

Diagnostic Study of Accounting and Auditing Practices (Private Sector)

Republic of Indonesia

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Preface

This report describes Indonesian accounting and auditing arrangements, identifies deficiencies in those arrangements, and presents recommendations to address those deficiencies. It is part of the Asian Development Bank (ADB) series of country Diagnostic Studies of Accounting and Auditing (DSAAs). In 2000, DSAAs were completed and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan and Viet Nam. In 2001-02, DSAAs were prepared for Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka.

This report was prepared for ADB by Barry Reid (Consultant) with guidance from Neside Tas-Anvaripour (Financial Management Specialist, ADB) under an ADB staff consultancy. Emil Bachtiar (University of Indonesia) provided valuable research guidance and assistance. A preliminary study discussion was conducted in Jakarta on 13 February 2002 at which representatives from government, the private sector and international organizations examined preliminary study recommendations. The discussion guided the future direction of the study. A further workshop, focusing on accounting and auditing standards, was conducted on 14 August 2002 in Jakarta. The workshop participants, representing government, professional bodies and auditing firms, agreed the related recommendations. Where necessary, changes are reflected in this report. Government officials and other parties reviewed other chapters, such as professional infrastructure. Their comments and suggestions have been incorporated in this report.

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Currency Equivalents

(as of 31 December 2002)

Currency Unit – Rupiah (Rp)

Rp 1.00 – \$ 0.0001116

\$1.00 – Rp 8,962.20

Acronyms

ACCSF	Asian currency crisis support facility
ADB	Asian Development Bank
AEI	<i>Asosiasi Emiten Indonesia</i> (Association of Publicly Listed Companies)
AFA	ASEAN Federation of Accountants
AFTA	ASEAN Free Trade Area
AICPA	American Institute of Certified Public Accountants
APAP	<i>Asosiasi Profesi Akuntan Publik</i> (Professional Accounting Association)
APB	Accounting Principles Board (U.S.)
APEC	Asia Pacific Economic Council
APEI	<i>Asosiasi Perusahaan Efek Indonesia</i> (Association of Indonesian Securities Companies)
ARB	accounting research bulletin (U.S.)
ASEAN	Association of South East Asian Nations
AusAID	Australian Agency for International Development
BAKUN	<i>Badan Akuntansi Keuangan Negara</i> (State Financial Accounting Agency, MOF)
BAN	<i>Badan Akreditasi Nasional</i> (National Accreditation Board)
BAP	<i>Bersertifikasi Akuntan Publik</i> (IAI Public Accountant Certificate)
Bapepam	<i>Badan Pengawas Pasar Modal</i> (Capital Market Supervisory Agency)
Bappenas	<i>Badan Perencanaan Pembangunan Nasional</i> (National Development Planning Agency)
BI	Bank Indonesia (Central Bank of Indonesia)
BKPM	<i>Badan Koordinasi Penanaman Modal</i> (Investment Coordinating Board)
BP2AP	<i>Badan Peradilan Profesi Akuntan Publik</i> (Judiciary Body for Public Accountants)
BPK	<i>Badan Pemeriksa Keuangan</i> (Supreme Audit Board)

