

II. Accounting and Auditing in Indonesia

This chapter presents an overview of Indonesia accounting and auditing arrangements. It provides context for the following chapters and comprises eleven sections as follows:

Part One: Accounting

- 1 – Introduction – identifies historical factors that have influenced accounting arrangements.
- 2 – The ‘Indonesian Accounting System’ – describes Indonesia accounting arrangements, which include the legislative and institutional framework, accounting bases and accounting information systems.
- 3 – Financial Reporting and Disclosure Requirements – describes financial reporting and disclosure requirements.
- 4 – The Quality of Financial Reporting and Disclosure – examines evidence regarding financial reporting quality.

Part Two: Auditing

- 5 – Introduction – introduces Indonesia auditing arrangements.
- 6 – Auditor Appointment and Dismissal – describes auditor appointment and dismissal by comparing Indonesian arrangements to regional norms and international best practices.
- 7 – Auditor Independence – examines the extent of Indonesian auditor independence.
- 8 – Auditor Reporting Requirements – describes Indonesian audit reporting requirements.
- 9 – Auditor Sanctions and Liability – examines auditor exposure to sanctions and litigation.
- 10 – Accounting and Auditing Firms – describes the presence of domestic and international accounting firms in Indonesia.
- 11 – The 2002 Decree on Public Accountant Services – describes the components of this important decree.

Part One. Accounting

1. Introduction

34. The Dutch introduced elements of double-entry bookkeeping to Indonesia in the 17th century. The East Indies Company—the principal commercial organization during the colonial era—had a significant and ongoing impact on Indonesian business arrangements.¹⁶

35. Colonial economic activities rapidly increased during the 1800s and early 1900s. This created demand for trained accountants and bookkeepers, which was partly met by an influx of Dutch and British accountants into the colony to help administer the vast estates, mills and industrial enterprises.¹⁷

36. Opportunities for local accountants grew during the 1942-45 interruption of Dutch colonial rule. Dutch accounting practices remained in use during the post-independence era of the 1950s. Moreover, tertiary accounting training continued to be based on the Dutch accounting system. However, the nationalization of Dutch-owned enterprises and the expulsion of Dutch nationals in 1958 created a shortage of technical, including accounting, expertise.¹⁸

37. In response, Indonesia turned to U.S. accounting practices. However, the introduction of U.S. accounting thought and practices blended well with Dutch accounting methods, particularly in government agencies. An increasing number of tertiary institutions, including the government-based *Sekolah Tinggi Akuntansi Negara* (College for State Accountancy, STAN), began to shift their accountancy programs from the Dutch to the U.S. system from 1960. In 1975, all institutions were required to adopt the U.S. system.¹⁹ Table 3 summarizes environmental developments that have influenced Indonesian accounting.

¹⁶ Diga, Joselito and Hadori Yunus. 1997. "Accounting in Indonesia" in *Accounting in the Asia-Pacific Region*, edited by Nabil Baydoun, Akira Nishimura and Roger Willet. John Wiley: Singapore. p. 284.

¹⁷ Yunus, H. 1990. *History of Accounting in Developing Nations: The Case of Indonesia*. Tim Koordinasi Pengembangan Akuntansi, Jakarta.

¹⁸ Diga, Joselito and Hadori Yunus. 1997. "Accounting in Indonesia" in *Accounting in the Asia-Pacific Region*, edited by Nabil Baydoun, Akira Nishimura and Roger Willet. John Wiley: Singapore. p. 285.

¹⁹ *Ibid.* p. 285.

Table 3. Environmental Factors Influencing Indonesian Accounting

Political and Social Developments	Economic Developments	Accounting Developments
<p>Dutch Colonial Era (1959–1945) The Dutch subjugated Java and other Indonesian islands. Islam was the dominant religion of the population.</p>	<p>The United East Indies Company had a monopoly of Indonesian commerce. Indigenous Indonesians were restricted from involvement in commerce. Ethnic Chinese were given special rights to the retail trade and coastal traffic.</p>	<p>The Dutch introduced accounting into Indonesia. The first recorded accounting regulation was issued in 1642 by the Dutch Governor General of the Netherlands East Indies. The regulation governed the administration of cash receipts and receivables.²⁰</p>
<p>Sukarno Era (1945–1966) Indonesia gained independence in 1945. Sukarno became the first President of the Republic of Indonesia, and a close alliance between communists in Indonesia and the People's Republic of China developed. In 1965, an abortive communist coup d'état led to a counter coup that enabled the military leaders to disable the local communist party and remove most of the President's powers.</p>	<p>Due to the dominance of the Dutch and Chinese in commerce and the consequent economic inequalities in society, Indonesia chose a socialist approach to development, with the state playing a dominant role. In 1958, all Dutch-owned companies were nationalized and Dutch nationals expelled.</p>	<p>U.S. academics filled the positions left vacant by the Dutch, and U.S. accounting and auditing practices were introduced. Both Dutch and U.S. accounting practices were used concurrently.</p> <p>The Indonesian Institute of Accountants (IAI) was established in 1957 to guide and coordinate the activities of accountants.</p>

²⁰ Abdoelkadir, K. K. 1982. *The Perception of Accountants and Accounting Students on the Accounting Profession in Indonesia*. Unpublished PhD Dissertation. Texas A & M University.

