

I. Introduction

1. Study Background

A growing body of compelling economic research reveals that governance arrangements strongly influence development outcomes including social indicators such as infant mortality and adult literacy rates.

1. Sound accounting and auditing practices are an integral part of good governance arrangements. There is strong evidence that sound accounting and auditing mechanisms: (i) attract investment; (ii) support financial market development; (iii) reduce country risk premiums; (iv) improve privatization outcomes; and (v) lower the risk of financial crises, but when crises do occur, reduce their severity and duration.²

2. Moreover, the 1997-1998 Asian financial crisis exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, a lack of transparency, and weak supervision and regulation.³

3. The Asian Development Bank (ADB) has been taking a number of initiatives to assist its Developing Member Countries (DMCs) to overcome these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

4. In 2000, under ADB Regional Technical Assistance (RETA) 5877⁴, Diagnostic Studies of Accounting and Auditing (DSAAs) were prepared and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan and Viet Nam. This work was

² ADB. 2002. *Accounting and Auditing Practices in Selected Developing Member Countries: A Diagnostic Study of Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka*. Manila. pp. 3-9.

³ Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. ADB: Manila.

⁴ *Strengthening Financial Management and Governance in Selected DMCs*.

extended during 2001-02 when further DSAs were prepared for Azerbaijan, Fiji Islands, Marshall Islands, the Philippines and Sri Lanka.⁵ This DSAA was prepared under an ADB staff consultancy.

2. Objectives

5. ADB has demonstrated its stand on the importance of good governance, through effective financial management, for sustained economic development. This study involved a diagnostic review of the existing accounting and auditing support and standards available in the Indonesian private sector. Its objective was to identify gaps and weaknesses in private sector accounting and auditing arrangements and to identify potential courses of action to overcome these problems.

3. Scope and Process

6. The study focused on private sector accounting and auditing arrangements and the private sector accountancy profession. It examined current Indonesian accounting and auditing structures and systems. It also: (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice and the level of enforcement of existing laws, rules, and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available and deviations from international standards; and (iii) identified options to remedy the identified weaknesses, with the objective of eventually doing away with these.

7. The study involved two workshops. Preliminary issues, and possible ways in which they might be resolved, were discussed at the first workshop. The second workshop focused on accounting and auditing standards. Both workshops were held at the ADB Indonesia Resident Mission (IRM) in Jakarta.

4. The Republic of Indonesia

General

8. Straddling the equator in Southeast Asia, Indonesia is the world's largest archipelago, with more than 13,700 islands covering 1.8 million square kilometers. The largest islands are the Kalimantan provinces on Borneo, Sumatra, Papua, Sulawesi and Java. The terrain is varied and

⁵ The Philippines DSAA was prepared under a staff consultancy. The remainder were prepared under RETA 5980: *Diagnostic Study on Accounting and Auditing Practices in Selected DMCs*

ranges from coastal lowlands to snow-capped mountains: nearly 60% of the land is forested and a significant portion is mountainous. A quarter of Indonesia's 400 volcanoes are active.

9. Indonesia's population of 211 million people makes it the world's fourth largest nation (after the People's Republic of China, India and the United States). With 173 million Muslims (88% of the population), it is also the world's largest Islamic country. The population comprises a range of ethnic groups including Javanese (45%), Sundanese (14%), Madurese (7.5%) and coastal Malays (7.5%). The official language is Bahasa Indonesia, with English, Dutch, and Javanese also widely spoken and more than 300 distinct regional languages.

10. Following around 300 years of Dutch rule, Indonesia declared independence from the Netherlands on 17 August 1945—legal independence was obtained in 1949 after four years of warfare and negotiations.

11. Indonesia is a republic with limited separation between the executive, legislative and judicial branches of government. The system of government is a presidential system with parliamentary characteristics. Recent reforms include imposing a limit of two five-year terms on both the President and Vice President. The President is both the chief of state and head of government, and is elected by the People's Consultative Assembly (the House of Representatives plus 200 indirectly selected members) for a five-year term; with the last election held on 23 July 2001.⁶ The House of Representatives comprises 500 members. The legal system is based on Roman-Dutch law, substantially modified by indigenous concepts.