BPKP	<i>Badan Pengawas Keuangan dan Pembangunan</i> (Audit and Development Supervising Agency)
BPN	<i>Badan Kepegamaan Negeri</i> (National Civil Service Board)
BPPK	<i>Badan Pendidikan dan Pelatihan Keuangan</i> (MOF Financial Education and Training Board)
BUMD	<i>Badan Usaha Milik Daerah</i> (Local Government Enterprise)
BUMN	<i>Badan Usaha Milik Negara</i> (State-owned Enterprise, SOE)
CAP	country assistance plan (ADB)
CAPA	Confederation of Asian and Pacific Accountants
CFAA	country financial accountability assessment (World Bank)
COS	country operational strategy (ADB)
CPA	certified public accountant
CPE	continuing professional education
CPM	country programming mission
DAI	<i>Dewan Akuntansi Indonesia</i> (Indonesian Accounting Board)
DGoT	MOF Directorate General for Taxation (<i>Direktorat Jenderal Pajak</i>)
DJLK	<i>Direktorat Jenderal Lembaga Keuangan</i> (MOF Directorate General for Financial Institutions)
DIKTI	<i>Direktorat Jenderal Pendidikan Tinggi</i> (Directorate General of Higher Education)
DKSAK	<i>Dewan Konsultatif Standar Akuntansi Keuangan</i> (Financial Accounting Standards Advisory Council)
DKSPAP	<i>Dewan Konsultatif Standar Profesional Akuntan Publik</i> (Public Accountants Professional Standards Advisory Council)
DMC	developing member country (ADB)
DPAJP	<i>Direktorat Pembinaan Akuntan dan Jasa Penilai</i> (MOF Directorate for Supervision of Accountants and Appraisers)
DPN	<i>Departemen Pendidikan Nasional</i> (Ministry of National Education)
DPRIN	<i>Departemen Perindustrian dan Perdagangan</i> (Ministry of Trade and Industry)
DSAA	Diagnostic Study of Accounting and Auditing
DSAK	<i>Dewan Standar Akuntansi Keuangan</i> (Financial Accounting Standards Board)
DSPAP	<i>Dewan Standar Profesional Akuntan Publik</i> (Public Accountants Professional Standards Board)

ED	exposure draft
FASAB	Federal Accounting Standards Advisory Board (U.S.)
FASB	Financial Accounting Standards Board (U.S.)
FATF	Financial Action Task Force on Money Laundering
FCGI	Forum for Corporate Governance in Indonesia
FDI	foreign direct investment
FGRSDP	financial governance reforms: sector development program (ADB)
FIFO	first-in first-out (Inventory valuation method)
FKSPI	<i>Forum Komunikasi Satuan Pengendauan Intern BUMN/BUMD</i>
BUMN/ BUMD	(Association of State-owned Enterprise Internal Auditors)
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GAGAS	generally accepted government auditing standards (U.S.)
GAO	General Accounting Office (U.S.)
GAPPI	<i>Gabungan Perusahaan Penilai Indonesia</i> (Indonesian Association of Appraisal Firms)
GASAC	Governmental Accounting Standards Advisory Council (U.S.)
GASB	Government Accounting Standards Board (U.S.)
GATS	general agreement on trade in services
GDP	gross domestic product
GFS	government finance statistics (IMF)
GNP	gross national product
IAASB	International Auditing and Assurance Standards Board (IFAC)
IAI	<i>Ikatan Akuntan Indonesia</i> (Indonesian Institute of Accountants)
IAI-KAA	<i>IAI Kompartemen Akuntan Akademik</i> (IAI Academic Accountants Compartment)
IAI-KAM	<i>IAI Kompartemen Akuntan Manajemen</i> (IAI Management Accountants Compartment)
IAI-KAP	<i>IAI Kompartemen Akuntan Publik</i> (IAI Public Accountants Compartment)
IAI-KASP	<i>IAI Kompartemen Akuntan Sektor Publik</i> (IAI Public Sector Accountants Compartment)
IAPC	International Auditing Practices Committee (IFAC)
IAPS	International Auditing Practice Statement (IAASB)
IAS	International Accounting Standard (IASB)