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Political and Social Developments	Economic Developments	Accounting Developments
<p>Suharto Era (1966–1998) Suharto was installed as president in 1966 and more conservative political and economic policies were pursued.</p>	<p>Under Suharto’s leadership, a capitalist approach to economic development was pursued. Foreign investment was again encouraged, and the 1967 enactment of the Foreign Investment Law resulted in an influx of foreign firms.</p> <p>1997-1998 Asian Financial Crisis hits Indonesia hard. Many companies collapse.</p>	<p>There was a transfer of accounting knowledge and skills from the head offices of foreign firms directly to their Indonesian employees and indirectly through their business activities.</p> <p>In 1973, IAI adopted a set of accounting principles, auditing standards and a code of professional conduct. The accounting principles were based on the accounting guidelines published by AICPA in 1965.</p> <p>A new set of IAS-based accounting standards were adopted in 1995.</p>
<p>Post-Suharto Era (post 1998) Suharto was forced to stand down as President in 1998.</p>	<p>Indonesia struggles amidst economic and social turmoil.</p>	<p>Regulations are tightened to improve financial disclosure.</p>

Source: Updated from: Siddik, A. F. and H. L. Jensen. 1984. *The Evolution of Accounting in Indonesia*. The Academy of Accounting Historians. pp. 41-60.

38. In the mid-1980s, a group of technocrats emerged with a strong interest in economic and accounting reform. Their objective was to create a more market-oriented and competitive economy, supported by good accounting practices—their policies received strong support from foreign investors and international agencies.²¹ Before the revival of the capital market and the introduction of accounting reforms in the 1980s and early 1990s, it had been common for private companies to maintain three sets of books—one which showed the “true” state of the business and was used for management decision-making; one which showed a positive result and which was used for raising loans from foreign and

²¹ Rosser, Andrew. 1999 July. *The Political Economy of Accounting Reform in Developing Countries: The Case of Indonesia*. Murdoch University: Working Paper No. 93.

local banks; and one which showed a loss or small profit and was used for taxation purposes.²²

39. In the early 1990s, pressure for accounting improvements grew in the wake of series of financial reporting scandals that seriously undermined investor confidence. It became clear to government policy-makers that the quality of financial reporting had to be improved if the capital market was to be transformed from a casino into a mechanism for mobilizing long-term investment flows.²³

40. The first and most serious scandal involved Bank Duta—a private bank owned by three Suharto-controlled charitable foundations. Bank Duta went public in early 1990, but failed to disclose several hundred million dollars in foreign exchange losses in its prospectus. Nor did the bank fully inform the capital market regulator (*Bapepam*), its auditors or its underwriters about these problems. In fact, its auditors had issued an unqualified audit opinion. Together with other factors, the Bank Duta scandal led to a massive withdrawal of funds from the capital market—the JSX Composite Index declined by a third between the middle and the end of 1990.²⁴

41. Other scandals involved Plaza Indonesia Realty (mid-1992) and Barito Pacific Timber (1993). The ensuing controversy resulted in a series of measures to strengthen financial accounting regulations. First, in late 1994, government introduced a new set of financial accounting standards, known as Financial Accounting Standards (PSAKs). Second, government launched a joint project with the World Bank to further develop Indonesia's accounting regulations and train accounting professionals. Third, in 1995, government introduced several accounting-related provisions in its new Companies Code. Fourth, later in 1995, government introduced further accounting requirements as part of the Capital Markets Law.²⁵

42. The rupiah's collapse in 1997-1998 further increased pressure for government to improve the quality of financial reporting. By early 1998, many of the country's conglomerates were technically bankrupt, the banking system faced collapse, a serious fiscal crisis was looming, rising inflation and unemployment had driven millions of people into poverty,

²² Kwik K. 1994. *Analisis Ekonomi Politik Indonesia*. Jakarta: Gramedia Pustaka Utama.

²³ Rosser, Andrew. 1999 July. *The Political Economy of Accounting Reform in Developing Countries: The Case of Indonesia*. Murdoch University: Working Paper No. 93.

²⁴ *Ibid.*

²⁵ *Ibid.*

and government had been forced to call in the IMF and negotiate a rescue package.

43. Moreover, amidst spreading political and social unrest, public analysis of the Asian economic crisis was blaming poor accounting practices for fueling the crisis. Foreign investors, it was argued, had “risked their money on deals that wouldn’t have looked so appealing had the books been prepared to international standards”.²⁶ The World Bank made accounting a major issue by calling on the (then) Big Five international accounting firms to withhold their brand name imprimaturs if their affiliates in developing countries did not meet international accounting and auditing standards.²⁷

44. Government pushed ahead with accounting reform. First, in February 1998, it announced that all limited firms with assets of Rp50 billion or more would be required to publish financial statements and have them audited by external auditors.²⁸ Second, in July 1999, this was followed by a decision by the nominally private but effectively government controlled JSX Company to introduce a new set of corporate governance regulations for publicly-listed companies.

45. Amidst all this, serious concerns continued to be expressed about the quality of financial reporting during the mid to late 1990s. Business consultants and analysts continued to claim that Indonesian financial reports were unreliable and misleading. Even figures associated with the Indonesia Accounting Institute (IAI) acknowledged that manipulation of financial reports was still widespread despite the regulatory changes.

46. At the same time, more financial reporting scandals were exposed. In May 1997, for instance, it was revealed that a leading listed property company, Summarecon, had produced two sets of financial accounts that reported contradictory results for one of its subsidiaries. The first set of accounts, which had been prepared to fulfill legal obligations in case the subsidiary was liquidated, reported that the subsidiary had made a loss of Rp70 billion. The second, which had been prepared for public shareholders, reported that the subsidiary had made a large profit. Concerned that the company had doctored its accounts to

²⁶ Asian Wall Street Journal. 1998. 20 October.

