Statements for 2007-2009, SOE financial statements for 2007-2009.
Asset transfer from central government to SOEs or Asset transfer (AT)	Dummy variable for fixed assets handed over or granted to an SOE by the Central Government with specific purpose. It is measured as 1 if the SOE receives transferred asset, or 0 otherwise.	Categorical	Central Government Financial Statements for 2007-2009

Table 4.1: *Summary of variables (continued)*

Variables	**Measurement Type**	**Data Type**	**Data Source**
Legal case resulting from non-compliance with regulation or Legal case (LEG)	Dummy variable for the presence of legal case related to any violation against the law or regulation that is bound to the SOEs operations. It is expressed as 1 if there is one or more legal case(s), or 0 otherwise.	Categorical	Various documents from the Supreme Audit Institution, Agency for Financial & Development Supervision (BPKP), Commission for Anti-Corruption (KPK), database of LKBN ANTARA.
History of Establishment (HIST)	Dummy variable for the initial set up of an SOE, expressed by 1 if it is initially established as nationalised SOE from Dutch's company, or 0 otherwise.	Categorical	SOE performance report 2009
Size (LogSIZ)	Natural log of total assets	Continuous	SOE financial reports for 2007-2009
Capital intensity (CI)	Dummy variable characterising the level of capital intensity of a company. It is measured by 1 if it is a high capital intensive company, or 0 if it is low capital intensive company. A company is categorised as a high capital-intensive one if it has a capital expenditure greater than 5 per cent to total assets in any year between 2007-2009.	Categorical	SOE annual reports for 2007-2009

Table 4.1: *Summary of variables (continued)*

Variables	**Measurement Type**	**Data Type**	**Data Source**
Industry competition (IC)	Dummy variable for the level of competition of an SOE within the industry, expressed by 1 if medium to high level of competitions (>5 players in the industry), or 0 if zero (monopoly) to low competition (up to 5 competitors).	Categorical	Report from Ministry of Industry, Bank of Indonesia, Ministry of Finance
Leverage (LEV)	Total debt scaled by total asset.	Continuous	SOE financial statement for 2007-2009
Year 2008 (YR08)	Year 2008 (Dummy), expressed as 1 if it is year 2008, or 0 otherwise	Dichotomous	
Year 2009 (YR09)	Year 2009 (Dummy), expressed as 1 if it is year 2009, or 0 otherwise	Dichotomous	
Legal case resulting from non-compliance with regulation or Legal case (LEG)	Dummy variable for the presence of legal case related to any violation against the law or regulation that is bound to the SOEs operations. It is expressed as 1 if there is one or more legal case(s), or 0 otherwise.	Categorical	Various documents from the Supreme Audit Institution, Agency for Financial & Development Supervision (BPKP), Commission for Anti-Corruption (KPK), database of LKBN ANTARA.
History of Establishment (HIST)	Dummy variable for the initial set up of an SOE, expressed by 1 if it is initially established as nationalised SOE from Dutch's company, or 0 otherwise.	Categorical	SOE performance report 2009
Size (LogSIZ)	Natural log of total assets	Continuous	SOE financial reports for 2007-2009

CHAPTER 5: UNIVARIATE ANALYSIS

5.1. Introduction

Chapter 4 defined the sample selection and the variable definition and measures. Following the positivist ontology, it explained the three areas of government intervention cascaded into proxies of 10 independent variables and 7 control variables. As such, a quantitative method is applied.

This chapter discusses descriptive statistics. The first section explains the statistical method used for the analysis. Then an in-depth discussion on the results of descriptive statistics is presented by each dependent, independent and control variable. The last section describes the summary of this chapter.

5.2. Approach for Univariate Analysis

It is essential to examine sample data and ensure that there are no violations of any of the assumptions before proceeding to further analysis. To do so, obtaining descriptive statistics of each variable is useful for data description as it informs the centre, dispersion and form of data distribution (Cooper and Schindler 2006) by measuring mean, median, standard deviation, score range, skewness and kurtosis (Trihendradi 2005). Descriptive statistics can provide sound but rough initial measurement, which, according to Ott and Longnecker (2001), makes more sense for significant summary measures.

After completing testing of assumptions, further statistical analysis is conducted using two types of techniques: non-parametric and parametric. The non-parametric technique is ideal for measuring nominal (categorical) and ordinal (ranked) scale. Using various cross-tabulation tables and Chi-square, this technique is primarily performed for group comparison (Pallant 2007, 210). In this thesis, the non-parametric tool is also used for confirmatory purpose. On the other hand, the parametric tests use assumptions about the population from which the sample was

drawn. Techniques used on the parametric tests for this thesis include independent sample t-test and one-way analysis of variance (ANOVA). One-way ANOVA is used to compare more than two groups, i.e. one independent variable with more than two groups and one dependent continuous variable. It compares the variability in scores (variance) between the different groups to validate whether the observed difference is significant. To further observe each group difference, this analysis also conducts the Tukey Honestly Significant Difference (the Tukey HSD) to detect the significant difference between every set group (Pallant 2007, 242).

In applying those techniques, this study uses some categorisations. First is the company size group, where SOEs are categorised into five groups based on the amount of the total assets. This category was previously used by Laksanawan (2008, 253). It comprises Group 1 (less than IDR 1 trillon), Group 2 (IDR 1 trillion to <IDR 5 trillion), Group 3 (IDR 5 trillion to < IDR 10 trillion) Group 4 (IDR 10 trillion to < IDR 50 trillion), and Group 5 (equal or more than IDR 50 trillion. Second is the industry group. Adopting the industry group categorisation of the Indonesian Stock Exchange (IDX), SOEs are grouped into 9 industry sectors. It includes agriculture; mining; basic industry and chemicals; miscellaneous industry; consumer goods industry; property, real estate, and building construction; infrastructure, utilities, and transportation; finance; and trade, services, and investment. Third is listing status. This simply divides SOEs by publicly listed and non-listed ones. Fourth is the SOE establishment history that differentiates between nationalised and non-nationalised SOEs. The reminder of this chapter discusses the result of this univariate analysis.

5.3. Dependent Variable- Return on Assets (ROA)

In this study, Return on Assets (ROA), derived from accounting rates of return, is used as a measure of SOE financial performance. To measure ROA, the SOE annual reports and financial statements of all SOEs were collected over a 3-year period of observation from 2007 to 2009. This includes 14 publicly listed SOEs and 111 non-publicly listed SOEs. Among non-listed ones, 8 companies presented unaudited financial statements. These companies are categorised as small with total assets less than IDR 3 trillion. Financial constraint is the reason for not appointing a public

accounting service to audit on an annual basis. As the total assets of these 8 companies is less than 1% of the total size of the entire samples, it is considered that it will not significantly affect the result of the study.

Return on Assets (ROA) is defined as the ratio of earnings before interest, extraordinary items and taxes to total assets and is expressed as a percentage (Mankin and Jewell 2010). The mean of ROA exhibits an upward trend over the three year period of study (Table 5.1), from 4.83% of ROA mean in 2007 to 7.20% in 2009. This significant growth 49.07% reflects the improved effectiveness on how the SOEs utilized their assets. The gradual rise of median has been consistent with the fact that SOE performance has steadily improved over times.

Table 5. 1: *Descriptive statistics for Return on Assets (ROA) measure in percentage*

Year	N[a]	Minimum	Maximum	Mean	Median	Std. Deviation
2007	122	-29.97	31.19	4.83	3.91	10.53
2008	121	-28.02	37.16	6.08	4.68	10.94
2009	122	-28.65	37.68	7.20	6.40	9.78

Note: [a] Outliers are identified following the SPSS convention as those observations falling greater than 3 interquartile ranges outside the 25th to 75th percentile range (Weinberg and Aramowitz 2008, 43). For the purpose of the descriptive statistics, data with outliers are eliminated.

The ROA performance is detailed by industry category. Using the Indonesian Stock Exchange (ISX) classification, the mean comparison is presented in the Table 5.2 below. As shown in the table, two of nine industry groups, mining and infrastructure utility and transportation, experienced a decline in performance in 2008. The ROA mean dropped from 8.75% in 2007 to 3% on mining and 7.07% to 6.44% on infrastructure, utility and transportation. The most plausible explanation is that both occurred during the 2008-2009 global economic crisis. Even though the economy of Indonesia was less affected by the crisis (Tambunan 2009, 6), a report issued by ASEAN and the World Bank noted that when the global economic crisis pulled in Indonesia, GDP growth of most sectors slowed in Quarter 4 2008 while remaining positive. Consequently, some economic sectors were vulnerable, nonetheless others were less affected or not at all by the crisis. For instance, mining and quarrying, manufacturing, oil and gas, construction, trade, hotel and restaurants experienced negative growth. Conversely, other economic sectors, such as agriculture, livestock,

forestry and fishery, transportation and communication, finance, real estate and business services, were not influenced by the crisis. This is consistent with the statistical evidence suggesting that the decline of two groups of SOEs as stated above happened because of the effect of the global financial crisis (Muchayat 2001, 66).

Table 5. 2: *Return on Assets (ROA) mean comparison by industry group*

	N [a]	ROA Mean (in percentage)		
		2007	2008	2009
Agriculture	23	7.19	7.65	6.03
Mining	3	8.75	3.00	5.04
Basic industry and chemicals	7	3.90	7.59	7.86
Miscellaneous industry	7	1.69	5.77	7.49
Consumer goods industry	5	4.76	5.08	7.45
Property, real estate, & building construction	15	3.80	5.72	8.12
Infrastructure, utilities, and transportation	19	7.07	6.44	8.34
Finance	19	4.56	5.42	5.60
Trade, services, and investment	18	6.45	7.77	8.68
Total	116	5.59	6.51	7.25

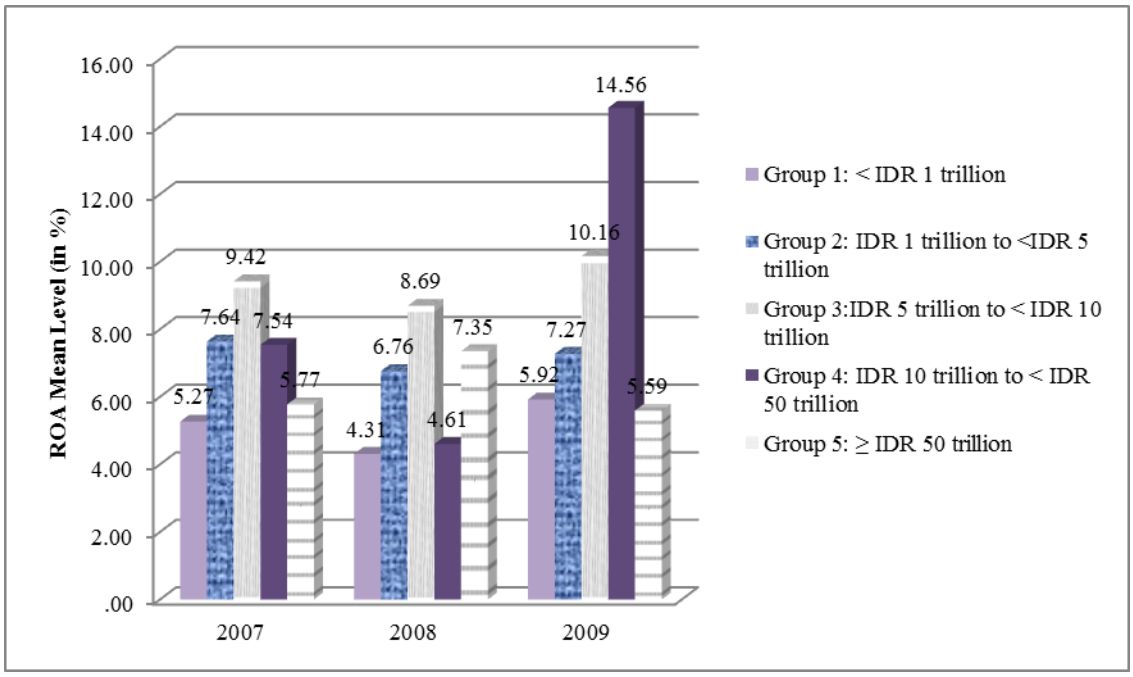
Note: [a] Outliers are identified following the SPSS convention as those observations falling greater than 3 interquartile ranges outside the 25th to 75th percentile range (Weinberg and Aramowitz 2008, 43). For the purpose of this descriptive statistics, data with outliers are eliminated.

On the other hand, SOEs in transportation and communication, finance, real estate and business service exhibited a positively increasing performance, which is consistent with the less affected economic sectors during and after the crisis. Several groups of SOEs (manufacturing, construction, trade, hotel and restaurant) achieved positive growth of ROA when the market was actually weakening as the crisis impacted. Agricultural industry is the only one with a slight increase of ROA mean in 2008. This industry group belongs to 23 SOEs from small to medium size companies.

The ROA performance is also grouped by company size. Adopting of Laksanawan's approach (2008, 253), the result of ROA mean comparison is illustrated in the Figure 5.1. Among the five groups, about half of the SOEs belong to the small group with less than IDR 1 trillion of total assets and almost 30% belongs to the group of IDR 1

to < IDR 5 trillion of total assets. Only nine companies fall into the very large size company category owning more than IDR 50 trillion of assets.

Figure 5. 1: *Comparison of Return on Assets mean by company size* [a]



Note: [a] Outliers are identified following the SPSS convention as those observations falling greater than 3 interquartile ranges outside the 25th to 75th percentile range (Weinberg and Aramowitz 2008). For the purpose of this descriptive statistics, data with outliers are eliminated.

The consistency of this upward trend is shown by Group 1, 2, 3, and 4 in comparison with the total ROA mean. Group 4 (SOEs with total assets between IDR 10 trillion to <IDR 50 trillion) exhibits the highest growth and level of mean among others in 2009, far higher than the total figure. Among others, group 3 (total assets of IDR 5 trillion to <IDR 10 trillion) has been the most effective group in utilizing their assets until 2008. Group 5 (the highest group with total assets equal to or more than IDR 50 trillion) is the only group with a different trend. While the ROA mean of group 5 experienced growth in 2008, other groups weakened. Conversely, the figure of Group 5 descents in 2009, when others get stronger.

5.4. Independent Variables: Governance Related Government Involvement

In this study, governance in SOEs is measured using a number of governance methods: including the General Meeting of the Shareholder (GMS), the Board of Directors (BOD), and the Board of Commissioner (BOC). In the context of GMS, governance is measured through government ownership. Data is collected from three years of Central Government Financial Statements (audited) for 2007-2009.

For the BOD, governance practice is measured through CEO External Appointment and the Proportion of Government Related Directors on the BOD. In three succeeding years (2007-2009) names and career background of members of the BOD's are gathered from two main sources including the Ministry of SOE's database and management information on SOE annual reports or general information on SOE financial statements. Some data is missing as the companies do not disclose an adequate amount of information to the public or they do not report sufficiently to the Ministry of SOE. These reduce the data on CEO career backgrounds by six; and by 11 the data on government representation on the BOD available for study.

For the Government's involvement in the governance of the BOC, governance is measured using three predictors - the Chairperson's external experience, the proportion of Government related commissioners on the BOC and the number of board sub-committees on the BOC. Archive data maintained by each Deputy of the Ministry of SOE are employed as the main source of data. SOE annual reports produced by limited SOEs as well as the SOE Performance Report, annually updated and printed by the Ministry of SOEs, are also collected to complete the data.

5.4.1. Government Ownership

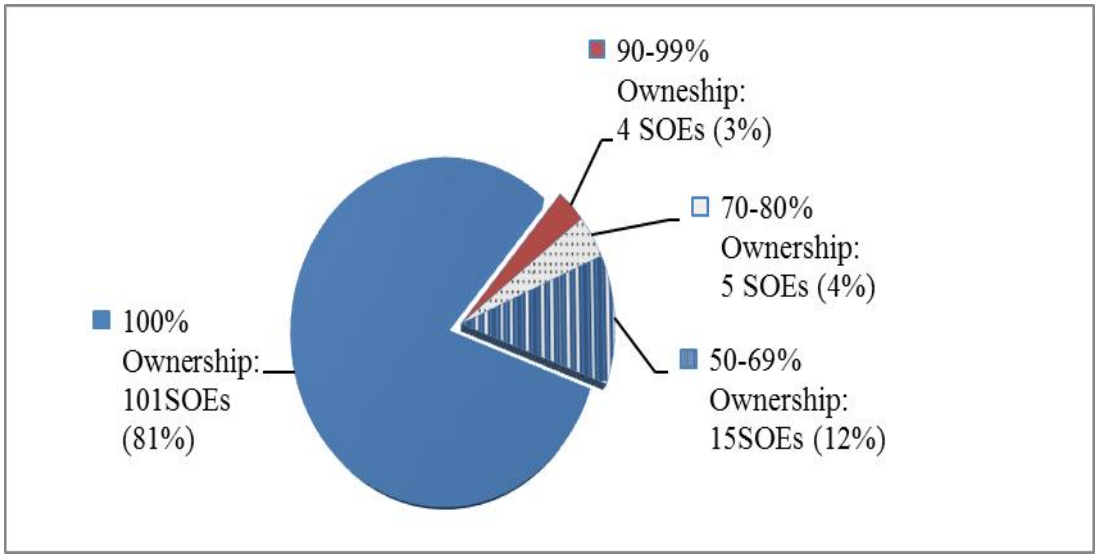
Government ownership refers to the total proportion of shares owned by the Central Government in the SOE to the total share ownership and is expressed in percentage. The descriptive statistics (Table 5. 3) shows the mean (median) of the government ownership accounting for 0.94 (1.00) for the subsequent three years. It indicates that the SOEs are dominantly owned by government.

Table 5. 3: *Descriptive statistics for government ownership*

Year	N	Min	Max	Mean	Median	Std. Deviation
2007	125	0.51	1.00	0.94	1.00	0.14
2008	125	0.51	1.00	0.94	1.00	0.14
2009	125	0.51	1.00	0.94	1.00	0.14

To further investigate the diversity of SOE ownership, the data is transformed to ordinal-level data and is distinguished in four categories as 0 for fully owned by the Government, 1 for 90-99% of ownership, 2 for 70-89% of ownership, or 3 otherwise. Majority of the populations (101 companies or 81% of the total) are fully owned by the Government. The rest of the companies, as presented in Figure 5.2, comprise 9 companies having a maximum of 20% of non-government ownership and 15 companies containing more diverse shareholders with 31-50% of share ownership.

Figure 5. 2: *Frequency distribution of SOEs by the proportion of government ownership (N=125)*



Additional analysis of comparing means is presented in the appendix D. It reveals that the larger size companies are likely to have less government ownership than the smaller size ones. Also, there is a significant difference of government ownership among different industry groups, of which mining industry, the consumer goods industry, and property, real estate, and the building construction industry are the companies with least government ownership.

5.4.2. CEO External Appointment

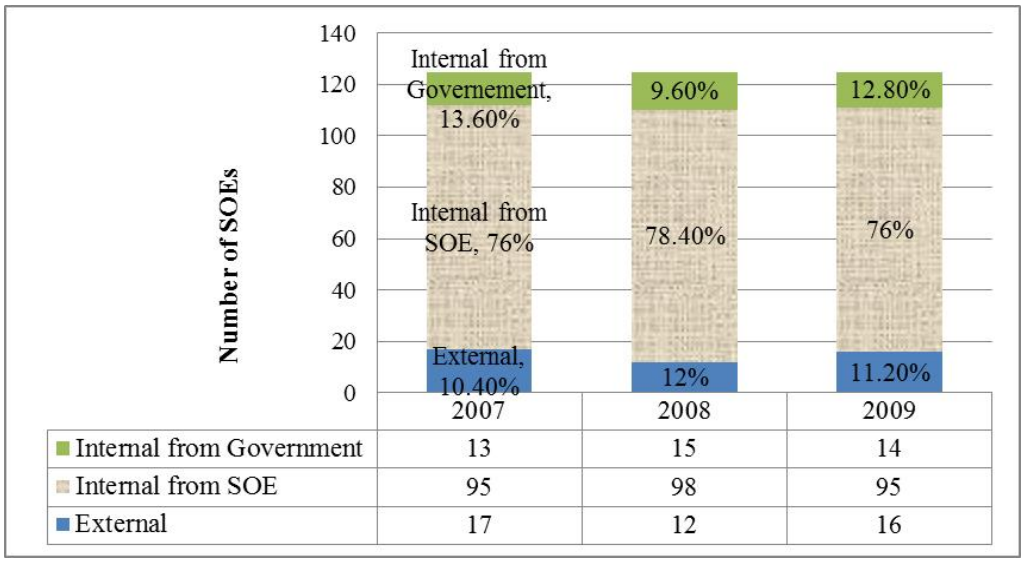
For the purpose of this study, a CEO external appointment is defined by a dummy variable for career or professional experience or background of a person prior to his or her appointment as the CEO. It is expressed as 1 for external or outsider CEO or 0 for an internal CEO. An internal CEO means that the CEO is appointed from within the current SOE, or another SOE or government bureaucracy, including those who work at local government officers, military and policy offices. Nine sets of data are missing due to the unavailability of information from three companies. As such, for the purpose of frequency analysis, the internal group is further divided into two sub-groups: CEOs from internal SOEs or other SOE and CEOs from Government, police and all military office.

Overall, SOEs are dominated by internally appointed the CEOs. The percentage of SOEs with a CEO from internal management/other SOE is 78.40 per cent in 2008 (Figure 5.3), dropping to 76%in 2009.The number of CEOs with an SOE career background is far larger than those from Government and external (six and eight times, respectively).

The composition figure in 2008 is particularly interesting since it portrays that the high number of CEO substitutions is linked to the decrease in number of independent CEOs from 17 to 12 people. This suggests very strong intervention of the Government as the General Meeting of the Shareholders are likely to appoint internal CEOs from internal to replace some external CEO positions in that specific year.

In addition, CEOs originating from outside the Government/SOE are more likely to be appointed to larger sized companies as compared to smaller sized ones. Similarly, such significant difference can also be found among different industry groups. Both analyses are presented in the Appendix D.

Figure 5. 3: *Frequency distribution of SOE's CEO external appointment for 2007-2009*



5.4.3. Chairperson's External Experience

The external experience of the chairperson of Board of Commissioners is a dummy variable for independence of career or professional background. It is expressed as 1 if the Chairperson is independent from the Government and political connection or 0 otherwise. An internal or insider chairperson can be from government officers/retired government officers. A retired government officer includes a former Minister or retired senior civil servant, former police or military or legal enforcement officer. An outsider/independent chairperson refers to professionals who come from private sectors, expert, or academic. For the purpose of frequency analysis, the insider chairperson is divided into two, namely government officer and other insider.

Table 5. 4: *Frequency distribution of chairperson external experience for 2007-2009*

	2007		2008		2009	
	Freq	Percent	Freq	Percent	Freq	Percent
Internal						
Government Officer	83	66.40%	85	68.00%	91	72.80%
Other insider [a]	18	14.40%	13	10.40%	11	8.80%
External/Independent	24	19.20%	27	21.60%	23	18.40%
Total	125	100.00%	125	100.00%	125	100.00%

Note: [a] Other insider includes retired Government officer/police/military unit and person works in an SOE.

Table 5.4 reveals that the majority of the chairpersons are government related (a government officer plus other insiders accounted for 80.80 percent in 2007), consisting of those who are functionally still active in one of the important positions in the Government bureaucracy (about 66.40 percent) and the remaining 14.40 percent of those who retired from government or are working for SOEs. The figure gradually rises every year as the number of chairpersons from other insiders slowly declines. On the other hand, the figure of external or independent chairpersons peaks in 2008 to 27 (21.60 percent) and declines afterwards to the lowest level at 23 (18.40 percent of the total). The fact that independent chairpersons increased in 2008 was part of the Ministry of SOE's restructuring program (Kementerian BUMN 2010b).

To add, additional analysis, presented in Appendix D, reveals that SOEs from certain industry groups tend to employ more independent chairpersons than those from other industry groups.

