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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)
Republic of Indonesia

ACCOUNTING AND AUDITING

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Contents

EXECUTIVE SUMMARY

This report provides an assessment of accounting and auditing practices in the Republic of Indonesia (Indonesia). Indonesian Financial Accounting Standards (*PSAK*) were established by an independent standard setting body, the Indonesian Institute of Accountants. By 2008, PSAK will have been converged with International Financial Reporting Standards (IFRS). Indonesian Generally Accepted Auditing Standards (*SPAP*), which were established by the Public Accountants Professional Standards Board (*DSPAP*), are mainly based on 1998 professional standards of the American Institute of Certified Public Accountants. The Indonesian Institute of Accountants has decided to move to full adoption of International Standards on Auditing, prepared and promulgated by the International Auditing and Assurance Standards Board, starting with FY2007 audits.

While the statutory regulator's audit engagement reviews have been strengthened in the last few years, noncompliance with established accounting and auditing standards still exists due to weak enforcement and relatively light administrative sanctions and fines. This seems to be changing, as evidenced by recent decisions by the Indonesian courts and stepped-up enforcement by securities regulators. Education of preparers and users is another major challenge. A great deal of effort will be required to create demand for high-quality financial information.

As Indonesia implements further reforms, stabilizing financial markets and fostering an investment friendly environment become priorities. These efforts should be supported through enhanced financial transparency and improved accounting and auditing practices. Accounting and auditing practices need to contribute to the reform process by adequately serving the needs of providers and users of financial information.

In order for Indonesia to further improve it accounting and auditing practices, measures need to be taken. The framework for oversight of the audit profession needs to be made consistent with international good practices. The Public Accountancy Law needs to be enacted. Adoption of International Financial Reporting Standards and International Standards on Auditing need to

become a high priority. The reporting requirements by various regulatory bodies must be streamlined. A different framework for financial reporting and auditing of small and medium enterprises and nonlisted companies need to be developed. In order to encourage reporting of violations of noncompliance, protective laws and regulations for whistleblowers need to be put in place.

Acknowledgments

The assessment was prepared by a team led by Behdad Nowroozi from the East Asia and Pacific Region of the World Bank and consisted of Unggul Suprayitno (EAPCO), Svetlana Klimenko (OPCFM), and Ronald Points (Consultant). The assessment is based on the template completed by Indonesian Institute of Accountants and local consultants and on the findings of due diligence missions carried out in April 2005. The assessment of practices is based on interviews with regulators, institutional investors, financial institutions, and reputational agents, such as market analysts, lawyers, accountants, and auditors. World Bank staff Frederic Gielen (ECSPS), Henri Fortin (LCSFM), Richard Symonds (LEGPS), P.S. Srinivas (EASFP) and John Hegarty (ECSPS) provided advice and comments.

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ABBREVIATIONS AND ACRONYMS

ASEAN	Association of Southeast Asian Nations
Bapepam	Capital Market Supervisory Agency
BPK	Supreme Audit Agency
BUMD	Regional government enterprises
BUMN	Central government enterprises
CML	Capital Market Law
CPA	Certified public accountant
CPE	Continuing professional education
DSAK	Indonesian Financial Accounting Standards Board
DSPAP	Public Accountants Professional Standards Board
GAAS	Generally accepted auditing standard
GDP	Gross domestic product
FDI	Foreign direct investment
IAASB	International Auditing and Assurance Standards Board
IAI	Indonesian Institute of Accountants
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IES	International Education Standards
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards on Auditing
JSX	Jakarta Stock Exchange
OECD	Organization for Economic Cooperation and Development
PAKAS	Insurance Council
PSAK	Indonesian Financial Accounting Standards
ROSC	Reports on the Observance of Standards and Codes
SEC	Securities and Exchange Commission
SME	Small and medium enterprises
SOE	State-owned enterprises
SPAP	Indonesian Generally Accepted Auditing Standard
SRA	State Registered Accountant Certificate
SSX	Surabaya Stock Exchange

I. INTRODUCTION

1. This report is based on a review of accounting and auditing practices in the Republic of Indonesia (Indonesia). The review is a part of the World Bank and International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC).[1] The review process involved an assessment of actual practices and analysis of effectiveness of the mechanisms for ensuring compliance with the formal standards. It uses International Financial Reporting Standards (IFRS)[2] and International Standards on Auditing (ISA)[3] as benchmarks and draws on international experience and good practices in the field of accounting and auditing regulation. The review used a diagnostic template developed by the World Bank to facilitate the assessment. The assessment results, complemented by the findings of a due diligence exercise conducted by the World Bank staff in April 2005, were used in preparing this report.

2. Indonesia had a population of 219 million. Its per capita income was US$1,050 in 2005.[4] Prudent economic management has enabled Indonesia to record consistently high rates of economic growth—well in excess of the expansion in population—for more than two decades. Industry was the main engine of this growth, which averaged more than 6 percent a year between 1970 and 1996. As a result of the 1997 financial crisis, gross domestic product (GDP) growth slowed in 1997 and tapered off in 1998. Growth resumed in 2000, fueled primarily by strong household and government consumption and recovery in investment, reaching 5.6 percent in 2005. Inflation has been brought down, significantly from the severe inflation that followed the 1997 financial crisis. In 2005 inflation was recorded at 10.5 percent (annual average).[5]

3. **Private investment began to increase in 2005.** There are current signs that the prolonged slump in investment following the 1997 crisis is coming to an end. The Government of Indonesia has recognized the importance of investment for private sector growth, as well as the existing problems, and is beginning to take steps to address them.[6] Stronger investment growth during 2005 indicates that the reforms have begun to pay off.[7]

4. **Indonesia's banking sector has shown clear signs of recovery.**[8] The banking sector has been restructured and is now much stronger, with fewer nonperforming loans and higher profitability. Overall credit growth is recovering, with significant growth of nearly 25 percent in each of the past two years. However, lending to the corporate sector remains sluggish, and banks are not yet a source of long-term

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[1] A Corporate Governance ROSC, completed in August 2004, details corporate governance practices and the corporate environment in Indonesia. The overall assessment was that, while Indonesia has an elaborate system of formal corporate governance rules which in some respects do not differ substantially from those of OECD countries, corporate governance practices in Indonesia often fall short of the requirements of the OECD Principles of Corporate Governance. The report is accessible at www.worldbank.org/ifa/rosc_cg_idn.pdf.

[2] IFRS refers to all standards and related interpretations issued by the International Accounting Standards Board (IASB) and its predecessor the International Accounting Standards Committee (IASC), which issued International Accounting Standards (IAS). . In this report, IFRS also refers to IAS.

[3] Within this report, ISA refer to the International Standards on Auditing and related practice statements developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

[4] Atlas method.

[5] IMF World Economic Outlook Database, September 2005.

[6] A 2003 Credit Lyonnais report showed that all Asian countries, particularly Indonesia, need to intensify their efforts to create a business environment for investors that is based on rule of law and that promotes transparency and accountability. Needed reforms—identified in the World Bank report "Raising Investment in Indonesia: A second Generation of Reforms," issued in 2005—include further improvements in financial supervision and regulation, corporate governance, legal and judicial framework.

[7] Among the other steps, a new investment law, which would open new sectors to foreign investment and smooth procedures for securing business permits, is currently being prepared.