²⁷ *Ibid.*

²⁸ Jakarta Post. 1998. 23 February.

mislead investors, both *Bapepam* and the IAI announced that they would launch investigations into the matter.²⁹

2. The ‘Indonesian Accounting System’

Legislative and Institutional Framework

47. Indonesia’s commercial regulatory framework reflects two influences. First, certain laws have been carried over from the Dutch colonial era. Second, the Sukarno and Suharto governments passed laws in the post-independence period. In contrast to some other countries, laws affecting commercial activities are formulated through Presidential decrees and regulations issued by government agencies. In general, the legal framework affecting present financial accounting practices includes the companies and investment laws, income tax laws and securities market regulation (see Table 4).

Table 4. Key Governing Laws and Regulations: Private Sector

Title	Description
<i>Commercial Code 1847</i>	Governs business activity and is based upon the 1838 Netherlands Commercial Code, with some minor amendments. It does not incorporate subsequent amendments to the Netherlands Commercial Code. The Code has a general requirement that adequate accounting records be maintained so that an entity’s financial position may be determined, however it does not specify what books or records must be kept.

²⁹ Rosser, Andrew. 1999 July. The Political Economy of Accounting Reform in Developing Countries: The Case of Indonesia. Murdoch University: Working Paper No. 93.

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Title	Description
<p><i>Law on Limited Liability Companies (No.1) 1995 (PT Law)</i></p>	<p>The <i>PT Law 1995</i> came into effect in March 1996 and stipulates the financial reporting requirements for companies and the manner in which profits may be appropriated. The company directors must present annual financial reports to the general shareholders meeting no later than five months after the end of the financial year-end. The company's directors and shareholders must sign the reports.</p> <p>The <i>PT Law 1995</i> requires that financial statements must be prepared in compliance with PSAKs. Non-compliance must be disclosed and the reasons for non-compliance should be provided.</p> <p>The <i>PT Law 1995</i> requires that the financial statements of the following types of companies be audited by a public accountant:</p> <ul style="list-style-type: none"> ▪ Companies in a field connected with the mobilization of funds from the public (i.e., banks, investment funds and insurance companies). ▪ Companies that have issued debt instruments. ▪ Publicly held companies. <p>The general shareholders' meeting may not approve financial statements that do not comply with the audit requirements. The <i>PT Law 1995</i> also requires that audited financial statements, once approved by shareholders, be published in two daily newspapers.</p>
<p><i>Law on Company Registration (No. 3) 1982</i></p>	<p>In addition to listing Indonesian companies, this law supports efforts to make company information publicly accessible. Among other things, this law requires that details of each company's authorized, issues and paid-in capital be reported to the Ministry of Trade and Industry.</p> <p>However, the NCCG has identified weaknesses with this law and its implementation, including:</p> <ul style="list-style-type: none"> ▪ The lack of publicly available information required by the law ▪ Absence of timely and accurate mechanisms for collection and publication of information.³⁰

³⁰ Kurniawan, Dudi M. and Nur Indriantoro. 2000. Corporate Governance in Indonesia. Paper Presented to the Second Asian Roundtable on Corporate Governance. Hong Kong, China. 31 May - 2 June 2000. p. 25.

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Title	Description
<p><i>Government Regulation (No. 64) 1999 regarding Company Financial Statements</i>³¹</p>	<p>The promulgation of this regulation reflected a significant improvement in promoting company transparency. Previously, only listed companies were required to file audited financial statements. This regulation required the following companies to file audited financial statements:</p> <ul style="list-style-type: none"> ▪ Those incorporated under the PT Law 1995 ▪ Those that accumulate funds from the public ▪ Those that issue debt instruments ▪ Those that have total or net assets exceeding Rp 25 billion. <p>In accordance with the regulation:</p> <ul style="list-style-type: none"> ▪ Audited financial statements, comprising a balance sheet, income statement, cash flow statement, statement of changes in equity, and notes to the financial statements (including a list of liabilities and capital participation) must be reported ▪ Information is more easily available, including through the Internet and in hard copy as local Company Registry Offices.
<p><i>Law on Capital Markets (No. 8) 1995</i></p>	<p>Among other things, governs the preparation, presentation and audit of financial statements (see Appendix 14). It is supported by <i>Bapepam</i> Rules that include:³²</p> <ul style="list-style-type: none"> ▪ Preemptive Rights (IX.D.1) ▪ Conflicts of Interest on Certain Transactions (IX.E.1) ▪ Material Transactions and Changes in Major Line(s) of Business (IX.E.2) ▪ Mergers and Consolidations of Public Companies and Issuers (IX.G.1) ▪ Planning and Conducting the General Meeting of Shareholders (IX.I.1) ▪ The Main Articles of Association of Companies Offering their Equities to the Public and of Publicly Listed Companies (X.K.1) ▪ Disclosure of Information that Must Immediately be Made Public (X.K.4)
<p><i>Banking Law (No. 7) 1992</i>³³</p>	<p>This law states that Bank Indonesia (BI) may assign a public accountant, for and on behalf of BI, to perform an audit on any bank, either on a periodical basis, or at any time required. In relation to this, public accountants are delegated BI authority (Article 31A).</p>

³¹ Kurniawan, Dudi M. and Nur Indriantoro. 2000. Corporate Governance in Indonesia. Paper Presented to the Second Asian Roundtable on Corporate Governance. Hong Kong, China. 31 May - 2 June 2000.

³² *Ibid.*

³³ As amended by *Law on Banking (No. 10) 1998*.

Title	Description
<i>Law on Bank Indonesia</i> (No. 23) 1999	This law repeats the <i>Banking Law (No. 7) 1992</i> delegation of BI authority to public accountants (Article 30(1)).
<i>Law on Pension Funds</i> (No. 11) 1992	Article 52(1)(a) of this law implies that the Minister of Finance shall receive the financial statements of pension funds that have been audited by public accountants.

