



Validation Report

Reference Number: PVR-182
Project Number: 35144-01
Loan Number: 2126
November 2012

Indonesia: State Audit Reform Sector Development Program

Independent Evaluation Department
Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
BAWASDA	–	Badan Pengawasan Daerah (regional internal audit agency)
BPK	–	Badan Pemeriksa Keuangan (Audit Board of the Republic of Indonesia)
BPKP	–	Badan Pengawasan Keuangan dan Pembangunan (Financial Supervisory and Development Board)
PCR	–	project completion report
PLMU	–	program loan monitoring unit
TA	–	technical assistance

NOTE

In this report, “\$” refers to US dollars.

Key Words

adb, asian development bank, evaluation, indonesia, project validation, public sector management, starsdp, state audit reform

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PROGRAM BASIC DATA

Project Number:	35144-01	PCR Circulation Date:	Mar 2010	
Loan Number:	2126	PCR Validation Date:	Nov 2012	
Program Name:	State Audit Reform Sector Development Program			
Country:	Indonesia		Approved (\$ million)	Actual (\$ million)
Sector:	Public sector management	Total Project Cost:	200.00	100.00
ADB Financing: (\$ million)	ADF: 0.00	Loan:	200.00	100.00
	OCR: 100.00	Borrower:	0.00	0.00
Approval Date:	16 Dec 2004	Effectiveness Date:	17 Dec 2004	17 Dec 2004
Signing Date:	16 Dec 2004	Closing Date:	31 Dec 2007	28 Dec 2007
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ADB = Asian Development Bank, ADF = Asian Development Fund, IED1 = Independent Evaluation Department (Division 1), OCR = ordinary capital resources, PCR = program completion report.

I. PROJECT DESCRIPTION

A. Rationale

1. While Indonesia had institutional arrangements for public sector audit since the 1940s, the legal, policy, and institutional frameworks had not significantly evolved to promote transparency and accountability. First, a weak legal framework exacerbated the lack of clarity between internal and external audit functions. Second, the allocation of resources had not always been in line with policy and legal mandates. Third, parliamentary oversight had been deficient. Fourth, public awareness of the benefits of audit had been very low; and fifth, the audit capacity had been weak.

2. Due to decentralization, the enormous transfer of resources necessitated strengthening of regional audit institutions to effectively fulfill their internal control and audit functions. The State Audit Reform Sector Development Program¹ (the program) of the Asian Development Bank (ADB) was designed to support selected policy interventions, adjustment measures, and critical investments that may otherwise be hampered by resistance to change, or adversely affected by budgetary constraints. The goal of the program was to enhance governance, and the efficiency, economy, and effectiveness of public sector audit through strengthened audit institutions operating to internationally-accepted standards.

¹ ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Republic of Indonesia for the State Audit Reform Sector Development Program*. Manila.

3. The Supreme Audit Board (Badan Pemeriksa Keuangan [BPK]) was the external auditor and Indonesia's supreme audit institution. The inspectorate general in each ministry performed internal audit functions and reported directly to the minister. There was also the Financial Supervisory and Development Board (Badan Pengawasan Keuangan dan Pembangunan [BPKP]) that reported directly to the President but was outside of any particular ministry. At the regional level, regional internal audit agencies (Badan Pengawasan Daerah [BAWASDAs]) report to their respective chief executives. In 2001, the amendments to the Constitution significantly expanded the BPK's mandate to cover the entire public sector at the central and local levels.

B. Expected Impact

4. The program was expected to enhance governance and the efficiency, economy, and effectiveness of the public sector audit.² Transparency in financial management, and public participation in the process, was expected to increase. The program was to increase integration and complementarities between the audit institutions, and interaction between the audit sector and civil society, thus strengthening the accountability in the public sector. Such complementarities were to provide the checks and balances for increased public confidence and participation in the public sector.