5.4.4. The Proportion of Government Related Directors on the BOD

The proportion of Government related directors on the BOD refers to the ratio of directors from inside (internal SOE or government assigned to the BOD) within the total BOD. As illustrated in Table 5.5, the mean of government related directors on the BOD descends slowly over the three-year period, from 0.92 (2007) to 0.89 (2009).

Table 5. 5: *Descriptive statistics for government related directors on the BOD*

Year	N [a]	Min	Max	Mean	Std. Deviation	Percentiles		
						25	50	75
2007	121	0.33	1.00	0.92	0.16	0.86	1.00	1.00
2008	121	0.17	1.00	0.90	0.17	0.82	1.00	1.00
2009	122	0.17	1.00	0.89	0.19	0.80	1.00	1.00

Note: [a]Eleven data are missing since the companies do not disclose adequate amount of information to the public or do not report sufficiently to the Ministry of SOE.

5.4.5. The Proportion of Government Related Commissioners on the BOC

BOC representation describes the proportion of appointed members of the BOC who have a career background in the government. Table 5.6 displays that in 2007 the mean and median of government related commissioners in the BOC is at a similar level, 0.77 and 0.80 respectively. This is in contrast with the figure of the BOD structure that has shown the decline of government officers employed in the three year period of study (Table 5.5).

Table 5. 6: *Descriptive statistics for government related commissioners on the BOC*

Year	N	Min	Max	Mean	Std. Deviation	Percentiles		
						25	50	75
2007	125	0.17	1.00	0.77	0.22	0.60	0.80	1.00
2008	125	0.14	1.00	0.79	0.23	0.67	0.80	1.00
2009	125	0.17	1.00	0.80	0.22	0.67	0.80	1.00

In addition, company size is found to be an important determinant in selecting BOC membership. The BOC is strongly dominated by government representatives in majority of small to medium size SOEs. Likewise, industry group is significant factor in selecting the composition of government and non-government background in the BOC. Both analyses are illustrated in Appendix D.

5.4.6. Number of Board Sub-Committees

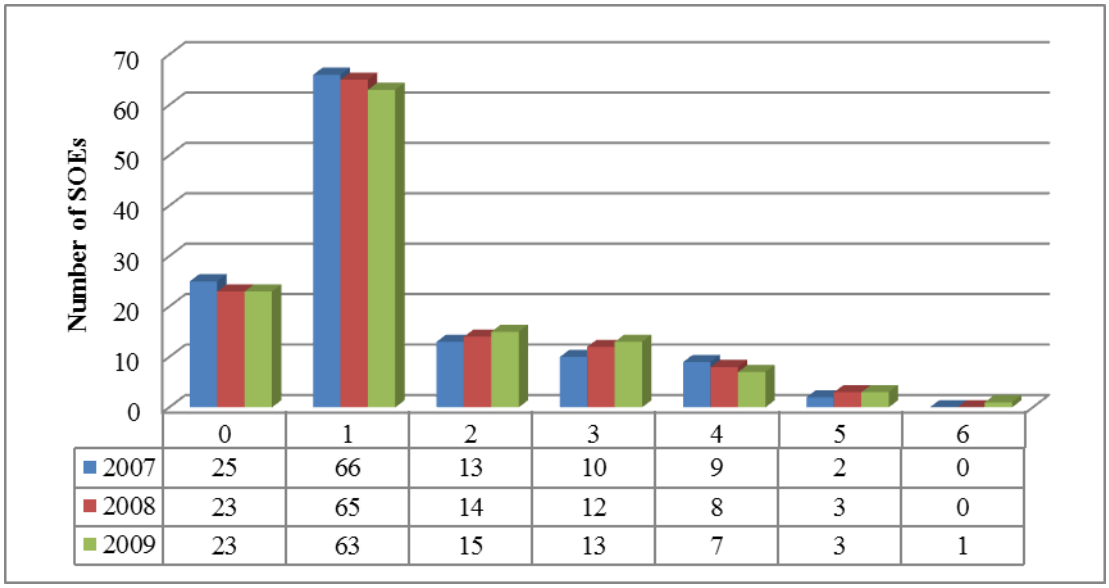
The last predictor of governance related intervention associates with the number of board sub-committees. A sub-committee serves special tasks (such as the audit sub-committee, nomination sub-committee, remuneration sub-committee) assigned by the BOC. Based on the three years of data relating to 125 SOEs, the mean (median) number of board sub-committees is 1.34 (1.00) within the range of 0 to 6 (Table 5.7). The increase of mean over the years of observation indicates that a number of SOEs are adding more sub-committees to assist the board.

Table 5. 7: *Descriptive statistics for the number of board sub-committees*

Year	N	Min	Max	Mean	Med	Std. Deviation	Percentiles		
							25	50	75
2007	125	0	5	1.34	1	1.26	1	1	2
2008	125	0	5	1.41	1	1.28	1	1	2
2009	125	0	6	1.45	1	1.27	1	1	2

Law Number 19 Year 2003[40] stipulates that every SOE is obliged to establish an Audit Sub-Committee as part of corporate governance practice. In addition, the Law spurs SOEs (BOC) to create additional sub-committees, such as remuneration sub-committees and corporate governance sub-committees, based on need and financial strengths. The pie chart shown in Figure 5.4 shows that 25 SOEs (20 per cent of the total) are not equipped with any board sub-committee, even an audit sub-committee.

Figure 5. 4: *Distribution of number of board sub-committees in 2007-2009*



	0	1	2	3	4	5	6
2007	25	66	13	10	9	2	0
2008	23	65	14	12	8	3	0
2009	23	63	15	13	7	3	1

Table 5.8 shows the greatest priority for the BOC is the audit sub-committee as 101 SOEs have this. Among other types of board sub-committee, risk management appears to be the next preferred (31 SOEs). Others frequently formed are remuneration and nomination sub-committees (24 and 22 SOEs) with some companies merging these two functions under one sub-committee. In addition, other

[40] The State-Owned Enterprise Law (Number 19 Year 2003).

types of sub-committee include corporate governance, investment, corporate social responsibility, ethics, oversight, and commerce marketing.

Table 5. 8: *Types of board sub-committees under the BOC*

	Number of SOEs
Audit	101
Remuneration [a]	24
Nomination [b]	22
Corporate Governance	12
Risk Management	31
Investment	6
Corporate Social Responsibility	1
Other	3

Note: [a], [b] Remuneration and nomination function can be found in one board sub-committee (nomination and remuneration sub-committee) or two sub-committees (remuneration sub-committee and nomination sub-committee).

In addition, company size as well as industry group appear to be determinant factors in deciding the board sub-committee numbers of a company. Figures of both analyses are depicted in Appendix D.

5.5. Independent Variables: Financial Related Government Involvement

The second group of independent variables concerns financially related government intervention. There are two measures: (i) government transfer payments in the form of subsidy and public service obligation (PSO) and (ii) dividend payout policy. The former is in the form of a cash outflow from the Indonesian Ministry of Finance (i.e. State Treasurer Account) to receiving SOEs; whereas the latter is a cash inflow activity from SOEs to the State Treasurer Account. All data are gathered from Central Government Financial Statements for 2007- 2009 (audited).

5.5.1. Government Transfer Payment in the Form of Subsidies or Public service obligation (PSO)

Government transfer payments show funding activities between the Central Government and the SOE. In this study, government transfer is in the form of subsidies and PSO. Subsidy is a government transfer of funds to the SOE to support the cost production, selling, export or import of goods and services so that the selling price is affordable by the public (Law No. 47 of 2009 and Law No. 10 of 2010), whereas PSO is an activity or a series of activities provided by a public service provider with the purpose of providing goods and services to every citizen and resident in accordance with the laws and regulations (Law No. 25 of 2009). The data is collected from the Central Government Financial Statements for the year 2007-2009.

Table 5.9 documents the fluctuating figures of government transfer in the consecutive years of observation. Government transfer experiences a significant increase by approximately 74.18 per cent in 2008, reaching a peak of total amount (mean) of IDR 232,382.47 billion (IDR 33,197.50 billion). Conversely, the figure drops substantially again by 57.84 per cent in 2009 even lower than that of 2007 with the government transfer total amount (mean) of IDR 97,981.38 billion (IDR 13,997.34 billion).

Table 5. 9: *Descriptive Statistics for government transfer*

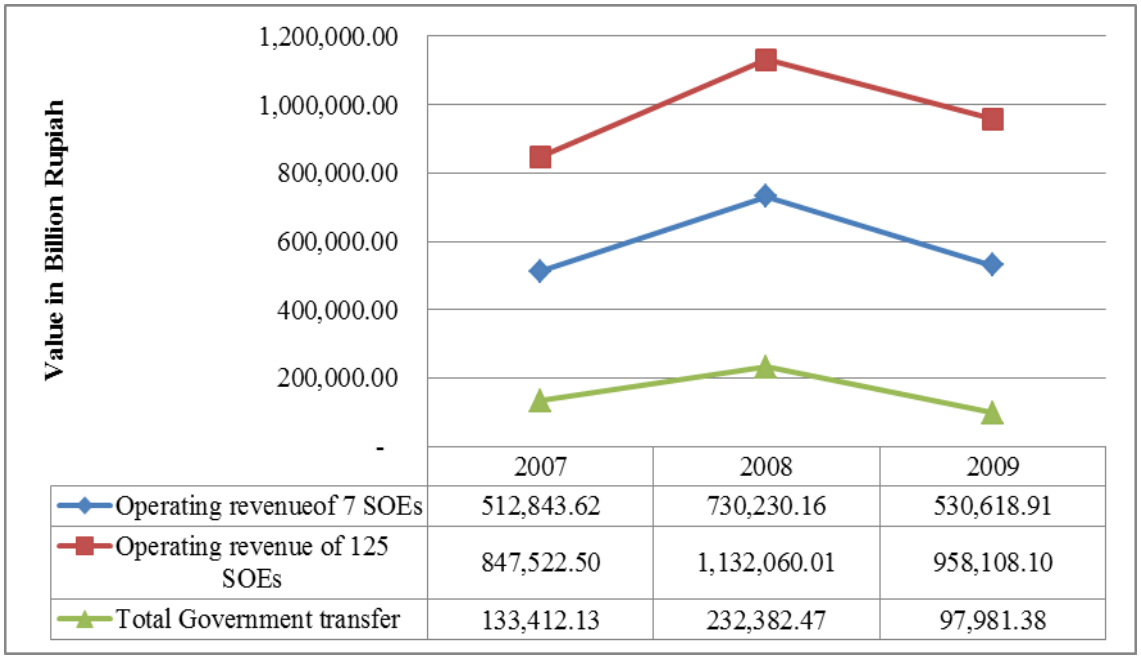
Descriptive Statistics	2007	2008	2009
Total N	7	7	7
Mean [a]	19,058.88	33,197.50	13,997.34
Minimum [a]	100.00	150.00	175.00
Maximum [a]	88,200.24	145,802.30	49,546.47
Sum [a]	133,412.13	232,382.47	97,981.38

Note: [a] (in IDR billion)

To further understand the value of this government allocated budget for subsidy and PSO, Figure 5.5 above depicts the trend of government transfer and the comparison to operating revenue. As can be seen, the movement of government transfer is proportionate to operating revenues. This indicates the consistent contribution of government transfer to the total operating revenue. Also, based on the ratio table, the

proportion of government transfer to the operating revenue of the seven SOEs (subsidy/PSO receivers) is relatively significant amounting 26.01% (2007), with the rise of 31.82% (2008) and the fall of 18.47% (2009). Compared to the total operating revenue from 125 SOEs, the ratio of government transfer to seven SOEs accounts for 15.74%, 20.53% and 10.23 in 2007, 2008 and 2009. This suggests that while only seven SOEs receive a government transfer, the value is very significant to the total operating revenue for 125 SOEs.

Figure 5. 5: *Trend of government transfer (Subsidy or Public Service Obligation) for 2007-3009*



	2007	2008	2009
Operating revenueof 7 SOEs	512,843.62	730,230.16	530,618.91
Operating revenue of 125 SOEs	847,522.50	1,132,060.01	958,108.10
Total Government transfer	133,412.13	232,382.47	97,981.38

Ratio (%)	2007	2008	2009
Government revenue of 7 SOEs transfer to Operating	26.01%	31.82%	18.47%
Government transfer to Operating revenue of 125 SOEs	15.74%	20.53%	10.23%

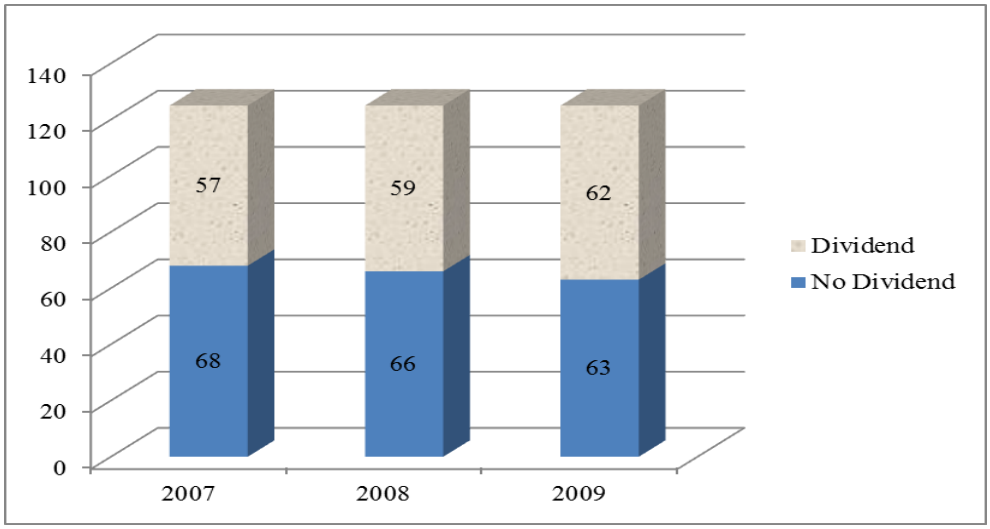
5.5.2. Dividend Payout Policy

Dividend payout policy signifies the dividend payout ratio of an SOE to be paid to government as its shareholder. The amount paid out is the portion approved by both the government and the House of Representative as shown in the annual budget and

the execution is presented in the financial statements. In this thesis, dividend payout policy is measured in percentage as a result of the total value of dividend by the total net income. Three years of data on dividend payout is collected from the Central Government Financial Statements (audited) for 2007-2009.

As shown in Figure 5.6, 57 SOEs (45.60 percent of the total) generated and paid out a dividend to the government in 2007. The number of SOEs paying out dividends increased every year to 59 and 62 for years 2008 and 2009 respectively.

Figure 5. 6: *The composition of SOEs paying out dividend for the 2007-2009*



The table 5.10 below outlines the descriptive statistics for the dividend payout variable. Overall the mean is relatively low (0.12 in 2007 to 0.11 in 2009). Among those who paid a dividend, the mean is 0.26 in 2007, declining to 0.21 in 2009.

Table 5. 10: *Descriptive statistics for dividend payout ratio*

Based on 125 SOEs	N	Minimum	Maximum	Mean
Dividend Payout 2007	125	0	2.01[a]	0.12
Dividend Payout 2008	125	0	0.53	0.11
Dividend Payout 2009	125	0	0.60	0.11
Based on 67 SOEs	N	Minimum	Maximum	Mean
Dividend Payout 2007	57	0	2.01[a]	0.26
Dividend Payout 2008	59	0	0.53	0.23
Dividend Payout 2009	61	0	0.60	0.23

Note: [a] A very high dividend payout ratio occurred because of the computation was formulized using retained earnings of 2006.

With regard to dividend value, the mean of dividend falls in 2008 despite the fact that there is an increased number of SOEs paying a dividend. The global financial crisis of 2008 is suspected to be the cause of this decline (Table 5.11).

Table 5. 11: *Descriptive statistics for dividend value (in IDR billions)*

Year	Mean	Med	Std. Deviation	Min	Max
2007	0.22	0	1.34	0	14.11
2008	0.19	0	0.99	0	10.47
2009	0.22	0	0.99	0	9.51

Table 5.12 below indicates the frequency and comparative mean for dividend among SOEs from different size groups. The table illustrates the presence of a significant difference amongst SOEs from different sized groups where larger companies are likely to produce a greater dividend. A one-way ANOVA test for dividend empirically supports that size is an important factor determining the value of dividend with p-value significance of 0.000, $p<0.01$.

Table 5. 12: *Mean comparison dividend by company size in pooled year*

In IDR	N	Percent of SOEs	Dividend Mean (IDR billions)
Group 1: <1 trillion	185	49.33%	4.43
Group 2: 1 trillion to < 5 trillion	108	28.80%	32.52
Group 3: 5 trillion to < 10 trillion	35	9.33%	174.65
Group 4: 10 trillion to <50 trillion	24	6.40%	377.81
Group 5: ≥ 50 trillion	23	6.13%	2,598.11
Total	375	100.00%	

As noted in the Table 5.13, another type of analysis using industry groups as the dependent variable reveals that the industry sector is a substantial determinant of a dividend payout policy. This indicates that SOEs from certain industries have greater dividend payout than others, for instance the mining sector, infrastructure, utilities and transportation sector, and finance sector pay higher rates of dividend than the remaining sectors. Mining sector SOEs are those with the highest contributor among others.

Table 5. 13: *Mean comparison analysis of dividend by industry group in pooled year*

	N	Percent of SOEs	Mean (in IDR billions)	Mean (rate)
Agriculture	72	19.20%	46.26	.12
Mining	15	4.00%	2,470.24	.22
Basic industry and chemicals	30	8.00%	93.03	.10
Miscellaneous industry	21	5.60%	1.42	.04
Consumer goods industry	18	4.80%	3.31	.03
Property, real estate, and building construction	45	12.00%	20.93	.07
Infrastructure, utilities, and transportation	63	16.80%	362.35	.15
Finance	57	15.20%	212.79	.15
Trade, services, and investment	54	14.40%	1.95	.08
Total	375	100.00%	11.38	.11

5.6. Independent Variables: Regulatory Framework Related Government Involvement

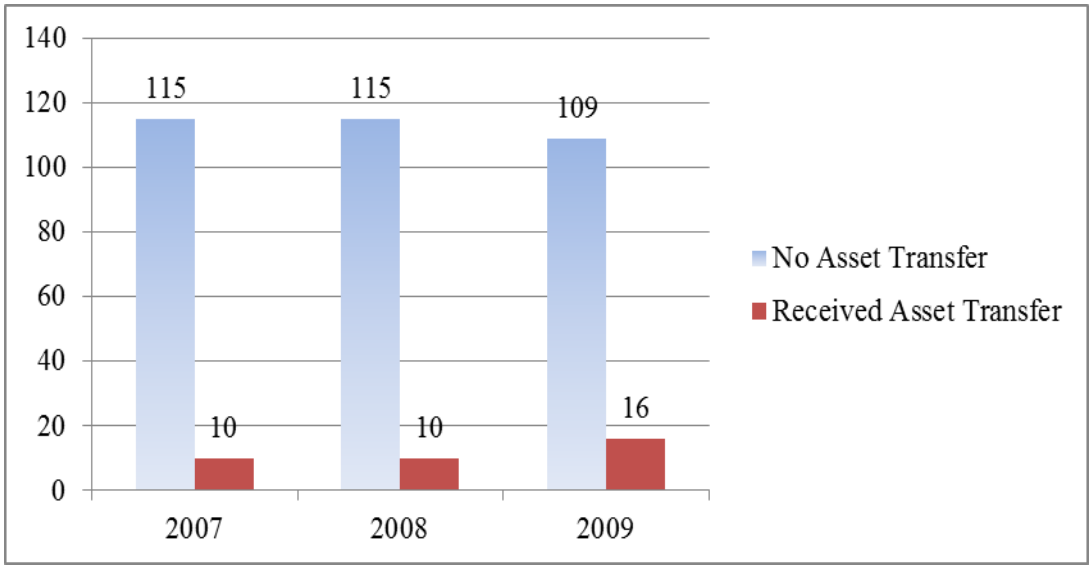
Two measures relating to government involvement through regulatory framework include asset transfer from the Central Government to SOEs and the legal case resulting from non-compliance with regulations. Both variables are newly introduced in this thesis.

5.6.1. Asset Transfer from Central Government to SOEs

Asset transfer from the Central Government to SOEs is a dummy variable for fixed assets granted to an SOE by the Central Government for a specific purpose. The physical asset transfer leads to obligations for an SOE to present the additional amount of assets and equity on their balance sheet. It is measured as 1 if the SOE receives a transferred asset, or 0 otherwise. Three years of data of asset transfer during 2007-2009 was collected from Ministry of Finance and below is the result of the descriptive statistics analysis.

Figure 5.7 below illustrates that only 10 SOEs (8 percent of the total) received an asset transfer from the government during 2007 and 2008. The number of SOEs receiving an asset transfer rose to 16 (or 12.8 percent) in 2009.

Figure 5. 7: *Comparison of SOEs receiving asset transfer from 2007 – 2009*



The descriptive statistics as shown in the Table 5.14 presents that a small number of SOEs receiving government transfer yet with very significant value (26.01 per cent of the total operating revenue of 125 SOEs). The figure fluctuates and peaks in 2009.

Table 5. 14: *Descriptive statistics for Asset Transfer in IDR billions*

Year	N	Mean	Std. Deviation	Med	Min	Max
2007	125	313.31	2287.18	0	0	23,855.89
2008	125	243.16	2143.55	0	0	23,855.89
2009	125	336.46	2749.67	0	0	30,376.63

Since transferred assets are mostly related to machinery and heavy equipment, asset transfers are very likely to occur in the SOEs from capital-intensive industries. Table 5.15 illustrates that SOEs related to infrastructure, utilities, and transportation obtain the highest mean of IDR 1,596.34 billions of transferred assets value, followed by mining industry (IDR 613.63 billions) and miscellaneous industry (IDR 86.45 billions).

Table 5. 15: *Mean comparison of transfer assets by industry group in pooled year*

	N	Percent of SOEs	Mean (in IDR billion)
Agriculture	72	19.20%	0.09
Mining	15	4.00%	613.63
Basic industry and chemicals	30	8.00%	-
Miscellaneous industry	21	5.60%	86.45
Consumer goods industry	18	4.80%	-
Property, real estate, and building construction	45	12.00%	-
Infrastructure, utilities, and transportation	63	16.80%	1596.34
Finance	57	15.20%	-
Trade, services, and investment	54	14.40%	0.39
Total	375	100.00%	297.64

5.6.2. Legal Cases Resulting from Non-Compliance with Regulation

In this study, legal case relates to any violation against the law or regulation that is bound to the operation of SOEs but not private firms. The relevant legal instrument is the State on Enterprise Law, the State Finance Law, the State Treasury Law, the Audit on Accountability of State Finance Execution Law, the Corruption Eradication Commission Law, and the Criminal Act on Corruption Law. The violation includes yet not limited to, embezzlement, , bribery and fictitious projects found by the law enforcement institutions such as the Indonesia Attorney, Indonesian National Police (known as POLRI), Corruption Eradication Commission (known as *Komisi Pemberantasan Korupsi* or KPK), Finance and Development Supervisory Agency (known as *Badan Pengawasan Keuangan dan Pembangunan* or BPKP), Supreme Audit Institution (known as *Badan Pemeriksa Keuangan* or BPK).

To measure legal case, data over three years from four different sources was collected. These sources include KPK, BPKP, BPK, and the Indonesia News Agency (known as LKBN ANTARA). Each institution provides data related to the outcome of the institution. Data provided by KPK relates to legal cases on violation against the law, abuse of power, or bribery by law enforcement officer or government officers that causes the state losses of minimum IDR 1 billion. Data maintained by BPKP relates to investigative audit results based on the request from the Indonesian Attorney or POLRI or KPK. Data from BPK is concerned with findings in financial

and special audits to the SOE, which are reported in the semi-annual audit report (known as *Hasil Pemeriksaan Audit*). Data from the ANTARA database relates to SOE legal cases as they release new information associated with on-going investigation or legal court issues.

