



Reform of Public Finance Auditing in Indonesia



Prof. Dr. Anwar Nasution
Chairman, The Audit Board of The Republic of Indonesia (BPK-RI)
4th October 2008

Address: Jl. Jenderal Gatot Subroto Kav. 31, Jakarta 10210, Indonesia



Outline

1. Causing factors of economic crisis in 1997-1998:
 - 1.1 Weak institutions:
 - (a) Poor quality of information due to:
 - (i) deficiencies in accounting system;
 - (ii) weak legal system.
 - (b) Poor policy analysis;
 - (c) Poor policy implementation;
 - 1.2 Weak economic fundamentals: public finance, banking system and corporate governance.
2. Multi Facet Reforms since 2000:
 - 2.1 Reforms of the political, governmental and economic system;
 - 2.2 Transparency and Accountability of Government Agencies;
 - 2.3 Fiscal reforms;
 - 2.4 Reforming BPK:
 - 2.4.1 BPK under Authoritarian Regimes;
 - 2.4.2 Restoring BPK's Autonomy and Independence;
 - 2.4.3 BPK Reform Initiatives.
3. BPK's Audit Opinion on Government Financial Reports for Fiscal Years 2004-2007.
4. BPK Initiatives to Promote Transparency and Accountability of Public Finance.



1. Causing factors of economic crisis in 1997-98

- The period between 1997-2005 was a lost decade for Indonesia. The economic rate of growth has improved recently mainly driven by the rise in commodities prices.
- The Asian crisis in 1997-98 was much more severe in Indonesia than in other crisis-hit countries, in terms of:
 - (i) the loss in output, economic contraction over minus 13 percent in 1998;
 - (ii) the drop in the external value of domestic currency, over 70 percent in 1998;
 - (iii) the cost of bank recapitalization amounted to 50 percent of annual GDP of 1998.
- The recovery has also been much slower in Indonesia as, since the past 10 years, the crisis has been over-shadowed by politics, security and other aspects of social life. In addition to a series of man made problems such as armed conflicts and terrorist attacks in several regions, the country has also been hit by a series of natural disasters;
- All of these events have consumed a great deal of financial resources and energy.



1. Causing factors of the economic crisis...

- The economic crisis in 1997-98 was caused by inadequate capacity of institutions to: (1) provide and collect information, (2) analyze the problems and formulate appropriate policies to address them, and (3) implement the appropriate policies.
- The main culprit of the economic crisis was the corporate sector (banks and non-banks) which were poorly supervised and heavily borrowed short-term loans from overseas, while investing the funds in long-term projects, mainly in the non-trade sector of the economy. The currency and maturity mismatches encouraged capital flow reversal and ignited the simultaneous occurrence of banking and currency crises;
- Public financial management, control and accountability were extremely poor. Without unified oversight of the formal development and recurrent budgets, spending were duplicated and public funds was diverted to unintended purposes. Government agencies, including the military and the police, supplemented their formal budget with extra revenues from their own business ventures mainly consisting of rent seeking activities. As there was not a Treasury Single Account, public funds were deposited in thousands of separate accounts, including those privately owned by officials who had passed away more than 10 years. The audit process was very weak, audit findings were hardly followed up and corruption cases were rarely prosecuted.



Poor quality of information

- The quality of information has been poor in Indonesia mainly because of deficiencies in the accounting system, poor auditing process and the flawed legal system. Until recently, financial reporting of the public sector applied the single entry and cash basis accounting system based on the outdated *Indische Comptabiliteitswet (ICW)* inherited from the Dutch colonial era. As the government budget, under this system, does not represent allocation of resources, it cannot be used as a tool for public resource management. In addition, there was no treasury single account for public funds.

- On the surface, the government's fiscal position had appeared to be relatively strong prior to the crisis as government budgets were either in balance or shown as having small surpluses. The real story was, however, different from the official figures as:
 - (i) Government budget did not provide the true picture of financial transactions of the public sector due to the presence of the large extra-budget funds;
 - (ii) not all government revenues and expenditures were reported in the formal budget;
 - (iii) a large amount of state funds was deposited under the names of individual government officials, including those who has long been passed away;
 - (iv) the losses of state-owned enterprises and state-owned banks and their clients, particularly those owned by politically well-connected groups, became contingent liabilities of the government. These future budget commitments were not recognized until cash payments had been made.



Poor quality of policy and information..