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IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBRA	Indonesian Bank Restructuring Agency (<i>Badan Penyehatan Perbankan Nasional, BPPN</i>)
ICSME	industrial competitiveness and small and medium enterprises development program
IEG	international education guideline (IFAC)
IES	international education standard (IFAC)
IFAC	International Federation of Accountants
IFEA	Indonesian Financial Executives Association
IFRS	international financial reporting standard (IASB) ¹
IIA	Institute of Internal Auditors – Indonesia Chapter
IMF	International Monetary Fund
INA	Indonesian Netherlands Association
INCOSAI	International Conference of Supreme Audit Institutions
INTOSAI	International Organization of Supreme Audit Institutions
IOSCO	International Organization of Securities Commissions
IPSAS	international public sector accounting standard (IFAC)
ISA	international standard on auditing (IAASB)
ISAK	<i>Interpretasi Standar Akuntansi Keuangan</i> (Financial Accounting Standard Interpretation)
ISAR	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting of the UNCTAD
IVS	international valuation standard (IVSC)
IVSC	International Valuation Standards Committee
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
JITF	Jakarta Initiative Task Force
KAP	<i>Kantor Akuntan Publik</i> (Public Accounting Firm)
KAPA	<i>Kantor Akuntan Publik Asing</i> (Foreign Public Accounting Firm)
KKN	<i>Korupsi, Kolusi dan Nepotisme</i> (corruption, collusion and nepotism)
KPAI	<i>Komite Prinsip Akuntansi Indonesia</i> (Indonesian Accounting Principles Committee)

¹ In 2001, the International Accounting Standards Board (IASB) assumed responsibility from the International Accounting Standards Committee (IASC) for promulgating IASs. In future, IASB-issued standards will be called International Financial Reporting Standards (IFRSs). While the IASB now expects its standards to be called IFRSs, this report uses the term IASs (in the interests of continuity).

KPMK	<i>Komite Penyempurnaan Manajemen Keuangan</i> (Financial Management Reform Committee)
KPSPI	<i>Komite Penyusun Standar Penilaian Indonesia</i> (Indonesian Valuation Standards Committee)
KSAK	<i>Komite Standar Akuntansi Keuangan</i> (Financial Accounting Standards Committee)
LIFO	last-in first-out (Inventory valuation method)
MAPPI	<i>Masyarakat Profesi Penilai Indonesia</i> (Indonesian Society of Appraisers)
MOF	Ministry of Finance (<i>Departemen Keuangan</i>)
MTI	<i>Masyarakat Transparansi Indonesia</i> (Indonesian Society for Transparency)
NCCG	National Committee on Good Corporate Governance
NGO	non-government organization
NMI	New Miyasawa Initiative
OECD	Organization for Economic Cooperation and Development
OJK	<i>Otorita Jasa Keuangan</i> (Financial Services Authority)
PA	public accountant
PAI	<i>Prinsip Akuntansi Indonesia</i> (Indonesian Accounting Principles)
PSAK	<i>Pernyataan Standar Akuntansi Keuangan</i> (Indonesian Financial Accounting Standard)
PSC	Public Sector Committee (IFAC)
PSE	private sector enterprise
REPELITA	<i>Rencana Pembangunan Lima Tahun</i> (Five-Year Development Plan)
RETA	regional technical assistance (ADB)
ROSC	report on the observance of standards and codes (IMF / World Bank)
SAI	supreme audit institution
SEC	Securities and Exchange Commission (U.S.)
SFAC	statement of financial accounting concepts (U.S.)
SFAS	statement of financial accounting standards (U.S.)
SME	small or medium-scale enterprise
SOE	state-owned enterprise
SPAP	<i>Standar Profesi Akuntan Publik</i> (Professional Standards for Public Accountants including Auditing Standards)
SPI	<i>Standar Penilaian Indonesia</i> (Indonesian Valuation Standard)

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STAN	<i>Sekolah Tinggi Akuntansi Negara</i> (College for State Accountancy)
TA	technical assistance
TKPA	<i>Tim Koordinasi Pengembangan Akuntansi</i> (Coordinating Agency for Accountancy Development)
UN	United Nations
UNA	<i>Ujian Nasional Akuntansi</i> (National Accounting Examinations)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
U.S.	United States
USAID	United States Agency for International Development
USAP	<i>Ujian Sertifikasi Akuntan Publik</i> (Examination for Public Accountant Certification)
WTO	World Trade Organization
YPIA	<i>Yayasan Pendidikan Internal Auditor</i> (Internal Auditor Education Foundation)
YPIAI	<i>Yayasan Pengembangan Ilmu Akuntansi Indonesia</i> (Indonesian Accountancy Development Foundation)

Notes

- (i) The fiscal year of the Government ends on 31 December. 'FY' before a calendar year denotes the year in which the fiscal year ends.
- (ii) In this report, \$ refers to U.S. dollars.