The legal case dummy variable is expressed as 1 if there is 1 or more legal case(s), or 0 otherwise. Frequency distribution, as presented in the Table 5.16, document that at least 12 percent of the total SOEs have violated the regulations . The number slightly fluctuates and declines to 15 in 2009.

Table 5. 16: *Frequency distribution for legal case variable*

	2007		2008		2009	
	Freq	%	Freq	%	Freq	%
Legal Case						
▪ *No case*	109	87.20%	108	86.40%	110	88.00%
▪ *With case*	16	12.80%	17	13.60%	15	12.00%

Furthermore, Table 5.17 describes the relationship between the presence of a legal case within an SOE and the size of the company using the *Independent sample t-test*. The test result confirms that there is a significant difference between the two groups (*t=4.3812,* p<.05) suggesting that cases are more likely occur in larger companies than smaller ones.

Table 5. 17: *Independent sample t-test for legal case by company size*

Dependent variable	*Levene's Test*		*t-test for Equality of Means*		
	F	*Sig.*	*t*	*Sig-2 tailed*	*Mean Difference (in billion)*
Company Size	434.614	.000	4.381	.000**	80,491.52

With regard to industry group, legal cases are also more dominant in certain industries. The cross-tabulation (Table 5.18) exhibits that most cases can be found in the infrastructure, utilities and transportation industry (4.53 percent) followed by finance.

Table 5. 18: *Legal case by industry group in pooled years*

	Legal Case		
	No case	With case	Total
Agriculture	17.33%	1.87%	19.20%
Mining	3.20%	0.80%	4.00%
Basic industry and chemicals	7.73%	0.27%	8.00%
Miscellaneous industry	4.80%	0.80%	5.60%
Consumer goods industry	4.27%	0.53%	4.80%
Property, real estate, and building construction	11.47%	0.53%	12.00%
Infrastructure, utilities, and transportation	12.27%	4.53%	16.80%
Finance	12.53%	2.67%	15.20%
Trade, services, and investment	13.60%	0.80%	14.40%
Total	87.20%	12.80%	100%

Table 5.19 provides the summary of the *Independent sample t-test* result to assess the nature of legal case differences between SOEs receiving capital investment and SOEs not receiving in the corresponding year; SOEs with PSO and SOEs without PSO; SOEs paying dividends to the government and SOEs without dividends; and SOEs with transferred assets and SOEs without . Overall, the *t-test* results show that significant difference occurs between SOEs with PSO and ones without PSO, SOEs with dividends and ones without dividends, and SOEs with transferred assets.

Table 5.19: *Independent sample t-test for legal case in pooled year*

	Levene's Test		*t-test for Equality of Means*			Mean Difference
	F	*Sig.*	*t*	*df*	*Sig*-2 tailed	(in IDR billion)
PSO	173.110	0.000	2.313	47.000	0.025	9,509.09
Dividend	158.633	0.009	2.776	47.094	0.008	1,158.36
Asset Transfer	107.944	0.00	1.965	47.039	0.055	1,839.53

Note: ** very significant p<.01

5.7. Additional Descriptive Analysis

5.7.1. History of SOE Establishment

In this thesis, history of establishment is defined as the initial set up of an SOE by the Central Government of Indonesia or by the Dutch Government during its occupation

of Indonesia. It is a dummy control variable for the initial set up of an SOE, expressed by 1 if it is initially established as a nationalised SOE from a Dutch company, or 0 otherwise.

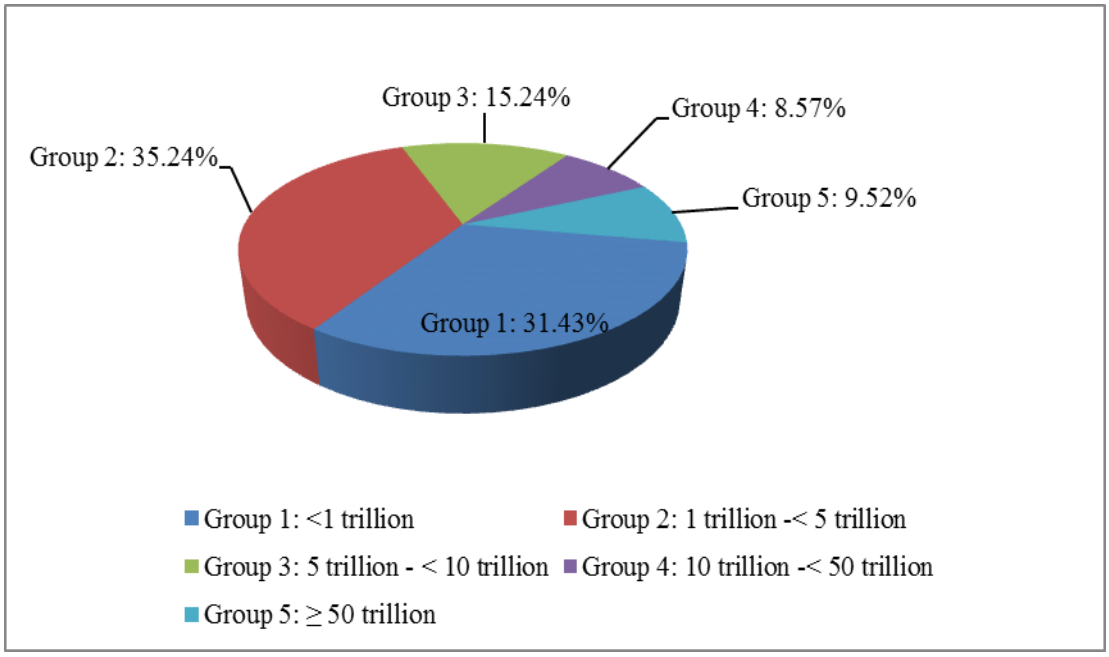
As exhibited in the Table 5.20, there are 35 SOEs established by the Dutch Government before being nationalised (28 percent of the total). These nationalised companies exist in all industry sectors with the biggest portion in the infrastructure, utilities, and transportation sector (5.60 percent), agriculture and property, real estate, and building construction sector (4.80 percent each).

Table 5.20: *Distribution of nationalised SOEs by industry group*

	Nationalised SOE		*Non-nationalised SOE*	
	Count	Percent	Count	Percent
Agriculture	6	4.80%	18	14.40%
Mining	2	1.60%	3	2.40%
Basic industry and chemicals	3	2.40%	7	5.60%
Miscellaneous industry	1	0.80%	6	4.80%
Consumer goods industry	4	3.20%	2	1.60%
Property, real estate, and building construction	6	4.80%	9	7.20%
Infrastructure, utilities, and transportation	7	5.60%	14	11.20%
Finance	4	3.20%	15	12.00%
Trade, services, and investment	2	1.60%	16	12.80%
Total	35	28.00%	90	72.00%

With regard to the size of the company, 66.67 percent of the nationalised SOEs are small to very small companies with total assets of less than IDR 5 trillion. The rest of these Dutch heritage companies vary from IDR 5 trillion or above, including 9.52 percent of SOEs with total assets of IDR 50 trillion or more (Figure 5.8).

Figure 5. 8: *Distribution of nationalised SOEs by company size in pooled year (in IDR)*

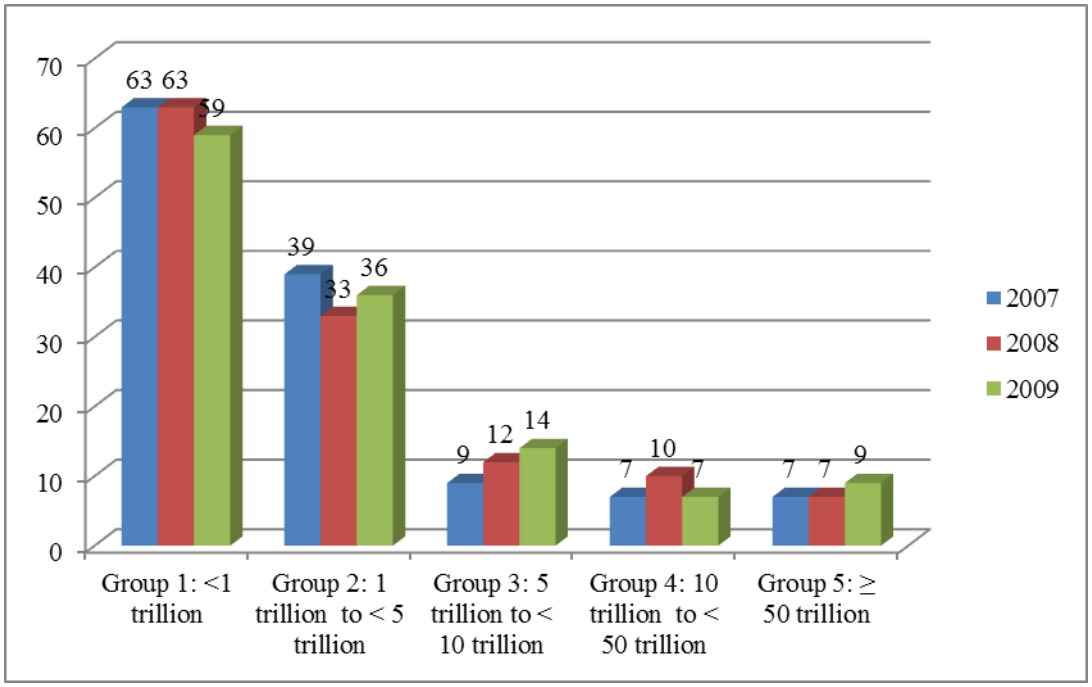


5.7.2. Company Size

As a control variable in this thesis, company size is computed as a natural log of total assets. For this univariate analysis, company size has also been presented in groups to examine whether or not it is a determinant factor of many predictors. The company size is categorised into five groups, as adopted from Laksanawan (2008).

The illustration of the five categories is presented in Figure 5.9. In 2007, the majority of SOEs were in the category of very small (50.40 % of Group 1) to small (31.20 % of Group 2). While there were some changes over time, SOEs continue to be dominated by very small companies in 2009 (47.20 % of the total). With only 7.20% of very large SOEs, it leaves the remaining 45.60% SOEs spread within small to large size companies.

Figure 5. 9: *SOE distribution based on company size in 2007-2009 (in IDR)*



With respect to the distribution of SOEs based on the company size, it is interesting to observe whether this size category associates with industry type. The cross-tabulation table portraying the distribution of companies based on the industry group is shown in the Table 5.24 below.

SOEs are spread in all industry or economic sectors with the largest proportion in agriculture (19.20%), followed by SOEs from infrastructure, utilities and transportation (16.80 %) and finance (15.20%). Conversely, mining and consumer goods are documented as having the least number of SOEs (4% and 4.80%, respectively).

With regard to size, it shows that SOEs from agriculture, miscellaneous industry, consumer goods industry and trade, service and investment consist of very small to small size companies only, unlike other sectors that have wider range from very small companies to large or very large ones. It is worth emphasizing that mining industry, infrastructure, utilities and transportation, and finance are only areas where the big players (very large size SOEs) exist.

5.7.3. Leverage

According to Gul (2001, 10) leverage might function as a governance mechanism as it results in the lenders monitoring company activity. Leverage refers to the total debt divided by the total assets. As illustrated in the Table 5.21, there is an increase in overall leverage as it went up from mean 0.69 (2007) to 0.71 (2008 and 2009).

Table 5.21: *Descriptive statistics for leverage for 2007-2009*

Year	N	Min	Max	Mean	Median	SD	Percentiles		
							25	50	75
2007	125	0.03	3.64	0.69	0.67	0.47	0.36	0.67	0.91
2008	125	0.00	3.02	0.71	0.64	0.47	0.34	0.64	0.93
2009	125	0.02	4.20	0.71	0.65	0.55	0.33	0.65	0.91

The following comparisons are meant to explore the determinant factor of leverage. First, Table 5.22 presents the results of mean comparison based on the industry groups. The mean varies among 9 industry sectors where the least leverage is 0.51 (for trade, service and investment) and 0.53 (for mining) and the highest is 1.05 (for basic industry and chemicals) and 0.87 (for property, real estate and building construction).

Table 5.22: *Mean comparison of leverage by industry group in pooled data*

	N	Mean	Std. Deviation
Agriculture	72	0.67	0.36
Mining	15	0.53	0.30
Basic industry and chemicals	30	1.05	0.77
Miscellaneous industry	21	0.60	0.26
Consumer goods industry	18	0.66	0.48
Property, real estate, and building construction	45	0.87	0.20
Infrastructure, utilities, and transportation	63	0.66	0.75
Finance	57	0.73	0.36
Trade, services, and investment	54	0.51	0.39
Total	375	0.70	0.50

A similar technique is applied for the second analysis using the company size group. Exhibited in the Table 5.23, the result of mean comparison shows variations of leverage among 5 size groups without a clear direction. Both the smallest size

companies (Group 1) and the largest size companies (Group 5) are high, 0.790 and 0.817 respectively, while the lowest rate is experienced by middle size companies (Group 3 and 4).

Table 5.23: *Mean comparison of leverage by company size group in pooled data*

In IDR	N	Mean	Std. Deviation
Group 1: <1 trillion	185	0.790	0.609
Group 2: 1 trillion to < 5 trillion	108	0.791	0.499
Group 3: 5 trillion to < 10 trillion	35	0.430	0.300
Group 4: 10 trillion to <50 trillion	24	0.627	0.281
Group 5: ≥ 50 trillion)	23	0.817	0.209
Total	**375**	**0.748**	**0.530**

5.8. Summary of the Chapter

This chapter presents the descriptive statistics and means comparison of variables of interest. Overall, the financial performance of SOEs increases gradually over the three years of observation despite the global financial crisis in 2008. The ROA figure demonstrates an upward trend indicating an improvement of companies' efficiency in asset utilization. The analysis reveals that government involvement in SOEs exists in various types and level of depth. In governance practice, government involvement is very strong, characterized by the high level of ownership that represents the government's role in the General Meeting of the Shareholders, particularly in mining, consumer goods, as well as property, real estate, and the building construction industry. With regard to governance practice on the BOD, government involvement is also very strong with the preference to appoint CEOs from inside the SOEs rather than outside, and the high level of government related directors on the BOD. Governance practice in the BOC is characterized by a high preference in the appointment of officers from government as chairpersons as opposed to outsiders. Government representation on the BOC is also very strong and with an upward trend, except for larger size companies. The number of board sub-committees rises over the years following an increase in company size.

Table 5.24: *Cross-tabulation table of company size group and industry group for 2007-2009 (% of the total)*

	Company Size Group (in IDR)	Industry Group									Total
		Agri-culture	Mining	Basic industry and Chemicals	Misc. industry	Consumer goods industry	Property, real estate, building construct.	Infra-structure, utilities, transport	Finance	Trade, services, and investment	
2007	< 1trillion	9.60%	1.60%	5.60%	4.80%	3.20%	6.40%	3.20%	3.20%	12.80%	50.40%
	1 to < 5trillion	9.60%	-	0.80%	0.80%	1.60%	4.80%	6.40%	5.60%	1.60%	31.20%
	5 to<10trillion	-	0.80%	0.80%	-	-	-	4.80%	0.80%	-	7.20%
	10 to<50trillion	-	0.80%	0.80%	-	-	0.80%	0.80%	2.40%	-	5.60%
	> 50 trillion	-	0.80%	-	-	-	-	1.60%	3.20%	-	5.60%
	Total	19.20%	4.00%	8.00%	5.60%	4.80%	12.00%	16.80%	15.20%	14.40%	100%
2008	< 1trillion	8.80%	1.60%	5.60%	4.80%	4.00%	6.40%	3.20%	2.40%	13.60%	50.40%
	1 to < 5trillion	8.80%	-	0.80%	0.80%	0.80%	3.20%	5.60%	6.40%	-	26.40%
	5 to<10trillion	0.80%	0.80%	-	-	-	1.60%	4.80%	0.80%	0.80%	9.60%
	10to<50trillion	0.80%	0.80%	1.60%	-	-	0.80%	1.60%	2.40%	-	8.00%
	> 50 trillion	-	0.80%	-	-	-	-	1.60%	3.20%	-	5.60%
	Total	19.20%	4.00%	8.00%	5.60%	4.80%	12.00%	16.80%	15.20%	14.40%	100%
2009	< 1trillion	8.00%	1.60%	5.60%	4.00%	3.20%	6.40%	2.40%	2.40%	13.60%	47.20%
	1 to < 5trillion	8.80%	0.80%	0.80%	1.60%	1.60%	3.20%	6.40%	4.80%	0.80%	28.80%
	5 to<10trillion	1.60%	0.80%	-	-	-	1.60%	4.80%	2.40%	-	11.20%
	10to<50trillion	0.80%	-	1.60%	-	-	0.80%	1.60%	0.80%	-	5.60%
	> 50 trillion	-	0.80%	-	-	-	-	1.60%	4.80%	-	7.20%
	Total	19.20%	4.00%	8.00%	5.60%	4.80%	12.00%	16.80%	15.20%	14.40%	100%

With regard to financial activity, an upward trend in dividend paid to the government shows that financially related government involvement has been stronger over the study period. Company size and type of industry are two factors determining the amount of dividend. For government transfer, the value fluctuates (increase by 74.18% in 2008, then decreases by 57.84% in 2009) with the peak of IDR 232,382.47 billion. Even though only seven SOEs received government transfer, the value is very significant when compared to the total operating revenue of the 125 SOEs. Four out of nine industry sectors obtained a government transfer (agriculture, mining, infrastructure, utilities, and transportation, and trade, service and investment) indicating that industry group is a factor driving government transfer policy.

In the regulatory framework, the increased level of asset transfer from the government to the SOEs signifies government involvement in the financial area, with the asset distribution targeted to SOEs from certain industry groups only. Government involvement in setting regulations for SOEs leads to the appearance of SOEs in legal cases for non-compliance. It seems the cases are more likely to occur in larger companies and in nationalised companies.

CHAPTER 6: MULTIVARIATE ANALYSIS

6.1. Introduction

The previous chapter reveals that Indonesian SOEs are characterized by strong government intervention of various types and levels of depth. In governance practice, government involvement is represented by very dominant voting rights in the General Meeting of the Shareholders leading to strong influence in the BOD and BOC governance. With regard to financial activity, Government involvement has been increasing over the study period with company size and type of industry as the main determinants. The following chapter conducts further statistical analysis. The remainder of this chapter consists of the following sections: a description of the statistical tool for multivariate analysis, a discussion of the assumptions, correlation analysis, and multivariate regression model and sensitivity analysis. The concluding comment summarises the chapter[41].

6.2. Statistics for Multivariate Analysis

This thesis consists of a set of hypothesis relating to the potential relationships between a group of independent variables and a dependent variable. To test these hypotheses, correlation and multiple regression are used as the main statistical techniques. Initially correlation analysis is applied to observe the direction and the degree of the relationship between two variables among the dependent variable, independent variables and control variables.

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[41] Parts of this chapter have been presented in an international conference and issued in the proceeding of the conferenceas shown below.

1. Paper "Governance Practice in Indonesian State-Owned Enterprises (SOEs). Presented in the 2nd International Conference on Business and Banking, held in Denpasar, Indonesia, 2-3 February 2012, (Puspasari and Evans 2012a).
2. Paper "Government Control of State-Owned Enterprises (SOEs)". Presented in the 13th Asian Academic Accounting Association Conference, held in Kyoto, Japan, 9-12 November 2012 (Puspasari and Evans 2012b).

There are several different statistical options for correlations. Pallant (2007, 126) argues that the selected option depends on the measurement level and the characteristics of the data element. This thesis adopts the Pearson product-moment coefficient or Pearson correlation coefficient since the variables contain interval level (continuous) and dichotomous variables (Field 2009). Correlation is also used to assess any multi-collinearity problems. According to Gujarati (1995), a coefficient of equal to or higher than 0.80 is suggests multi-collinearity.

The second technique applied is multiple regression analysis. This study applies Ordinary Least Squares (OLS) regressions for hypothesis testing.

Assumptions

The OLS technique provides flexibility for the use of dummy variable coding to include grouped explanatory variables and data transformation methods (Moutinho and Hutcheson 2009). It is powerful mainly for its ability to test the model assumptions. Assumptions of multiple regressions include ratio of cases to independent variables, normality, multi-collinearity and singularity, linearity, homoscedasticity and independence of residuals (Tabachnick and Fidell 1996, 132-139; Pallant 2007, 148-149).

Assessment of those assumptions is conducted prior to the regression analysis to avoid statistical problems. One assumption to be met is the ratio of cases to independent variables or sample size. Adopting the formula from Tabachnick and Fidell, the number in the sample size is calculated using $N \geq 50+8m$ where N equals to number of samples and m equals to the number of independent variables (IV). With the total IV is 10, the required N should be at least 130. Since this study uses the entire population of *Persero* SOEs with three consecutive years of data and 375 samples, the assumptions is not violated.

The normality assumption concerns the continuous variables, in that they should be close to a normally distributed condition (Allen and Bennett 2010, 180).. The assessment of normality is undertaken by investigating skewness and kurtosis. Both components can be inspected either statistically or graphically. However, Tabachnick and Fidell (1996) argue that assessing skewness and kurtosis values can be too

sensitive for large samples and thus suggest that examining the distribution shape to evaluate the normality as a better alternative. As this study is considered using a large sample, the assumption of normality is explored through graphs, i.e. histograms of variables.

On inspection the majority of the variable patterns, meet the normally distributed assumption, except for the histogram of *company size*. For this variable data transformation is undertaken to improve the distribution.

In order to resolve skewness in the data that occurs with *company size*, a logarithm method is applied. This is a common transformation method to produce normality if the figures are positively skewed (Field 2009, 155) and the distribution diverges substantially from normal (Tabachnick and Fidel 1996, 82; Pallant 2007, 87). Appendix E capture the result after the data has been log transformed, indicating that *company size* is more normally distributed.

Another potential violation of the assumptions of multiple regression analysis is the presence of multi-collinearity i.e. when two independent variables are highly correlated with each other as can be detected from their correlation coefficient. Statistics literature provides various limits on correlation coefficient as an indication of multi-collinearity, such as 0.80 (Gujarati 1995; Field 2009, 224), 0.85 (Allen and Bennett 2010, 181) or 0.90 (Pallant 2007). For the purpose of benchmarking, a 0.80 correlation coefficient is set as the limit. The Variance Inflation Factor (VIF) can also be a diagnostic tool to detect multi-collinearity (Field 2009, 224) as it gives an indication about whether a predictor has a strong liner relationship with another predictor. A value of VIF 10 or more is considered an indication of multi-collinearity. Therefore, this study will examine the correlation coefficient (produced by the correlation test) and the VIF (generated from a multi regression test) to assess the presence of multi-collinearity and whether the assumptions are violated. The assumption of homoceasticity is met when each level of predictor variables have the same variance. Homocedasticity presents a series of uncorrelated, purely random errors, ϵ, with the assumption of a normal distribution with mean zero and constant variance (Aczel and Soundarapandian 2005). The examination of homoscedasticity and linearity assumptions is conducted through residual scatterplots, which is

generated from the multiple regression procedure. The homocedasticity assumption is met if the variance of residuals about dependent variable is equal to all predicted scores. The linearity assumption is met when the residuals shows a straight-line relationship with dependent variables (Pallant 2007, 149). Results are presented in the section below.