5. In terms of economic benefits, the program was to contribute significantly to the overall reform program for a democratic Indonesia, which was in transition from an autocratic, centralized form of government. Improved financial management would mean that scarce government resources would be better used and more effectively deployed than before. General economic benefits were to accrue from increased regional and central government efficiency through improved performance, transparency, and increased public-private partnerships. Investor confidence was to improve due to strengthened governance. No monitorable impact indicators were provided.

C. Objectives or Expected Outcomes

6. The objectives of the program loan were to (i) strengthen the legal and regulatory framework for public sector audit, (ii) initiate the realignment of national auditing resources to enable audit institutions to fulfill their mandate, (iii) support measures to enhance the parliamentary oversight on public audit institutions, and (iv) provide strategies to increase public awareness of audit and audit institutions.

D. Components and Outputs

7. The program was a package of financial assistance approved by ADB to Indonesia comprising (i) a program loan; (ii) a project loan; and (iii) the administration of two technical assistance (TA) grants for (a) program loan coordination and monitoring and project loan monitoring and quality assurance, and (b) implementation assistance for the project loan. The program loan of \$200 million was to be released in two tranches of \$100 million each from ADB's ordinary capital resources. The project loan was sourced from the Asian Development Fund in the amount of \$25 million. The project completion report (PCR) validated is a report on the program loan component.³

² ADB. 2004. *Report and Recommendation to the President to the Board of Directors: Proposed Loans to the Republic of Indonesia for the State Audit Reform Sector Development Program*. Manila. para. 89–92.

³ ADB. 2010. *Completion Report: State Audit Reform Sector Development Program*. Manila.

8. The activities under the program loan were to be carried out over 42 months from January 2005 to June 2007. The program loan was to be released in two tranches. To obtain their release, the government was required to carry out actions specifically identified as conditions for tranche release in the policy matrix, and to demonstrate satisfactory progress implementing other actions in the policy matrix.⁴

9. The expected outputs of the program loan were the following: (i) submissions of audit laws that defined the role of audit in public sector financial management, and the organization and structure of the external auditor (BPK); (ii) submissions of draft central and regional government regulations and presidential decrees to reorganize internal audit institutions; (iii) realignment and efficiency in budgetary resource use; (iv) BPK's audit board regulation on adopting international auditing standards; (v) regulation on certification of internal auditors based on international standards; (vi) a clear vision for BPK as the supreme audit institution; and (viii) the adoption of a public awareness strategy for audit at central and regional levels.

E. Provision of Inputs

10. The first tranche of \$100 million was disbursed on 17 December 2004 upon loan effectiveness. The second tranche was not disbursed because it was canceled at the request of the government in view of the difficulty in reaching a consensus on new regulations needed for internal control, realigning staff and budget resources among the various audit entities, and establishing an internal auditor certification system.

11. TA support in the amount of \$1.3 million was allocated to the program loan monitoring unit (PLMU) to ensure that the deliverables on the policy matrix were achieved.⁵ Only \$775,460 of the TA support was disbursed, with the balance of \$524,540 canceled due to failure to complete the reform program in full.⁶ Another TA in the amount of \$3.7 million was allocated for the investment loan monitoring unit to provide in-depth project monitoring and reporting assistance to ensure quality assurance through the establishment of regional monitoring systems. Support was also provided by this TA for the audit reform program by enhancing the capacity of government audit institutions.

F. Implementation Arrangements

12. The implementation arrangements envisaged in the project design were generally followed.⁷ The Ministry of Finance (MOF) was the executing agency for the program loan, within which the PLMU was established.

13. The government complied with all conditions for the release of the first tranche, 13 of the 17 conditions for the release of the second tranche, and almost all of the non-tranche and program-end conditions. However, the lack of progress in complying with 4 of the 17 conditions for the second tranche, despite 2 years of ADB engagement, led to the cancellation of the second tranche of the program.

⁴ ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Republic of Indonesia for the State Audit Reform Sector Development Program*. Manila. Appendix 6.

⁵ ADB. 2004. *Technical Assistance Support for the Implementation of the State Audit Reform Program*. Manila.