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Executive Summary

Background

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. 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. Following around 300 years of Dutch rule, Indonesia obtained legal independence from the Netherlands in 1949.

Government is a major player in the market-based economy—it owns around 180 state-owned enterprises (SOEs). Despite an abundance of natural resources and growth rates of 7%–8% in the early 1990s, Indonesia has faced severe economic problems. These problems have been exacerbated by structural issues including the lack of reliable legal recourse in contract disputes, corruption, banking-system weaknesses and an unstable political environment. The 1997-98 Asian financial crisis hit hard—inflation and interest rates escalated, gross domestic product (GDP) declined by 13.7% in 1998, real wages and employment fell, and poverty rose—moreover, in comparison to other affected countries, it has been slow to recover.

Significant challenges faced by government include: (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.

Financial Governance: Challenges and Responses

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. Several 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.

During periods of economic growth, this lack of disclosure and regulation was not considered a problem. In fact, the lack of transparency financial reporting suited those who engaged 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.

However, Indonesia has experienced a number of severe economic crises and has needed to attract both foreign investment and foreign assistance. 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.

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.

Continued pressure from external agencies and a series of financial reporting scandals paved the way for further financial reporting reform. In 1994, the government entered into a project to improve the quality of financial reporting in both the public and private sectors. 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 project output was a set of accounting standards based on international accounting standards (IAS).

Government also introduced new requirements for corporate reporting and disclosure by way of the Companies Code and Capital Markets Law, including: (i) the required use of financial accounting standards (PSAKs) by companies in reporting their annual accounts; (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.

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. In late 2002, the Finance Minister signed a Decree on Public Accountant Services, which introduced a regime of tough sanctions and brought auditing practices into line with emerging international best practice.

Whatever the case, problems with Indonesia's judicial environment mean that effective enforcement of sanctions for non-compliance with regulatory requirements will remain a problem.

Accounting and Auditing in Indonesia

Following independence, Indonesia increasingly turned from Dutch to U.S. accounting practices. 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.

Among other things, the ensuing controversy resulted in measures to strengthen financial accounting regulations. First, in late 1994, government introduced a new set of IAS-compliant PSAKs. Second, government launched a joint project with the World Bank to further develop 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.

The 1997-1998 Asian financial crisis further increased pressure for government to improve the quality of financial reporting. At the same time, political and social unrest was spreading rapidly because of rising prices and growing opposition to President Suharto. Moreover, the blamed poor accounting practices for fueling the crisis.

Corporate disclosure is regulated by several different organizations. In particular, Bank Indonesia, Pertamina (the state petroleum agency), Ministry of Finance, Directorate General of Taxation, and the capital market agency (*Bapepam*). Evidence regarding the quality of Indonesian financial reporting and disclosure varies. On one hand, disclosure is good. Conversely, asset and liability valuations are not robust. In general, there is room to improve investor perceptions.

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

On 30 September 2002, the Finance Minister signed a Decree on Public Accountant Services. Among other things, the new decree reflects international trends and: (i) tightens public accountant licensing requirements and procedures; (ii) mandates audit partner rotation (three years) and auditing firm rotation (five years); (iii) requires periodical quality reviews of local public accountant firms that have signed cooperation agreements with foreign firms; (iv) specifies supervision and inspection arrangements; and (v) specifies sanctions for infringements.

While the Decree aligns Indonesia with emerging international best practices, the challenge is that of effective implementation. Furthermore, the enactment of the Public Accountants (PA) Law would provide a stronger legal basis for accounting and auditing.

Professional Infrastructure

Colonialism didn't leave Indonesia much accounting infrastructure. Despite that, accountancy is today one of the country's strongest professions. Established by the first local accounting graduates in 1957, the Indonesian Institute of Accountants (IAI) faced immediate problems when demand for accountancy services collapsed in the 1960s. Economic liberalization renewed development momentum in the 1970s, but it was not until the mid-1990s that IAI standards and practices approached international norms.