[8] Restructuring of Indonesia's banking sector began in the early 1980s. The banking sector was deregulated by the removal of direct controls on lending and interest rates by Bank Indonesia. Further reforms in 1988 removed barriers to the establishment and expansion of privately owned domestic banks and foreign banks, setting off an explosion in the number of new banks. Most banks had violated prudential regulations covering lending to related parties, capital adequacy ratios, loan/deposit ratios, and limits on their net open position (access to offshore sources of funds). These factors, among others, contributed to the impending crisis. Indonesia paid a high price for having a weak financial sector. Over 50% of GDP was spent to bail out the banking sector after the 1997-1998 crisis.

capital. Banks are reluctant to lend because of the highly indebted nature of many large companies and prefer to keep their liquidity in the risk-free safety of government bonds. A sizeable proportion of Indonesian firms' external financing comes from informal sources, which are more expensive and more limited in duration. This is especially the case for small and medium enterprises (SME). Continuous measures are being implemented to strengthen Indonesia's banking sector.[9]

5. **Non-bank financial institutions in Indonesia are underdeveloped.** Pension funds, insurance, capital markets, and mutual funds (non-bank financial institutions) make up less than 15 percent of Indonesia's financial system. In addition, they have not yet served as critical suppliers of long-term capital needed for infrastructure development and growth.[10]

6. The focus of policymakers is now shifting to ensuring development of a diversified financial sector that is able to finance economic growth in the future on a sustainable basis. The private sector is expected to be the primary engine of this growth. The private sector needs access to different types of capital: risk capital from capital markets, short-term financing, and longer-term financing from banks. Indonesia's financial sector has to further improve to meet these growing needs.[11]

7. **The SME sector accounts for more than 50 percent of Indonesia GDP.**[12] Small enterprises in Indonesia are concentrated in trading, food, beverages, textiles, wood, and non-metallic mineral production. They operate in a highly competitive and uncertain environment. Access to and cost of financing has been identified as a major obstacle for small and medium enterprises. Limited assets to use as collateral and shorter credit histories make it more difficult for small and medium enterprises to obtain financing from official sources. Surveys have shown that small and medium enterprises rely heavily on retained earnings and family sources for their working capital and investment financing.[13]

8. **Indonesia's economy includes a significant share of state-owned enterprises (SOE) that are primarily intended to handle strategically important economic sectors (oil, mining, banking).** According to the ownership and scope of operation, the state-owned enterprises can be classified as central government enterprises or *BUMN* (*Badan Usaha Milik Negara*) and regional government enterprises or *BUMD* (*Badan Usaha Milik Daerah*). The BUMN fall under the control of the sector ministry, the Ministry of State-Owned Enterprises, and Ministry of Finance. The BUMD belong to a regional government (provincial or regency/municipality); their scope of operation is commonly limited to the respective region. Majority of the larger state-owned enterprises are publicly traded companies, and accordingly are subject to all applicable requirements. While there is some privatization activity with regards to the state-owned enterprises, at the present it is not very significant.

9. **These considerations should shape the arrangements for private sector accounting and auditing in Indonesia, which need to be strengthened to meet the needs of a modern economy.** As Indonesia moves toward further reforms, stabilizing financial markets and fostering an investment-friendly climate and business environment become priorities. These efforts should be supported through enhanced financial transparency and improved accounting and auditing practices. Increased inflow of foreign direct investment

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[9] *Indonesia: Economic and Social Update,* Washington, D.C.: World Bank, October 2005. On July 1, 2005, Bank Indonesia announced the criteria for anchor banks (i.e. a bank that can acquire other banks). In addition, it issued a regulation requiring banks to increase their minimum capital to Rp. 80 billion by end of 2007 and Rp. 100 billion by end of 2010.

[10] Currently, pension funds and insurance firms in Indonesia invest nearly 60% of their resources in short-term bank deposits, in essence transforming long-term resources into short-term assets: based on the World Bank concept paper "Unlocking Indonesia's Domestic Financial Resources for Development: The Role of Non-Bank Financial Institutions".

[11] Based on the World Bank concept paper "Unlocking Indonesia's Domestic Financial Resources for Development: The Role of Non-Bank Financial Institutions."

[12] In comparison with developed countries, Indonesia has a "missing middle" in its industrial structure. There are a small number of large firms at one extreme, and an abundance of small domestic market-oriented businesses at the other end of the scale. Based on the World Bank report "Raising Investment in Indonesia: A Second Generation of Reforms" issued in 2005.

[13] Based on the findings of the World Bank report "Raising Investment in Indonesia: A Second Generation of Reforms" issued in 2005.

and domestic investment demands higher-quality financial information, requiring much greater transparency and consistency with international standards. Accounting and auditing practices should contribute to the reform process by adequately serving the needs of providers and users of financial information and helping the market economy grow.

10. This ROSC focuses on the importance of continuing with further reforms, specifically on the benefits that the proposed reforms will bring to Indonesia and its citizens. In this context, this report suggests policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable growth in the private and financial sectors. It is recommended that—under the leadership of the Ministry of Finance and *Bapepam* and with the participation of the Indonesian Institute of Accountants, Bank of Indonesia, Jakarta Stock Exchange, and members of academia—a committee be established to develop a country strategy and a detailed action plan based on the recommendations outlined in this report (Section VI).

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

11. The Indonesian legal system is complex and is largely a confluence of the legacy of Dutch law and a national legal system based on Indonesian precepts of law and justice. While Indonesia has generally adopted a civil law system, some elements of a common law have also been introduced into the legal framework. This duality is especially prominent when it comes to the regulation of the capital market activities, where common law concepts such as trust, beneficial owner, tender offer, and others have been introduced.

12. **The major forms of business organization existing in Indonesia include partnerships[14] and limited liability companies.** While the governance structure of the former are set in the Civil and Commercial Codes, the latter are regulated by the requirements of the Law on Limited Liability Companies (Company Law No. 1) issued in 1995. The Limited Liability Companies can be classified as either private or public and represent the most common type of business organization. Their corporate governance structure is based on a two-tier board system, including a board of directors, responsible for the active management of the company; and a board of commissioners (an oversight board). In an effort to strengthen the corporate governance environment, the Jakarta Stock Exchange (JSX) and Bapepam have introduced additional regulations that make the establishment of independent commissioners, audit committees, and corporate secretaries mandatory for listed companies.

13. **The principal law governing the stock markets is the Capital Market Law (CML) No. 8/1995.** The Capital Market Law contains a number of special rules applicable to listed firms and is implemented by the Capital Market Supervisory Agency, known as the *Bapepam*.[15] As of June 2005, the total market capitalization on the Jakarta Stock Exchange amounted to about US$76.6 billion, approximately 29 percent of the country's GDP. As of June 2005, the number of companies traded was 334. In addition, there is the Surabaya Stock Exchange (SSX), which is primarily designed for smaller firms, fixed income securities, and for trading over the counter. The Surabaya Stock Exchange is much smaller than the Jakarta Stock Exchange, but most of the stocks listed on the Surabaya Stock Exchange are also listed on the Jakarta Stock Exchange. As of June 2005, there were 208 companies listed on the Surabaya Stock Exchange.

[14] There are a few different types of partnerships, which can be established according to the Indonesian legislation.
[15] In December 2005, the merger between Bapepam and Directorate General Financial Institution (DGFI) of the Ministry of Finance became effective. The two combined organizations are now called Badan Pengawas Pasar dan Lembaga Keuangan (Bappepam and KL), which has the authority to supervise capital market, pension funds, and non-bank financial institutions.

14. **The Capital Market Law requires public companies to file audited financial statements with the Bapepam.**[16] The Capital Market Law requires financial statements submitted to Bapepam to be prepared in accordance with generally accepted accounting principles (GAAP). In the Capital Market Law, generally accepted accounting principles refer to the Indonesian Financial Accounting Standards (*PSAK*) set by the Indonesian Institute of Accountants (IAI). The Capital Market Law also empowers Bapepam with the authority to establish accounting regulations with respect to capital markets when necessary.

15. **The Capital Market Law requires all public accountants to submit a report to Bapepam under certain circumstances**. The report must be submitted confidentially within three working days after a public accountant discovers either (a) any violation of the Capital Market Law and/or regulation in capital market; or (b) any matter which may jeopardize the financial condition of the public companies, securities exchanges, clearing guarantee companies, central securities depository, and other persons engaged in capital market.