⁶ ADB. 2010. *Completion Report: Support for the Implementation of the State Audit Project in Indonesia*. Manila.

⁷ ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Republic of Indonesia for the State Audit Reform Sector Development Program*. Manila. paras. 53–58.

14. The TA to support the state audit reform program provided support in the timely processing and implementation of program conditions. The PCR rated the performance of the consultants as *satisfactory*. The consultants worked closely with the executing agency, the PLMU, implementing agencies, and ADB to formulate and monitor the policy matrix conditions and to assist in the implementation of the reform program. Significant support was given to develop and enact law no. 15/2006 on the BPK in October 2006. The TA completion report rated the TA as *successful*, as it helped achieve most of the tranche release conditions and milestones of the policy matrix.

15. The TA support for the implementation of the State Audit Reform Investment Project was still under implementation at the time the PCR was prepared in March 2010. Hence, the assessment of the said TA was not included in the PCR.

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

16. The PCR rated the program *less relevant*. The program was relevant at appraisal. There was ongoing democratization and decentralization in Indonesia and it was necessary for the state audit function to be strengthened to serve as an effective accountability framework for Parliament, the executive, the judiciary, and civil society. However, the relevance of the program declined during implementation and at completion. There was lack of political will to carry out the internal control regulation, which was a vital reform measure.

17. The reform program required reorganizing the BPKP and aligning its relatively huge resources with its reduced scope of work following decentralization. These were not realized during implementation. Also, the BPKP did not set in place the necessary internal auditor certification system needed to enforce and properly implement the legal and regulatory framework introduced under the program. These forced the cancellation of the second tranche of \$100 million. Given this, this validation agrees with the PCR rating and rated it *less than relevant*.

B. Effectiveness in Achieving Program Outcomes

18. The PCR rated the program *less effective*. The government met the conditions for the release of the first tranche in December 2004.⁸ For the second tranche, of the 17 conditions that needed to be met by 30 June 2006, 13 were met on time, while 4 were not met within the prescribed time limit. Consensus could not be reached between the government and ADB, and therefore, the second tranche had to be canceled at the government's request.

19. The unmet conditions concerned the regulatory framework for internal control system, which was essential in achieving the main objective of efficiency and economy of the public sector audit function and prudent use of public funds. This objective was not met because of the failure to reorganize the BPKP and to put in place an independent internal auditor certification program that was needed to increase the number of adequately skilled and competent internal auditors. This validation concurs with the PCR statement that without meeting these conditions, much of the improved state audit system would not have been able to function effectively as expected under the program.

⁸ ADB. 2010. *Completion Report: State Audit Reform Sector Development Program in Indonesia*. Manila. para. 10.

20. Nonetheless, the program had some positive outcomes in that it laid the foundation for the public sector audit system to begin operations and address issues such as an unclear legal and institutional framework, suboptimal allocation of resources between institutions, lack of transparency and accountability in the audit process, and lack of appreciation on the role of public audit among legislators and the general public. In view that vital conditions of the program were unmet, this validation rates the program as *less than effective*.

C. Efficiency of Resource Use in Achieving Outputs and Outcomes

21. The PCR rated the program *less efficient*. The conditions necessary for the release of the \$100 million second tranche, particularly those related to strengthening of the internal control systems were not met. Considerable discussions between ADB and the government were undertaken to weigh options but no consensus was reached. Eventually, the envisaged second tranche was canceled. The program had to be closed in December 2007 for lack of progress in instituting the reforms for achieving efficiency and economy in the audit system function. Also, Appendix 2 of the PCR, which presents the policy matrix in relation to program-end condition, does not contain numbers 20–26 of the policy action; thus those policy actions cannot be confirmed. In view of the above, the validation rates the project *less than efficient*.