12. Indonesia's main exports are crude oil, natural gas, plywood and other wood products, textiles, garments, rubber and rubber products and shrimp. It is the world's second-largest producer of rubber, the third-largest grower of coffee, and the leading producer of coconut and certain spices. Indonesia's natural resources include petroleum, natural gas, coal, timber, tin, copper, gold, silver, bauxite and nickel.

⁶ Indonesian presidents have been:
President Sukarno (1945-1966). The period from 1959 to 1965 was an authoritarian regime referred to as "Guided Democracy".
President Soeharto (1967-1998). This period is sometimes referred to as the "New Order" government.
President Habibie (1998-1999). President Habibie lifted controls on freedom of speech and association.
President Wahid (1999-2001).
President Megawati Sukarnoputri (daughter of President Sukarno) 2001-

13. In addition to the main export industries, Indonesia produces chemicals, cement, glass, fertilizer, ceramics, machinery and metal-based products. Indonesia is also involved in tourism and high-technology fields such as electronics and aerospace. Only 10% of the total land is cultivated. The main crops include rice, cassava, cocoa, sugar, coffee, peanuts, soybeans, rubber, palm oil and coconuts. Indonesia is now self-sufficient in rice production, after having once been the world's largest rice importer. Manufacturing overtook agriculture to become the largest sector of the economy (in terms of GDP) in 1991. Indonesia's main trading partners are Japan, the U.S., the European Union and Singapore. Table 1 presents key indicators for Indonesia and four other ADB DMCs.

Table 1. Key Indicators for Selected ADB DMCs

Indicator	Indonesia	Malaysia	Philip- pines	Lanka	People's Sri Republic of China
General					
Population (<i>millions, 2000</i>)	210.5	23.3	78.4	19.4	1,262.5
Population density (<i>people per km², 2000</i>)	116.0	71.0	263.0	295.0	135.0
Urban population (<i>% of total, 2000</i>)	40.2	57.3	58.6	23.6	34.3
Average annual pop. growth rate (<i>%, 1995-2000</i>)	1.6	2.4	2.2	1.3	0.9
Social					
Under-five mortality rate (<i>per 1000, 1999</i>)	42.0	8.0	31.0	15.0	30.0
Life expectancy at birth (<i>years, 1999</i>)	66.0	72.5	69.0	74.0	70.0
Adult literacy rate (<i>15-yr+, %, 1999</i>):					
– Females	81.0	83.0	95.0	89.0	78.0
– Males	91.0	91.0	95.0	94.0	91.0
Population in poverty (<i>%, 1996-99</i>)	23.4	8.1	40.0	26.7	...
Human Development Index (<i>1999</i>)	0.68	0.77	0.75	0.74	0.72
Economic					
Gross National Product (<i>\$ million, 1999</i>)	125,043	76,944	77,967	15,578	979,894
GDP per capita (<i>\$, 2000 derived</i>)	730	3,836	1,008	845	855
GDP growth rate (<i>%</i>) – 2003 (<i>forecast</i>)	3.6	5.8	4.5	5.5	7.4
– 2002 (<i>forecast</i>)	3.0	4.2	4.0	3.5	7.0
– 2001	3.3	0.4	3.4	-1.3	7.3
– 2000	4.8	8.3	4.2	6.0	8.0
– 1999	0.8	6.1	3.3	4.3	7.1
– 1998	-13.1	-7.4	-0.6	4.7	7.8
– 1997	4.7	7.3	5.2	6.3	8.8

INTRODUCTION

Indicator	Indonesia	Malaysia	Philip- pines	Lanka	People's Sri Republic of China
Consumer Price Index (<i>Annual % change, 2001 estimate</i>)	11.5	1.4	6.1	11.0	1.5
Fiscal Balance / GDP (<i>%, 2001 estimate</i>)	-2.3	-6.7	-3.8	-10.0	-2.6
Total External Debt / GNP (<i>%, 1999</i>)	113.3	62.5	64.8	60.3	15.9
Debt Service Ratio (<i>% of goods & services exports, 2000 estimate</i>)	44.8	5.4	12.7	14.7	10.0
Official Development Flows					
U.S.\$ million (<i>1999</i>)	3,825.2	457.7	295.0	343.6	2,595.7
Dollars per capita (<i>1999</i>)	18.2	19.6	3.8	17.7	2.1
Percentage of GNP (<i>1999</i>)	3.1	0.6	0.4	2.2	0.3

Sources: ADB. 2001. *Growth and Change in Asia and the Pacific: Key Indicators 2001*. Volume XXXII. Manila. ADB. 2002. *Asian Development Outlook 2002*. Manila.