48. A new draft company law was prepared by the Ministry of Justice and Human Rights and submitted to the State Secretary's Office in April 2002 for consideration. Although the Company Law 1995 and the new draft law provide for substantial responsibilities of directors, they only cover liability for annual reports, not all public information.³⁴ The company law is administered by the Investment Coordinating Board (BKPM), whose principal mandate is to regulate all forms of investment activities in the country. The registration function is incidental to its main objective although BKPM uses its statutory powers over financial reporting to monitor the nature and level of foreign ownership in Indonesian-based enterprises.³⁵

Accounting Bases and Accounting Information Systems

49. Financial statements must be prepared using the accrual accounting basis. Accounting information systems range from paper-based manual systems to sophisticated, distributed internet-based systems. Many businesses and SOEs use locally-developed accounting packages.

3. Financial Reporting and Disclosure Requirements

50. Corporate disclosure is regulated by several different organizations. The agencies concerned with aspects of financial reporting in Indonesia include:³⁶

³⁴ ADB. 2002 June. Progress Report on the Release of Third Tranche: Financial Governance Reforms Sector Development Program (Loan I618-INO) to Indonesia. Board Paper: Manila.

³⁵ Saudagaran, Shahrokh M. and Joselito G. Diga. 2000. The Institutional Environment of Financial Reporting in ASEAN. *International Journal of Accounting*. Vol 35(1). pp. 1-26.

³⁶ Diga, Joselito and Hadori Yunus. 1997. "Accounting in Indonesia" in *Accounting in the Asia-Pacific Region*, edited by Nabil Baydoun, Akira Nishimura and Roger Willet. John Wiley: Singapore. p. 288.

- Bank Indonesia. Apart from administering the country's monetary policies, the Indonesian central bank prescribes financial reporting requirements for all banks and non-bank financial institutions operating in Indonesia.
- Pertamina. This state petroleum agency is responsible for regulating all aspects of the oil and gas industry in Indonesia, including exploration, production and distribution. Pertamina also administers all production sharing contracts involving joint ventures with foreign companies. Pertamina prescribes the financial reporting requirements for the industry.
- Ministry of Finance. This ministry oversees activities of the Directorate General of Taxation and *Bapepam*.
- Directorate General of Taxation. This agency is responsible for administering tax laws. It prescribes the books of accounts and financial statements required of all corporate taxpayers.
- *Bapepam*. *Bapepam* acts as the overall securities regulator of the corporate securities market in Indonesia. Together with the privately-operated JSX and Surabaya Stock Exchange (SSX), *Bapepam* specifies the reporting requirements of domestic companies that intend to raise finance through a public issuance of its securities.

51. Companies of identified industries are required to submit their annual audited financial statements to specified government regulatory agencies. Publicly listed companies have to submit their annual audited financial statements to *Bapepam* and the JSX or SSX 120 days after the end of their fiscal year. These companies are also required to submit their annual audited financial statements to the Department of Trade and Industry 180 days after the end of their fiscal year. Technically there are no explicit regulatory requirements to submit audited financial statements to the Tax Office, however, practically some tax officials will expect the taxpayer to attach a copy of the audited financial statements with the annual tax return when lodged. During tax examinations, examiners will normally ask for the corporation's annual audited financial statements if there are any.

52. Decree No 97/PM/1996 states that government requires all companies listed on a stock exchange to provide four copies of financial statements. The financial statements should include two consecutive comparisons of two years. In addition, those financial statements should conform with PSAKs. In total, the number of disclosures required by the

government comprise 158 items. The content of decree No.97/PM/1996 in the financial statement section is as follows:³⁷

- Financial statements are based on Accounting Standards determined by IAI and *Bapepam* regulations in the accounting field and a public accountant registered at Bapepam must audit it. If there are differences between the company and the public accountant on reported financial statements and if the conflict causes the public accountant to give a negative comment, refuse to comment, resign, or be fired, then the company has to disclose this fact and the cause of conflict and important aspects regarding it.
- Financial statements must be presented for the last two years or since the company started business for the companies that started less than two years ago. The statements must include: Balance sheet, Income statement, Income balance statement, Cash flow statement, Notes to financial statement, and Other reports and explanatory materials, which are an integral part of the financial statements if required, such as Commitment and Contingencies Statement for eminent and public company operating in banking industry.
- Notes to the financial statements must show separately the amount of each kind of transaction and balance of directors, employees, commissioners, outstanding stockholders, and other parties that have special relationship as stated in the Statement of Financial Accounting Standard. Those separate summaries are needed for receivables, debt, sales or revenue, and expenses. If the amount of transaction for each category with certain party is over Rp 1 billion, this amount must be presented separately and all parties' name must be disclosed.
- The company must disclose all the transactions that influence the equity account and matching with initial balance and ending balance on separate summary in the Notes to Financial Statements.
- Notes to Financial Statements must disclose business segment information as stated in Statement on Financial Accounting Standard.
- The additional information below must be disclosed in the notes, which are in accordance with PSAKs.

³⁷ Tearney, Michael G. 2001. An Evaluation of Disclosure of Financial Information by Public Companies in Indonesia. Unpublished Paper. Von Allmen School of Accountancy, Gatton College of Business and Economics, University of Kentucky.

- Detail of stock ownership by the directors, commissioners, and stockholders who own 5% or more (amount of stock, nominal value and percentage)
- Brief description about unfinished litigation, which probably has impact of more than 2% of net assets or annual profit of company and its subsidiaries.
- Export sales or foreign revenue more than 10% (ten percent) of total sales and revenue.
- Sales or revenue related to certain business area, as determined by the company or its subsidiaries, if the stated sale is 10% or more of total sales or revenues.
- Sales to or revenue from a customer or group of affiliated customers which is more than 20% of total sales or revenue
- Expenses which are more than 5% of total expense or cost related to a project or product that will only provide revenue in the future, or that does not relate to the productive activities.