D. Preliminary Assessment of Sustainability

22. The PCR rated the preliminary assessment of the program's sustainability as *likely sustainable*. Parliament has begun to show support for effective and efficient functioning of the state audit system by passing the necessary laws and budgets, ensuring that public funds are used for intended purposes, strengthening governance, and contributing to improvement in the performance of state entities through performance audits and use of risk-based methodology.⁹

23. Furthermore, the basic legal, regulatory, policy and institutional framework for a state audit system has been established; international standards for auditing have been introduced; and BPK's use of quality-assurance methodology in audit work has improved the quality of audits. The decentralization of the audit function from the center to the provinces and to the districts will also contribute to the sustainability of the program outcomes. This validation agrees with the PCR that the outcome of the program is *likely sustainable*.

E. Impact

24. The PCR rated the program impact *modest*. The program increased the level of public perception on the advantages of high-quality audits. Similarly, Parliament increased its support for improving auditing standards by providing adequate budget to BPK, increasing its budget from Rp330 billion in 2005 to Rp2 trillion in 2010 (or about \$34 million in 2005 to 220 million in 2010¹⁰). A government financial accountability committee was also established in the Parliament to follow up on audit findings.

25. The program improved the quality of external audits as a result of adherence to international standards, improved staff competence, better management, the conduct of performance and risk-based audits, and implementation of quality-assurance methodology. Several high-profile audits that were undertaken exposed the waste, misdemeanors, misuse,

⁹ ADB. 2010. *Completion Report: State Audit Reform Sector Development Program in Indonesia*. Manila. para. 44.

¹⁰ Based on average exchange rate, Indonesian Rupiah per US\$.

and inefficiencies in the use of public funds. These helped improve governance, reduced waste and misuse of public funds, and promoted efficiency in the use of public funds.

26. However, the quality of internal audits conducted by the BAWASDA has been hampered by budget and capacity constraints. Hence, the impact of high quality internal audit has yet to be realized. In addition, efficiency and economy envisaged in a state audit system was not achieved due to failure to institute reforms in the BPKP. Overall, the validation concurs with the PCR and rates the impact of the program *moderate*.

III. OTHER PERFORMANCE ASSESSMENTS

A. Performance of the Borrower and Executing Agency

27. The program was a well designed reform program but was complex in that it involved enacting new laws, instituting regulations, strengthening institutions, and realignment of resources among audit institutions. With the conditions for the first tranche met, the government was able to put in place the basic framework for a state audit system that included the legal, regulatory, and institutional frameworks.

28. However, the government failed to achieve the overriding objective of the program, which was to establish a state audit system that operated on the principles of efficiency, economy, and judicious use of public funds. The adopted new regulation fell short of this objective. Under Government Regulation (Peraturan Pemerintah) No. 60/2008, the BPKP was given new tasks that paved the way for it to continue a dominant role in the audit system. This was opposite the direction of the program that sought to downsize and realign BPKP resources in line with the principles of efficiency and economy in the Indonesian audit system.

29. Apparently, the new regulation under Peraturan Pemerintah No. 60/2008 was watered down to pacify conflicting forces. Thus, the audit system was back to where it was when the program started. The lack of political and bureaucratic will makes it difficult to realize the internal control regulation envisaged in the program. This validation concurs with the PCR's *partly satisfactory* rating of the performance of the borrower (government) and the executing agency and rates it *less than satisfactory*.

B. Performance of the Asian Development Bank

30. The validation assesses ADB performance as *satisfactory*, concurring with the PCR rating. The first tranche of \$100 million was released on time at loan effectiveness. However, the second tranche of \$100 million was canceled because of the government's failure to meet all the conditions of the program loan on time. ADB exerted efforts to realize the unmet conditions, but without success. ADB discussed and presented options to the government through review missions, workshops, and dialogue but the government decided not to avail of the second tranche.

31. Apparently, there were political ramifications on the conditions for internal regulation that the government struggled with. The internal regulation (no. 60/2008) eventually adopted by the government did not meet expectations envisaged in the program design. ADB's decision to agree with the cancellation was appropriate.