16. **The Capital Market Law requires public companies to submit and publish periodic reports to Bapepam**. Issuers and public companies are required to have their annual financial statements audited by certified public accountants registered with Bapepam, and to file the statements with Bapepam within three months following year-end.Bapepam requires both annual and semi-annual financial statements, consisting of a balance sheet, income statement, statement of cash flow, statement of changes in equity, and notes to the financial statements. The annual financial statements must be audited and submitted to Bapepam within three months following the end of the year. Bapepam requires all public companies and issuers to submit their Annual Reports within two weeks before the annual shareholders meeting (for equity issuer), or within five months following the end of year (for bond issuer). Bapepam requires that semi-annual financial statements must be submitted to Bapepam (a) no later than last day of the first month after the semi-annual report date, if they are unaudited; (b) no later than last day of the second month after the semi-annual report date, if they are accompanied by an auditor's limited review report, and (c) no later than last day of the third month after the semi-annual report date, if the financial statements are audited and accompanied by auditor's opinion.[17]

17. **The Jakarta Stock Exchange also requires quarterly reports.** The listing requirements of the Jakarta Stock Exchange require listed companies to submit quarterly financial statements as well as annual and semi-annual financials. The Surabaya Stock Exchange requirements are the same as the Bapepam in requiring only annual and semi-annual financial statements. The financial reporting requirements can be summarized in Table 1.

18. **The Banking Law requires banks to submit annual reports, including audited financial statements, to Bank Indonesia within five months after year-end.** Bank Indonesia also requires banks to submit quarterly reports within 2 months following the end of the quarterly and monthly reports within 75 days following the end of the month. In addition to submitting those reports, listed banks are also required to submit their audited financial statements and annual reports according to the Capital Market Law and other capital market regulations.

19. **The Ministry of Finance is the regulator and supervisor of the insurance industry in Indonesia**.[18] There is a requirement for insurance companies to submit regular reports to the Ministry of Finance under the Law of Insurance Business (No.2/1992).

Table 1. Financial Reporting Requirements

[16] According to Capital Market Law, a public company has at least 300 shareholders and paid-in capital of at least Rp 3 billion or such other number of shareholders and paid-in capital that may be stipulated in government regulation. (9,500 Rp equals US$1).
[17] Bapepam Rule No. X.K.2 , Obligation to Submit Periodic Financial Statements, Number 3 (a)
[18] Directorate of Insurance under the Directorate General of Financial Institutions.

	Audit	*Review*	*Unaudited*	*Publications*
Quarterly statements				
Bapepam	**No**	**No**	**No**	
JSX	**No**	**No**	**Yes**	**In JSX Website**
SSX	**No**	**No**	**No**	
Semi-annual statements				
Bapepam **JSX** **SSX**	**Within 90 Days**	**Within 60 Days**	**Within 30 Days**	**Balance Sheet, Income Statement, and reports required by certain industries**
Annual Statements				
Bapepam **JSX** **SSX**	**Within 90 Days**	**No**	**No**	**Balance Sheet, Income Statement, and reports required by certain industries**

20. **Bank Indonesia also requires public accountants to report to it within 7 days upon finding any breach in financial and banking regulation.** There is no publicly available information to assess whether this reporting mechanism is effectively being exercised.

21. **Companies that meet certain criteria are required to submit their audited financial statements to the Ministry of Trade.**[19] The criteria include companies that (a) are public companies; (b) obtain funds from public; (c) issue debt instruments; (d) own total assets of more than Rp 25 billion; (e) as a debtor, its financial report should be required; (f) are foreign companies that domicile and operate in Indonesia; (g) are state-owned enterprises. It is believed that this requirement is not being effectively enforced and practiced.

22. **Bapepam regulates registration of auditors' of listed companies.**[20] Bapepam requires that periodic financial statements submitted to Bapepam should be audited by auditors registered with Bapepam.[21] In practices, the process of auditor appointment is determined in accordance with the Articles of Association through the general shareholders meeting or the board of commissioners.

23. **Public accountants may also render audit services in the form of an Audit Service Cooperative.**[22] An Audit Service Cooperative offers services mainly to its members and may offer services to nonmembers when there is excess capacity availability. However, an Audit Service Cooperative by its very structure inherently lacks independence from its member clients. There is no information available on the number of nonmember clients that are served by Audit Service Cooperatives.

24. **Audit is mandatory for companies that meet certain criteria.** The types of companies subject to the statutory audit requirement are specified under the law.[23] The law requires audited financial statements from listed companies, banks, non-bank financial institutions, companies issuing debt securities, and companies with assets of more than Rp25 billion.[24] The government does not enforce and monitor the compliance of companies in the last category with the respective law. As a result, the utility of such

[19] Government Regulation No.64/1999.
[20] Under the Bapepam Rule No. VIII.A.1: A Public Accountant must be registered with Bapepam and fulfill the requirement stipulated in Bapepam rule in order to provide services in the Capital Market.
[21] Bapepam Rule No.X.K.2.
[22] As of December 31, 2004, there were 13 public accountants working at 12 Audit Service Cooperatives throughout Indonesia.
[23] According to the Ministry of Trade, Approximately 2315 companies submitted their audited financial statements to the Ministry in 2004.
[24] Government Regulation No.64, 1999.

requirement is questionable. Currently, lack of enforcement of this requirement does not have a significant impact on the Indonesian economy. There is no demand for those audits. An audited financial statement is not a key factor for these companies in their dealings with the banking and investing communities.

25. **The Supreme Audit Agency (*BPK*) is required by law to perform compliance audits for all state-owned enterprises, both listed and unlisted**. A public accountant who audits financial statements of a state-owned enterprise should also conduct a compliance audit of laws/regulations and internal controls. This is to ensure that the state-owned enterprises are complying with the various laws and regulations. Listed state-owned enterprises have to follow the requirements in Capital Market Law regarding financial reporting as well as other state financial laws.

26. **The current regulatory and public oversight of auditing requirements is fragmented and needs to be rationalized.** The responsibility is divided among Ministry of Finance, Bank Indonesia, Bapepam, Ministry of Trade, and Indonesian Institute of Accountants (see Section E).

27. **In response to the needs to strengthen the accounting profession in Indonesia and recognize the movement to international standards, the Government is preparing a new Public Accountancy Law.** There is no law currently in effect that explicitly addresses the issue of accountants' legal liability. This new law should address two key areas: (a) accountants legal liability (since currently no law explicitly addresses the issue of accountants' legal liability) and (b) an independent public oversight system. The Ministry of Finance has prepared a draft of the Public Accountancy Law.

B. The Profession

28. **There is an established accountancy profession with a clearly defined organizational structure in Indonesia.** The Indonesian Institute of Accountants (IAI) is the only professional accountancy body in Indonesia acknowledged by the Ministry of Finance**.** The IAI is also a founder of ASEAN Federation of Accountants and a full member of the International Federation of Accountants (IFAC). As a self-funded accountants' professional body, IAI is responsible for setting up a code of ethics, accounting and auditing standards, conducting exams for certified public accountants (CPA), and running programs for professional education. Membership in IAI is strictly limited to holders of the "accountant" title. The IAI members originate from all accounting backgrounds, including auditor academics and public sector accountants. As of December 31, 2004, the IAI had 5,984 registered members, with 988 of them being public accountants. As noted from these figures, Indonesia has relatively few professional public accountants and most of them are largely concentrated in the main urban centers.

29. **The Indonesian Institute of Accountants is not a well-resourced professional organization**. The Institute has a few full-time staff and most of the functions are carried out on a voluntary basis by IAI members. If IAI is to meet the challenges that are confronting the accounting profession in Indonesia, it will have to find additional financial resources to aid in the re-tooling of the profession in order to comply with international best practices.

30. **There is a requirement in law for the profession to adhere to a code of ethics but it falls short of the requirement mandated by IFAC**. The Indonesian Institute of Accountants has issued a code of ethics but it is not fully compliant with the most recent IFAC Code of Ethics for Professional Accountants. There is a system in place to monitor member's compliance with the IAI code of ethics which should enhance public confidence in both the quality of auditing and financial reporting.