Forty-five years after its foundation, IAI has matured into a nationally respected professional institute. Its 6,000 members—of whom more than 65 percent reside in Jakarta—comprise accountants from public practice, management, government and academia. There are four qualifications; three of these are government regulated. In 1997, IAI introduced the government-recognized public accountant exam (USAP) and public accountant qualification (BAP).

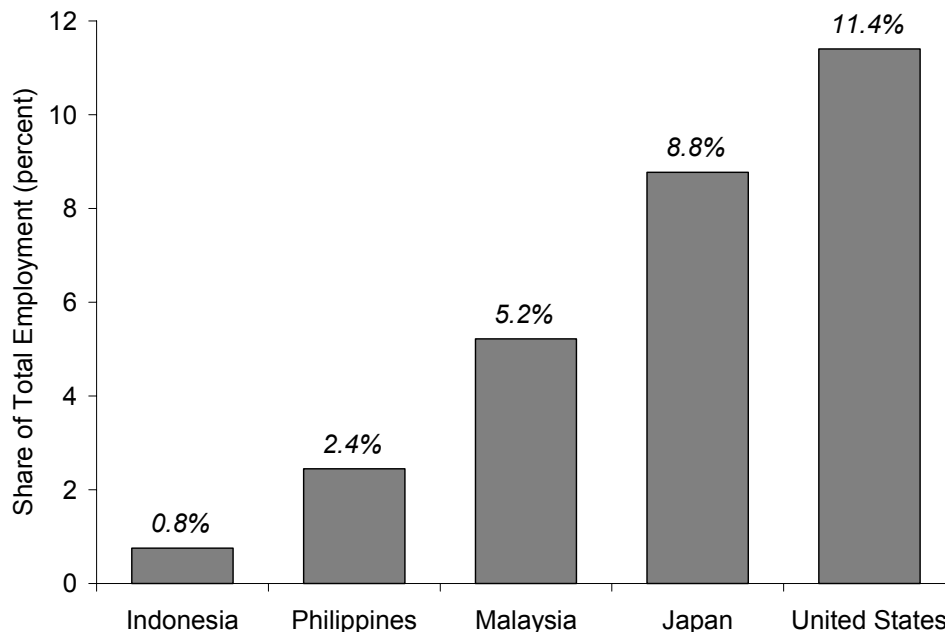
The BAP qualification fully meets international guidelines and compares well with the equivalent accountancy qualifications of most other countries; developing and developed. Moreover, in an environment

characterized by endemic levels of corruption, collusion and nepotism (KKN), this study found no evidence of examination leakage or manipulation.

Nevertheless, ineffective quality assurance and disciplinary mechanisms undermine the usefulness of audited financial statements and seriously impair the profession's credibility. Recent U.S. accounting scandals—and their Indonesian counterparts—highlight the importance of a strong ethical profession. Moreover, analyses reveal that strong professions contribute to economic development and minimize the occurrence and effects of financial crises. But Indonesia has relatively few financial sector professionals, including accountants (see Figure 1) and those professionals are concentrated in the main urban centers. This shortage has particular implications for ensuring effective accountability amidst massive government decentralization.

Figure 1. Indonesian Financial Sector Professionals

Employment in Finance, Insurance, Real Estate, and Business Services as a Percentage of Total Employment by Country (1997)



Source: United Nations (UN). 1997. *Statistical Yearbook 1997*. UN: New York. Cited in: Pomerleano, Michael (Lead Financial Specialist, World Bank). 2002 April. Back to the Basics: Critical Financial Sector Professions Required in the Aftermath of an Asset Bubble. *The Appraisal Journal*. pp. 173-181.

Indonesia is liberalizing its very restricted accountancy profession in line with international commitments. Foreign accounting firms may only operate through correspondent relationships, which negates some mechanisms that support high audit quality.