Recent Economic Trends⁷

14. Government is a major player in Indonesia's market-based economy. It owns around 180 state-owned enterprises (SOEs) and administers prices on certain goods including fuel, rice and electricity. Under Soeharto's New Order government, inflation was generally 5-10%, the rupiah was stable and the government avoided domestic financing of budget deficits.

15. Despite an abundance of natural resources and growth rates of 7%–8% in the early 1990s, Indonesia has faced severe economic problems. These economic problems have been exacerbated by structural problems including the lack of reliable legal recourse in contract disputes, corruption, weaknesses in the banking system and an unstable political environment.

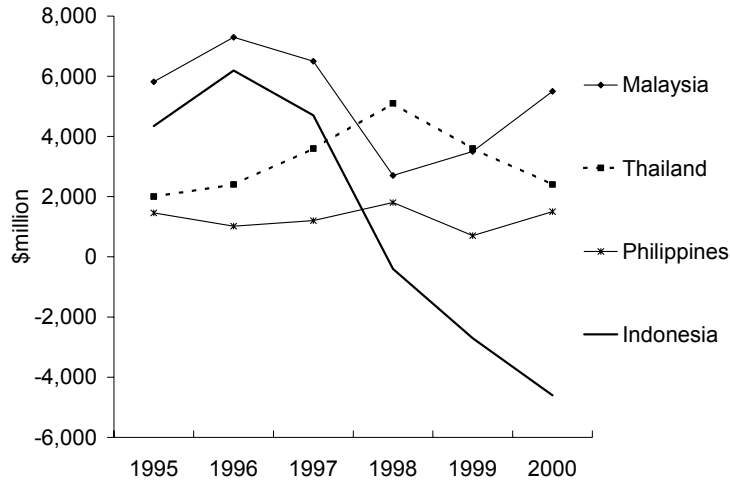
16. During the Asian financial crisis, inflation and interest rates escalated, GDP declined by 13.7% in 1998, real wages and employment fell, and poverty rose. In comparison to other crisis-affected economies, Figure 2 indicates that Indonesia's recovery has been less-than-smooth.

⁷ Primary Sources:

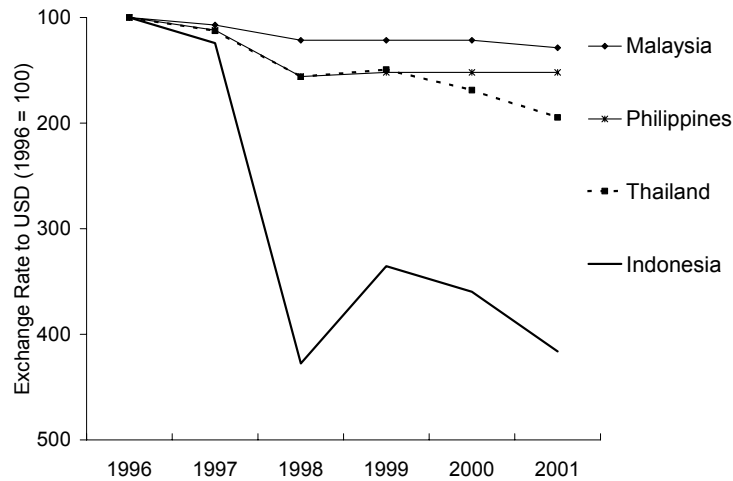
- World Bank. 2001. *Indonesia: The Imperative for Reform: Brief for the Consultative Group on Indonesia*. Report No. 23093-IND. Washington. 2 November.
- ADB. 2002, *Asian Development Outlook 2002*, 14th Edition. Manila.

Figure 2. The Asian Financial Crisis Hit Indonesia Hard

1(a) Foreign Direct Investment



1(b) Relative Exchange Rates



Source: Derived from ADB. 2001. *Growth and Change in Asia and the Pacific: Key Indicators 2001*. Volume XXXII. Manila.

17. Government initiated action to address a number of Indonesia's economic problems. It reduced inflation, generated modest growth (4.8% in 2000 and 3.3% in 2001), recapitalized a handful of private banks and has begun recapitalizing the state-owned banking sector. In the aftermath of the financial and economic crisis, the government took custody of a significant portion of private sector assets through acquisition of non-performing bank loans and debt restructuring

process. However, progress has been limited. Banks continue to be wary of issuing new debt in an environment where little progress has been made in restructuring the huge burden of outstanding debts.