6.3. Correlation Analysis

This section examines the relationship among dependent, independent, and control variables and the level of association among variables observed. As previously mentioned, this analysis investigates correlations based on the Pearson approach. Table 6.1 demonstrates the correlation matrix between the dependent variable (ROA) and both independent and control variables. The result suggests that based on the Pearson correlation, coefficient correlations between SOE financial performance and governance related involvement provide preliminary support for *CEO external appointment, chairperson external appointment, government related commissioners in the BOC, and number of board sub-committees*, with the highest correlation occuring between *ROA* and *number of board sub-committees* (Coef: 0.286, $p<0.01$). With regard to financial involvement, *ROA* appears to have highly significant association with both *government transfer* and *dividend payout policy* (Coef: -0.092 and 0.469, $p<0.01$). None of the regulatory involvement associated variables seems to have initial support. In addition, among others, coefficient correlations of five control variables, *history of establishment, size (log), capital intensity (dummy), leverage* and *year 2009 (dummy)* indicate the presence of significant correlation with ROA, with *leverage* the highest correlation coefficient of -0.358 with $p<0.01$). Therefore, based on Table 6.1, it concludes that coefficient correlations provide initial support for hypothesis 2 (H_2: *CEO external appointment*), hypothesis 3 (H_3: *Chairperson external background*), hypothesis 5 (H_5: *government related commissioners in the BOC*), hypothesis 6 (H_3: *number of board sub-committees*), hypothesis 7 (H_7: *government transfer*) and hypothesis 8 (H_8: *dividend payout policy*).

Table 6. 1: *Pearson correlation analysis of the ROA and government intervention*

Variables	*ROA*	
	Coef.	*Sig.*
1. OWN	129***	0.007
2. CEO	-.096**	0.034
3. CHAIR	.089**	0.044
4. BOD	0.020	0.354
5. BOC	-.130***	0.006
6. SC	.286***	0.000
7.TF	-.092**	0.040
8.DIV	.469***	0.000
9.AT	0.06	0.126
10.LEG	0.020	0.352
11.HIST	-.086**	0.049
12.SIZ	.220***	0.000
13.CI	.183***	0.000
14.IC	-0.041	0.219
15.LEV	-.358***	0.000
16.YR08	0.008	0.443
17.YR09	0.083*	0.057

Note: *** Correlation is highly significant at the 0.01 level (1-tailed). ** Correlation is significant at the 0.05 level (1-tailed). * Correlation is moderately significant at the 0.10 level (1-tailed). Independent Variable: OWN=Government ownership; CEO= CEO external appointments; CHAIR = Chairperson external appointment ; BOD = The proportion of government related directors on the BOD; BOC = The proportion of government related commissioners in the BOC; SC = The number of Board sub-committees; TF = Government transfer payment in the form of subsidies or PSO (government transfer); DIV =Dividend payout policy; AT= Asset transfer from central government to SOEs (asset transfer); LEG= Legal case resulting from non-compliance with regulation (legal case). Control Variables: HIST= History of Establishment; SIZ= LogSize; CI=Capital intensity; IC = Industry competition; LEV = Leverage; YR08=Year 2008; YR09= Year 2009.

Investigation of relationships between independent variables are presented (Table 6.2). G*overnment ownership* correlates with all governance related variables, except *CEO external appointment.* The coefficient correlations are all highly significant with the highest correlation between *government ownership* and *number of board sub-committees* (Coef.:-0.364, $p<0.01$).

Coefficient correlation detects an association between *government ownership* and all financial related variables and between *government ownership* and all regulatory framework related variables. Among others, *dividend payout policy* experience the highest (Coeff.: -0.218, $p<0.01$), followed by *legal case* (Coeff.: -0.150, $p<0.01$).

Table 6. 2: *Pearson correlation analysis of independent variables and control variables*

Variable		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.OWN	Coeff.	-0.129***																
	Sig.	0.007																
2.CEO	Coeff.	-0.06*																
	Sig.	0.127																
3.CHAIR	Coeff.	-.275***	.161***															
	Sig.	0.000	0.001															
4.BOD	Coeff.	.150***	-.712***	-.202***														
	Sig.	0.002	0.000	0.000														
5.BOC	Coeff.	.301***	-.131***	-.508***	.240***													
	Sig.	0.000	0.006	0.000	0.000													
6.SC	Coeff.	-.364***	.099**	.208***	-.226***	-.264***												
	Sig.	0.000	0.030	0.000	0.000	0.000												
7.TF	Coeff.	.106**	-0.017	-0.063	-0.052	0.024	.133***											
	Sig.	0.021	0.373	0.115	0.163	0.325	0.005											
8.DIV	Coeff.	-.218***	-0.011	0.061	-0.058	-.116**	.358***	0.014										
	Sig.	0.000	0.415	0.122	0.134	0.013	0.000	0.397										
9.AT	Coeff.	0.083*	-0.035	-.094**	0.017	0.082*	.135***	.234***	.173***									
	Sig.	0.056	0.252	0.036	0.371	0.059	0.005	0.000	0.000									
10.LEG	Coeff.	-.161***	.114**	.139***	-.143***	-.144***	.327***	.221***	.172***	.175***								
	Sig.	0.001	0.015	0.004	0.003	0.003	0.000	0.000	0.000	0.000								
11.HIST	Coeff.	.090**	.136***	-0.023	-0.029	.122***	-.270***	-.235***	0.027	0.005	-.138***							
	Sig.	0.043	0.005	0.327	0.290	0.010	0.000	0.000	0.302	0.465	0.004							
12.SIZ	Coeff.	-.232***	.104**	.197***	-.243***	-.288***	.671***	.244***	.448***	.212***	.418***	-.242***						
(log)	Sig.	0.000	0.023	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000						
13.CI	Coeff.	-.244***	-.122***	-.167***	0.055	.112**	.326***	0.063	.188***	.313***	.100**	-.155***	.141***					
	Sig.	0.000	0.010	0.001	0.147	0.016	0.000	0.116	0.000	0.000	0.028	0.002	0.003					
14.IC	Coeff.	-0.002	-0.003	.205***	-0.009	-.114**	-0.016	-.201***	-.101**	-.409***	-.101**	-.128***	-.122***	-.335***				
	Sig.	0.485	0.480	0.000	0.435	0.015	0.381	0.000	0.027	0.000	0.026	0.007	0.010	0.000				
15.LEV	Coeff.	0.018	0.050	.146**	0.009	-0.044	-0.048	0.000	-.348**	-.293**	0.066	-.159**	0.016	-.184**	.364***			
(log)	Sig.	0.366	0.171	0.003	0.428	0.201	0.180	0.498	0.000	0.000	0.103	0.001	0.379	0.000	0.000			
16.YR08	Coeff.	0.366	0.171	0.003	0.428	0.201	0.180	0.498	0.000	0.000	0.103	0.001	0.379	0.000	0.000	0.046		
	Sig.	0.454	0.223	0.270	0.442	0.373	0.378	0.489	0.427	0.240	0.439	0.440	0.310	0.490	0.373	0.268		
17.YR09	Coeff.	-0.005	0.012	-0.015	-0.047	0.047	0.033	0.000	0.018	0.078	-0.012	-0.004	0.036	0.008	-0.014	-0.051	-.497***	
	Sig.	0.461	0.410	0.391	0.185	0.183	0.262	0.500	0.363	0.069	0.413	0.467	0.249	0.441	0.396	0.165	0.000	

Note: *** Correlation is highly significant at the 0.01 level (1-tailed). ** Correlation is significant at the 0.05 level (1-tailed). * Correlation is moderately significant at the 0.10 level (1-tailed). Independent Variable: OWN=Government ownership; CEO= CEO external appointments; CHAIR = Chairperson external appointment ; BOD = The proportion of government related directors on the BOD; BOC = The proportion of government related commissioners in the BOC; SC = The number of Board sub-committees; TF = Government transfer payment in the form of subsidies or PSO (government transfer); DIV =Dividend payout policy; AT= Asset transfer from central government to SOEs (asset transfer); LEG= Legal case resulting from non-compliance with regulation (legal case). Control Variables: HIST= History of Establishment; SIZ= LogSize; CI=Capital intensity; IC = Industry competition; LEV = Leverage ; YR08=Year 2008; YR09= Year 2009.

It is also relevant to highlight interactions among independent and control variables. As documented in Table 6.2, significant correlation is found between *CEO external appointment* and *government related directors on the BOD* (Coeff.: -0.712, $p<0.01$),

chairperson external appointment and *government related commissioners on the BOC* (Coeff.: -0.508, p<0.01), and *number of board sub-committees* and *government related commissioner on the BOC* (Coeff.: -0.264, p<01). In financial related variables, a high correlation is shown between two variables: *dividend policy* and *the number of board sub-committees* (Coeff.: 0.358, p<0.01). In the regulatory framework related variable, highly significant correlation is shown between *legal case* and all independent variables. With reference to control variables, *size* is the only control variable that indicates the presence of significant to highly significant correlations with all independent variables. Capital intensity is another influential factor for most of the independent variables.

To conclude Table 6.2 infers that *government related directors on the BOD* and *CEO external appointment* are two independent variables with the strongest correlation (Coef: -0.712, p<0.01), while the *number of board sub-committees* and *size* show the *highest* correlation between independent and control variables (Coef: 0.671, p<0.01). All coefficients in Table 6.1 and Table 6.2 are below the critical limit of 0.80 (Field 2009, 149). This signifies that multi-collinearity amongst independent variables is not a serious issue in this analysis.

6.4. Multivariate Regression Analysis

The Ordinary Least Square (OLS) regression analysis is executed as the main statistical method to test the hypotheses in this study. The analysis helps to model how SOE performance in Indonesia can be predicted by the explanatory variables The model tests pooled data association between one dependent variable (*Return on Assets)* and 17 predictors comprising 10 independent variables and 7 control variables. The independent variables consist of *Government Ownership, CEO External Appointment, Chairperson External Appointment, Government Related Directors on the BOD, Government Related Commissioners on the BOC, Number of Board Sub-Committees, Government Transfer, Dividend payout policy, Asset Transfer* and *Legal Case;* while the control variables include *History of Establishment, Size, Capital Intensity, Industry Competition and Leverage, Year08 and Year09*.

The dependent variable is metric, whereas independent variables and control variables are both metric and categorical. The regression model is as below.

$$ROA = \beta_0 + \beta_1 OWN + \beta_2 CEO + \beta_3 CHAIR + \beta_4 BOD + \beta_5 BOC + \beta_6 SC + \beta_7 TF + \beta_8 DIV + \beta_9 AT + \beta_{10} LEG + \beta_{11} HIST + \beta_{12} LogSIZ + \beta_{13} CI + \beta_{14} IC + \beta_{15} LEV + \beta_{16} Yr08 + \beta_{17} Yr09 + \epsilon$$

β_0	*= Intercept*
ROA	*= Return on Assets*
OWN	*= Government Ownership*
CEO	*= CEO External Appointment*
CHAIR	*= Chairperson External Appointment*
BOD	*= Government Related Directors on the BOD*
BOC	*= Government Related Commissioners on the BOC*
SC	*= Number of Board Sub-Committees*
TF	*= Government Transfer Payment in the Form of Subsidies or PSO or Government transfer (dummy)*
DIV	*= Dividend Payout Policy*
AT	*= Asset Transfer from Central Government to SOEs or Asset transfer (dummy)*
LEG	*= Legal case resulting from non-compliance with regulation or Legal case (dummy)*
HIST	*= History of Establishment*
SIZ	*= Company Size (log)*
CI	*= Capital Intensity*
INDC	*= Industry Competition*
LEV	*= Leverage*
Yr 08	*= Year 2008 (dummy)*
Yr 09	*= Year 2009 (dummy)*

The hypotheses in this study are directional and a one-tailed test for significance of independent variables is applied (Bryman and Cramer 2005, 136). The p-values generated from the regression analysis in this study are interpreted at the 5% significant level ($p<0.05$). The reason for using one-tailed test at 5% significant level is for consistency and comparability with prior social studies, eg Setyadi (2009).

Before running the OLS regression test, possible outliers of dependent variable (ROA) are detected. Multiple regression is very sensitive to outliers, therefore both univariate outliers and multivariate outliers are observed and the course of action for

each level is decided. Univariate outliers, where cases with extreme values on the dependent variable, are detected graphically with boxplots. The result identifies 9 possible outliers. Allen and Bannett (2010, 182) suggests that deleting outliers leads to a more robust model. Hence 9 outliers are excluded resulting in 366 remaining samples.

Multicollinearity is tested using the Variance Inflation Factor (VIF) and tolerance score in order to test the assumptions of multiple regression. The VIF value of 10 or above is an indication of multicollinearity in the data sample (Pallant 2007, 155-156; Field 2009, 224). The tolerance score, in converse, shall be above 0.1 or otherwise is identified as a serious problem of multicollinearity. According to the test results, there is no evidence of multicollinearity. The result is presented in Table 6.3.

Multivariate outliers are detected using the Cook's distance score. Field asserts that the Cook's distance counts the effect of every case on the model as a whole. The Cook's distance score of 1 or above shows the presence of an outlier issue (Field 2009, 217). The test result indicates that no value is more than 1 suggesting no multivariate outliers exist.

The OLS regression test result associating various government intervention related predictors with company performance (ROA) is presented in Table 6.3. According to the model summary, the value of the adjusted R-square score of the model is 0.324 at the F-value of 1% level of significance (F-stat=11.269, $p<0.01$).

Amongst independent variables, three governance related variables are significant predictors of the extent of ROA. These include *government ownership, Chairperson external background* (both moderate significant at p-value<0.10) and *number of board sub-committees* (significant at p-value<0.05). Two variables related to financial involvement (*government transfer* and *dividend payout policy*) are found highly significant (each p-values<0.01). Only one variable from regulatory framework related involvement (*asset transfer)* is a moderately significant contributor to ROA. Among control variables, *leverage* is regarded as highly significant predictors with p-value<0.01 while the remaining control variables are significant (*history of establishment, capital intensity* and *Year 2009* with p-values<0.05).

Table 6. 3: *Multiple regression analysis: Return on Assets*

Model Summary	
N	366
R-Squared	0.355
Adj. R-Squared	0.324
F-statistic	11.269
Significance	0.000[b]

	Variables	Predic-ted sign	Unstd. Coef.		Std.		Sig.	Collinearity Statistics	
			B	Std. Error	Beta	t	(1-tailed)	Tole-rance	VIF
Indpendent Variables	(Constant)		(1.003)	10.831		(0.093)	0.463		
	H_1 - OWN	NEG	6.010	3.869	0.079	1.553	0.061 *	0.714	1.400
	H_2 -CEO	POS	(1.140)	2.094	0.035)	(0.544)	0.293	0.455	2.200
	H_3 -CHAIR	POS	2.026	1.402	0.076	1.445	0.075 *	0.665	1.503
	H_4 -BOD	NEG	2.041	4.024	0.033	0.507	0.306	0.440	2.271
	H_5 -BOC	NEG	(2.613)	2.572	(0.054)	(1.016)	0.155	0.646	1.547
	H_6 -SC	POS	1.032	0.575	0.118	1.794	0.037 **	0.425	2.351
	H_7 -TF	NEG	(5.549)	2.187	(0.122)	(2.537)	0.006 ***	0.799	1.252
	H_8 -DIV	POS	23.512	3.920	0.327	5.998	0.000 ***	0.622	1.607
	H_9 -AT	NEG	(2.293)	1.813	(0.065)	(1.265)	0.103	0.709	1.410
	H_{10} -LEG	NEG	(1.356)	1.542	(0.043)	(0.880)	0.190	0.777	1.287
Control Variables	HIST		(1.860)	1.145	(0.079)	(1.625)	0.053 **	0.775	1.290
	SIZ (log)		0.098	0.759	0.009	0.129	0.449	0.382	2.619
	CI		2.339	1.161	0.110	2.014	0.022 **	0.620	1.612
	IC		0.773	1.347	0.031	0.574	0.283	0.644	1.552
	LEV		(6.448)	1.137	(0.289)	(5.669)	0.000 ***	0.714	1.400
	YR08 (dummy)		1.404	1.127	0.063	1.246	0.107	0.736	1.359
	YR09 (dummy)		2.206	1.127	0.098	1.956	0.026 **	0.732	1.367

Note: ***Highly significant at p<0.01 (one-tailed).** Significant at p<0.05 (one-tailed).*Moderate significant at p<0.10 (one-tailed). [a] Dependent Variable: ROA [b.] b. Predictors: (Constant), Year 2009 (Dummy), Government Transfer (dummy), CEO External Appointment , Dividend Payout Ratio, Chairperson External Appointment, History of Establishment , Capital Intensity , Legal Case, Leverage, Asset Transfer (dummy), Government Ownership , Year 2008 (Dummy), Government Related Commissioners on the BOC, Industry Competition , Number of Board Sub-Committees, Government Related Directors on the BOD, Size log.

To conclude, the main analysis reveals that there is significant support for hypothesis 3 (H_3: *chairperson external experience*), hypothesis 6 (H_6: *number of board sub-committees*), hypothesis 7 (H_7: g*overnment transfer)* and hypothesis 8 (H_8: *dividend*

payout policy) suggesting that these variables make the strongest contribution to explaining the SOE financial performance. For hypothesis 5 (H_5: *government related commissioners on the BOC*), hypothesis 9 (H_3: *asset transfer*) and hypothesis 10 (H_{10}: *Legal case*), the evidence failed to support these hypotheses. Table 6.9 summarizes the hypotheses result.

6.5. Interview: Additional Analysis

6.5.1. Semi-structured Interview

The univariate analysis has indicated strong government involvement in many ways, including dominant voting rights and strong influence in the governance process of BOD and BOC as well as dominant intervention in financial activity. Moreover, the result of multivariate analysis suggests that CEO, Chairman, and BOC size have positive relationship with financial performance, both BOD and BOC result in negative association with financial perfomance, but only Chairman and BOC size that indicate highly significant relationship. To understand comprehensively the government intervention level, an extended qualitative information is required.

To do so, in this study, an interview process was conducted following the quantitative data collection. The interviews serve two main objectives. First, to improve the validity and reliability of the overall result (Saunders, Lewis and Thornhill 2009, 320). The qualitative result is useful to support the quantitative data, mainly sourced from the financial statements and government documents. Thus, it is expected the collection of qualitative data from this set of interviews can confirm or otherwise the robustness of the findings as well as adding richness and depth to the discussion as a whole. Second, is to explore new information and perceptions of key players that explains the SOE's situation in the absence of such information in the financial statements and other sources used for this study.

It should be noted that this interview has been conducted to supplement the main analysis. It focuses on an explanatory approach to understanding and interpreting phenomena as well as interpreting the quantitative results in the main analysis. It is

not intended to build the hypotheses as it might be used in the mixed-method context. Because of this, all interviews were conducted after the quantitative analysis was completed.

For the best results, semi-structured interviews were conducted. There were several advantages of adopting such a method for this study. First, the semi-structured interview technique offered an opportunity for discussion and to elicit a broader range of issues, opinions and views of interviewees (Saunders, Lewis and Thornhill 2009, 230). Second, the technique gives the freedom to explore further explanations required in particular areas in detail by maintaining the consistency across interviews. Third, the form of the interview is more flexible than a structured interview, yet more focused than a non-structured interview. Dunn (2005) explains that a predetermined order, yet still maintaining the flexibility in addressing the issues, is possible in this technique. Last, a semi-structured interview is conversational and informal in tone. It allows for an open response in the participant's own words. In this interview, the majority of the questions addressed were in the form of open-ended questions (what, why or how questions). This was intended to allow respondents to express their fresh and personal opinion on the actual circumstances.

6.5.2. Sample Selection and Demographics

To choose respondents, purposive sampling is applied. Saunders, Lewis and Thornhill (2009, 237) assert that purposive sampling allows the examiner to select issues that provide the best answers to the research questions as well as meeting the research objectives. In this investigation, the respondents met the following conditions: First, a respondent must be in a key position, either in an SOE or government institution that relates to SOEs. Second, the position held should be within any year of the observation years (2007 to 2009).

Saunder, Lewis and Thornhill suggest that in purposive sampling, it is the purpose and the concentration of the study that matters more than the sample size (2009, 233). Therefore, among 125 SOEs involved in this study, 13 respondents were selected from two groups that represented the key players of 13 SOEs (10 per cent of the total SOEs covered in this study), comprising government (n=7) and SOE (n=6).

The first group consisted of seven respondents. They were either current or former senior government officers who had BOC membership experience. Among these seven, one is a former top level government officer, one is a current top level government officer, and the remaining five are the second top level government officers from either the Ministry of SOE or Ministry of Finance. The rationale to select this group was due to the context of variables of which government involvement is relevant to their experience. Current or former senior government officers were selected because of their experience in the role of making regulations and policy in relation to SOEs as well as monitoring the impact of the implementation. The chairperson and members of the BOC from both government offices and non-government offices were included as interview participants because they could contribute to specific areas of this study that were relevant to their role on the BOC. In addition, the chairperson and members of the BOC were chosen from small, medium and large SOEs so that all groups of company size were represented.

The second group comprised six respondents with BOD membership experience (either current or former) representing all size company groups (small, medium and large). With similar backgrounds to the first group, CEOs or members of the BOD, both from inside and outside, were also invited to participate in this interview to share their specific insight on related governance issues. In particular chief financial officers (CFO) were targeted to elicit information related to financial and regulatory frameworks related government intervention. The information on the demography of the respondents contributing to this interview is presented in the table 6.4 below. The abbreviations used as a code is G for government (G1–G7) and S for state-owned enterprise (S1-S6).

Table 6.4: *Respondents demographics*

Respondent Code	Organisation Type	Position	SOE Size Group
G1	Government	Former Top Level Officer, GMS, BOC	Large
G2	Government	Former Senior Officer, Proxy GMS, BOC	Medium
G3	Government	Senior Officer, Proxy GMS, BOC	Medium
G4	Government	Senior Officer, Proxy GMS, BOC	Small
G5	Government	Senior Officer, Proxy GMS, BOC	Large
G6	Government	Senior Officer, Proxy GMS, BOC	Small

Table 6.4: *Respondents demographics (continued)*

Respondent Code	Organisation Type	Position	SOE Size Group
G7	Government	Senior Officer, Proxy GMS, BOC	Small
S1	SOE	Former CEO	Medium
S2	SOE	Director	Small
S3	SOE	Director	Large
S4	SOE	Director (CFO)	Large
S5	SOE	Director (CFO)	Medium
S6	SOE	Director (CFO)	Small

After determining the sample, an invitation letter was sent to each respondent. The letter informed them of the research objectives and significance. Informal contact with relevant colleagues or their secretary was made to confirm the interview and set up an interview schedule. Once confirmed, the respondents were asked to sign a consent letter to take part in the interview. All interviews were subject to the respondents' voluntarily agreement. Some interviews were rescheduled several times. Due to their very tight time availability, the duration of the interview varied yet most of them were at around 60 to 90 minutes length. All interviews were per respondents' convenience in time and place. Therefore, there were no unnecessary interruptions during the interview process. Prior to interview, respondents were briefed on the interview protocol, research questions and objectives, and information that the respondents were expected to share. All interviews were communicated in the Indonesian language. The majority of the respondents agreed to the interview being tape-recorded. Two respondents declined to be recorded thus the interview was documented by writing notes.

6.5.3. Technique and Approach

The interviews were intended to understand and interpret phenomena about government involvement in SOE's operations to further explain the findings identified in the main analysis. Because it adopted a semi-structured technique, questions addressed to the interviewees were tailored and different one to another. The questions, however, were constructed into three groups, i.e. governance related, financial related and regulatory framework related government involvement. Each

respondent received at least one set of group questions that were tailored to the context of the person's relationship with the SOE. A respondent could be addressed with more than one group of questions depending upon their background and experience relevant to the issue. For example, a respondent with a background as a senior government official at the Ministry of SOE was asked questions related to government involvement in governance and regulatory frameworks. A person currently serving as chief financial officer received a question related to government involvement in financial and regulatory frameworks. Starting with basic questions, the interview was developed and directed to more specific information that the respondent was familiar with.

After conducting 13 interviews, all data was gathered. Transcripts in Indonesian were prepared immediately after a group of first interviews was completed so that all significant information was recalled and captured while they were still fresh in the researcher's memory. Transcripts of each recorded interviews were done in Indonesian and contextual translation and interpretations were conducted only on the relevant parts.