4. The Quality of Financial Reporting and Disclosure

53. Evidence regarding the quality of Indonesian financial reporting and disclosure varies. But in general, there does appear to be room to improve investor perceptions.

54. First, a 1999 PricewaterhouseCoopers survey of Singapore-based institutional investors, showed that Indonesia ranked lowly among 12 Asia-Australia countries in perceived standards of disclosure and transparency, accountability to shareholders, board processes and auditing and compliance.³⁸

55. Second, a 2001 study comparing Indonesian and U.S. disclosure, calculated a disclosure index of 97% for the U.S. and 96% for Indonesia—i.e., 97% of the required U.S. disclosures were actually made. The authors concluded that:³⁹

“perhaps the primary reason for different disclosure indexes in Indonesia and the United States is because of the much more severe sanctions (i.e. civil liability under current legal conditions in the U.S.) for non-disclosure in the U.S. than Indonesia.”

³⁸ PricewaterhouseCoopers and Singapore Stock Exchange. 1999. 1999 Survey of Institutional Investors.

³⁹ Tearney, Michael G. 2001. An Evaluation of Disclosure of Financial Information by Public Companies in Indonesia. Unpublished Paper. Von Allmen School of Accountancy, Gatton College of Business and Economics, University of Kentucky. tearney@ukcc.uky.edu

56. Table 5 reports the results of a comparative study of financial reporting requirements.

Table 5. Financial Reporting Requirements for East Asian Economies

Economy	Mandatory consolidated reporting	Disclosure of derivatives	Disclosure of related party transactions*	Reporting frequency in months*	Mandatory disclosure of extraordinary items*
Australia	Yes	Yes	Yes	3	Yes
China, People's Republic of (PRC)	No	n.a.	Yes	3 ²⁰⁰²	Yes
Hong Kong, China	Yes	Yes	Yes	3	Yes
Indonesia	Yes	Yes	Yes	12	Yes
Japan	Yes	Yes	Yes	6	Yes
Korea, Republic of	Yes	Yes	Yes	6	Yes
Malaysia	Yes	Yes	Yes	3	Yes
Philippines	Yes (draft)	Yes (draft)	Yes	3	Yes
Singapore	Yes	Yes	Yes	6	Yes
Taipei, China	Yes	Yes	Yes	6	Yes
Thailand	Yes	Yes	Yes	3	Yes
Viet Nam	No	No	No	3	Yes

Note: * Listed company requirements, except for PRC and Viet Nam.

Source: PricewaterhouseCoopers. 2001 August. Consultancy Prepared for the Economic Analysis Unit (EAU). Reported in Economic Analytical Unit (EAU). 2002. *Changing Corporate Asia, What Business Needs to Know: Volume 1. Main Report*. Department of Foreign Affairs and Trade: Australia. p. 38.

Part Two. Auditing

5. Introduction

57. Auditing has historically been concerned with the faithful and accurate accounting of entity financial performance and position. This concern arises from the imperative of maintaining accountability in the presence of agency conflicts between firm management and owners.⁴⁰ Over time, this notion of accountability has expanded as interest groups established new performance standards.⁴¹ However, the underlying philosophy has remained constant—essentially one of ensuring that accounting records have been kept and verifying compliance with generally accepted accounting principles.⁴²

58. Accordingly, audit quality can influence the market value of a company as investors place a higher level of trust in information that has been subject to an independent audit. Investors should be able to rely on the audit function to provide an independent and comprehensive review of the information being reviewed and of the judgments and estimates behind it.⁴³

59. Auditing was established in Indonesia with the 1907 establishment of State Accountant Bureau with duties including preparing and auditing companies' accounts. Accountants from the Netherlands

⁴⁰ Jensen and Meckling posit that the demand for auditing results from a desire to reduce the management shirking that results from information asymmetries between managers and owners. They demonstrate that managers will voluntarily increase the observability of their actions by hiring independent auditors to monitor their behavior: Jensen, M, & Meckling W. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Accounting and Economics* 305 October. See also Chow C. 1982. The Demand for External Auditing: Size, Debt and Ownership Influences. *The Accounting Review* April 272; Benston G. 1985. The Market for Public Accounting Services: Demand, Supply and Regulation 4. *Journal of Accounting and Public Policy* 33.

⁴¹ In addition to agency theory, a number of theoretical frameworks have been put forward to explain the demand for auditing services and the behavior of auditors. These include information theory, insurance theory, legislated demand theory and contracting theory.

⁴² see Flint D. 1988. *Philosophy and Principles of Auditing: An Introduction*, Macmillian, London. p. 20.

⁴³ The Parliament of the Commonwealth of Australia. 2002. Joint Standing Committee on Public Accounts and Audit: Report 397: Review of Independent Auditing by Registered Company Auditors. 18 September. p. 93.

undertook these functions. Indonesia's first private auditing firm was established in 1918 in Jakarta.⁴⁴

60. The exposure of previously undetected frauds and financial misstatements following the 1997 crisis, led to auditors being publicly blamed for business collapses. However, auditors contended that they were under intense management pressure to accept rosy results. Moreover, they felt that had little control over asset valuations, which depended on the judgments of other professionals, such as valuers.⁴⁵

61. The following sections examine Indonesian auditing practices regarding auditor appointment and dismissal, auditor independence, auditor reporting requirements, and auditor liability. Malaysian arrangements are presented for comparison.⁴⁶

6. Auditor Appointment and Dismissal

62. Section 13 of the IFAC *Code of Ethics for Professional Accountants* (1996) outlines procedures for communicating between incoming and outgoing auditors.⁴⁷ Furthermore, ISA 315 states the requirements for communications between predecessor and successor auditors when a change of auditors occurs. It places the initiative for communication with the successor auditor who is required to make specific inquiry, after obtaining permission from the prospective client, of the predecessor auditor as to such matters as management integrity, management disagreements and the reason for change in auditor. Table 6 sets out Indonesian arrangements for auditor appointment and dismissal.