18. Higher growth rates are constrained by continuing dissatisfaction with the pace of bank and debt restructuring, the lack of progress on necessary economic reforms, burdensome public sector debt and ongoing conflicts in certain regions. In particular, the high level of government debt is a problem. Not only does it impose a big burden on the budget, it is itself a cause of instability. Reducing government debt is an important part of restoring stability and encouraging growth—both essential elements of poverty reduction.

19. Government's current targets include achieving medium-term fiscal sustainability, reducing budget subsidy expenditures, single digit inflation, continued divestiture of the government's holdings in the banking system, asset recovery from the sale of restructured and unstructured loans, decentralization of functions to local governments, privatization of state assets and publication of audited financial statements for the Bank of Indonesia.⁸

20. However, government continues to face challenges including: (i) eliminating widespread poverty and regional disparities; (ii) protecting and restoring the environment; (iii) strengthening democracy and human rights; (iv) improving public access to health, education, clean water, and sanitation; (v) promoting good governance and the equal role of women in development (vi) developing infrastructure; (vii) promoting economic growth, particularly by developing small- and medium-sized enterprises; and (viii) addressing corruption within the business sector.

Financial Governance: Issues and Challenges⁹

21. In the early 1990s, a number of problems with accounting, auditing and financial disclosure were identified. No specified financial records were required to be maintained or filed by companies and there was no requirement for financial statements to be independently audited. Company law required only that "adequate financial records" be kept. A

⁸ IMF. 2002. *Indonesia: Letter of Intent*. 2 April.

⁹ Primary Sources:

- Rosser, Andrew. 1999 July. *The Political Economy of Accounting Reform in Developing Countries: The Case of Indonesia*. Murdoch University: Working Paper No. 93.
- World Bank. 1994. *Indonesia: Sustaining Development*. Washington.

number of financial scandals were linked to misleading or fraudulent financial reporting. There were no requirements for public registration or disclosure of ownership and financial records, except in the case of listed companies.

22. During periods of economic growth, this lack of disclosure and regulation was not considered a problem. In fact, the lack of transparency financial reporting has suited those who engage in profitable related-party transactions with SOEs, those wishing to manipulate financial results to obtain finance or avoid taxation and those who sought to access state revenues outside the budget authorization process.

23. However, Indonesia has experienced a number of severe economic crises and has needed to attract both foreign investment and foreign aid. In order to do so the government has had to respond, at least in part, to the demands of investors and aid agencies for accounting and other capital market reforms.

24. The first major capital reforms occurred around 1988-89 and focused on capital market deregulation. The reforms included: (i) eliminating restrictions on share price movements; (ii) allowing foreign investors to purchase shares in publicly-listed companies; (iii) establishing a new over-the-counter market; (iv) simplifying procedures for issuing and listing securities; and (v) equalizing the tax treatment of interest and dividends.

25. Continued pressure from external agencies and a series of financial reporting scandals paved the way for further financial reporting reform. In 1994, government entered into a project (Second Accountancy Development Project) with the World Bank to improve the quality of financial reporting in both the public and private sectors.¹⁰ This project sought to: (i) modernize the government's accounting system; (ii) improve accounting education and training; and (iii) initiate actions for meeting the financial information requirements of capital markets. One of the outputs of this project was the development of a set of accounting, Financial Accounting Standards (PSAKs)¹¹ that were based largely on international accounting standards (IAS).

¹⁰ World Bank. 1994. *Staff Appraisal Report: Indonesia: Second Accountancy Development Project*, unpublished report, 29 July.

¹¹ These standards replaced Indonesia's first set of accounting standards, Indonesian Accounting Principles (PAI). PAI were initially developed in 1973 and significantly revised in 1984. Although these accounting standards do not have legislative backing, government agencies have generally supported the use of these standards by Indonesian companies.

26. Government also introduced new requirements for corporate reporting and disclosure by way of the Companies Code and Capital Markets Law. These changes included the following: (i) use of PSAKs by all companies in reporting their annual accounts, except where they had just cause not to do so; (ii) an audit requirement for all publicly listed companies; (iii) personal liability by directors and commissioners for provision of misleading financial information in financial reports; (iv) a specified format for financial reports; and (v) requirements that public accountants notify the regulatory agency *Bapepam* of breaches of the law.