Interestingly, the majority of responses provided by the interviewees showed some commonality. Therefore, the results of the interview are presented in two ways. First is by finding common terminology or phrases that could accommodate similar answers. All answers were then compiled, grouped and presented in a matriculation table based on the similarity of the answers. This provides information about the variety of views or opinion on the subject matter. Second is to present the results of the interview in the form of quotations of respondent statements. This was determined based on the respondent's statements that provided the most substantial information in further explaining the quantitative findings.

6.5.4. Results and Interpretation

Because it was a semi-structured interview, a set of questions was prepared starting with basic questions that led to further detailed questions. These basic questions were split into two groups, i.e. governance, financial and regulatory framework related government involvement. The first group of questions regarding government involvement in governance, was specifically aimed to mine information to explain

the results of hypothesis 2 (*CEO external appointment*), hypothesis 3 (*chairperson external experience*), hypothesis 4 (*government related directors on the BOD*) and hypothesis 5 (*government related commissioners on the BOC*). Table 6.5 presents the summary of interviews related to CEO and BOD member appointments in which the government may be involved in the governance process.

The summary of data depicts strong government involvement in the CEO appointment process. When 10 respondents were asked about the process of CEO selection (Question 1), they referred to the importance of the fit and proper test in generating a shortlist of CEO candidates. These candidates can be recommended by the BOD (4 respondents), BOC (3 respondents), directly by the Minister or the special team chaired by the President (8 respondents) or external stakeholder such as the Supreme Audit Institution (1 respondent).

The next question addressed the factors they considered when choosing a candidate (Question 2). The response to this question varied. As summarized in Table 6.5, the answer is condensed into seven factors. It shows that track record, leadership and performance are the three strongest factors that determined the selected CEO. Interestingly, respondents from the Ministry of SOEs responded differently using their own experience and context. On top of the criteria on the list for the fit and proper test, each respondent tended to have their own view on what characteristics were the most significant for a CEO to have, such as ability to work within a team, independence, being visionary, persistent and fearless in making tough decision that may disadvantage people from outside the company, the GMS or BOC. This indicates that the government impacts in selecting the CEO based on the personal preference of the selection team, which in this case is the deputy ministry unit.

The third question (Question 3) mines information on the factors affecting the choice of CEOs from outsider over internal candidates. In principle, there were four reasons explaining why an outsider was more preferable to an insider. This included the need for specific expertise that insiders may not have (10 respondents), the need to eliminate internal conflicts (1 respondent), the need to change corporate culture (7 respondents) and special requests from non-corporate intervention (2 respondents).

Table 6.5: *Summary of interview relating to CEO and BOD member appointment*

No	Question	Hypo-thesis	Answer	Respondent									
				G1	G2	G3	G4	G5	G6	G7	S1	S2	S3
1	What is the process of appointing CEO?	H2	Ministry of SOE (GMS) conducts fit and proper test	√	√	√	√	√	√	√	√	√	√
			BOD recommends CEO candidate from internal	√			√			√		√	
			BOC recommends CEO candidate from internal				√		√		√	√	
			Minister or joint-team led by the President decides their own candidate (prerogative)	√	√	√	√	√	√	√	√	√	√
			Others recommend a CEO candidate (eg. SAI)				√						
2	What is the important factor(s) to consider in CEO selection?	H2	One's leadership skill	√	√	√	√		√		√	√	√
			One's performance	√	√	√	√	√	√				√
			One's track record	√	√	√	√	√	√	√	√	√	√
			One's integrity	√	√	√		√	√	√			
			One's business competence				√	√	√	√	√		
			One's technical competence		√		√	√	√	√	√	√	
			Others (eg attitude, teamwork, independent, visionary)	√	√		√	√		√		√	√
3	What is the factor(s) to consider in appointing a CEO candidate from outside?	H2	The company is in need of specific expertise	√	√	√	√	√	√	√	√	√	√
			The company is in need for resolving conflict		√								
			The company is in need for corporate culture change	√	√			√	√	√	√		√
			Politically related special request		√						√	√	

Table 6.5: Summary of interview relating to CEO and BOD member appointment (continued)

No	Question	Hypo-thesis	Answer	Respondent									
				G1	G2	G3	G4	G5	G6	G7	S1	S2	S3
4	What is the important factor(s) to consider in BOD member appointment?	H4	Performance	√	√	√		√	√				√
			Work history/track record	√		√		√	√	√	√	√	
			Integrity	√	√			√	√	√			
			Business competence					√		√	√		
			Technical competence	√	√			√	√	√	√		√
5	What is the factor(s) to consider in appointing a BOD candidate from outside?	H4	The company is in need of specific expertise	√	√	√	√	√	√	√	√	√	√
			To meet the legal condition requirement						√				
			Politically related special request		√						√	√	
6	What is the factor(s) to consider to determine BOD size?	H4	Business complexity			√	√	√	√	√			√
			The need /problem of the company	√	√	√	√	√		√			
			Request from higher authority		√	√		√			√	√	√
			Company size (larger company, larger BOD size		√	√	√	√	√		√		
			CEO request for more members of BOD.	√									
			Level of industry competition					√					

Follow up investigation related to government involvement in governance, the questions were extended into the BOD related governance areas. Like CEOs, government involvement can be predicted to occur in the process of BOD member recruitment. The first question to interviewees (Question 4) was about the criteria for BOD member appointment. The responses varied and can be grouped into five answers with overall track record and technical competence the most frequently mentioned by the respondents (7 out of 10 respondents for each). Besides the two, performance, integrity and business competence were also stated as the criteria for selecting BOD members. It should be noted that these answers reflected the individual view of what was the main factor(s) they considered in nominating BOD members regardless of the fact that there was common guidance applied in conducting the fit and proper test of BOD member candidates.

Furthermore, the respondents were asked about the reason for nominating outsider candidates as BOD members, if they were facing the situation of preferring outsiders to insiders (Question 5). It is apparent that all ten respondents indicated that the outsider candidate was preferable if the company needed specific expertise in the absence of that expertise within internal candidates, one example of which was a finance specialist needed for the chief financial officer position. Another answer related to special requests with a political motive (3 respondents) and the need for legal compliance (1 respondent).

To gain more understanding of government involvement on the BOD member selection process, respondents were questioned about factors that determined the number of BOD membership (Question 6). Among various answers, the respondents stated that business complexity, the company needs, company size or special requests from authority were the strongest factors determining the BOD size. In addition, one respondent pointed out that CEO request or competition level in the industry could also influence the GMS decision on the BOD size.

The second part of government involvement in the governance group of questions investigated government involvement in the chairperson and BOC member selection. Table 6.6 summarises the essence of the interview.

Table 6. 6: *Summary of interview relating to chairperson and BOC member appointment*

No	Question	Hypo-thesis	Answer	Respondent									
				G1	G2	G3	G4	G5	G6	G7	S1	S2	S3
1	What is the important factor(s) to consider in chairperson appointment?	H3	One's track record	√				√	√			√	
			One's ability to handle political intervention		√								
			One's expertise or competence				√	√		√			
			One's integrity					√	√	√			
			One's knowledge about the industry				√	√		√			
			Minister of SOE (GMS)'s prerogative	√	√	√	√	√	√				
2	What is the important factor(s) to consider in BOC member appointment?	H4	One's accessibility to bureaucracy (networking)	√			√	√		√	√	√	√
			One's ability to evaluate BOD performance						√				
			One's track record in career			√		√	√	√			
			One's ability to control political intervention		√								
			One's integrity		√			√					
			Expertise or competency		√		√	√		√	√		
			Minister of SOE (GMS)'s prerogative	√	√	√	√	√	√				
			Politically related special request	√	√	√	√	√	√			√	
3	What is the factor(s) to consider in appointing a BOC member from independent (non-government)?	H4	Specific expertise to support business process	√			√	√	√	√			√
			Highly complex business			√			√				√
			Politically related special request	√	√	√	√		√				√
			Regulatory compliance (for public listed SOE)					√					
4	What is the ideal size for BOC?	H6	No basic rule for BOC size	√	√	√		√	√				
			At least equal to BOD size		√	√	√	√	√	√			√
			Depends on each industry regulation							√			

Ten respondents were asked to explain the criteria for electing the chairperson of the BOC (Question 1). A number of respondents confirmed that there was no clear standardised criteria for chairperson appointment as their answer indicated a GMS prerogative or Ministerial discretion (6 respondents). Other answers given to this question were due to the track record of the candidate (4 respondents), expertise in the specific area of competence, integrity of the candidate and knowledge about the company or industry (3 respondents for each answer) and ability to handle non-corporate intervention (1 respondent).

Question 2 surveyed the criteria for BOC member appointment. This question generated the most varied answers indicating that BOC membership was less regulated than that of BOD. This might be due to the absence of standardised criteria for BOC membership as well as the shareholder's prerogative in determining the criteria. It should be noted that among others, "special request" and "President or Minister's prerogative" were the main determinants of the appointment of BOC members (stated by 7 and 6 respondents, respectively) indicating that the BOC has more chance for non-corporate intervention. Other factors considered when selecting BOC membership included the power to provide access or networking to the government, ability to monitor the BOD, track record in his/her current position, ability to control intervention, integrity and specific competence.

Question 3 explored the factors explaining the reason for preferring an independent member to an ordinary member (government). The response to this question was varied with "specific need of expertise to support business process" and "political demand" as the most frequently mentioned by the respondents (each question has 6 respondents answering). Other factors suggested by the respondents were business complexity (3 respondents), regulations and company size (1 respondent each).

When the ideal number of BOC size was inquired about (Question 4), 5 respondents stated that there was no basic regulation. However, at least 7 people pointed out that the number of BOC should not exceed the number of BOD.

The second part of the interview addressed government involvement in the financial and regulatory frameworks, which both impact on government funding. This involved five respondents, comprising three chief financial officers in SOEs, one

director and one senior government officer. Six main questions were addressed to each individual. The questions were specifically targeting information with regard to hypothesis 7 *(government transfer)*, hypothesis 8 *(dividend payout policy)* and hypothesis 9 *(asset transfer).* The questions were aimed to seek the opinion of each respondent on the subject matter based on their respected role. Table 6.7 summarizes the interview results.

The summary of this interview stage provides some evidence that government involvement in financial or funding activities can be strongly influential. When the respondents were asked to describe their opinion on government involvement in relation to government transfer policy such as subsidy and public service obligation (Question 1), all of the respondents stated that government transfer is a government prerogative and that the decision is made by the government without t negotiation (one-way communication). When asked about the impact of government transfer to SOEs, the respondents claimed that government transfers created a loss for the SOEs since the costing calculated by the government as stipulated in the annual budget documents, is lower than the production cost required. All respondents shared a similar view that the budget execution, because often the amount paid was less than what was planned, did not follow as intended. For example, when an oil subsidy was provided to an oil company and the demand for the oil exceeded the quota; the company was forced to sell the oil to the public based on the subsidised price even though the company did not receive any compensation from the government. In such situation, the company would have to bear the cost.

Question 3 of the government involvement in financial issues questions, asked for respondent's opinions with regard to government involvement in dividend payout policy. Strikingly, all respondents agreed that dividend payout policy was another government prerogative. They also claimed that the process of dividend payout determination was one-way as the SOEs had to agree with the government's determination. Another statement by 4 respondents affirmed that the SOE bargaining power to negotiate the dividend payout ratio was low.

Table 6. 7: *Summary of interview relating to government transfer, dividend payout policy and asset transfer*

No	Pointer of question	Hypo-thesis	Answer	Respondent				
				G6	S3	S4	S5	S6
1	How do you view government transfers?	H7	The policy is government prerogative (The decision is made by one way communication by government)	√	√	√	√	√
2	How does a government transfer impact on SOE?	H7	Budget realization does not follow budget plan (amount, payment time, costing)	√	√	√	√	√
			It is non-profitable and create loss for SOE		√	√	√	√
			It creates moral hazard	√			√	
3	How do you view dividend payout policy?	H8	The policy is government prerogative (The decision is made by one way of communication)	√	√	√	√	√
			Low power of negotiation for SOE		√	√	√	√
			Subject to the need of financing for annual budget	√	√	√	√	√
4	How does the dividend impact on SOE?	H8	Dividend target outweigh SOE or too high target	√	√		√	√
			It suppresses investment plan		√	√	√	√
5	How do you view asset transfers?	H9	The decision is made by one way communication by government	√	√	√	√	√
			Asset provided is unmatched with the need				√	√
			It has limited value or benefit				√	√
6	How do asset transfers impact on SOE?	H9	Assets are obsolete and not optimal in function				√	√
			Assets are overvalued or overstated	√			√	
			It creates cost or inefficiency for SOE	√			√	
			It creates cost or inefficiency for line ministry (budget spender)	√				
			It creates accountancy problem. Unmatched with the need	√			√	√

Furthermore, all respondents viewed dividend payout policy as driven strongly by the need to cover government expenditure in the annual state budget. In addition, when the respondents were asked about the impact of the determined dividend payout on the SOEs, 4 of them also explicitly stated that the payout ratio set by the government was excessive, especially if the company already set an investment strategy. As such dividend payout policy was viewed as discouraging investment.

Lastly, Question 5 seeks opinion in relation to government involvement in regulating asset transfers from the central government to SOEs. As documented in the matriculation table, 4 respondents declared that asset transfers are a one-way communication from the central government indicating that it is at government's discretion to initiate an asset transfer. Question 6 attracted many views of the limited value or benefit that could be gained from asset transfer due to the minimum value or obsolescence of the assets. Several respondents claimed while asset transfer required SOEs to introduce the assets into their accounting record, the value of the assets provided by the government was often overvalued. Such accounting issues would lead to overstated capital expenditure, and distortion of their financial statements.

6.6. Discussion

6.6.1. Governance Related Government Involvement

Government Ownership

Proposition one hypothesizes that the level of government ownership has a negative impact on SOE performance. It infers that when ownership reaches a certain level, the majority owners are benefited by major or full control (Shleifer and Vishny 1997, 759), exploiting the minority shareholders. This leads to SOEs with more government ownership being less likely to maximise long-term profit than those SOEs with less government ownership. Therefore, hypothesis 1 proposes that "government ownership is negatively associated with SOE financial performance".

The investigation of the OLS regression test does not provide evidence that the proportion of government ownership associates negatively to the extent of ROA. A

plausible reason to explain this finding is to link it to earlier analysis. As exhibited in the univariate analysis result (Chapter 5 sub-section 5.4.1), Indonesian SOEs are majority owned by the Government with a mean (median) rate of 0.94 (1.00) for 2007-2009 (Table 5.3); about 81 per cent are fully owned and 12 per cent are 50-69% owned by the Government (Figure 5.2). This supports La Porta's finding (1999) that in companies with state or government ownership, the government is typically the controlling shareholder.

The very high level of government ownership in the majority of sample companies (105 of 125 SOEs (84%) are greater than 90%) suggests that these dominate the results of those with lower ownership. The small portion of non-fully owned or dominant government owned SOEs does not allow for the financial performance of SOEs with low ownership to be discerned in the statistical analysis. This may explain why the result is inconsistent with that of Gunasekarage, Hess and Hu (2007, 20) whose study concluded that a high level of government ownership influences the company's performance negatively in China.

CEO External Appointment

An appointment of a CEO with an outsider background can be seen as a way of securing the interest of the principals since a CEO from outside may provide independent leadership that creates value for the organisation due to new information, competence and ideas (Said, Zainuddin, and Haron 2009; Karaevli 2007). The selection process of external CEO candidates benefits the organisation in a number of ways such as careful examination of the relevance of past experience and the future strategy of the company (Westphal and Fredrickson 2001, 1127) as well as pushing the appointed outsider to build commitment that should bring about the implementation more effectively (Finkelstein and Hambrick 1996, 192). Particularly in an unstable company environment, external CEOs can offer a more prospective transformation of the company (Virany, Tushman, and Romanelli 1992, 87). Following up the evidence of diverse studies, hypothesis 2 proposes that *CEO external appointment* relates positively to the SOE financial performance.

The univariate test documents that SOEs are dominated by internally appointed CEOs. The highest percentage of SOEs with CEOs from internal management/other

SOEs was 78.40 per cent in 2008 (Figure 5.3). Despite the decline in figures in 2009, the number of CEOs with a SOE career background is far larger than those from government and external (76 per cent). This describes the preference of the shareholders to select insiders to outsiders as appointed CEOs. One of the respondents, who has a background as the senior officer at the Ministry of SOE, raises the following:

> *There is no guarantee that outsider is always better than insider. We consider outsider depending upon the challenge the SOE is facing. If an SOE is in steady condition, we give priority to internal candidates to be the CEO. However, if the SOE is in turmoil, then we look for someone from outside. For example, to build a new corporate culture we need someone with strong leadership track record. To boost the performance of natural resource related SOE, we need someone with specific expertise (G1).*

The interview results, reveal that the GMS prefers an outsider as CEO in special circumstances, including need for specific ex pertise, need for conflict resolution, need for culture change and other special requests (Question number 3 on the Table 6.5). This statement is supported by the result of the univariate analysis. Table D.5 confirms that *CEO external appointment* varies among different *industry group*. SOEs from mining, basic industry and chemicals, infrastructure, utilities and transportation, finance and trade, services and investment are more likely to be led by an outsider. These are areas where specific expertise or corporate culture improvement are required.

With regard to external CEO appointment, the main analysis of OLS regression reveals an insignificant relationship between *CEO external appointment* and ROA; therefore hypothesis 2 is rejected.

In the interview, all ten respondents were asked two core questions about the CEO appointment process. Their answer was alike. First, when asked about the process of CEO appointment, they responded that the CEO appointment is strongly controlled by the Minister of SOEs. For SOEs categorized as strategic industries, the appointment involves a special taskforce comprising very high level government

officials (ministers) chaired by the President of the Republic of Indonesia. This taskforce is known as the Final Assessment Joint-Team[42] (known as *Tim Penilaian Akhir or TPA)*. They also shared commonality in that a fit and proper test takes place to assess CEO candidates. Such a process follows the State Owned Enterprise Law[43] that the appointment and dismissal of CEO and BOD members are done by the General Meeting of the Shareholders. This seems to be an attempt at practicing good corporate governance in the recruitment process, especially because the fit and proper test involves an independent third party in the assessment team. A senior government officer (G1) claims during the interview that:

> *Having established a CEO candidate, we appoint an independent consultancy agent to do the assessment or fit and proper test. The result is a short list of names for further interview before we make the decision (G1).*

Second, when respondents are asked about factors affecting CEO appointment, they refer to their own experience in the interview team or their opinion based on their knowledge about the interview process, that track record and leadership are the most important factors the team observed during the selection. Other important factors, such as performance, integrity, technical competence, business competence and other soft skills, are also mentioned. The emphasis on the background of the CEO from outside is only relevant for special cases because they believe that an internal CEO is as capable as that from outside. Therefore, the external appointment is not always viewed as the best option for an SOE depending upon the needs of the SOE.

Chairperson's External Experience

The third proposition affirms that a supervisory board (or Board of Commissioners) functions as an effective disciplining mechanism (Baums 2003) to resolve the emerging conflict of interest between principals and agents (Jensen and Meckling

[42] The Final Assessment Joint-Team is regulated by the Presidential Instruction Number 8 Year 2005 (the Appointment of Directors Members and/or Commissioners/Supervisory Board of State-Owned Enterprises) and the Presidential Instruction Number 9 Year 2005(The Amendment of Presidential Instruction Number 8 Year 2005.

[43] The State-owned Enterprise Law (No. 19/ 2003), the appointment and dismissal of CEO and BOD members are done by the General Meeting of the Shareholders (article 15 point 1). In the case of the Minister of SOEs are the GMS, then the selection and the replacement are done by the Minister (article 15 point 2).

1976). One of the keys for an effective supervisory board concerns the appointment of a chairperson of the BOC who acts on behalf of the General Meeting of Shareholders (GMS). An independent chairperson is generally experienced and an expert from outside the company (Sari, Halligan, and Sutiyono 2010). The appointment of a chairperson has a direct impact on promoting an effective disciplining mechanism and to guarantee a successful alignment between the interest of shareholders (the GMS) and the accomplishment of management (Jensen 1993) and therefore is a very critical element of governance in SOEs (Syakhroza 2005).

Univariate analysis shows the dominance of chairpersons from government offices (66.40 per cent in 2007) and its upward trend (72.80 per cent in 2009). The number of external chairpersons fluctuates reaching the peak to 21.60 percent of the total in 2008 and declines afterwards at the lowest level to 18.40 percent (Table 5.4).

Appendix D (Table D.6) documents that finance is the industry with the highest number of external chairpersons, followed by agriculture, basic industry and chemicals, property/real estate and building construction, and infrastructure, utilities and transportation. This finding is strengthened by the statements of the respondents who claim that being expert in an area and having competence/knowledge of the company or industry is one of the criteria for electing a chairperson (Table 6.6 question 1). According to one respondent (a senior government officer),

> *It is the minister's prerogative to decide a chairperson. Mostly, he considers the industry background of an SOE when inviting someone from outside as a chairperson (G3).*

The Pearson correlation test provides initial support to the proposition that a *chairperson's external experience* is correlated with SOE financial performance at a significant level. The main multivariate analysis shows that *a chairperson's external experience* is positively related to SOE financial performance at a moderately significant level. Accordingly, it allows the acceptance of hypothesis 3 (H_3: *Chairperson external experience*).

The Proportion of Government Related Directors on the BOD

The fourth proposition posits that an agency problem arises because of the separation of ownership and management functions. As a utility maximiser, managers can potentially take advantage of their expertise and accessibility to internal information for personal use, but at cost to the owner (Jensen and Meckling 1976; Shleifer and Vishny 1997) when the owner has a limited ability to monitor the company (Li 2008). An effective management board (board of directors) may resolve such agency problems, possibly by having a combination of insider and outsider directors in a company (Byrd and Hickman 1992; Erickson et al, 2005). Insider directors are usually favoured because of their knowledge about the company's day-to-day operations and regulations built from their experience working in the company (Bryd and Hickman 1992), while outsider directors are recruited because of their expertise, knowledge or experience in certain areas (Palmieri 1979; Erickson et al, 2005) that create value to the company they join (Said, Zainuddin, and Haron 2009).

In the context of SOEs, an insider director may come from someone inside the government or a military officer or inside the specific SOE or other SOE (Puspasari and Evans 2012a). A study by Frye and Iwasaki (2011, 643) on Russian government behaviour indicates that the tendency of the government to place government officers at better performing companies can give mutual benefits for both government and the companies. The presence of government officers in the company enhances corporate governance yet conversely worsens the practice of collusion between state directors and government officials. In contrast, the presence of outsiders on the board, as recognized by agency theory (Fama 1980; Fama and Jensen 1983), is believed to promote effective monitoring and therefore increase the company's value.

Descriptive statistics analysis documents a high proportion of government related directors on the BODs but with a declining trend over the three-years of observation. It starts with the mean of 0.92 in 2007 and slightly falls to 0.89 in 2009 (Table 5.5) indicating an increase of demand for external directors every year.

The Pearson correlation analysis of the Return on Assets and government related directors on the BOD does not support evidence of a significant correlation. Consistently, the OLS regression test fails to provide evidence that the presence of

government related directors on the BOD is a contributing factor to the negative financial performance of the SOE. Hence, hypothesis 4 is rejected.

There are at least six aspects of BOD composition uncovered by this study. The first relates to company size. A one-way ANOVA test, analyzing government representation on the BOD and its association with company size (Table D.7), shows that the larger companies are more likely to have less government related directors on the BOD.