31. **The auditing profession in Indonesia lacks an independent public oversight system.** The fragmented approach in dealing with audit requirements in Indonesia falls short of emerging international good practice, which should properly subject the audit profession to public oversight in order to protect the public interest. An independent public oversight system should have ultimate responsibility for approval and registration of statutory auditors and audit firms; adoption of standards on ethics, internal quality control of audit firms and auditing practices; quality assurance; and investigative and disciplinary systems. In developing such a system for an effective public oversight of audit, lessons and experiences of other countries, such as Australia, the United Kingdom, and the United States can be used as examples of evolving regulatory and oversight structures.[25]

32. **Current law does not provide for mutual recognition arrangements for foreign accountancy qualifications.** Therefore, foreign accountants or foreign accounting firms are not allowed to render attestation services in Indonesia. However, local public accountants and accounting firms may cooperate with foreign accounting firms in terms of technical assistance. There are ongoing discussions between Indonesia and Malaysia to enter into mutual recognition of accountants and accounting firms.

33. **Accountants' legal liabilities are being addressed in the proposed Public Accountants Law.** Under the current legal system, it is difficult to sue independent accountants. In fact, there are only a few cases in which public accounting firms have ever been sued in court. Under the current law, auditors are not required to carry professional indemnity insurance. However, liability of independent accountants has been an issue intensely discussed recently in accounting and auditing forums as part of the debate on the draft Public Accountants Law. There is also no minimum capital requirement for accounting firms. Due to ambiguities in the current laws and regulations, no accounting firm has been sued for substandard work by companies/shareholders/third parties.

34. **There is a requirement for rotation of the auditor and accounting firms**. A decree from the Ministry of Finance mandates a 3-year rotation for audit partners and a 5-year rotation for accounting firms.[26] The provision requires one year off and, for listed companies, the provision requires three years off. The rotation of auditors and accounting firms are also regulated by Bapepam. This same Bapepam regulation also prohibits certain nonaudit services from being rendered by independent auditors, if only the same auditor conducts the audit for the same period.[27]

C. Professional Education and Training

35. **The Accountant Title Law sets forth the requirements for becoming an accountant and for licensing public accountants.** Only those who graduate in accounting (with a minimum of 144 credit units) and undertake the Professional Education Program (comprising 20-40 credit units) may earn an "accountant designation" and obtain a State Registered Accountant (SRA) Certificate.[28] Only SRA holders are eligible

[25] Increasingly the public oversight system has the ultimate responsibility for (a) the approval and registration of statutory auditors and audit firms; (b) the adoption of standards on ethics, internal quality control of audit firms and auditing; and (c) continuous education, quality assurance, and investigative and disciplinary systems. In addition, the oversight system of public oversight has the right, when necessary, to conduct investigations on statutory auditors and audit firms and to take appropriate action. For more details, refer to (a) www.frc.org.uk for the United Kingdom's Financial Reporting Council, (b) www.frc.gov.au for Australia's Financial Reporting Council, and (c) www.pcaobus.org for the United States' Public Company Accounting Oversight Board.

[26] The MOF decree, No. 359/KMK.06/2003 is an amendment of decree No. 423/KMK.06/2002 on public accountant service.

[27] Bapepem Rule No. VIII.A.2. Other prohibited services include accounting services or other services related to accounting services to the client; information system design and implementation; appraisal (valuation) or fairness opinion; actuarial services; management consulting; human resource consulting; financial and investment advisory; and other services which will impact conflict of interest.

[28] As of December 31, 2004, there are more than 40,000 SRA holders.

for the CPA exam, which is administered by the IAI twice a year. The CPA exam is mandatory to get an auditor license from the Ministry of Finance and become an auditor member in the Institute. The CPA Board of Examiners was established by the IAI, the IAI National Council appoints the Board's members. The CPA Board of Examiners has the authority to (a) set the subject and syllabus; (b) approve the papers; and (c) set the passing grade. The CPA exam is a written examination with main emphasis on testing the technical knowledge with practical skills. To enter the audit profession, a CPA should have had a minimum 1,000 hours of general audit during the last 5 years whereby 500 hours should be at the supervisory level. The Directorate of Accountant under the Directorate General of Financial Institutions in the Ministry of Finance will grant an audit license when requirements are met.

36. **The academic curriculum in universities and the Professional Education Program compare reasonably with the requirements of the International Education Standards (IES) prescribed by IFAC.** Most universities' curricula have subjects relating to financial accounting, international accounting standards, international standards on auditing, and business and professional ethics. A university or college must by recommended by the IAI and licensed by the Ministry of Education in order to deliver the Professional Education Program. In general, the syllabus of the Professional Education Program covers all areas recommended by the IFAC educational guidelines, including financial accounting seminar, management accounting seminar, taxation seminar, practices for auditing, business and professional ethics, knowledge of capital market, and business environment. Since Indonesia has committed to the adoption of IFRS and ISA, the IAI in cooperation with the Ministry of Education should modify the curriculum syllabus for undergraduate courses, continuing professional education, and the Professional Education Program. This effort needs to be intensified and be completed within a short timeframe given the complexities of IFRS and ISA.

37. **The IAI requires public accountants to attend a minimum 120 credit hours of continuing professional education (CPE) every three years and not less than 30 credit hours annually.** Minimum 100 out of the 120 credit hours must be in the form of structured learning activities. Of those required credits, 30 percent of those credit hours can be claimed from training providers other than the IAI, but only if the IAI and/or Ministry of Finance recognize the training providers. The Ministry of Finance, Bapepam, and Bank Indonesia also have similar requirements for continuing professional education. At the beginning of every year, all public accountants receive notification about the standing of their CPE credit hours. The Indonesian Institute of Accountants requires CPE-noncompliant members to fulfill any shortfall of credit hour in the next year. On average, more than 80 percent of IAI members comply with CPE requirements. Monitoring of non-compliance and sanction measures are also set out by the Ministry of Finance and Bapepam.

38. **The education of accountants in industry has not kept pace with the demands of the changing business environment**. Although there are approximately 40,000 accountants in Indonesia, there is no program to ensure that they are provided the opportunity to obtain continuing education in order to keep pace with the many changes in the business environment. The IAI continuing professional education is focused on public accountants and not accountants in general.

D. Setting Accounting and Auditing Standards

39. **The Indonesian Financial Accounting Standards Board (*DSAK*), which is under the auspices of the Indonesian Institute of Accountants, is the accounting standardsetter.** The IAI National Council appoints members of DSAK. The Indonesian Financial Accounting Standards Board has been setting accounting standards since 1973.[29] The Capital Market Law is the only law that specifically provides that the

[29] At that time, they were called Indonesian accounting principles (PAI).

Indonesian Financial Accounting Standards (*PSAK*) are those set by the Indonesian Financial Accounting Standards Board. In addition, the law authorizes Bapepam to establish accounting regulation with respect to capital markets when necessary.

40. **The DSAK consists of 12 members comprising three academics, five public accountants, and four public sector accountants**. The members' qualifications include (a) knowledge in accounting and financial reporting; (b) judicial and instinctive understanding of the business environment; (c) discipline and integrity; and (d) willingness to serve and dedication to accounting profession. The DSAK members are supported by five fulltime staff. The DSAK follows an open process in setting accounting standards. In the "due process," user participation is encouraged through public hearing and provision of comments. The process of standards-setting is transparent covering identification of national standards issues, consultation with consultative board, setting up task forces, discussing exposure drafts in board meeting, issuing exposure draft to constituents, holding public hearings, and final checking and legalizing standards. The DSAK submits its reports to the IAI National Council and is directed by the Consultative Financial Accounting Standards Board. The DSAK attends regularly both annual standardsetter meeting hosted by the International Accounting Standards Board and regional standards setter meeting.