27. Following the Asian financial crisis, the government required all limited firms with assets of Rp50 billion to publish financial statements and have them audited by external auditors (February 1998) and the Jakarta Stock Exchange (JSX) issued corporate governance regulations for listed companies in July 1999.

28. Implementation of these reforms has not been smooth. Moreover, despite improvements in accounting standards, audit requirements and financial disclosures, there were still serious gaps in the financial reporting and disclosure regime. For example, calls for improvements in the qualifications and independence of auditors were not heeded until 1997. Before 1997, international auditing firms were forced to operate by forming relationships with domestic firms. From 1997 onwards, foreign auditors were permitted to operate as individuals but were still prohibited from establishing auditing firms. Effective enforcement of sanctions for non-compliance with the law remains a problem.

5. ADB Focus on Indonesia Financial Governance

29. ADB has been actively involved in the Partnership for Governance Reform. The Partnership has led assessments of governance needs, coordinated international assistance, and highlighted best practice reform models. In particular, ADB has spearheaded corporate governance activities and actively participates in other areas, especially anti-corruption, public procurement and financial management, and decentralization activities.¹²

30. ADB's *Financial Governance Reforms: Sector Development Program*, along with IMF and World Bank assistance, has supported a set of public sector reforms that have created the basic legal framework and

¹² ADB. 2001. *Country Assistance Plan: Indonesia 2001-2003*. Manila.

environment for SOE reforms and helped to improve financial governance in both banking and non-banking sectors.¹³

6. International Guidelines and Surveillance¹⁴

31. The international community is supporting the development of guidelines, standards and codes to assess financial management and governance practices (see Table 2). Where appropriate, this report compares Indonesian arrangements and practices against these benchmarks.

32. These guidelines, standards and codes—to varying extents—all involve accounting and auditing arrangements. Furthermore, in an attempt to identify and avoid potential crises before they occur, the IMF and the World Bank have together embarked on a series of *Reports on the Observance of Standards and Codes (ROSCs)*. These reports summarize the extent to which countries observe certain internationally recognized standards.¹⁵ Although ROSCs are intended to be voluntary, the information provided by each country (or not provided, as the case may be) is likely to influence country dealings with international financial institutions, and the level of confidence that the international financial community has in a country.

Table 2. Selected International Guidelines, Standards and Codes

Guideline, Standard or Code	Promulgated By
• Principles of Corporate Governance	Organization for Economic Cooperation and Development (OECD)
• Code of Good Practices on Fiscal Transparency	IMF
• Code of Good Practices on Transparency of Monetary and Financial Policies	IMF
• Implementation of the Objectives and Principles for Securities Regulation assessment surveys	International Organization of Securities Commissions' (IOSCO)

¹³ ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the State-Owned Enterprise Governance and Privatization Program*. November 2001.

¹⁴ Narayan, Francis B., Ted Godden, Barry Reid, and Maria Rosa Ortega. 2000. *Financial Management and Governance Issues in Selected Developing Member Countries: A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam*. ADB: Manila. pp. 12-13.

¹⁵ IMF. September 2000. *Experimental Reports on Observance of Standards and Codes (ROSCs)*. www.imf.org/external/np/rosc

INTRODUCTION

Guideline, Standard or Code	Promulgated By
• International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
• International Standards on Auditing (ISA)	International Auditing and Assurance Standards Board (IAASB)
• Banking Supervision guidelines	Basel Committee on Banking Supervision (BCSB) of the Bank for International Settlements (BIS)

7. Report Structure

33. This report examines Indonesian accounting and auditing practices. In addition to this introduction, the report has the following chapters:

- Chapter II – **Accounting and Auditing in Indonesia** – presents an overview of accounting and auditing arrangements in Indonesia. It provides context for the following chapters on professional infrastructure, and accounting and auditing standards.
- Chapter III – **Professional Infrastructure** – describes the professional accountancy infrastructure in Indonesia.
- Chapter IV – **Accounting and Auditing Standards** – describes the accounting and auditing standards that govern the preparation of external financial reports and the audit of those reports.
- Chapter V – **Issues and Recommendations** – presents the issues and recommendations that are associated with gaps or weaknesses in accounting and auditing arrangements.