The second factor determining BOD composition is business complexity. According to one respondent:

> *BOD size depends on the company size and business complexity. If the size is large yet the business process is not that complex, then there is no need for large number of BOC. In addition, the level of competition within the industry also affects the BOD size as happens in the banking sector (G4).*

Based on the respondent's statement, the level of competition is another factor in determining the BOD composition. The fourth factor relates to problems or issues a company is facing. According to one of former senior government officer in the Ministry of SOE:

> *When hunting for BOD candidates, we perform a need analysis based on the problems being faced by SOEs. From there, as we try to meet regulations, we also look for persons who can match with the existing problems. If we are unable to find an ideal composition of BOD, then usually we try to cover it from the composition of the commissioners (G2).*

Another statement referring to SOE specific problems that drives the BOD composition is expressed by a senior government officer as below:

> *We are seeking for outsiders for the purpose of building a better corporate culture. If the corporate culture is established already, then we prefer someone from internal SOEs (G2).*

Specific problems of an SOE can come from the need for specific expertise. For some industries where the SOE is the major player, such as plantations, the local experts might come from SOEs. In other words, technical expertise is stronger from inside SOEs than from outside. Meanwhile, for other industries, such as banking, outsiders are considered to have higher qualifications in the market than those from inside. A senior government officer from the Ministry of SOE explained in the interview that:

> *We used to have a policy to promote bankers or financial experts to become CEO or finance directors in many SOEs. Their presence is good for SOEs which are in the IPO preparation stage because they are innovative and knowledgeable in financial restructuring (G4).*

Another respondent seconds the above argument, saying that

> *For mining companies, we need to appoint a local expert who can approach and be acceptable by the local people, especially because it deals with natural resources (G7).*

The statements above are supported in Table D.8 presenting the outcome of the one-way ANOVA testing the difference in government related directors of the BOD among industry groups. The result suggests that SOEs from the mining industry, finance, trade, service and investment, basic industry and chemicals are more likely to have less government representation on the BOD compared to the remaining industry groups.

The last two factors influencing BOD composition are special requests, either from inside (CEO request) or from outside the SOE. This can be a case of political intervention. From five respondents who address this, one of them explained that

> *We receive an official letter from ministries, such as Ministry of Defence, Ministry of Industry, Minister of Research and Technology and Ministry of Transportation, proposing names of BOD candidates. We also receive requests from Parliaments, political parties and non-government organisation. They are stakeholders who also determine the company's sustainability (G3).*

Moreover, the special request can be very intrusive on the selection process. A respondent with the senior government officer and BOC experience comments that,

> *Decision bias is due to the presence of non-corporate intervention… Ministry of SOE office is the main gate for the intervention. This can be political intervention, non-government office intervention, media intervention and law enforment intervention (G2).*

The Proportion of Government Related Commissioners on the BOC

The fifth proposition is based on the premise of agency theory of the importance of separating decision management (eg executing decisions) and decision control (eg supervising decision) in order to perform an effective decision process (Fama and Jensen 1983, 304). The presence of a supervisory board or BOC is argued as the most important control for this (Bathala and Rao 1995, 59). Moreover, the board composition (proportion of independent board members in the BOC) is the enabling mechanism that alleviates agency conflicts in the company. Independent directors are effective monitors of the boards' decisions due to their independence and reputation (Fama 1980; Fama and Jensen 1983; Kaplan and Reishus 1990). On the other hand, a government officer on the board is suspected of being unable to perform independently (Hamzah 2007). They can be influenced by non-corporate interventions (Didu 2011a) that may jeopardize the quality of the BOC independence when they prioritize their personal agenda over the best interest of the organisation. Because of this, government related commissioners on the BOC are predicted to negatively impact on SOE financial performance.

The Pearson coefficient correlation analysis reveals that government related commissioners on the BOC are insignificantly associated with ROA. A consistent result is generated from the OSL regression test showing that government related commissioners on the BOC is not a significant predictor to determine SOE financial performance. Therefore, this study rejects hypothesis 5.

The interview result is used to investigate the rationale of this finding. Table 6.6 explains that there are a number of considerations in selecting the BOC composition. As identified, they include accessibility to bureaucracy, ability to evaluate BOD

performance, the track record of applicants, ability to control intervention from various stakeholders, integrity and specific expertise or competency. On top of these, additional factors are claimed by many respondents, i.e. the prerogative right of the Minister and special requests from the non-corporate sector.

It should be noted that BOC membership is a prerogative right of the Minister as the owner of single voting rights in the GMS in the fully owned companies or as the controlling shareholder in the majority owned companies. With such a condition, the decision on BOC size, composition and membership always adheres to the Minister's preference. Therefore, the method of selection and appointment of the BOC membership becomes a crucial as part of the governance mechanism. While the regulation does not stipulate specifically the mechanism for BOC appointment, the criteria is subjective to the situation as stated by a former senior officer in the Minister of SOE during the interview,

> *There is an absence of specific mechanism for BOC selection and appointment. All processes are subjective…. We are strict in three criteria, i.e. competence, integrity and professionalism. .....However, we have to accept the fact that special request does exist (G5).*

With regard to specific expertise, both ordinary commissioners (government related) and independent commissioners have a certain capability that can benefit the SOE. Ordinary commissioners include senior government officers, military/police/law enforcement officers and retired government /military/policy/law enforcement officers.

Senior government officers are high-level government officers from various ministries, including the Ministries of SOEs, Finance, Energy, Transportation and other line ministries which have a relevance to the industry the SOEs belong to. According to one respondent, a government representative on the BOC understands the processes of bureaucracy better than those from non-government. This benefits the SOEs. Moreover, they also to some extent gain networking opportunities and accessibility to the bureaucracy, including the minister, parliament, and policy makers that may help the SOEs to shorten the long bureaucratic process.

For military or ex-military (including army, navy, air force), their presence on the BOC can be very useful to circumstances that relate to security. For example, for SOEs related to the maritime or shipping industry, accessibility to authorities in the navy can stop some crimes from occurring on shore. Similarly, illegal logging and theft in the plantation, forestry, and mining industries can be controlled with the ex-army or police deploying their networks. A respondent states that,

> *It is good for an SOE to have army in the BOC…They have capability to communicate with their strong networks (G7).*

> *Placing strong figures, such as Head of Police, Commander or ex-commander, in SOEs' BOC are good since they have power to stop crime (G1).*

Independent commissioners have certain advantages that may not be found in ordinary commissioners. The main reason stated by many respondents was the specific expertise or competency they possess. According to a respondent with chairperson and BOC member experience:

> *Independent commissioners have an adequate level of technical competence or expertise in the industry that the government officers may not. Also, they have confidence to deliver their opinion without being afraid of losing their position in the BOC (G6).*

Another opinion by a respondent with BOC membership experience adds:

> *The choice of independent commissioners is closely related to corporate culture transformation. We observe that insiders that have been staying too long in the company may be resistant to change for a better working culture that might shift their comfort zone. In such circumstance, BOC is best served from independent commissioner.*

Independent commissioners on the BOC are invited for specific reasons based on their background. During the interviews, respondents with senior government experience in the Ministry of SOE or experience on BOCs name academics, professionals or experts from private companies, military/ex-military, law

enforcement officers, local community figures and retired government officers as independent commissioners. An academic is invited to be a BOC member because he or she can help develop the SOEs in the long-term. A respondent confirms that

> *We believe academicians have better sensitivity to the issue. We need them to help the board develop the SOE. Sometime we also involve academicians from local universities and invite their participation in the SOEs in their domicile (G2).*

A BOC member from a local community can benefit SOEs in local or remote areas where there is some sensitivity because they can be the intermediary between the SOEs and the local community. This approach is essential to resolve various sensitive issues concerning the environment, exploitation of natural resources, local economic development, local government income and redistribution and labour. According to one respondent,

> *We need local representations, scholars from the local university or local community leaders, as a bridge that connects the SOEs plan with the needs of the local community. Their voice represents the local government. Their strategic ideas can be accommodated (G5).*

Another respondent seconds this opinion. As he explains,

> *The local prominent figures can protect SOEs from avoiding unnecessary problems that may happen due to miscommunication. They can explain to the local community addressing the issues that arise (G2).*

To conclude, it is evident that both commissioners originating from government and independent commissioners benefit the supervisory function of the BOC in their own way. It is a logical approach to assume that a balanced BOC with both a corporate context (non-government members) as well as a political context (government members) can be more beneficial for the company. This may explain why a high number of government related commissioners on the BOC does not always have a negative impact on SOE performance.

Number of Board Sub-Committees

In the sixth proposition, it is stated that a check and balance mechanism is vital for minimizing agency problems that emerge as an impact of principal-agent relationships (Mallin 2004). One of the vital tools of this mechanism is to form a board sub-committee(s) to help the BOC monitor the managers (Weir, Laing, and McKnight 2001a, 9). The OECD's recommendation states that an SOE should establish a specialised sub-committee to support the board in performing its respective functions (2005) to help ease agency problems and eventually increase firm financial performance.

For this sample, a mean (median) of the number of board sub-committees is 1.34 (1.00) within the range of 0 to 6 (Table 5.7). At least 20 per cent of the SOEs have no sub-committee on board.

In the univariate analysis, support is given to the number of board sub-committees showing highly significant correlations with ROA. The OLS regression analysis finds a positive relationship to SOE financial performance and therefore allows the study to accept hypothesis 6.

With specific expertise, a sub-committee works for and is dedicated to help the BOC run their functions. As one of the respondents, who is a BOD member, also emphasizes:

> *A board sub-committee is in charge of data analysis on a specific area. The establishment of the board sub-committee needs people with specialty. Their presence is useful (S3).*

An effective board sub-committee relies on the independence and clear direction of the BOC. A respondent with experience in the BOD states that,

> *The type of sub-committees as well as the number of each sub-committee members is solely determined by the BOC. If not well-coordinated, they will create confusion and slow down our job because each individual work on their own, does not share with each other and overlap in what they do. However, when effective and the*

number of members of a committee is optimized, they consist of the expertise in particular field, they are better organized and more effective and lead to the result of much faster decision making by the BOC.

To sum up, an addition of board sub-committee(s) established by the BOC is shown to affect the performance of SOEs positively yet only when it is effectively managed.

6.6.2. Financial Related Government Involvement

Government Transfer Payment in the form of subsidies or public service obligation (PSO)

The next propositions are newly introduced to the area of study of government intervention in SOEs. Proposition 7 affirms that government transfer in the form of subsidy and public service obligations (PSO) leads to SOEs having anti-competitive behaviours (Tye 1980, 204). In common practice, subsidy which is aimed to help SOEs become competitive in the market, fails to achieve the goal since they have urgent demands for profit. Subsidy used to off-set the high cost of operations of the SOEs, promotes inefficiency (Sakai and Shoji 2010; Sidak 2002). Subsidy encompasses strong political intervention (Ritschel et al. 2003) with various types of risks involved, such as severe financial difficulties and environmental problems.

As for PSO, there seems to be no comparable international study. In this study, PSO is treated equally as subsidy because the PSO has similar characteristics. Both are government transfer funds allocated for the end-goal of providing goods and services to the public. Both are also highly regulated by government.

From the univariate analysis, the descriptive statistics show only a small number of SOEs receiving government transfer but with very significant value (26.01 per cent of the total operating revenue of 125 SOEs) as presented in the Figure 5.7 and the Table 5.14. Also the figure fluctuates with the peak in 2009. A mean comparison shows that the industry group has an influence in the determination of government transfer. Among nine groups, only four received a subsidy, comprising agriculture, mining (the highest mean), infrastructure, utilities, and transportation, and trade, service and investment (Table 5.15).

From the univariate analysis, support is given to government transfer and ROA indicating a significant correlation between both (Table 6.1). Consistently, the OLS regression test finds a highly significant relationship between government transfer and ROA allowing the acceptance of hypothesis 7 (H_7: *government transfer*).

The negative impact of government transfer may be related to the following reasons. First, according to the Central Government Annual Budget Law, the budget plan for government transfer, either subsidy or PSO, must follow the state budget mechanism. This means that government transfer is a government funding activity and is unilaterally set by the government. In the calculation, the government merely considers the production cost plus the percentage rate of the minimum profit margin. This may be because the main purpose of subsidy and PSO is to deliver the government's social agenda, not to provide opportunities for SOEs to run profitable businesses. Such motives with subsidy are common in other countries (Ritschel et al. 2003).

Second, instead of providing an avenue to earn profit, a government transfer was likely to create a loss. Interviews have confirmed the negative impact of government transfer activity. The result of the interviews consistently reported that the government transfer policy resulted in a loss of business. All five respondents agreed upon the government prerogative in government transfer activity (Table 6.7). Moreover, three of them stated that the funding transfer is solely one-way communication from the government causing the disparity between what the companies planned in the budget and what the government controls on their policy and subsidy or PSO budget allocation. One of the respondents, a chief financial officer (CFO) at one SOE, stated that:

> *…every year there is an evaluation on the PSO realization; and the next PSO prediction is always based on this realization data. However there is always a sudden change made by the Parliament at the end. This is problematic for us to sell the PSO goods while the amount of approved PSO and funding availability are uncertain (S3).*

Another respondent (a CFO from large size SOE) also emphasized that:

> *PSO policy leads to great loss for SOEs because any cost due to the excess of the quota [the work that was accomplished yet unpaid by the government because of the exceeding amount of PSO] became SOE's debt and the SOEs had to cover the loss (unpaid amount) (S4).*

Likewise, another CFO from medium sized SOE supports the previous arguments by commenting that:

> *PSO policy is unfair because it only takes into account the direct cost and disregards indirect cost. In addition, the realization of PSO policy is not the same as the plan (S5).*

To conclude, government transfer is a significant factor contributing to the decline of SOE financial performance. In the context of subsidy in international studies, the result is consistent with earlier findings studied by Tye (1980), Sidak (2002) and Wang and Wang (2013).

Dividend Payout Policy

While dividend policy can be driven by various factors, cash dividend is a reflection of a controlling shareholder using its power and position to control the corporate economy from individual investors (Wang, Manry and Wandler 2011). In particular, for Indonesian SOEs, the dividend payout ratio set by the government characteristically prioritises the needs of government. According to Patriadi, the approach and projection models for dividend policy prepared by the government (Ministry of Finance and the Ministry of SOE) are without specific formulation for optimal dividend policy as well as providing opportunity for SOE business development (2013, 4).

The univariate analysis shows an upward trend of SOEs paying dividends to the government, comprising 62 SOEs or 45.60 per cent of the total in 2009 (Figure 5.6). A test of one-way ANOVA concludes tha t there are significant differences amongst SOEs from different size groups where larger companies are likely to pay higher dividends. Another one-way ANOVA test using the industry groups reveals that industry sector is a substantial determinant for the presence of a dividend payout

policy, with certain industries having a greater dividend payout rate than others. The mining sector, infrastructure, utilities and transportation sector, and the finance sector are the groups with higher rates of dividend payouts and value.

Correlation analysis demonstrates that dividend payout policy is significantly correlated with ROA. Consistently, the multivariate data analysis provides evidence that dividend payout policy is a highly significant predictor of SOE financial performance. Hence, hypothesis 8 (H_8: *dividend payout policy*) is accepted.

Dividend payout ratio is determined by the government as part of the budget process because the government views dividend as a source of non-tax revenue. However, there is no fixed standard to formulate the rate of dividend of an SOE as it is driven by the current financial situation and political policy (Sunarsip 2012a, 30). Intervention in the dividend rate determination seems to be highly controlled by the government. A respondent with chief financial officer experience claims that

> *There is a chance for negotiation of the amount of the dividend with the government but not with equal bargaining power. The final decision on dividend payout is more a one-way communication by the Ministry of Finance as the ultimate shareholder (S4).*

This is confirmed by another respondent (a CFO):

> *Dividend payout policy on SOEs is more emphasized to meet the source of revenue of state finance rather than SOE's interest. The government relies heavily on this source and hence SOE investment plan is lower priority (S4).*

Dividend payout policy formulation begins with the government (Ministry of Finance and Ministry of SOE) setting a non-tax revenue for the state budget (Patriadi 2013). Each SOE prepares the initial data and submits it to the Ministry of SOE. Then the Ministry of SOE hands over the data to the Ministry of Finance for further decision-making within the Parliament. This was confirmed in the interview as one respondent explains:

Determination of the amount of dividends has to go through several processes, started from submission of data by SOE to the Ministry of SOE, from the Ministry of SOE to the Ministry of Finance and discussions between the Ministry of Finance and Parliament to determine the state budget. At this stage of discussion, the focus is only for the interest of the state, i.e. the state revenue. SOEs cannot say anything (S3).

When setting the target, the payout ratio can be extremely high, especially when it is compared with projected earnings. However, this seems to be an effective trigger for SOE management to strategize to meet the dividend target. A respondent from the BOD members of an SOE comments that:

The dividend payout policy set by the government is extremely high and to some extent as we wonder how we could pay that much of dividend. However, by the end of the day, surprisingly we meet the target because we generate more earnings and enforce greater efficiency (S3).

To conclude, this finding confirms that company size and industry specifics are two important determinants for the formulation of the dividend payout ratio. Also, the high dividend payout ratio targets motivate the management to work efficiently. Therefore a high dividend payout ratio is associated with SOE financial performance.

6.6.3. Regulatory Framework Related Government Involvement

Asset Transfer from Central Government to SOEs

Principal-agency problems in SOEs emerge as two goals of the government in controlling SOEs - social and political objectives and a profit maximization conflict. Hypothesis 9 is based on the asset transfer as another political interference leading to a decrease in performance. Despite the fact that the asset transfer policy is not based on profit orientation, this practice of regulatory intervention affects the operation and performance indicators of an SOE. The presence of an asset transfer itself is most likely recognized when audit findings related to asset transfer are announced by the Supreme Audit Institution.

The result of descriptive statistics analysis suggest the number of SOEs receiving asset transfers rose from 10 SOEs in 2007 to 16 SOEs or 12.8 percent in 2009. A mean comparison documents that only capital-intensive industries receive an asset transfer, including the infrastructure, utilities, and transportation industry (the highest mean of IDR 1,596 billion), mining industry and miscellaneous industry. This suggests that the receiving SOEs are selected by the industry category as the determinant factor.

Correlation analysis concludes that there is insufficient evidence to support a relationship between asset transfer and ROA. The OLS regression documents a positive direction with p=0.103 significant level. It signifies that the result does not support hypotheses 9 (H_9: *asset transfer*).

From the interviews, all five respondents claimed that asset transfer policy is a one-way communication. However, the number of companies receiving transferred assets is limited.

Legal Case Resulting from Non-compliance with Regulation

Lastly, hypothesis 10 views the need for a clear separation of function between government as the owner and as regulator (OECD 2004). Also, an assurance of an effective legal and regulatory framework for SOEs by the government is required for fair competition in the market. This means rules for private companies and state owned companies should be applied equally (OECD 2005).

Frequency distribution documents that about 12 percent of total SOEs experience violations against regulations that are bound to specific SOEs (Table 5.16). The independent sample t-test confirms that a significant difference exists between the groups of SOEs with legal cases and those without legal cases, suggesting that legal cases are more likely to occur in larger companies than smaller ones (Table 5.17). A comparison of these two groups by industry indicates that legal cases are mostly found in the infrastructure, utilities and transportation industry (4.53 percent) followed by the finance industry (2.67 per cent) (Table 5.31).

The multivariate analysis suggests a highly significant correlation exists between *legal case* and ROA. However, the OSL regression infers that *legal case* does not

contribute significantly to the SOE financial performance and therefore hypothesis 10 is rejected.

6.7. Sensitivity Test

The descriptive statistics and univariate analysis illustrate that the 125 companies range in company size ranging from very small companies (total assets less than IDR 1 trillion) to very large companies (total assets equal or more than IDR 50 trillion). Tests run using an independent sample t-test demonstrated find that company size is a factor influencing *government ownership, CEO external appointment, chairperson external background, government related directors on the BOD, government related commissioners on the BOC, number of board sub-committees, dividend payout policy* and *legal case* variables. Correlation analysis also documented consistent results indicating initial support for a relationship between company size and all independent variables (section 6.3 Table 6.2). It is therefore important to investigate whether the model is sensitive to company size.

The following sensitivity analysis assesses the robustness of the result from the main analysis and examines whether or not the results are sensitive to all government involvement related variables in the practice of Indonesian SOEs. To do so, unit measurement of *size (log)* is transformed back to metric data (the values of total assets) into categories (company size group). Size group contains Group 1 (total assets worth less than IDR 1 trillion), Group 2 (total assets worth between IDR 1 trillion and 10 trillion) and Group 3 (above IDR 10 trillion). Data of 2007 total asset value is used as the baseline to determine the size group of each sample.

Following that, 366 data are grouped into three. Accordingly, there are 185, 140 and 41 samples for group 1, group 2 and group 3, respectively. The multiple regression test is then replicated for each group. The analysis will examine whether the results of each group to demonstrate consistency with the main regression result.

As summarised in Table 6.8, the adjusted R-square score for group 1, group 2 and group 3 is 0.297, 0.654 and 0.757, respectively. Each regression model underlines

different key explanatory variables. First, Group 1 (SOEs with the total assets less than IDR 1 trillion) shows five variables statistically support the hypothesis with one of them highly significant (H_8: *dividend payout policy*). Hypothesis 2 (H_2: *CEO external appointment*), hypothesis 5 (H_5: *government related commissioners in the BOC*) and hypothesis 6 (H_6: *number of board sub-committees*) are also accepted suggesting that these variables make the highest contribution to explaining the SOE financial performance. Hypothesis 1 (H1: *government ownership*) should be interpreted with caution since there is limited sample for those with low percentage government ownership in this group (refer to Section 6.6.1). Second, for group 2 (SOEs with total assets between IDR 1 trillion and 10 trillion), it reveals that nine predictors are found statistically supporting, where five are moderate to highly significant contributors to the model. Therefore, hypothesis 3 (H_3: *Chairperson external experience*), hypothesis 6 (H_6: *number of board sub*-committees), hypothesis 7 (H_7: *government transfer*), hypothesis 8 (H_8: *dividend payout policy*) and hypothesis 9 (H_9: *asset transfer*) are accepted.