41. **The Indonesian Financial Accounting Standards are moving toward convergence with the IFRS.** As of December 31, 2004, there were 59 accounting standards and 7 interpretations prescribed by Indonesia Financial Accounting Standards Board. The Indonesian Financial Accounting Standards Board switched the benchmark to the International Accounting Standard Board in 1994 and has worked consistently toward harmonizing with the IAS (IFRS). However, there are several standards which are not IAS based, such as accounting for Syariah banking, accounting for cooperatives, accounting for land, accounting for nonprofit organizations, accounting for quasi-organizations, and accounting for joint operations. The Indonesian Financial Accounting Standards Board is intensifying its effort and is expected to make Indonesia Financial Accounting Standards consistent with IFRS by 2008, both in substance and in format. This is an important issue and needs to be addressed by IAI, Ministry of Education, and Ministry of Finance as it will affect the curricula in universities, Professional Education Program, CPA exams, accounting textbooks, and other aspects of the training process.

42. **The Public Accountants Professional Standards Board (*DSPAP*) of IAI promulgates the Indonesian Generally Accepted Auditing Standards (*SPAP*).** The Public Accountants Professional Standards Board consists of 10 members, all public accountants. The chair of the IAI Public Accountant Department appoints the members of the Public Accountants Professional Standards Board. This Board is supported by a full-time staff. In setting standards, the Public Accountants Professional Standards Board follows a formalized consultative process to identify, develop, and revise Indonesian Generally Accepted Auditing Standards. This process involves constituents, particularly in seeking comments on exposure drafts and in public hearings. Currently, most auditing standards are adopted from U.S. Statements of Auditing Standards and several International Standards on Auditing. The Indonesia Institute of Accountants has decided to move toward full ISA compliance starting with the audit of FY2007.

43. **There is a regulatory burden on nonlisted companies and small and medium enterprises to have audited financial statements in accordance with international standards.** Despite there being a significant number of small and medium enterprises and nonlisted companies in the country, Indonesia does not have a different accounting and financial reporting framework for entities. This imposes unnecessary compliance costs and potentially undermines the quality of financial reporting.

E. Enforcing Accounting and Auditing Standards

44. **The current oversight responsibilities are divided among the Ministry of Finance, Bapepam, Bank Indonesia, and IAI.** The Ministry of Finance supervises public accountants and accounting firms. This involves licensing the profession, ensuring adequate professional standards are in place, policing standards, and developing the profession. Bapepam registers and supervises public accountants and public accounting firms engaged in capital market activities. The Bank Indonesia registers public accountants and public accounting firms for financial sector audits and supervises their activities. The IAI is involved in accounting and auditing standard setting, certification, ethics and disciple, and continuing professional education. There is a need for streamlining of some of these functions and strengthening of public oversight with a view to improve enforcement.

45. **The oversight of accounting and auditing has been improved in the last few years, compliance gaps exist, and more effective enforcement is required.** Ineffective enforcement could be due to a weak legal environment, unclear accountants' legal liabilities, and lack of appropriate training for the regulatory staff. The current regulatory enforcement mechanisms and oversight arrangements require improvement. While the quality and compliance reviews by Bapepam and Bank Indonesia are intended to identify accounting manipulations or irregularities, the level of sanctions against violators may not be adequate to deter companies from such acts.[30] There is a need to review the level of sanctions for these types of violations to ensure their adequacy.

46. **The boards of directors and commissioners are responsible jointly and severally for any information stated on the financial statements which prove to be incorrect or misleading.** Other related laws (e.g., the Capital Market Law and the Banking Law) also provide that the executive directors are responsible for any information they provide.[31] Bapepam is authorized to impose administrative sanctions for any violation of the Capital Market Law, and states that it is a criminal offense to intentionally provide a false record, omit or cause to omit any records, or hide any information in the financial statements. There is no specific article in the laws, regulation, or circulars providing for sanctions for noncompliance with accounting standards or for gross negligence or fraud by accountants. In practice however, Bapepam has applied sanctions based on its authority arising from the Capital Market Law.[32]

47. **The Capital Market Law provides the authority to Bapepam to monitor financial reports to determine whether listed companies have complied with the law.** Bapepam has established the Bureau of Accounting Standards and Disclosure to perform field examinations and desk reviews on a sample basis to determine the level of compliance with the accounting and auditing standards as well as the disclosure requirements as set forth in the law.[33] For violations found as a result of the reviews, Bapepam can impose various administrative sanctions—written admonitions, restriction on business activities, suspension of business activities, revocations of business activities, cancellation of approvals, cancellations of registrations, and fines. The levels of administrative sanctions, such as fines, are relatively light and may not deter accounting manipulations or irregularities. For example, fines range from Rp1 million to Rp500 million (approximately US$100 to US$50,000) is used for late submission of the periodic reports. In addition to administrative sanctions, Bapepam can impose criminal sanctions such as imprisonment for a maximum of three years and a fine, and provisions related to compensation.[34] . In practice, in certain cases, Bapepam has imposed administrative sanctions of more than Rp500 million (approximately USD 50,000) and even brought the case to criminal investigation.

[30] Fines range from the equivalent of Rp1 million to Rp100–500 million (approximately US$100 to US$50,000), depending on the nature of the violation.

[31] Bapepam Rule No. VIII.G.11 specifies the responsibility of management (board of directors) for financial statements.

[32] Article 5.n., Capital Market Law states that Bapepam shall have authority to take steps necessary to avert loss to the public arising from violation of capital market regulations.

[33] Bapepam has adopted the U.S. Securities and Exchanges Commission (SEC) organizational model. Bureau of Accounting Standards and Disclosures in Bapepam can also be translated into the Office of the Chief Accountant of Bapepam, since it is copied from the similar unit, which is also named Office of the Chief Accountant in the USSEC. The tasks and duties performed by both offices are similar in nature.

[34] Article 102-110, Capital Market Law

48. **Bapepam has stepped up its enforcement actions.** In 2004, Bapepam conducted technical investigation of 34 securities companies. The investigation was conducted to ensure compliance of securities companies with their internal control and bookkeeping in relation with the capital market rules and regulations. During 2004, Bapepam imposed sanctions to 313 issuers due to late submission of semi-annual financial reports, annual financial reports, annual reports, reports on the uses of funds received from a public offering and violation of rules regarding disclosure of information. The sanctions resulted in fines totaling Rp8.885 billion. In particular, Bapepam fined two issuers with a combined Rp200 million based on seven particular violations. Subsequently, total fines imposed to issuers amounted to Rp9.085 billion, a 60 percent increase over 2003 (Rp5.677 billion).

49. **There are two authorities responsible for regulating listed banks.** Bapepam has the authority to supervise and regulate the capital market with respect to transparency, market mechanisms, and investor protection. Bank Indonesia has authority to regulate and supervise the banking sector. Bank Indonesia has a unit that reviews all the financial reports for compliance with regulations that require all banks to submit financial statements in accordance with the Indonesia Accounting and Auditing Standards. Violations can result in sanctions, including reprimand, suspension of business activities, or fines.[35] As is the case with the Bapepam-levied fines, the level of fines to banks is relatively light and may not deter noncompliance.

50. **The Ministry of Finance and the IAI conduct an examination or quality review to ensure the compliance of auditors with the auditing standards**. The Ministry of Finance performs both regular and "for cause" investigative examinations while the IAI performs quality review. The Quality Review Board was established by the IAI in 2001 to conduct such reviews. The Disciplinary Committee and Appeals Committee were established in 1998 to process complaints from the public or IAI members. Prior to 1998, there was only the Disciplinary Committee. The quality review run by the IAI is conducted on a voluntary basis; it will be mandatory starting in 2006.

51. **Complaints against public accountants can be submitted to the Minister of Finance or IAI**. Complaints against public accountants that relate to financial statements of issuers and public companies can also be submitted to Bapepam. Any party who suffers a loss as a result of audited financial statements can ask the Directorate General of Financial Institutions of the Ministry of Finance, Bapepam, or IAI to investigate. There has been coordination among various parties on such investigations. The Discplinary Committee of IAI processes the case and informs the relevant regulators of the result.[36]

52. **The Capital Market Law mandates auditors to comply with the code of ethics and professional standards set by their professional body**.[37] The recently formed Accounting Standards & Disclosure Bureau of Bapepam is responsible for monitoring compliance of auditors with professional standards. The Enforcement Bureau of Bapepam enforces such compliance. The Bapepam may initiate a criminal or lesser investigation of any person, including auditors, suspected of violating the law.