C. Others

32. The cancellation of the second tranche was a result of the lack of political will to institute the envisaged internal control regulation. Reorganizing and realigning BPKP resources was difficult due to BPKP's oversized staff resources and political history.

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

33. The PCR rated the program *partly successful*. This validation concurs with that rating and rates it *less than successful* (see table).¹¹ The overriding goal of enhancing governance, and the efficiency, economy, and effectiveness of public sector audit through strengthened audit institutions operating to internationally accepted standards was not fully realized. The conditions for the second tranche necessary for the attainment of this goal were not met under the program loan. Nonetheless, the program was able to establish the basic legal, regulatory, policy, and institutional framework for operating a state audit system.

Overall Ratings

Criteria	PCR	IED Review	Reason for Disagreement and/or Comments
Relevance	Less relevant	Less than relevant	
Effectiveness in achieving outcome	Less effective	Less than effective	
Efficiency in achieving outcome and outputs	Less efficient	Less than efficient	
Preliminary assessment of sustainability	Likely sustainable	Likely sustainable	
Overall assessment	Partly successful	Less than successful	
Borrower and executing agency	Partly satisfactory	Less than satisfactory	
Performance of ADB	Satisfactory	Satisfactory	
Impact	Modest	Moderate	
Quality of PCR		Satisfactory	

ADB = Asian Development Bank, IED = Independent Evaluation Department, PCR = project completion report.

Note: From May 2012, IED views the PCR's rating terminology of "partly" or "less" as equivalent to "less than" and uses this terminology for its own rating categories to improve clarity.

Source: ADB Independent Evaluation Department.

B. Lessons

34. The lessons presented by the PCR are valuable to ADB operations. Reform measures that involve reorganizing and downsizing a large and well-entrenched organization such as BPKP are generally difficult to implement. There were complex issues that involved changes in seniority, salaries, staff positions, and political ramifications that should have been thoroughly assessed. BPKP resistance should have been anticipated since the reform entailed significant downsizing.

¹¹ The overall weighted average score based on IED rating is 1.2, which is equivalent to an adjectival *less than successful* overall rating

35. Implementing a program that requires reforms at the level of a national agency, inter-agency coordination and cooperation needs the highest political support. The PCR pointed out that the conditions for release of the first tranche should have included a reorganization plan for BPKP. This would have demonstrated the government's commitment to reorganize BPKP. Subsequently, the second tranche should have been conditional on the government beginning to implement the reorganization. This would have given ADB more leverage to move the program toward reorganizing BPKP.

36. At the program level, ADB should continue dialogue with the government in pursuing the reform and ensuring that BPKP strictly adhere to its new scope of work and tasks identified in the new regulation (no. 60/2008). There is also a need to continue the work on establishing an internal certification system.

V. OTHER CONSIDERATIONS AND FOLLOW-UP

A. Monitoring and Evaluation Design, Implementation, and Utilization

37. The PLMU regularly monitored the implementation of the policy and institutional reforms envisaged under the program. The program framework and policy matrix were used in monitoring and evaluating the progress of the reforms. ADB carried out review missions to assess implementation of the policy agenda and policy developments with concerned agencies.

B. Comments on Project Completion Report Quality

38. This validation rates the quality of the PCR *satisfactory*. The report is consistent with the PCR guidelines.¹² The discussion on how and why the conditions for the second tranche were not met was adequate. There was enough evidence and analysis to substantiate the performance ratings. The lessons and recommendations were sound and drawn from the findings of the report. However, Appendix 2 of the PCR, which presents the policy matrix in relation to program-end condition, does not contain numbers 20–26 of the policy actions.

C. Data Sources for Validation

39. Information from back-to-office reports, ADB PCR, report and recommendation of the President, minutes of the management review meeting, and TA completion report were used in this validation.

D. Recommendation for Independent Evaluation Department Follow-Up

40. None.

¹² ADB. 2009. Project Completion Report and Extended Annual Review Report. *Project Administration Instructions*. PAI 6.07. Manila.