Table 6.8: *Sensitivity test for Return on Assets*[a]

Model Summary		Size Group 1: Total Assets < IDR 1trillion						Size Group 2: Total Assets IDR 1trillion - 10 trillion						Size Group3: Total Assets > IDR 10 trillion					
N				185						140						41			
R-Squared				0.297						0.654						0.757			
Adj. R-Squared				0.226						0.606						0.577			
F-statistic				4.152						13.562						4.207			
Significance				0.000						0.000						0.001			
Variables	Pred. Sign	Unstandardized Coefficients		Standardized	t	Sig.1-tailed		Unstandardized Coefficie		Standardized	t	Sig.1-tailed		Unstandardized Coefficients		Standardize	t	Sig.1-tailed	
		B	Std. Error	Beta				B	Std. Error	Beta				B	Std. Error	Beta			
(Constant)		-23.986	18.267		-1.313	0.095		12.821	22.618		0.567			-41.979	57.875		-0.725		
H1: OWN	NEG	10.017	7.467	0.101	1.341	0.091	*	-2.482	5.469	-0.034	-0.454	0.325		-5.632	12.160	-0.125	-0.463	0.324	
H2: CEO	POS	4.807	3.564	0.134	1.349	0.090	*	-1.953	3.060	-0.053	-0.638	0.262		7.213	4.023	0.370	1.793	0.043	**
H3: CHAIR	POS	-1.191	2.496	-0.037	-0.477	0.317		3.062	1.757	0.123	1.743	0.042	**	-3.026	5.209	-0.170	-0.581	0.283	
H4: BOD	NEG	8.769	7.138	0.121	1.229	0.110		-0.956	5.294	-0.015	-0.181	0.428		15.339	8.805	0.393	1.742	0.047	**
H5: BOC	NEG	-8.284	4.396	-0.152	-1.884	0.031	**	-3.092	3.457	-0.062	-0.894	0.186		12.704	5.896	0.348	2.154	0.021	**
H6: SC	POS	2.201	1.245	0.147	1.768	0.039	**	1.365	0.702	0.144	1.945	0.027	**	0.773	1.356	0.105	0.570	0.287	
H7: TF	NEG	-1.957	4.117	-0.034	-0.475	0.318		-7.304	3.002	-0.170	-2.433	0.008	***	-17.923	8.321	-0.714	-2.154	0.021	*
H8: DIV	POS	22.192	6.780	0.250	3.273	0.001	***	26.047	5.380	0.373	4.841	0.000	***	-5.189	10.454	-0.099	-0.496	0.312	
H9: AT	NEG	-1.849	6.064	-0.021	-0.305	0.380		-3.102	2.038	-0.123	-1.522	0.065	*	-3.090	4.057	-0.123	-0.762	0.227	
H10: LEG	NEG	0.555	3.363	0.011	0.165	0.435		-0.588	1.723	-0.019	-0.341	0.367		1.827	2.923	0.103	0.625	0.269	
HIST		0.834	2.034	0.029	0.410	0.341		-2.463	1.327	-0.120	-1.856	0.033		-9.665	3.169	-0.531	-3.050	0.003	***
SIZ log		1.031	1.376	0.062	0.749	0.227		0.573	1.681	0.024	0.341	0.367		4.388	3.803	0.361	1.154	0.130	
CI		3.797	1.911	0.167	1.987	0.024	**	-1.984	1.600	-0.100	-1.240	0.109		0.724	4.744	0.041	0.153	0.440	
IC		1.808	2.305	0.063	0.784	0.217		-1.783	1.940	-0.080	-0.919	0.180		0.434	3.933	0.022	0.110	0.457	
LEV		-4.691	1.539	-0.231	-3.048	0.001	***	-10.941	2.020	-0.452	-5.416	0.000	***	-30.775	6.802	-0.838	-4.525	0.000	***
Yr08 (Dummy)		1.831	1.812	0.077	1.010	0.157		0.794	1.339	0.037	0.593	0.277		3.686	2.678	0.200	1.377	0.091	*
Yr09 (Dummy)		4.532	1.861	0.192	2.436	0.008	***	-1.484	1.320	-0.070	-1.124	0.132		4.116	2.650	0.216	1.553	0.067	*

Note: ***highly significant at p<0.01 (one-tailed). **significant at p<0.05 (one-tailed). *moderate significant at p<0.10 (one-tailed). . Dependent Variable: ROA. a. Predictors: (Constant), Year 2009 (Dummy), Government Ownership , CEO External Appointment , Government Transfer (dummy), Legal Case , Asset Transfer (dummy), Number of Board Sub-Committees, Chairperson External Appointment, Dividend Payout Policy, History of Establishment ,.Leverage, Year 2008 (Dummy), Industry Competition , Log Size, Government Related Commissioners on the BOC, Capital Intensity , Government Related Directors on the BOD. c. Predictors: (Constant), Year 2009 (Dummy), History of Establishment , Capital Intensity , Log Size, CEO External Appointment , Legal Case , Government Related Commissioners on the BOC, Dividend Payout Policy, Government Transfer (dummy), Government Ownership , Year 2008 (Dummy), Number of Board Sub-Committees, Chairperson External Appointment, Asset Transfer (dummy), .Leverage, Government Related Directors on the BOD, Industry Competition. d. Predictors: (Constant), Year 2009 (Dummy), Chairperson External Appointment, Asset Transfer (dummy), .Leverage, Government Related Directors on the BOD, Government Related Commissioners on the BOC, Dividend Payout Policy, History of Establishment , Log Size, Year 2008 (Dummy), Industry Competition , Legal Case , Number of Board Sub-Committees, CEO External Appointment , Capital Intensity , Government Ownership , Government Transfer (dummy).

Lastly, for group 3 (SOEs with total assets more than IDR 10 trillion) four significant contributors to support the hypotheses (H_2: *CEO external appointment*; H_4: *Government related directors on the BOD*; H_5: *Government related commissioners on the BOC;* and H_7: *government transfer*).

Table 6.9 summarizes the multivariate tests: both the main analysis and sensitivity analysis. Group 2 generates the most consistent results with the main analysis. There are eight predictors in group 2 that match the result of the main analysis even though there is a slightly different level of significance. There are six results of group 1 that are consistent with that of the main analysis and four results of group 3 that is coherent with that of the main analysis. To conclude, the sensitivity test for examining the robustness reveals that only small to medium sized companies (group 1 and group 2) tends to conclusively support the main findings.

Table 6.9: *Summary of hypotheses result*

Independent variables	Pred. Sign	Main Analysis	Sensitivity Analysis		
			Group 1	Group 2	Group 3
H_1: Government ownership	(-)	-	-	S	S
H_2: CEO external appointment	(+)		S*	-	S**
H_3: Chairperson external experience	(+)	S*	-	S**	-
H_4 : Government related directors on the BOD	(-)	-	S	S	-
H_5: Government related commissioners on the BOC	(-)	S	S**	S	-
H_6: Number of board sub-committees	(+)	S**	S**	S**	S
H_7: Government transfer (dummy)	(-)	S***	S	S***	S**
H_8: Dividend payout policy	(+)	S***	S***	S***	-
H_9: Asset transfer (dummy)	(-)	S	S	S*	S
H_{10}: Legal case	(-)	S	-	S	-

Note: S*** : statistically highly supported with $p<0.01$. S** statistically supported with $p<0.05$. S*: statistically moderately supported with $p<0.10$. S statistically supported yet insignificant.

6.8. Concluding Comment

This chapter presents the results of analysis of the variables testing government involvement and its impact on SOE performance. The ten main hypotheses (H_1-H_{10}) are tested with the main regression model finding four of them as significant contributors.

The four hypotheses include H_3:*Chairperson external experience* relates positively to SOE financial performance. $H_{6:}$ *number of board sub-committees* relates positively to SOE financial performance. H_7: *government transfer* relates negatively to SOE financial performance and H_8: *dividend payout policy* associates positively with SOE financial performance. In addition, *history of establishment, capital intensity, leverage* and *year 2009 (dummy)* are statistically significant control variables.

The next chapter provides a further detailed analysis of all findings from univariate and multivariate testing. Additional qualitative data from the interviews will be added to confirm the quantitative results.

CHAPTER 7: CONCLUSION AND IMPLICATIONS OF THE RESEARCH

7.1. Introduction

In this chapter, a summary of the research methodology and key findings are presented. This is followed by a discussion of the implications of the findings. The limitations of the research and suggestions for future research conclude the chapter.

7.2. Summary of Hypotheses, Data Samples and Research Contexts

The hypotheses developed in Chapter 3 propose that government intervention is related to SOE financial performance. All SOEs are more than 50 per cent government owned, which gives the government ultimate power over all researched predictors. It extends the study of SOEs to test the impact of the high degree of control of the government on SOE financial performance in the Indonesian context.

The success of the SOEs financial performance is measured through Return on Assets, a recognised indicator of SOE financial performance. The magnitude of government control is cascaded into the form of intervention in the SOE governance system represented by ten key factors including CEO external appointment, chairperson background, government related directors on the BOD, government related commissioners on the BOC, the number of board sub-committees, government imposed transfer in the form of subsidy and public service obligation and dividend payout policy, asset transfer from central government to SOEs and legal action resulting from non-compliance with SOE specific regulations.

This thesis investigates the whole population of fully commercially based SOE groups, both listed (SOE *Persero Terbuka*) and non-listed (SOE *Persero*) from 2007-2009. Taking into account the entire 125 SOEs from all industry categories, the

investigation on government involvement on SOEs is based on secondary data from various sources, including SOE annual reports/financial statements and government documents, SOE performance reports and central government financial statements. Data sourced from the ANTARA database is also utilized. An interview process was undertaken to further investigate the findings.

The thesis provides new insight into a set of policy and regulation based actions by the government, as well as the level of control and how effective those intervention factors are in influencing the financial performance of SOEs.

7.3. Summary of Key Findings

Prior literature suggests mixed results on the impact of government ownership on SOE performance. Some report government as a factor inhibiting the SOEs performance with conflicting goals of profitability as well as a political goal of providing service to society (eg Dornstein 1976; Lin, Cai and Li 1998; Chang 2007; Nugroho and Wrihatnolo 2008; Siqueira, Sandler and Cauley 2009; Zhang and Rasiah 2013; Xiongyuan and Shan 2013). Others evidenced the increase of SOE performance with government intervention such as in Singapore (e.g. Feng, Sun, and Tong 2004; Chang 2007) and in China (e.g. Sun, Tong, and Tong 2002; Lu, Tao, and Yang 2010).

Indonesian state-owned enterprises are established as part of the Indonesian political system as mandated by the Indonesian Constitution (Section 2.5). This leads to having government involvement in almost every aspect of SOE operations.

Government influence appears under three authorities. First, the Ministry of SOEs, a proxy shareholder who controls the voting rights in the General Meeting of the Shareholders (GMS). This influence is extended to the BOD and BOC whose leader and members are selected by the GMS. Second is the government as the regulator of fiscal policy, which is represented by the Ministry of Finance. Third is authority in line ministries (depending upon the fields in which SOEs operate). This research

explores whether these governance, financial and regulatory measures influenced by government impact on performance in Indonesian SOEs.

The key findings of this research are summarised below. The main empirical analysis confirmed that SOE financial performance was influenced positively by the chairpersons' external experience, the number of sub-committees assisting the BOC and dividend payout. Meanwhile, SOE performance was affected negatively by government transfer in the form of subsidy and public service obligations. CEO external appointment, government related commissioners on the BOC, government related directors on the BOD, asset transfer and legal action were found to have no significant influence on SOE financial performance.

With regard to control variables, leverage was found to be the most significant factor with a negative relationship to SOEs performance. Interestingly, the history of SOE establishment was also associated negatively with SOE performance. This inferred that non-nationalised companies tend to perform better than companies with a nationalisation history. In contrast, capital intensity (measured by whether a company has a capital expenditure greater than 5 per cent of total assets) displayed a positive relationship with SOE performance.

The sensitivity analysis revealed that company size was a significant determinant factor in assessing the impact of the independent variables on SOE performance. The small to medium size SOEs (equal to or less than 10 trillion rupiah of total assets) support the main findings, whereas large companies (more than 10 trillion rupiah of total assets) produce different results. Despite a slightly different level of significance, CEO external appointment, Chairperson external experience, government related commissioners on the BOC, and number of board sub-committees are governance related factors that are largely consistent between small and medium size SOEs and the main analysis.

With regard to financial and regulatory framework related factors, government transfer and asset transfer at all groups were consistent with the main analysis. It should be noted, however, dividend payout policy and legal case supported in the main analysis impacted differently in large SOEs (Table 6.7).

The semi-structured interview conducted with 13 respondents shed light on the strong government involvement in governance activities. With respect to the appointment of CEO and BOD members, the interviews revealed the importance of the fit and proper test in providing a shortlist of CEO candidates. The strongest factors consisted of track record, leadership and performance. In the selection of BOD members; they comprised performance, track record, and technical competence. The need for specialists, corporate culture change and politically related special requests were the main factors influencing the choice of external CEOs, while the need for specific expertise was the strongest reason to prefer an external BOD member (Table 6.5).

With regard to the appointment of chairpersons and BOC members, the interview concluded that the Minister of SOE's prerogative rights were paramount. Networking or someone's access to the bureaucracy and politically related special requests were found to be the most important reason for BOC member appointment. The preference for independent (non-government) membership of the BOC was mainly controlled by the need for expertise in supporting business processes and politically related special requests (Table 6.6).

In addition, respondents viewed government transfer, dividend payout policy and asset transfer as the government's right to determine. The responses on how government transfer impacted on SOEs are consistent and assist in explaining the negative relationship between government transfer and SOE performance.

The respondents propose that government policy on dividend payout prioritised the need of funding for government's over the SOE's need for future investment in its infrastructure. They further suggest government transfers in the form of subsidies often do not cover the cost of the service leading to losses in the SOE. They also believe that the subsidies are subject to arbitrary changes from that initially budgeted by government.

During the interview, respondents frequently referred to non-regulatory issues such as political or non-corporate factors to explain reasons for government intervention.

These were not specifically defined as one of predictors in the hypothesis, but from the interviews are a potentially influential variable.

7.4. Implications

The findings from the research lead to a number of theoretical and practical implications as outlined below.

7.4.1 Theoretical Implications

This study contributes to corporate governance literature by showing that the entrenchment effect can explain the impact of government involvement on the success of SOE performance.The research findings (Section 6.8) reveals that four variables in this research (*chairperson external appointment, number of board sub-committees, government transfer payment in the form of subsidy and PSO* and *dividend payout policy*) are significant contributors to SOE financial performance. Based on the findings, government involvement in Indonesian SOEs could be seen as rooted in the business processes of SOEs, from the appointment of the BOD and BOC, and as the provider of funding and regulation setter. The discussion below highlights the implications of the research findings on academic theory and policy practice.

Taking into account existing governance attributes from common international practice and bringing in new attributes of government involvement variables, the results of this study present several theoretical implications. First, the study reveals a more nuanced definition of SOEs in the Indonesian context. As discussed in Section 2.2, international practice based on the OECD definition has characterized SOEs as 'enterprises where the state has significant control, through full, majority, or significant minority ownership' (OECD 2005). This gives possibility to government having different roles as a single owner or as minority owner. In the Indonesian context, the Law defines an SOE as a 'business entity which is fully or majority owned by the state', indicating that government is always in the dominant or controlling position. Moreover, an Indonesian SOE may be categorised into three

different groups. First is SOE *Perum*, which is fully owned by the government but non-fully commercially based. Second, SOE *Persero*, which is a wholly or majority owned and fully commercially based SOE. Third, SOE *Persero Terbuka* is a publicly listed SOE. This sheds light on the need for three different approaches to Indonesian SOE research as they are unique in their corporate mission and levels of government involvement. This study looks uniquely at all commercial based SOEs (SOE P*ersero).*

Previous studies on SOEs in Indonesia predominantly focused on SOE performance in certain industries, such as the weaving industry (Hill 1982), mining mineral industry (Gillis 1982), banking industry (Prabowo and Soegiono 2010) and construction industry (Pamulu, Kajewski, and Betts 2007, 2009; Pamulu 2010; Widjajanto, Pribadi, and Suraji 2011). Others conducted specific case studies (e.g. Kamal 2008; Kamal 2010; Hadiyanto 2012). Some researchers have tried to study SOEs across industries with a specific theme or limited samples, such as Board of Commissioners (Sari, Halligan, and Sutiyono 2010) or privatisation (Siagian 2004; Sugiharto 2008; Laksanawan 2008). This study, however, adopts a different approach through investigating the government's role as the dominant and controlling shareholder (the principal in agency theory) and how it impacts upon the SOEs acting as agents.

New variables to the study of SOE performance are also introduced. Unique variables included of *'government transfer payment in the form of subsidy or PSO'*, '*dividend payout policy'* and '*asset transfer from the central government to SOE*' give new insight to the uniqueness of SOEs in the Indonesian context. Additionally, new control variables '*history of establishment*', and '*capital intensity*' seem to be the significant factors impacting on SOE performance. These new variables should enrich the existing theory on SOE governance in the Indonesian context.

7.4.2 Practical Implication

Government involvement appears to be prominent based on policies that impact on SOE operations and performance; however, the study reveals the involvement occurs in various types and level of depth. The high level of government ownership predicts

the government's influence in the General Meeting of the Shareholders. The preference to appoint CEOs from inside the SOEs rather than outside and the high level of government related directors on the BOD show the involvement in BOD governance. Likewise, a high preference to appoint officers from government as chairpersons as opposed to outsiders also implies very dominant intervention by the government. The interview data evidences the prerogative of the Minister (for overall SOEs) and the join-team led by the President (for SOEs on strategic sectors) to appoint their own candidate. In fact, regulation allows this practice. The interviews also highlighted political interference that allows BOC members to be appointed as a reward for contributing to the success of the Presidential election. One of the respondents states the following:

> *There are commissioner members, such as the President's dedicated people who handle special task, the vice President's people. Some officials work for the state with low level of salary, becoming commissionaire members provides them with additional income…it is ok, but one person at one SOE which is not too strategic (G1)*

Such interference might lead to SOEs being unable to or hampered in achieving their optimum performance. The Minister of SOE has single voting rights in the GMS of the fully owned SOEs (SOE *Persero*) and has a position as the controlling shareholder in the GMS of majority owned SOEs (SOE *Persero Terbuka*). It implies that the operating efficiency of SOEs can only prevail if the Minister acts independently of political interest.

By definition, the appointment of a Minister by the President is politically charged. Under such circumstances, a mechanism that ensures a governance system that independently examines BOD and BOC candidates and guarantees the quality of the election results is needed. Currently, attempts are being made to eradicate collusion and interventions, including s the formation of a talent pool and independent third party assessment of candidates. An open transparent and independently managed recruitment process should produce the best chance for an optimum appointment.

With regard to SOE finances, government intervention is also influential. As demonstrated, the results for hypothesis 7 and hypothesis 8 suggested that

government transfer policy and *dividend payout policy* are significant contributors to SOE financial performance. As also previously discussed, the form of intervention is shown as "one-way communication," which tends to prioritise the interests of the government in carrying out governmental priorities and to be less accommodating to the SOE financial agenda. For example, subsidies are meant to reimburse prices of goods and services set by the government with the cost of SOE delivery. In the case of PSOs, the government sets the goods and services and value unilaterally.

Fund transfers or subsidies/PSOs create a moral hazard for both SOEs and the government. For the government, the SOE is considered a political vehicle, mirroring departments, and government policies. Policies adopted by the government may not take into account the financial performance and strategy of the SOEs in the fulfilment of the government agenda.

For SOEs, the government funds transferred can create losses if the value does not take into account the full cost of service delivery. Equally however, the fund transfer may generate profits if the SOE overstates the true cost of delivery to government. This situation negatively impacts on the company and creates dependency upon the government. It is, therefore, important to ensure a more open two-way communication process to ensure the accountability of both the SOEs and Government

7.4. Limitation of Research

The data collection period 2007 to 2009 is used in this study.It captured data arising from the 2007 introduced w obligation for SOEs to report the summary of financial statements to the Ministry of Finance required by the State Finance Law. The use of three years of data is a limitation of the study and this research would benefit from extension over a longer time-frame covering different economic situations.

In studies relating to SOEs, numerous measures of company performance have been modelled. The company financial performance measurement included predicting company profitability, such as Return on Assets, Return on Sales or Return on Equity

(Boubakri, Cosset, and Guedhami 2005); efficiency such as sales efficiency and net income efficiency (Aivazian, Ge, and Qiu 2005); labour productivity (Major 1999) or financial stability such as leverage (Major 1999). The use of only one variable as the dependent variable (Return on Assets) is also a limitation of this study. Other market value based measures were not available as they require market value information and the majority of the sample SOEs (89 per cent) are non-publicly listed.

7.5. Suggestion for Future Research

This study investigates government involvement in two groups of fully commercially based SOEs, namely non-listed SOEs (SOE *Persero)* and listed SOEs (SOE *Persero Terbuka),* whereas non-fully commercially based SOEs (SOE *Perum*) are excluded. Further study in this area could be replicated to SOE *Perum* groups where many of the variables tested in this study are comparable and relevant.

The result of the sensitivity analysis shows that large companies behave differently from other groups. One example is shown by '*CEO external appointment*', which was a significant contributor to SOE financial performance in large companies but not in others. Therefore, it is suggested that a similar study could be undertaken specific to the larger sized group in a broader timeframe than for this study.

During the interview stage, the researcher uncovered a number of interesting opinions about government involvement in SOEs, particularly as the controlling shareholder. For example, while the Minister and to some extent the team led by the President, have prerogative rights to decide the membership of the BOD and the BOC, political intervention is likely to continue. Further qualitative research in this area is required to investigate this rich source of information. One finding documented from this study is that the dividend payout policy is a significant determinant of SOE financial performance. As governments demand dividends as one of the main revenue sources of their budgets, the exploitation of SOE earnings for dividend rather than investment may have created an opportunity cost for SOEs.

Further study regarding government intervention in the dividend payout policy and investment strategy of SOEs would be valuable.

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Appendix A: Corporate governance ratings

(Source: Wu 2005, 160).

Country	PWC Rating[a]	McKinsey Rating[b] (%)	CLSA Rating[c]
Argentina	49	24	
Brazil	63	24	
Canada		11	
Chile	28	18	
China	86	25	49.1
Colombia	55	21	
Czech Republic	77		
Ecuador	68		
Egypt	68	39	
France		13	
Germany		13	
Greece	49		
Guatemala	71		
Hong Kong	53		62.9
Hungary	65		
India	79	23	55.6
Indonesia	68	25	37.3
Israel	62		
Italy	26	16	
Japan	81	21	
Kenya	72		
Lithuania	59		
Malaysia		22	56.6
Mexico	29	19	
Morocco		41	
Pakistan	62		33.9
Peru	61		
Philippines		22	43.9
Poland	55	23	
Romania	78		
Russia	81	38	
Singapore	38	21	64.5
South Africa	82	22	69.3
South Korea	90	20	47.1
Spain		14	
Sweden		13	
Switzerland		15	
Taiwan	56	19	54.6
Thailand	78	20	55.1
Turkey	80	27	43.0
United Kingdom	45	12	
United States	25	14	
Uruguay	56		
Venezuela	50	24	

Appendix A: Corporate governance ratings (continued)

Note:

[a]PricewaterhouseCoopers (PWC), 2001. *The Opacity Index.*PWC rating reflects the accounting/corporate governance opacity of the country. Higher rating indicates lower standards of corporate governance.

[b]McKinsey & Company, 2002. *Global Investor Opinion Survey: Key Findings.*McKinsey rating represents the average premiums investor would pay for a well-governed company in a particular country. Higher premiums indicate lower standards of corporate governance.

[c] Credit Lyonnais Securities Asia (CLSA), 2002. *Saints and Sinners, Who's Got Religion?* CLSA rating is the weighted average of ratings on key areas of corporate governance such as discipline, transparency, independence, accountability, responsibility, fairness, and social awareness. The higher rating indicates higher standards of corporate governance.

Appendix B: Laws related to state-owned enterprises

A. Specific to SOEs

1. The Cooperatives Law (Number 25 of 1992)
2. The State Non-Tax Revenue Law (Number 20 of 1997)
3. The Corruption, Collusion and Nepotism- Clean and Free State Governance Law (Number 28 of 1999)
4. The Corruption Eradication Commission Law (Number 30 of 2002)
5. The Sovereign Debt Law (Number 24 of 2002)
6. The Synergy between State-Owned Enterprises Law (Number 109 of 2002)
7. The State Finances Law (Number 17 of 2003)
8. The State-Owned Enterprises Law (Number 19 of 2003)
9. The State Treasury Law (Number 1 of 2004)
10. The Establishment of Regulatory Legislation Law (Number 10 of 2004)
11. The Management Audit and State Financial Responsibility Law (Number 15 of 2004)
12. The National Social Security System Law (Number 40 of 2004)
13. The Supreme Audit Institution Law (Number 15 of 2006)

B. Not Specific to SOEs

1. The Capital Market Law (Number 8 of 1995)
2. The Company Documents Law (Number 8 of 1997)
3. The Prohibition of Monopoly Practices and Unfair Business Competition Law (Number 5 of 1999)
4. The Foundations Law (Number 28 of 2004)
5. The Special Economic Zones Law (Number 39 of 2009)
6. The Public Information Law (Number 14 of 2008)
7. The Information and Electronic Transactions Law (Number 11 of 2008)
8. The Limited Liability Companies Law (Number 40 of 2007)
9. Other sectoral regulations.

Source: Muchayat (2010, 128).