53. **There are legal requirements for adherence to codes of ethics and professional standards in the capital market**. The Capital Market Law requires all capital market supporting professionals[38] to comply with codes of ethics and professional standards set by each respective professional body, provided that those codes and standards are not in conflict with the Capital Market Law or regulations there under. In addition,

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[35] Fines range from Rp50–100 million for annual reports and Rp100–500 million for quarterly financial statements.

[36] During 2001–2004, there were 25 complaints submitted, whereby 14 public accountants were sanctioned and 7 cases were proven not guilty.

[37] Article 66 of Capital Market Law.

[38] According to Capital Market Law, capital market supporting professionals includes: (a) accountants; (b) legal consultants; (c) appraisers; (d) notaries; and (e) other professionals specified in government regulation.

an MOF Decree requires public accountants to comply with Professional Standards for Public Accountants and Code of Ethics of IAI.[39]

54. **The Jakarta Stock Exchange also monitors the compliance of listed companies with accounting and auditing standards through its Monitoring Division.**[40] The Stock Exchange's Monitoring Division conducts reviews of annual and quarterly financial statements, as well as the disclosure of information as required by Bapepam. The Monitoring Division is authorized to call listed companies and auditors to provide the necessary information and report to the Bapepam any violation of the accounting or auditing standards. Based on the results of the monitoring process, the Jakarta Stock Exchange may require listed companies to make additional disclosure and/or hold public expose and impose sanctions in case of violations. In 2004, a total of 132 hearing sessions were conducted with 81 listed companies.[41] During 2004, the Jakarta Stock Exchange imposed a number of sanctions on listed companies, including warnings sent to 84 listed companies for failure to hold public expose and 6 listed companies for violation of information disclosure requirements.[42]

55. **Bapepam and Jakarta Stock Exchange rules specifically require listed companies to establish audit committees.** Indonesian limited liability companies adopt a two-tiered board system: board of directors, including president director and directors who actively manage the company) and board of commissioners (who have oversight of the board). An audit committee is established by, and accountable to, the board of commissioners. The audit committees consist of at least one independent commissioner and at least two other members from outside the company who are not members of the board of commissioners.[43] The chair of the audit committee is required to be an independent commissioner. Due to the new concept of the audit committee, they are generally perceived to be neither effective nor adequately equipped to discharge their responsibilities.

56. **The Supreme Audit Agency is required by law to perform compliance audits for all state-owned enterprises, both listed and unlisted**. A public accountant who audits financial statements of a state-owned enterprise should also conduct a compliance audit of laws/regulations and internal controls. This is to ensure that the state-owned enterprises are in compliance with laws and regulations. Listed state-owned enterprises have to follow requirements in Capital Market Law regarding financial reporting as well as other state financial laws. Therefore, there is an opportunity for further coordination between the Supreme Audit Agency and other regulatory bodies in the audit process.

57. **Recently, the Indonesian courts have given strong indication that corporate fraud, including white-collar crime, will be dealt with more stringently than in the past.** Several cases have resulted in imprisonment, which rarely occurred in the past when only a fine was imposed. By imposing stringent fines and imprisonment, the courts are signaling the importance of accountability and transparency, as well as good corporate governance. These cases may well set a precedent for others to follow and should constitute a deterrent to poor practice. However, in the short term, the problem with Indonesia's judicial environment means that effective enforcement of sanctions for noncompliance with regulatory requirements will remain a problem. There are however certain provisions in Capital Market Law relating to the responsibility of registered accountants on compliance with laws and regulations.

58. **In Indonesia, "whistleblower" and "hotline" are not familiar concepts.** Having a safe and secure mechanism for staff or the public to bring wrongdoers to the attention of a responsible body can be used to

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[39] MOF Decree No.423/KMK.06/2002 Article 24.
[40] In 2004, the Monitoring Division found 5 cases of noncompliance with accounting or auditing standards.
[41] The discussion covers issues such as information disclosures.
[42] In 2004, 5 companies were (forced) delisted based on the fact that these companies were unable to demonstrate their viability of their business.
[43] Bapepam Rule IX.1.5. The rules also specifies that one member of the audit committee should have financial and accounting background.

assist in the effort to identify fraud, corruption, and noncompliance with laws and regulations. Adoption of laws and regulation and creating awareness of this approach could facilitate enforcement by Bapepam and Bank Indonesia and could enhance compliance.

III. ACCOUNTING STANDARDS AS DESIGNED AND PRACTICED

A. Indonesian Financial Accounting Standards

59. **The Indonesian Financial Accounting Standards (*PSAK*) are moving toward convergence with IFRS/IAS, with full adoption planned in 2008.** There are significant differences at the present that lead to inconsistencies between PSAK and IFRS.[44] These differences are summarized as follows:

- ***Financial instruments.*** PSAK has not yet adopted the concepts of IAS 32, *Financial Instruments: Disclosure and Presentation,* and IAS 39, *Financial Instruments: Recognition and Measurement,* particularly in the measurement and recognition concepts of the financial statements instruments such as asset, liability, and equity. Efforts are underway to adopt IAS 32 and 39.

- ***Fixed asset.*** While PSAK does refer to the historical cost concept, the standard still permits the recognition of asset revaluation with government's approval. IFRS/IAS refers to the historical cost as well as fair value concepts in which the financial statements should be adjusted periodically to the fair value of assets.

- ***Hyperinflation accounting.*** PSAK does not adopt the IAS 29, *Financial Reporting in Hyperinflationary Economies*, in connection with the hyperinflation of accounting for unstable economics. This is currently not an issue for Indonesia.

- ***Business combinations.*** PSAK still permits implementation of pooling of interests for the purpose of managing transactions in business combinations, which is inconsistent with IFRS 3, *Business Combinations*, that prohibits the pooling of interests. In addition, the goodwill that originates from a business acquisition is be amortized over not more than 20 years. This contradicts the concept in IFRS, which states that the goodwill obtained from business combinations should be evaluated on a regular basis in order to ascertain that the value of goodwill is not impaired.

- ***Accounting for land.*** PSAK requires land to be stated at cost and not depreciated. Specific costs associated with the acquisition or renewal of legal titles over land rights are deferred and amortized using straight-line method over the legal term of the land-right. These deferred costs are disclosed below fixed assets or other assets in the financial statement.

- ***Government grants accounting.*** Indonesia has not yet adopted PSAK to the concept of government grants accounting, as in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. This is not an issue since the government does not currently provide grants to the private sector.

- ***Accounting for agriculture.*** Indonesia has not yet adopted PSAK to the concept of agricultural accounting, as covered in IAS 41, *Agriculture*.

[44] The Financial Accounting Standards Board spends a great deal of effort to keep Indonesian PSAK up to date and consistent with IAS/IFRS.

60. The Indonesia Financial Accounting Standards Board (*DSAK*) is considering a thorough comparison between PSAK and IFRS in order to promote synchronization with international standards and the application of high-quality accounting principles. This comparison will assist the Indonesia Financial Accounting Standards Board in identifying the areas that will have the greatest impact as Indonesia moves toward full adoption of IFRS.[45]

B. Banking Sector

61. Based on the ROSC review, all eight banks selected as samples indicate compliance with local standards. Accounting standards for banks are based on Bank Indonesia regulations, circulars, and PSAK.[46]

62. Poorly capitalized banks and inadequate risk management processes were identified as major contributing factors to the Asian financial crisis in the late 90s. In response, Indonesia has taken steps to improve the capitalization, supervisory review, and information disclosure of banks, and to implement international standards, such as Basel Accord. In this regard, it is important for the authorities to ensure implementation of the international standards, especially relating to information disclosure (i.e., bank health and soundness data).