- The quality of policy and data was also poor in other sectors of the economy:
 - (a) the prudential rules and regulations of the banking system were hardly implemented. These included capital adequacy, legal lending limits and net open positions;
 - (b) part of the external reserves of the central bank were deposited at NV Indover Bank, its own commercial bank in Holland. The funds were pledged as back up for its sour credit extended to politically well-connected business groups in Indonesia;
 - (c) privatization of state-owned enterprises was only a transfer of monopoly rights from the state to the cronies of the regime;
 - (d) weak corporate governance. State-owned enterprises were no more than the arm extension of government bureaucracy.



2. Multi Facet Reforms since 2000

2.1 After the fall of President Soeharto in 1998, Indonesia has undergone major and wide-ranging reforms in its social, economic and political systems.

There are four aspects of Indonesia's social reforms, namely:

- To replace the authoritarian political system with democracy, This ended direct involvement of the armed forces (including the police) in politics;
- To replace the centralized government system by granting broad autonomy to local governments at the sub-province level;
- To relax strong government intervention with a market mechanism and to integrate the economy into global markets;
- To improve governance of the corporate sector, including state-owned enterprises.



2.2 Accountability and Transparency of Government Agencies

- Following the hard lessons after the crisis in 1997-98, people began to realize that fiscal transparency and accountability are the key elements in solving the problems and in implementing the social reforms.
- Transparency and accountability serve several objectives, namely, as follows:
 - (i) to improve the management and monitoring of government organizations;
 - (ii) to promote a more symmetric transmission of information to make political democracy, local autonomy, market system and economic globalization work effectively, efficiently and equitably. Fiscal transparency also helps defuse regional conflicts due to suspicion and mistrust;
 - (iii) to help upgrade the ratings of Indonesia's sovereign bonds to investment grade and reduce interest charges. The grade of sovereign bonds is also related to the capacity of the government to service its debt. This, in turn, is determined by its tax efforts to accumulate budget surplus and export growth in case of external debt. Servicing external debts is similar to surrendering a part of national product to external creditors. To avoid the transfer problem, the debtor should accelerate the rate of its economic growth;
 - (iv) to allow the corporate sector to rejoin the international community.



2.3 Fiscal Reforms

- The reform of the fiscal system and endeavors to align it with the international best practices started with the issuance of a Presidential Decree on Government Financial Accountability in 1999. Major reforms were introduced with the promulgation of the following three laws on state finance in 2003 and 2004:
 - (1) Law No. 17 of 2003 on State Finance;
 - (2) Law No. 1 of 2004 on State Treasury;
 - (3) Law No. 15 of 2004 on Auditing the Management and Accountability of State Finance.



Fiscal Reforms.....

- Fiscal reforms address the weaknesses of the previous fiscal system by, among other things:
 - 1) end separation between routine and development expenditures in order to avoid duplication of spending and misuse of public funds for unintended purposes;
 - 2) move from a single entry to a double entry accounting system, and from cash basis to accrual basis to allow medium- and long-term planning and performance basis and multi-year budget;



Fiscal Reforms.....

- 3) adopt a Treasury Single Account to improve financial control;
- 4) modernize and integrate computerized accounting system;
- 5) decentralize the accounting implementation in a hierarchical manner by each accounting unit, both at the central and regional levels;
- 6) Improve the audit of public funds, applying a tight time frame for the accountability report, strengthen follow up on audit findings and prosecute cases of corruption.



2.4 Reforming BPK (*Badan Pemeriksa Keuangan*)

- BPK was reformed along with the fiscal reforms. The reform resulted in BPK's regaining its independence and constitutional mandate as the sole external auditor of the government to assure transparency and accountability of government finance.

2.4.1 BPK Under Authoritarian Regimes:

- Under the past authoritarian regimes, BPK was unable to fully implement its constitutional mandate as it was controlled by the executive branch of the government through the following:
 - 1) control of BPK's organization, budget, appointments of its Chairman and members. BPK auditors are civil servants and their career path, salary and discipline are subject to government scrutiny;
 - 2) during the long period of President Soeharto's administration, BPK was banned from auditing the 'gold mines' of the regime, such as the central bank and state banks and Pertamina, the state oil company. Auditing of these entities was entrusted to the internal controller of the government, the BPKP-*Badan Pengawasan Keuangan dan Pembangunan*, the Agency for Supervising Government Finance and Development;
 - 3) Until now, BPK is banned from auditing tax revenues and certain non-tax revenues. In the absence of auditing, self assessment is a license for both illegal tax evasion and corruption by tax officials;
 - 4) to preserve political stability, BPK audit reports were "toned down" and not made available to the general public;
 - 5) suspicions of criminal practices could be reported to law enforcers only through the government.