In response to these challenges, government is preparing a new PA Law, which is likely to support liberalization, significantly strengthen sanctions against negligent auditors and establish an independent oversight body to supervise standard setting, accreditation and discipline. The proposed restructuring is generally consistent with international trends. However, this study strongly supports continuation of professional certification because IAI: (i) has powerful incentives to support high certification standards, thereby negating rent-seeking behaviors; and (ii) is best placed to recognize and respond to market demands for professional skills.

Accounting and Auditing Standards

Over the past three decades, the foundation for Indonesian financial reporting has evolved substantially—it is now broadly consistent with IAS. Although much was accomplished with external support, IAI members contributed countless days of voluntary time to develop standards.

Pre-1973 financial reporting requirements were prescribed by Dutch-based company law that simply required “adequate accounts to be kept”. In 1973, IAI released Indonesian accounting principles that reflected 1965 U.S. generally accepted accounting principles (GAAP). In 1994, the Seventh IAI National Congress endorsed IAS as the basis for domestic financial reporting.

At June 2002, 57 PSAKs were effective. They were largely developed and refined under the Accountancy Development Projects—ADB also provided support. The Financial Accounting Standards Board (DSAK), under IAI auspices, promulgates PSAKs. DSAK’s formalized standard-setting process meets international norms and Indonesian legislation requires that company financial statements comply with PSAKs. However, DSAK is not legally recognized.

PSAKs comprise IAS, U.S. GAAP, sector-specific standards and Indonesia-specific standards, all within an IAS framework. The existing structure was conceptually sound when developed in the early 1990s. It blends the beneficial aspects of principle-based IAS, rules-based U.S. GAAP and sectoral guidance. Nevertheless, its structure differs from the two international benchmarks, IAS and U.S. GAAP. This potentially

reduces investor confidence. Furthermore, maintaining PSAKs requires constant monitoring of both systems. Without very significant resources being devoted to standard setting on an ongoing basis, PSAKs will tend to remain out of step with their international parents.

The Public Accountants Professional Standards Board (DSPAP), under IAI-KAP auspices, promulgates generally accepted auditing standards (SPAPs). DSPAP standard-setting procedures meet international norms. Since 1994, IAI has been committed to raising SPAPs to international levels. Most are based on U.S. AICPA-issued statements, although International Standards on Auditing (ISAs) are sometimes adopted. Although SPAPs were not closely examined, no evidence suggests that they differ from international benchmarks.

The 2001 Academic Paper envisages independent accounting and professional standard-setting boards. This proposal aligns with international trends for both accounting and auditing standard-setting arrangements.

Issues and Recommendations

This Diagnostic Study of Accounting and Auditing (DSAA) identifies issues and recommendations that are associated with gaps or weaknesses in private sector accounting and auditing arrangements. These recommendations are intended to supplement and support existing strategies and projects.

The study concludes that Indonesian private sector accounting and auditing practices and standards are largely consistent with international best practice. Moreover, Indonesian professional accountancy qualifications compare very favorably with regional and international norms. These conclusions are contrary to popular perception.

Nevertheless, Indonesia faces significant issues. First, the weak judicial environment negates many of the incentives and sanctions that support strong and reliable financial reports. Second, in comparison to other countries, Indonesia has relatively few professionally-qualified accountants, particularly outside the main urban centers. Third, the accuracy of financial statements depends largely on the reliability of asset and liability valuations. However, Indonesia's valuation profession is only just beginning to develop in line with regional and international norms.

In response, this study recommends continued development of standards and practices, and that support is given to facilitate the devel-

opment, enactment and implementation of the PA law. It also recommends measures to strengthen the valuation profession.

However, this study presents no magic solution for addressing the apparent shortage of accountants, particularly in non-urban areas. While some supply-side recommendations are made regarding education and training, the real issue appears to be demand. Nevertheless, anecdotal evidence suggests that two factors are creating stronger demand for accountants. First, increased awareness of corporate governance is driving demand for accountancy services, and second, decentralization activities are increasing demand for accountants, particularly outside the main urban centers.