63. Moreover, current international standards require capital adequacy ratios be equal to or greater than the 8 percent level of Bank for International Settlement. To comply with the international standards in general, banks are expected to disclose the following items in their financial statements: capital adequacy ratio, net open position, gap analysis, loan maturities, legal lending limits, and risk management. Based on the ROSC review, the related local standards are generally comparable with related international standards.

C. Insurance Sector

64. The Ministry of Finance Determines the format, structure, and frequency of financial reporting for insurance companies.[47] There is, however, no specific regulations regarding mandatory accounting standards. Therefore, the industry adopts standards issued by the Indonesian Institute of Accountants, which has issued a number of PSAKs in this area. Based on the ROSC review, all three insurance companies selected as samples indicate compliance with local standards. Accounting standards for insurance companies were based on PSAK No.28 (Revised 1996, *Accounting for General Insurance*), PSAK No.36 (Revised 1996, *Accounting for Life Insurance*), and *Accounting and Reporting Guideline* from Insurance Council (*PAKASI*).

65. To comply with the international standards in general, insurance companies are expected to disclose the following articles in their financial statements: solvency margin calculation, analysis of admitted asset, reinsurance, and own retention program. Based on the ROSC review, local standards are not consistent with the related international standards.

66. For life insurance companies there are also critical areas that require more comprehensive disclosure, such as:

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[45] An IDF grant has been approved by the World Bank to help facilitate adoption of international accounting and auditing standards in Indonesia and to provide training.

[46] Bank Indonesia Regulation No. 3/22/PBI/2001, *Transparency of Banks' Financial Condition*; Circular Letter No. 3/30/DPNP, *Quarterly and Monthly Financial Statements of Banks and Certain Reports, which are submitted to Bank Indonesia*. This circular letter has been revised with Circular Letter No. 7/10/DPNP; Circular Letter No. 3/31/DPNP, *Annual Reports and Certain Annual Reports which are submitted to Bank Indonesia*; PSAK No. 31, *Accounting for Bank*; and Indonesian Banking Accounting Guidance.

[47] Law of Insurance Business (No. 2/1992) and Mininstry of Finance Decress.

- ***Deferred acquisition cost.*** Requires disclosure in relation to the nontraditional product to be in line with IAS 38, *Intangible Assets*, and IAS 39, which has not been incorporated in the current standard.

- ***Premium reserve.*** Requires disclosure concerning the method and assumptions of the actuary (life insurance) applied for the calculation of the reserve. It will be far more informative for the user of financial statements if the calculation of the reserve is also approved by Ministry of Finance.

D. Accounting Standard in Practice

67. The ROSC review of the 2003 financial statements of a selected sample of 39 listed companies indicates overall compliance with most disclosure requirements. However, the scope of the ROSC review did not cover the accounting records and/or working papers of external auditors. In addition, noncompliance with recognition and measurement standards cannot generally be identified through mere review of financial statements. A checklist of selected disclosure requirements as issued by Indonesia Financial Accounting Standards Board was used to identify compliance by the 39 sample listed companies selected. The result of the review shows the following cases of noncompliance:

- ***Segment information.*** As much as 38 percent of population does not disclose segment information related to several requirements, such as geographical areas (PSAK No. 5 Par. 73) and reconciliation with primary financial statements (PSAK No. 5 par. 48 – 57).

- ***Related party transactions.*** PSAK requires disclosure of related party transactions. The disclosures must emphasize the nature of the relationship, the type of transactions, and element of transactions (including volume of the transactions, pricing policies, and outstanding items). Of the sample, 38 percent of the 39 companies failed to comply with such requirement, mostly with respect to the nature of the relationship (PSAK No.7 Par. 23) and the element of the transaction (PSAK No. 7 Par. 23).

- ***Borrowing costs.*** PSAK requires disclosure for borrowing cost of accounting policies, rate of capitalization and the amount capitalized during the accounting period (PSAK No. 26 Par 35). However, as much as 31 percent of the 39 companies do not fully disclose their borrowing costs.

- ***Presentation of accounting policies.*** Approximately 26 percent of sampled companies do not mention the currency used (PSAK No. 1 Par. 72). There is also no disclosure related to subsidiaries (PSAK No. 4 Par. 28c).

- ***Employee benefits.*** PSAK No. 24 (Revised 2004) that regulates the accounting for employee benefits was implemented in the middle of 2004. Thus, the 2003 financial statements of sampled companies did not include the required disclosures concerning employee benefits, which was required for 2004 financial statments. Most companies therefore only disclosed the method of employee benefits applied during the year, and left other requirements in PSAK No. 24 (Revised) undisclosed, particularly the actuarial calculation.

- ***Accounting for general insurance.*** PSAK No. 28 (*Accounting for General Insurance*) does not cover detailed regulations concerning the reinsurance contract, especially the prospective and retroactive contract. Neither PSAK No. 36 nor PSAK No. 28 specifically requires a disclosure related to the solvency margin and own retention program in addressing the health and soundness of the companies. One of three sampled insurance companies failed to comply with PSAK No. 28 Par. 45 regarding adequate disclosure that should be provided by insurance companies.

- ***Restructuring transactions among companies under common control.*** PSAK No. 38 (*Restructuring Transactions among Companies under Common Control*) requires the type; book value; and takeover of assets, liabilities, common stock, and other equity instruments be completely disclosed. Other items that should be disclosed in financial statements are the date of the restructuring transaction among companies (below common control), names of related entities, and accounting method. For instance, one out of three companies failed to comply with PSAK No. 38.

IV. Auditing Standards as Designed and as Practiced

68. The survey of selected public accounting firms in Indonesia indicated a general compliance with Indonesian Generally Accepted Auditing Standards. [48] Going forward, the most important issue to be addressed by standardsetters and the practitioners is adoption of International Standards on Auditing (ISA), since current standards are largely consistent with US GAAS instead of ISA.[49] There is a plan to adopt ISA within 2007.

69. Compliance with ongoing changes in regulations and accounting and auditing standards requires a coordinated and synchronized effort by standardsetting bodies, regulators, accounting firms, other professionals/specialists, and companies. This effort is necessary to provide further guidance on the implementation of changes, as well as to develop acceptable training to all personnel and to guide companies in setting up accounting systems and records, procedures, and policies to support the implementation of these changes.

V. Perception on the Quality of Financial Reporting

70. Perception regarding the quality of Indonesian financial reporting and disclosure varies. Despite the weaknesses identified in compliance with accounting and auditing practices in this report, investors are voicing a higher opinion on the quality of information available in published financial reports, particularly those audited by the Big-4 firms, than in the past. Based on interviews and feedback received from market participants, including commissioners and directors, there is a perception that the quality of audit carried out by Big-4 firms is higher than those carried out by firms not associated with the Big-4.

71. However, in general, investor perception is one of an improving financial reporting system. For example, as was reported by Credit Lyonnais Emerging Market survey during 2002-2005, Indonesia has been continuously improving its corporate governance and financial reporting practices during the last several years. But, major challenges remain, particularly concerning enforcement. During discussions with representatives of audit firms, several areas were cited for improvement: the continuing professional education program administered by the IAI needs to offer quality courses; quality accounting systems, particularly for small companies, to make it possible to comply with all regulatory requirements; and guidance for chief financial officers and chief executive officers in addressing fraud within organizations.

VI. Policy Recommendations

[48] Majority of listed firms are audited by Big-4 firms.

[49] The present local standards were constructed in 2001 based on 1998 US GAAS and are not up to date. U.S. GAAS is generally consistent with ISA. The main differences include expression of reliance on other auditors, qualification on going concern, and the code of ethics.

72. The policy recommendations presented in this section emerge from the ROSC review of accounting and auditing practices in Indonesia. The policy recommendations include valuable inputs received from various parties interviewed by World Bank staff conducting the due diligence exercise.[50] These recommendations are aimed at developing an environment for high quality corporate financial reporting. It is expected that the recommendations presented in this section will be used as inputs for preparing and implementing a country action plan for further reform of accounting and auditing practices in Indonesia.