⁴⁴ Bachtiar, Emil. 2001. The Professionalization of Accounting in Indonesia. Paper Presented to the Second Accounting History International Conference, Osaka, 8-10 August 2001.

⁴⁵ Kurniawan, Dudi M. and Nur Indriantoro. 2000. Corporate Governance in Indonesia. Paper Presented to the Second Asian Roundtable on Corporate Governance. Hong Kong, China. 31 May-2 June 2000. pp. 21-22.

⁴⁶ The analytical framework used, and the Malaysian information, is adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149. (The Indonesian information was provided by HTM, member firm of Deloitte Touche Tohmatsu International).

⁴⁷ International Federation of Accountants (IFAC). 1996. *Code of Ethics for Professional Accountants*. New York.

Table 6. Auditor Appointment and Dismissal

Factor	Indonesia	Malaysia
Nominating party	Directors and/or shareholders	Shareholders
Appointing party	Shareholders	Shareholders
Party approving appointment	BI and Bapepam approve appointments in some cases.	Shareholders and the Central Bank of Malaysia for financial institutions
Dismissal by appointing body	Yes	Yes
Dismissal by body other than appointing body	Yes. Statutory auditors appointed by the Board of Directors can be dismissed by the shareholders	No
Auditors rights to defend position on dismissal or resignation	No	Yes. Written or personal representations to the shareholders
Compensation on termination	Yes. Any outstanding fees for professional services before termination	Fees owing to the outgoing auditor must be paid before the incoming auditor can accept the engagement

7. Auditor Independence

63. The *Code of Ethics for Professional Accountants* states that accountants in public practice should be, and should appear to be, free of any interest that might be regarded as being incompatible with integrity, objectivity and independence.⁴⁸ ISA 220 and the Statement of Policy by the IFAC Council (1992) support periodic peer reviews. Furthermore, Section 8 of the IFAC *Code of Ethics* (1996) relates to the objectivity of auditors with respect to their clients.

64. As regards auditor independence, in a recent landmark case, the U.S. SEC brought its first successful action for fraud against an auditor in more than twenty years. The case underscored the SEC's concern that "the quality of auditing is being compromised by the amount of (more lucrative) non-audit work that companies' auditors now perform for

⁴⁸ International Federation of Accountants (IFAC). 1996. *Code of Ethics for Professional Accountants*.

their clients.⁴⁹ Table 7 summarizes the restrictions aimed at preserving the independence and objectivity of statutory auditors.

Table 7. Auditor Independence

Factor	Indonesia	Malaysia
Restrictions on relationships: personal commercial financial, or influential	Yes	Yes. However, financial interests or relationships are allowed if the auditor's indebtedness to the company or related party is less than RM 2,500
Restrictions on services provided by audit firms to audit clients (other than the audit)	Legal services	Bookkeeping, accounting, legal services and corporate recovery
Audit fees fixed in advance	Yes	Yes
Rules to calculate audit fees	No	Yes. However, the Malaysian Institute of Accountants' (MIA) basis for determining audit fees serves as a guide only. In practice, audit fees are negotiated between the company and the auditors
Over-dependence on a single client with respect to audit fees	No	Yes
Rules to avoid low balling	No	Yes
Required rotation of audit firms	Yes. Every three years	No
Required rotation of audit partners	Yes. Every five years	No
Restrictions on auditors moving to clients	No	No
Sanctions for breach of independence	Yes	Yes
Safeguards to objectivity:		
• Challenges to objectivity disclosed	No	Yes

⁴⁹ The Economist. 2001 June 23. *Andersen's Fairy Tales: A \$7 million fine from the SEC again raises doubts about the independence of auditors.* p. 77.

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Factor	Indonesia	Malaysia
• Quality reviews by regulators	Yes	No
• Quality reviews by peer audit firms	No. By MOF.	No
• Internal quality reviews	Yes	Yes

8. Auditor Reporting Requirements

65. ISA 700 – *the Auditor's Report on Financial Statements* – establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.

Table 8. Audit Reporting

Issue	Indonesia	Malaysia
In Auditor's Report:		
• Fraud or irregularities	No	No
• Illegal acts	No	No
• Internal controls and systems	No	No
• Maintenance of proper accounting records	No	Yes
Reporting to Other Parties:		
• Fraud or irregularities	Yes. Report to the Board of Directors	Yes. Report to the Board of Directors
• Illegal acts	Yes. Report to the Board of Directors	Yes. Written report to the Registrar of Companies
• Internal controls and systems	Yes. Report to the Board of Directors	Yes. Report to the Board of Directors
• Maintenance of proper records	Yes. Report to the Board of Directors	No
Report on compliance with accounting laws and regulations	Yes	Yes
Standard forms of audit reports required by law	Yes	No
Matters to be included in reports specified by law	Yes	Yes
Standard forms of audit reports established by professional bodies	Yes	Yes

9. Auditor Sanctions and Liability

66. Exposing auditors to civil liability creates strong incentives to raise quality and maintain independence. There must however be a balance between providing this incentive and avoiding a decline in audit services due to excessive litigation costs.⁵⁰

Table 9. Auditor Liability

Issue	Indonesia	Malaysia
Professional Sanctions:		
• Warning	Yes	Yes
• Reprimand	Yes	Yes
• Fine	Yes	Yes
• Temporary suspension	Yes	Yes
• Permanent exclusion	Yes	Yes
Civil liability Exposure:		
• Auditee	Yes	Yes
• Shareholders	Yes	Yes
• Other third parties	Yes	Unclear. No legal precedence
Professional indemnity insurance required	No	No

67. The following table summarizes liability and sanctions applicable to auditors of publicly listed companies for issuing misleading audit opinions. It reflects the provisions of the 2002 Finance Minister Decree.