Appendix C: Mapping of industry group and industry sub group

Code	Industry Group[a]	Industry Sub-Group[b]	
1	**Agriculture**	11	Crops
		12	Plantation
		13	Animal husbandry
		14	Fishery
		15	Forestry
		19	Others
2	**Mining**	21	Coal mining
		22	Crude petroleum and natural gas prod.
		23	Metal and mineral mining
		24	Land/stone quarrying
		29	Others
3	**Basic industry and chemicals**	31	Cement
		32	Ceramics, glass, porcelain
		33	Metal and allied products
		34	Chemicals
		35	Plastics and packaging
		36	Animal feed
		37	Wood industries
		38	Pulp and paper
		39	Others
4	**Miscellaneous industry**	41	Machinery and heavy equipment
		42	Automotive and components
		43	Textile, garment
		44	Footwear
		45	Cable
		46	Electronics
		49	Others

Appendix C: Mapping of industry group and industry sub group (continued)

Code	Industry Group	Code	Industry Sub-Group[b]
5	**Consumer goods industry**	51	Food and beverages
		52	Tobacco manufacturers
		53	Pharmaceuticals
		54	Cosmetics and household
		55	Houseware
		59	Others
6	**Property, real estate and building construction**	61	Property and real estate
		62	Building constructing
		69	Others
7	**Infrastructure, utilities, and transportation**	71	Energy
		72	Toll road, airport, harbor, and allied products
		73	Telecommunication
		74	Transportation
		75	Construction
		79	Others
8	**Finance**	81	Bank
		82	Financial institution
		83	Securities company
		84	Insurance
		85	Investment fund/mutual fund
		89	Others
9	**Trade, services, and investment**	91	Wholesale (durable and nondurable goods)
		93	Retail trade
		94	Restaurant, hotel and tourism
		95	Advertising, printing, and media
		96	Health care

Appendix C: Mapping of industry group and industry sub group (continued)

Code	Industry Group	Code	Industry Sub-Group[b]
		97	Computer and services
		98	Investment company
		99	Others

Note: [a] Based on Indonesian Stock Exchange (ISX) categorization. [b] Based on DJKN categorization (2011)

Appendix D: Additional Univariate Analysis

Additional univariate analysis below aims to investigate if company size and industry group variables control variaous governance variables.

A mean comparison by company size, as presented in the Table D.1, shows that the larger companies are likely to have less government ownership. For instance, the largest companies group with total assets equal to or more than IDR 50 trillion have less than 80 per cent government shares (Mean=.79) whereas the rest of the groups have at least 90 per cent shares.

Table D. 1: *Government ownership mean comparison by company size (in IDR)*

	N	Mean	Std. Deviation
Group 1: <1 trillion	63	.96	.11
Group 2: 1 trillion to < 5 trillion	39	.95	.13
Group 3: 5 trillion to < 10 trillion	9	.91	.19
Group 4: 10 trillion to <50 trillion	7	.90	.17
Group 5: (≥ 50 trillion)	7	.79	.21
Total	125	.94	.14

It is reasonable to assume that listed companies have more diverse shareholders and therefore less government shares. Even though not trading in shares on the stock market, non-publicly listed SOEs can be owned by a non-Central Government entity, such as local governments, other SOEs, subsidiary companies and private companies (DJKN 2009). Using an independent sample t-test analysis, the result of *Levene's* test for government ownership is less than .05 (sig.=.005) indicating that the equal variance not assumed data should be used. As presented in the Table D.2 below, the result also reveals that there is a significant difference between two groups (t=-17.866, p<.000). It specifies that publicly listed SOEs are likely to have less government ownership by 64.81 per cent mean as compared to non-publicly listed SOEs with a 97.42 per cent mean.

Table D. 2: *Independent sample t-test for public listing status of SOEs by government ownership*

Public Listing Status	*N*	*Mean*	*Levene's Test*		*t-test for equality of Means*			
			F	*Sig.*	*T*	*df*	*Sig.2-tailed*	*Mean Diff.*
Public Listed	42	.6481						
Non Public Listed	333	.9742						
			7.951	.005	-17.866	48.349	.000	-.326

A one-way ANOVA test was used to investigate the level of relationship between government ownership and industry group. The result (Table D.3) reveals that there is a significant difference of government ownership among different industry groups or economic sectors at the p=.000 (p<.05) [Government ownership, F (8,366)=4.464, p=.000)]. The mean comparison concludes that three industry groups have less government ownership. These include the mining industry (mean=.86), the consumer goods industry (mean=.87); and property, real estate, and the building construction industry (mean=.89).

Table D. 3 *Summary of one-way ANOVA test for government ownership by industry group in pooled data*

	N	Mean	SD
Mining	15	.86	.18
Basic industry and chemicals	30	.93	.168
Miscellaneous industry	21	1.00	.00
Consumer goods industry	18	.87	.17
Property, real estate, and building construction	45	.89	.19
Infrastructure, utilities, and transportation	63	.94	.15
Finance	57	.94	.13
Trade, services, and investment	54	.92	.15
Total	375	.94	.14

ANOVA	*Sum of Squares*	*df*	*Mean Square*	*F*	*Sig.*
Between Groups	.660	8	.083	4.465	.000**
Within Groups	6.764	366	.018		
Total	7.424	374			

Note: *** very significant p<.01*

Furthermore, the CEO external/internal appointments are further explained by the size of the company. Using the independent sample t-test analysis (Table D.4), the result of the *Levene's test* for CEO appointment is less than .05. It indicates that there is a significant difference between the two groups (t=2.147, p<.037) with CEOs originating from outside the Government/SOE more likely to be appointed to larger sized companies as compared to smaller sized ones.

Table D. 4: *Independent sample t-test for CEO external appointment by company size*

Levene's Test		t-test for equality of Means			
F	Sig.	t	Df	Sig.2-tailed	Mean Diff.
34.796	.000	2.147	47.255	.037	30,605,777,925,375

Table D.5 supports this conclusion showing that SOEs in the trade, service, and investment industry have the most consistent number of independent CEOs (four) over the three years. External CEOs in14 SOEs in the finance sector, however, declined from seven SOEs (2007) to only 3 SOEs (2009). SOEs from agriculture, consumer goods, and property, real estate, and building construction all have CEOs from SOEs or with a government career background.

Table D. 5: *Distribution of SOEs with independent CEO by industry group*

	Frequency (SOEs)		
	2007	2008	2009
Agriculture	0	0	0
Mining	2	1	2
Basic industry and chemicals	3	1	3
Miscellaneous industry	0	0	1
Consumer goods industry	0	0	0
Property, real estate, and building construction	0	0	0
Infrastructure, utilities, and transportation	1	0	3
Finance	7	6	3
Trade, services, and investment	4	4	4
Total	17	12	16

Other evidence of a relationship is found describing the CEO appointment based on their history of establishment. As shown in the cross-tabulation table, nationalised (with a Dutch ancestry) SOEs are more likely to have a lower proportion of external/outsider CEOs than that of non-nationalised SOEs (4.7 per cent as opposed to14.8 per cent).

Furthermore, a cross-tabulation in Table D.6 shows the spread of chairpersons originating from government and those who are external across 9 industry groups. It shows that every year, the finance industry has the highest number of independent chairpersons, followed by agriculture. Other industries that are likely to have a chairperson from outside are basic industry and chemicals, property, real estate and building construction, and infrastructure, utilities and transportation. The information suggests that industry group is a determinant factor in the background of the chairperson.

Table D. 6: *Proportion of chairpersons with external experience by industry group*

	2007		2008		2009	
	Gov.	External	Gov.	External	Gov.	External
Agriculture	20	4	17	7	21	3
Mining	3	2	4	1	4	1
Basic industry and chemicals	7	3	7	3	8	2
Miscellaneous industry	6	1	6	1	6	1
Consumer goods industry	5	1	5	1	5	1
Property, real estate, building construction	12	3	14	1	14	1
Infrastructure, utilities, transportation	18	3	18	3	17	4
Finance	14	5	12	7	12	7
Trade, services, and investment	16	2	15	3	15	3
Total Count	101	24	98	27	102	23

To further examine the government related BOD members variable a one-way ANOVA was performed to test its association with company size. The result in Table

D.7 shows that there is a statistically significant difference for the five company size groups at the p=.000 (p<.05) [Government related directors on the BOD, F (4, 359)=7.662, p=.000)]. This suggests that the larger companies are more likely to have less government related directors on the BOD.

Table D. 7: *Summary of one-way ANOVA test for government related directors on the BOD by company size (in IDR)*

In IDR	N	Mean	Std. Deviation
Group 1: <1 trillion	185	0.926	0.161
Group 2: 1 trillion to < 5 trillion	108	0.932	0.152
Group 3: 5 trillion to < 10 trillion	35	0.843	0.190
Group 4: 10 trillion to <50 trillion	24	0.833	0.212
Group 5: ≥ 50 trillion	23	0.765	0.207
Total	375	0.904	0.174

ANOVA

	Sum of Squares	*df*	*Mean Square*	*F*	*Sig.*
Between Groups	.869	4	.217	7.709	.000**[a]
Within Groups	10.426	370	.028		
Total	11.295	374			

[a] ** very significant p<.01

Table D. 8: *Mean comparison of government related directors on the BOD by industry group in pooled year*

	N	Mean	Std. Deviation
Agriculture	67	0.96	0.10
Mining	15	0.69	0.31
Basic industry and chemicals	24	0.85	0.20
Miscellaneous industry	21	0.94	0.18
Consumer goods industry	18	0.92	0.13
Property, real estate, and building construction	45	1.00	0.03
Infrastructure, utilities, and transportation	63	0.92	0.14
Finance	57	0.82	0.20
Trade, services, and investment	54	0.88	0.19
Total	364	0.90	0.17

A mean comparison is conducted to detect any difference in government related directors on the BOD among industry groups. Table D.8 suggests that SOEs from the mining industry are more likely to have less government representation on the BOD (Mean=.69). An additional Tukey test also recognizes that the mining industry is the only industry with a significant mean difference compared to the rest of the industry groups. Other groups including finance (Mean= .82), basic industry and chemicals (Mean=.85), and trade, service, and investment (Mean=.88) have slightly lower government representation compared to the rest of the industry groups.

A mean comparison by company size is presented in Table D.9. SOEs with total assets about IDR 50 trillion have an average of 0.53 government officers functioning as BOC members, which is notably less than SOEs worth IDR 1 trillion with an average of 0.82 commissioners from the government. As 87.47 per cent of SOEs have total assets of less than or equal to IDR 10 million, it reveals that overall, the BOC is strongly dominated by government representatives in the majority of the small to medium size SOEs. For the remaining 12.53 percent (large sized SOEs), external or independent BOC members comprise nearly half of the total composition.

Table D. 9: *Mean comparison of government related commissioners on the BOC by company size in pooled year*

In IDR	N	Mean	Std. Deviation
Group 1: <1 trillion	185	0.824	0.209
Group 2: 1 trillion to < 5 trillion	108	0.797	0.185
Group 3: 5 trillion to < 10 trillion	35	0.800	0.197
Group 4: 10 trillion to <50 trillion	24	0.639	0.256
Group 5: ≥ 50 trillion	23	0.533	0.256
Total	375	0.784	0.221

Another figure (Table D.10) compares means of SOEs by industry groups. SOEs from miscellaneous industries (consisting of machinery and heavy equipment, electronics, and national defense and technology based industries) have most government representation on the BOC (Mean=0.88). Basic industry and chemicals

as well as the consumer goods industry are likely to have less government representation (with mean equal to 0.68 and 0.69 respectively) compared to others.

Table D. 10: *Mean comparison of government related commissioner in the BOC by industry group in pooled year*

	N	Mean	Std. Deviation
Agriculture	72	0.74	0.19
Mining	15	0.81	0.22
Basic industry and chemicals	30	0.68	0.27
Miscellaneous industry	21	0.88	0.14
Consumer goods industry	18	0.69	0.21
Property, real estate, & building construction	45	0.85	0.21
Infrastructure, utilities, &transportation	63	0.82	0.21
Finance	57	0.76	0.25
Trade, services, and investment	54	0.82	0.22
Total	375	0.78	0.22

One of the determinants of the number of sub-committees is the size of the company, which is measured by the amount of the total assets. Table D.11 below presents the *one-way ANOVA* analysis for company size. It shows that company size is very significant with p-values of 0.000 ($p<0.01$) indicating that size is a substantial determinant to the number of board sub-committees established in a company. The mean comparison also shows that the larger sized group has a higher mean suggesting that larger companies are more likely to establish more board sub-committees.

Similar to company size, industry group appears to be an important factor in determining the number as well as type of sub-committee formed. The *one-way ANOVA* test result as shown in the Table D.12 above reveals there appears to be a very significant difference among companies from different industry groups with p-value of 0.000 ($p<0.01$). The table also exhibits that SOEs related to the mining industry have the highest mean of 2.47 while SOEs from agriculture and trade, services and investment industries set up the least number of sub-committees (none or one sub-committee) with mean of 0.92 and 0.81 respectively.

Table D. 11: *ANOVA analysis of number of board sub-committees by company size*

In IDR	N	Percent of SOEs	Number of SC Mean	Std Deviation
Group 1: <1 trillion	185	49.33%	0.77	.69
Group 2: 1 trillion to < 5 trillion	108	28.80%	1.39	.81
Group 3: 5 trillion to < 10 trillion	35	9.33%	2.14	1.35
Group 4: 10 trillion to <50 trillion	24	6.40%	3.17	1.52
Group 5: ≥ 50 trillion	23	6.13%	3.52	.90
Total	375	100.00%	1.40	

ANOVA

	Sum Squares	*of Df*	*Mean Square*	*F*	*Sig.*
Between Groups	270.510	4	67.628	85.842	.000**[a]
Within Groups	291.490	370	.788		
Total	562.000	374			

Note: [a] ** very significant p<.01

Table D. 12: *ANOVA analysis of number of board sub-committees by industry group*

Industry Group	N	Percent of SOEs	Number of SC Mean	Standard Deviation
Agriculture	72	19.20%	0.92	.64
Mining	15	4.00%	2.47	2.17
Basic industry and chemicals	30	8.00%	1.37	1.77
Miscellaneous industry	21	5.60%	1.43	.75
Consumer goods industry	18	4.80%	1.06	1.11
Property, real estate, and building construction	45	12.00%	1.53	1.22
Infrastructure, utilities, and transportation	63	16.80%	1.84	1.22
Finance	57	15.20%	1.81	1.31
Trade, services, and investment	54	14.40%	0.81	.48
Total	375	100.00%	1.40	1.226

ANOVA

	Sum of Squares	*Df*	*Mean Square*	*F*	*Sig.*
Between Groups	77.075	8	9.634	7.272	.000**
Within Groups	484.925	366	1.325		
Total	562.000	374			

Note: ** very significant p<.01

To conclude, company size is found to be an important determinant in government ownership, appointing CEO and chairperson, selecting the composition of government and non-government background of BOD and BOC, and determining the number of sub-committees. Likewise, industry group is significant factor in all governance related variables.

Appendix E: Histogram for variables with continues type of measurements

Before Data Transformation

Figure 1

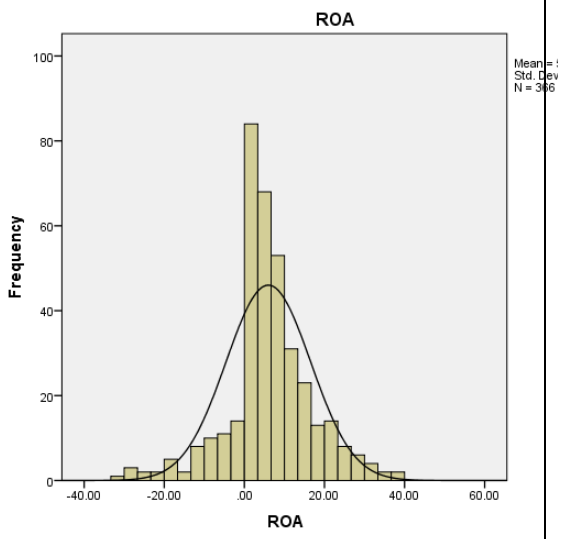


Figure 2

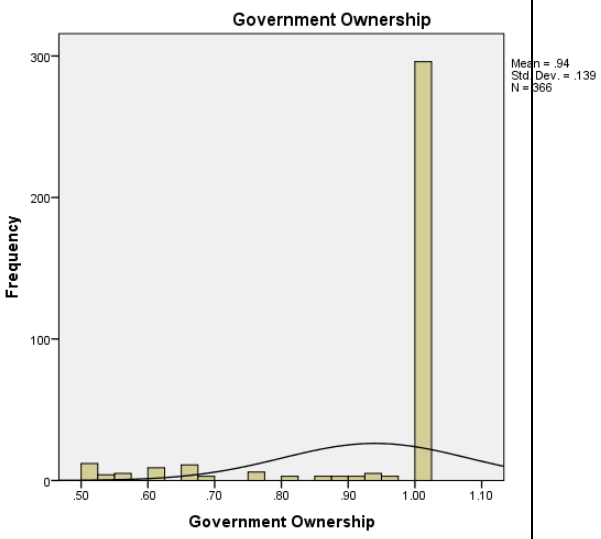


Figure 3

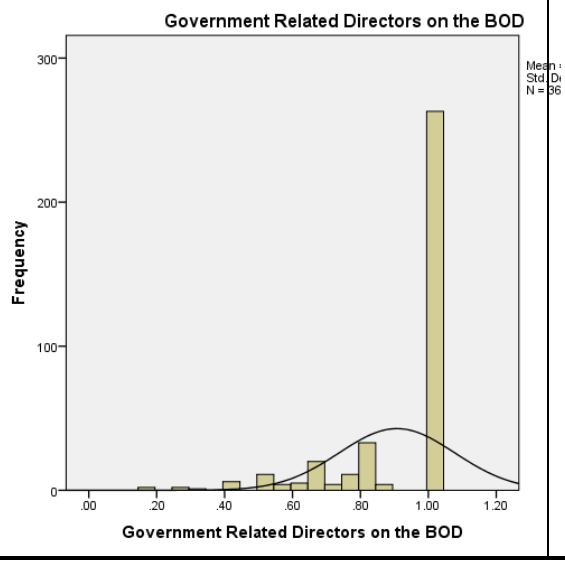
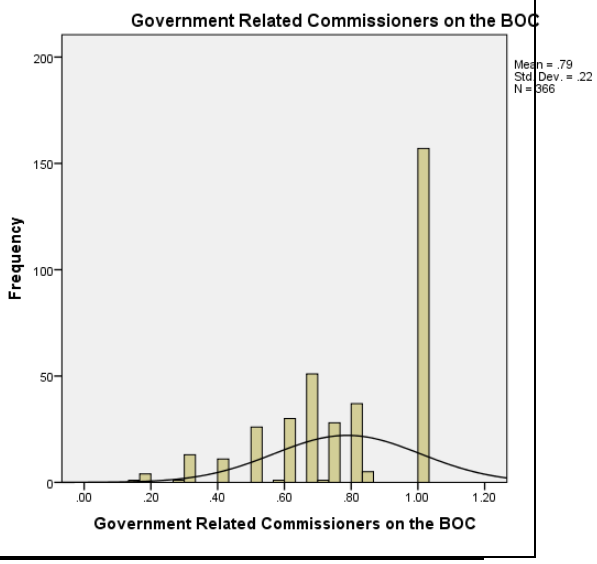


Figure 4



Appendix E: Histogram for variables with continues type of measurements (continued)

Figure 5

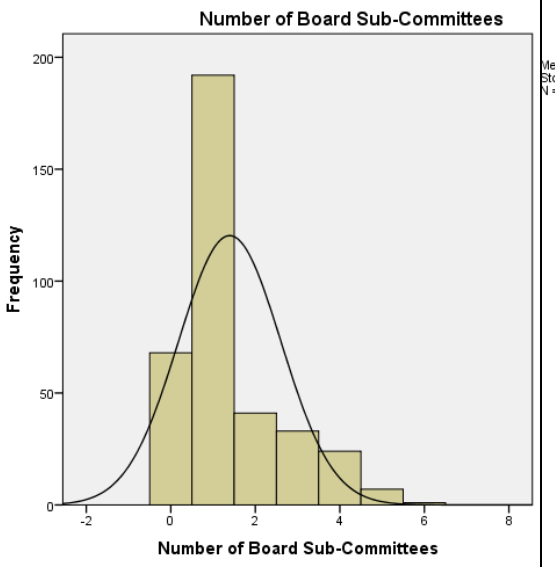


Figure 6

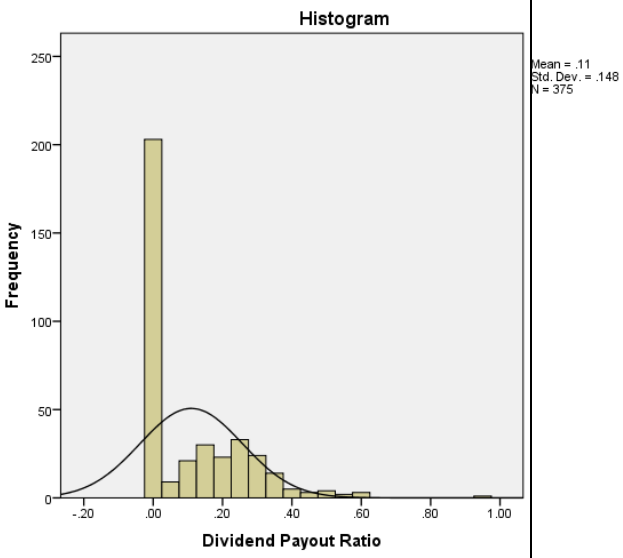


Figure 7

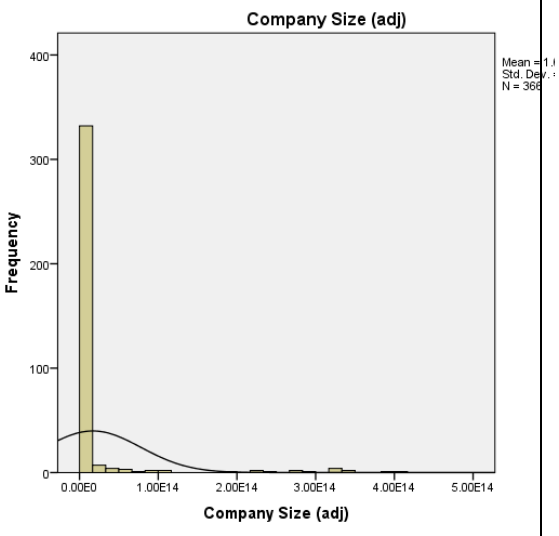
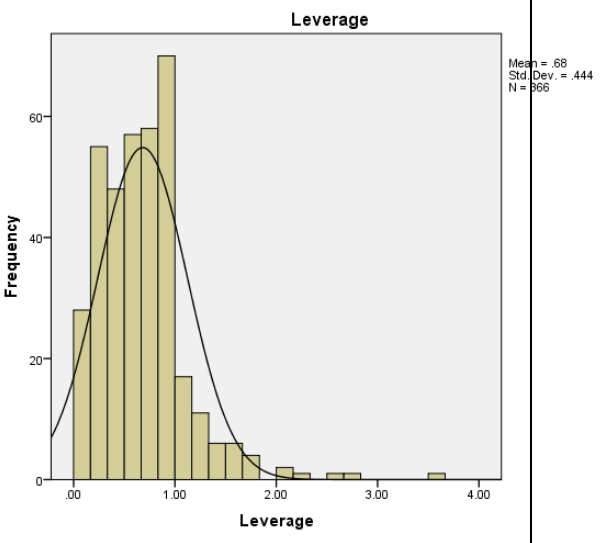


Figure 8



Appendix E: Histogram for variables with continues type of measurements (continued)

After Data Transformation

Figure 9

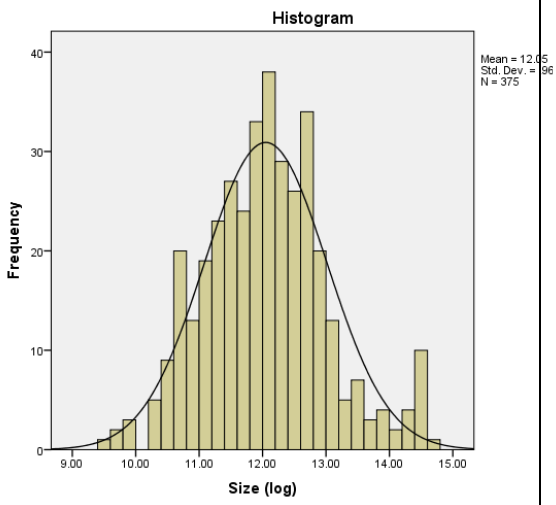


Figure 10