73. High-quality corporate financial reporting depends on integrated efforts of all parties in producing and assuring financial information. There are four important parties involved: (a) the accounting and auditing standardsetters; (b) the preparers of financial statements; (c) the auditors; and (d) the regulators, both statutory and self-regulatory bodies. The challenge going forward lies in raising awareness and increasing the effectiveness of implementation and enforcement of legislation and regulations to improve the accounting and auditing culture and practices.

74. **In order to address the ROSC policy recommendations, it is recommended that a multidisciplinary committee be established.** Based on the successful experience of other countries, the report recommends that this multidisciplinary committee develops a country strategy and a detailed action plan to enhance the quality and reliability of financial reporting in Indonesia. The committee should be formed under the leadership of the Ministry of Finance and Bapepam with participation of all stakeholders, including IAI, Bank of Indonesia, Jakarta Stock Exchange, and the academic community. The strategy should be endorsed by the Government; and the action plan should be implemented under the coordination of the committee. The formation of such committee will be essential to the reform process, given the diversity of legislation, regulatory authorities, and the fragmentation of the financial reporting framework.

75. **The standardsetter's objective should be full convergence with International Financial Reporting Standards**.[51] Adequate funding and staffing of the standardsetter will be a prerequisite to a well-functioning mission. It is also important that a decision be made on the scope of IFRS implementation. International good practice suggest that, at the minimum, banks, insurance companies, and other entities, which are considered to be of interest to the public at large, adopt IFRS.

76. **The current optional arrangement available for audit or review of semi-annual and quarterly financial reports is confusing and potentially misleading to an unsophisticated investor.** It is recommended that the audit and review requirements of semi-annual and quarterly reports be strengthened to the level of international best practice. This requires that, at a minimum, semi-annual reports be reviewed by independent auditors.

77. **The Government should alleviate the regulatory burden on nonlisted companies and small and medium enterprises to have audited financial statements in accordance with international standards.** Indonesia does not have a different accounting and financial reporting framework for small and medium enterprises and unlisted companies. This imposes unnecessary compliance costs and potentially undermines the quality of financial reporting. The recommended simplification would eliminate an impractical, unenforceable, and counterproductive rule. The simplification could start with adoption of SME standards or by amending the current law (Government Regulation No. 64, 1999) by introducing a combination of factors, including increasing the current threshold (currently assets of more than Rp25 billion) above which companies must present audited financial statements to the Ministry of Trade. The increased threshold amount should be defined after adequate consultation with the regulatory bodies, private sector, the

[50] Participants include IAI, Bapepam, Ministry of Finance, Bank Indonesia, Jakarta Stock Exchange, the National Committee of Corporate Governance, accounting and law professors, members of the boards of directors and commissioners of listed companies, and accounting professionals.

[51] The IAI plans to revise Indonesia accounting standards in accordance with IFRS by 2008.

accounting profession, and other stakeholders. After raising the threshold amount, there is a need for a simplified accounting and financial reporting framework for the remaining unlisted companies commensurate with their size and capital structure.

78. **Further efforts should be made to strengthen the effectiveness of audit committees, including measures to clarify and strengthen their role and function, consistent with international best practice.**[52] Audit committee members should continuously upgrade their knowledge and skills, through one of the institutions that provide director's training.

79. **There is a need to improve the capacity of the accountants in industry as Indonesia moves toward full adoption of the IFRS for listed and public interest companies.** In order for the practitioners to obtain a deeper understanding of the accounting standards and general purpose financial reporting, a program should be developed by IAI to specifically target the significant retooling needs of accountants in industry. A prerequisite to adoption of IFRS is that management of companies should be committed to preparation of quality financial statements.

80. **Further effort will be required to fully adopt International Standards on Auditing.** The Public Accountants Professional Standards Board needs to issue more practice guidance to help implement auditing standards. As the IAI moves more toward adoption of the International Standards on Auditing, the Public Accountants Professional Standards Board needs to provide adequate guidance on the new and the revised audit standards, such as those on consideration of laws and regulations in an audit of financial statements and consideration of fraud in a financial statement audit. This would include more effective in-depth training of auditors.

81. **An appropriate oversight system for the audit profession should be established in tandem with the IAI.** The purpose of the oversight system is to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity; it should also instill public confidence in the profession and demonstrate to regulators and the public an adequate discharge of self-regulating responsibilities. Given the growing presence of large Indonesian companies on international equity and debt markets, these measures will help underpin the confidence in the functioning of the Indonesia capital market and help prevent unnecessary international regulatory overlap through reciprocal cooperation with other countries.

82. **The Government should consider legislation (and regulations) that would establish protection for "whistleblowers" who report accounting manipulations or irregularities to the regulatory bodies.** This would encourage individuals to report violations that they have identified in the course of their work. This could be a major tool in assisting Bapepam and Bank Indonesia in their enforcement and compliance activities.[53]

83. **Although Bapepam has a mechanism to process complaints, it is recommended that Bapepam and Bank Indonesia consider jointly establishing a "hotline" so individuals could report violations of noncompliance with laws and regulations.** Unlike the concept of whistleblower, the hotline does not identify the informant. This is to encourage individuals to come forward with information on corporate fraud and corrupt practices, as well as violations of laws without the worry of being identified. As with the whistleblower concept, the hotline would be another tool for Bapepam, Bank Indonesia, and other enforcement agencies to strengthen their enforcement efforts.

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[52] Examples of good practice are the recommendations by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees and the recommendations by the NYSE Listing Committee issued in 2002.

[53] Malaysia has put in place legislation to protect whistleblowers and is the first Asian country to implement such provisions. The provisions were aimed at protecting directors, management, and auditors of publicly listed companies, who report breaches of securities laws or listing rules and any matter that had material and adverse financial impact on publicly listed companies (the whistleblowing provisions to report such breaches or financial matters were mandatory for auditors).

84. **Streamline and harmonize financial reporting requirements for listed companies, banks, and insurance companies in order to lessen the administrative burden.** Various regulatory bodies have different reporting and timing requirements for the reports that companies must submit, even though their core accounting and auditing standards are the same. One example is the different dates imposed by different regulatory bodies for when the semi-annual and annual financial reports are due from companies. Another example is when the auditor finds a serious violation of the Capital Market Law or regulation, Bank Indonesia requires it to be reported in seven days, whereas Bapepam requires the violation to be reported within three days.

85. **Strengthen market surveillance and enforcement on the part of Bapepam and Jakarta Stock Exchange**. Although it is agreed that the oversight function is improving, there is still a perception that enforcement is not fully effective. This perception may be explained by a weak legal environment, the absence of accountants' legal liability, lack of an appropriate risk management methodology, and insufficient training for the regulatory staff. For example, special training programs for enhancing the staff's understanding of insider trading rules and related party transactions would minimize legal uncertainty and increase the ability to enforce compliance. It is recommended that regulatory bodies review the level of sanctions for violations of laws and regulations, as well as noncompliance to ensure their adequacy.

86. **The concept of risk management needs to be further developed to assist the regulatory bodies in identifying companies that pose a high risk of noncompliance.** This will better enable the compliance and enforcement staffs to focus on the higher risk areas since they have very limited resources. The auditing profession has already developed such a concept used in their audit planning in order to target high risk areas. The auditors then focus significant resources on those areas. A similar approach would enable Bapepam and the Jakarta Stock Exchange to identify potentially questionable practices and risks in the capital markets that could be exploited by others to the detriment of investors and the Government. Ideally, being able to spot such risks early could prevent them from growing into full-fledged, confidence-eroding scandals. This would also contribute to reducing the perception that enforcement is not effective, consequently instilling more confidence in the capital markets. Recent improvements in enforcement are welcome and demonstrate the need to persist with effective enforcement to change behavior.