Table 10. Auditor Liability and Sanctions as at 30 September 2002

Mechanism	Liability for Compensation to Injured Parties	Operating Restrictions	Financial Sanctions	Custodial Sanctions	Other Sanctions
Finance Minister Decree 2002					
• Material report differences	...	License suspension for maximum of 24 months	Other (e.g., must undertake CPE)
• Very material report differences	...	License revocation

⁵⁰ Palmrose, Zoe-Vonna. 1988. An Analysis of Auditor Litigation and Audit Service Quality. *The Accounting Review*. 63. pp. 55-73.

Mechanism	Liability for Compensation to Injured Parties	Operating Restrictions	Financial Sanctions	Custodial Sanctions	Other Sanctions
Bank Indonesia Law (No. 23) 1999	In association with Civil Code	License suspension or revocation	Fines	...	Warnings and reprimands
Capital Markets Law	In association with Civil Code	License suspension or revocation	<ul style="list-style-type: none"> • Maximum IDR500m for non-individuals • Maximum IDR100m for individuals⁵¹ 	...	Warnings and reprimands
Civil Code (in conjunction with other laws)	Allows class actions to be filed for unlimited compensation
Professional Body (IAI)	...	License suspension or revocation	Vary	...	Warnings and reprimands

10. Accounting and Auditing Firms

68. All the large international accountancy firms are represented in Indonesia. As of 1 August 2001, there were 137 accounting firms registered with *Bapepam* ranging from sole practitioners to the Big Four international firms (see Table 11).

Table 11. Accounting Firms Registered with *Bapepam* at June 2001

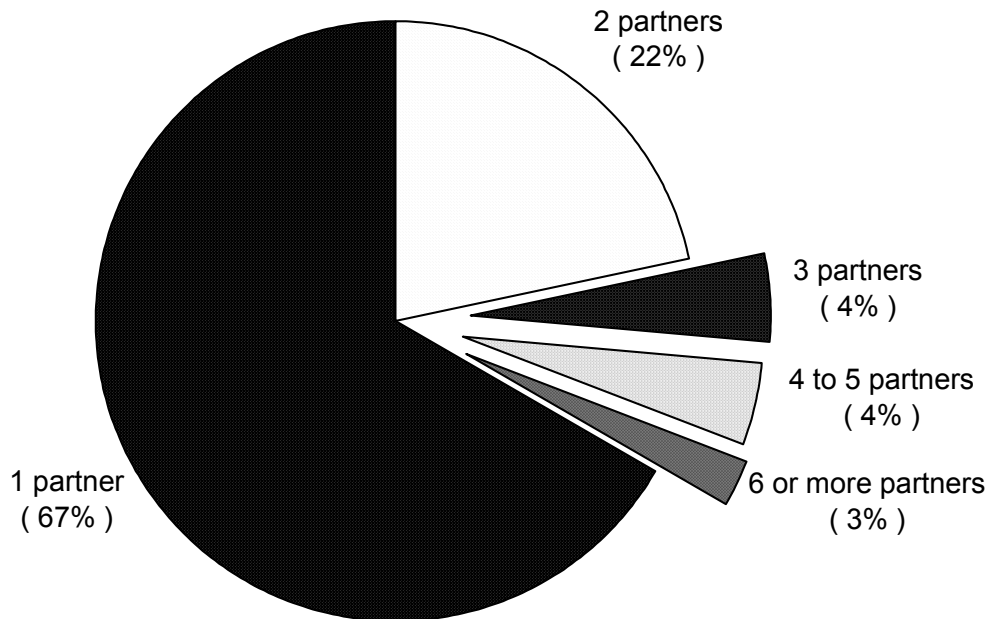
Type of Firm	Number of Firms	Number of Partners		
		Minimum	Average	Maximum
'Big Five' International Firms (June 2001)	5	4	8.8	15
Affiliates of Other International Firms	20	1	2.1	7
Other Firms	131	1	1.4	4
Total	156	1	1.7	15

Source: www.Bapepam.go.id

⁵¹ President of Indonesia. 1995 November 10. *Regulation Concerning Capital Market Organization No. 45*. Article 64.

69. Most Indonesian accounting firms are very small (see Figure 3).
70. Indonesian accountants may practice as either sole proprietorships or in partnerships. There are essentially three types of partnership: basic, open and limited. The primary legislation dates from the Dutch colonial period and partnerships are still referred to by their Dutch names.⁵²
71. In the basic partnership (*maatschaap*), partners are jointly and severally liable and their liability for the partnership's debts is unlimited. The provisions of the Indonesian Civil Code 1847 govern *maatschaaps*. This type of partnership is most common among professionals, including accountants.
72. Similar to the basic partnership, the partners in an open partnership (*firma*) are jointly and severally liable and their liability for the partnership's debts is unlimited. In addition, each partner has the right to bind the partnership to third parties, unless that right has been specifically denied. This partnership is most commonly used by trading and service enterprises.

Figure 3. Distribution of *Bapepam*-Registered Accounting Firms by Number of Partners (as at June 2001)



Source: Derived from Bapepam data (Source: www.Bapepam.go.id)

⁵² Foo, See Liang. 1997. "Indonesia" in *Financial Reporting in the Pacific Asia Region*, edited by Ronald Ma. Singapore: World Scientific Publishing, pp. 347-364.

73. The third type of partnership is the limited partnership or the *commanditaire vennootschap (cv)*. It is similar to the open partnership but permits the admission of silent partners. The *firma* and *cv* are governed primarily by the provisions of the *Commercial Code*.

11. The 2002 Decree on Public Accountant Services

74. Amidst international efforts to strengthen auditing arrangements (see Box 1), on 30 September 2002, the Indonesian Finance Minister signed a Decree on Public Accountant Services.⁵³

⁵³ Finance Minister Decree No. 423/KMK.06/2002. 30 September 2002.

Box 1. Stricter Rules for U.S. Capital Markets

On 30 July 2002, the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act 2002 was signed into U.S. law. In accordance with the Act:

- The lead audit partner and the reviewing partner must rotate off the audit every five years.
- The General Accounting Office (GAO) will examine and report on the potential effects of mandatory rotation of public accounting firms by July 2003.
- The CEO, Controller and CFO, Chief Accounting Officer may not have been employed by the company's audit firm during the one-year period preceding the audit.
- Audit committees must be established.
- A Public Company Accounting Oversight Board will be created. Among other things, the Board will: (i) register public accounting firms; (ii) establish auditing, quality control, ethics, independence, and other standards; (iii) conduct inspections of public accounting firms; (iv) conduct investigations and disciplinary proceedings; and (v) impose sanctions on public accounting firms and associated persons. The SEC will appoint the Board's five fulltime members in consultation with the Federal Reserve Chair and the Secretary of the Treasury. Two of the members must be or have been CPAs, and the remaining three must not be and cannot have been CPAs. The Chair may be held by one of the CPA members, if they have not been engaged as a practicing CPA for five years.
- Annual quality reviews (inspections) must be conducted for firms that audit more than 100 companies, all others must be conducted every 3 years.
- CEOs and CFOs must sign a written statement certifying that the financial statements fairly present, in all material respects, the operations and financial condition of the issuer. Fines and imprisonment may be imposed where the report is found misleading or fraudulent.
- GAO will conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems discovered.
- Public accounting firms may not provide the following services to audit clients: (i) bookkeeping or accounting services; (ii) information systems design or implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services and expert services unrelated to the audit; and (ix) any other service that the Board determines impermissible.
- Public accounting firms must gain pre-approval from the audit committee before any other non-audit services are provided (e.g., taxation advice).
- Annual reports must contain an "internal control report", which: (i) states that management is responsible for establishing and maintaining adequate internal control structures and procedures for financial reporting; and (ii) assesses the effectiveness of internal control systems. Auditors must attest to, and report on, management's internal control assessment.
- The SEC must examine and report on the adoption of principles-based accounting by July 2003 (see p. 120).

75. This new Finance Minister decree (see Appendix 22):
- Revokes an earlier Finance Minister Decree [63].⁵⁴
 - Tightens public accountant licensing requirements and procedures [2–5, 7–16].
 - Defines attestation services as including general audits, performance audits and special audits [1, 6].
 - Mandates audit partner rotation (three years) and auditing firm rotation (five years) [6].
 - Requires periodical quality reviews of local PA firms that have signed cooperation agreements with foreign firms [17(2)(c)].
 - Specifies supervision and inspection arrangements [18–23].
 - Specifies sanctions for infringements [47–48] (see Table 12).

Table 12. 2002 Finance Minister Decree: Synopsis of Sanctions

Infringement Type	Sanctions
<p>Light Infringement [48(3)]</p> <ul style="list-style-type: none"> • Failure to satisfy relevant laws regarding provision of non-attestation services [6(2)]. • Failure to meet provisions regarding PA Office establishment, organization and operations [7, 11, 15, 16, 17, 38, 39, 40, 41]. • Impeding inspections [21]. • Incorrectly signing attestation report [25, 44]. • Failure to respect prohibitions and obligations regarding PA functions [26, 29, 34]. • Failure to meet continuing professional education (CPE) requirements [28, 54]. • Failure to maintain prescribed records or submit required reports [35, 36, 37, 42]. • Warning sanction from IAI [55(1)(a)]. • Not meeting transitional provisions [59(2-3), 60(d)]. 	<p>Warning</p> <ul style="list-style-type: none"> • Maximum of three times within 48 months—fourth warning results in license freeze [49]. • May be publicized [57(2)].

⁵⁴ Finance Minister Decree on Public Accountant Services (No. 43/KMK.017/1997) as amended by Finance Minister Decree No. 470/KMK.017/1999.

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Infringement Type	Sanctions
<p>Serious Infringement [48(4)]</p> <ul style="list-style-type: none"> • Failure to comply with professional standards or engagement agreement results in material report differences [24]. • Business license freeze [43(4)(a)] • License freeze sanction from IAI [55(1)(b)]. • Failure to adhere to auditor rotation requirements [6(4)]. • Fourth light infringement within 48 months [49(2)]. • Not meeting transitional provisions [59(5-6)]. 	<p>License Freeze</p> <ul style="list-style-type: none"> • Maximum of 24 months [50]. • Second infringement results in license revocation [50(3)]. • Business license frozen during license freeze [51]. • Prohibited from rendering attestation and non-attestation services during freeze period [50(1)]. • Must continue to undertake CPE and remains responsible for services that were rendered [54]. • Sanction must be publicized [57(1)].
<p>Very Serious Infringement [48(5)]</p> <ul style="list-style-type: none"> • Failure to comply with professional standards or engagement agreement results in very material report differences [24]. • Business license revocation [43(4)(b-c)]. • Second serious infringement [50(3)]. • Failure to meet licensing or registration requirements [5(1-3), 27, 33(3), 52, 53]. • Dismissal from IAI membership [55(1)(c)]. • Not meeting transitional provisions [58(3)]. 	<p>License Revocation</p> <ul style="list-style-type: none"> • Sanction must be publicized [57(1)].