2.4.2 Restoring BPK's Autonomy and Independence

- Law No. 15 of 2006, promulgated in October 2006, restored the independence and autonomy of BPK. This is in line with the spirit of both the 1945 Constitution of the State of the Republic of Indonesia as well as the Lima Declaration of INTOSAI of 1977. Under the present law, BPK is independent in making decisions with regard to auditing and organization. It is also more independent in finance and budget related matters as its financing now comes directly from the Parliament. BPK is now more flexible with regard to personnel policy, even though the staff are civil servants.

- The salient characteristics of BPK under the present law as compared to the previous one are indicated in Table 1.



Table 1. BPK under the laws of 1973 and 2006

	<i>Under Law No. 5 of 1973 during the New Order regime</i>	<i>Since 2005 and under Law No. 15 of 2004 and Law No. 15 of 2006</i>
1. Representative Office in the regions	Not specified. The number of Rep Office was 7 in December 2004	Exist in provincial capital. At present, BPK has Rep. Offices in 30 out of 33 Provinces.
2. Total number of Chairman, Vice-Chairman and Members	7 persons	9 persons
3. Election of Chairman	Appointed by the President based on the proposal of the Parliament	Elected by and from among BPK Members
4. Independence		
4.1 Organization	Regulated by the State Minister for Administrative Reforms	Flexible
4.2. Finance	From State Budget (APBN). The budget was low and the salary of BPK Auditors was far below that of internal auditors of the government	Separate budget in the State Budget (APBN) and rising to expand Rep. Offices, improve IT and equipment and improve salaries of auditors.
4.3 Personnel	Civil Servant	Civil Servant but more flexible in hiring, promotion and dismissing
4.4 Audit Report	Consulted with the Government for 'national stability' reason	Announced on BPK website immediately after having submitted to legislative bodies (Parliaments both at national, provincial and local levels and Regional House of Representatives Council (DPD)
5. Accountability		
5.1 Code of Ethics	Unclear	Binding and its implementation is monitored by a Council of Honor and Ethics whose members include professionals and academicians from outside BPK
5.2 Audit of BPK's Budget	Conducted by BPK's auditors in charge of auditing state institutions and the audit results were not published	Conducted by Public Accounting Firm and the audit report is reported to the Parliament and made available on BPK's website.
5.3 Assessment of BPK's Performance	None	Conducted by SAIs of other countries who are members of INTOSAI

Continued.....



BPK under the laws of 1973 and 2006

Comparison of BPK during the new order regime and the Reform Era

5.4 Audit Report	Not available for the public	Available to the general public as they are published on BPK website
6 Audit Object		
6.1 State Revenue	Nearly none	Starting to audit mining contracts, including oil and gas, and Non-tax State Revenues. However, the Tax Law does not give the access for BPK to audit tax revenues and certain non-tax revenues
6.2 State Cash Deposit	Nearly none	Starting to audit and in 2005 BPK reported 957 private accounts of state officials containing state money and in 2006 the number reached 1,303 accounts
6.3 State Expenditure	Limited to the Central Government and those originating from the State Budget (APBN) and several provinces that could be reached by the representative offices of BPK.	Comprising all Government levels: Central, Province and Regency/Municipality and including expenditures using non-budgetary funds
6.4 The public institutions that are not subject to be audited by BPK including state-owned banks, Bank Indonesia (BI), the state-oil company, Pertamina, and some other SOEs	Legal fees collected by the Supreme Court, Directorate General of Taxation Bank Indonesia (the central bank), Pertamina (the state oil company) and several other SOEs were not audit objects of BPK	Audit objects of BPK
7. Time frame for the preparation, audit and accountability of state budget	No regulation	Regulated clearly in Chapter IV of Law No. 15 of 2004
8. Audit Report	<ul style="list-style-type: none"> a. Submitted to DPR (Parliament); b. Alleged criminal violations were reported to the Government; c. Not published for public interest. 	<ul style="list-style-type: none"> a. Submitted to DPR, DPD and DPRD; b. All reports submitted to DPR/DPRD/DPD released in BPK's <i>website</i> for public access; c. Alleged criminal violations are reported to the Police, Attorney General's Office and Corruption Eradication Commission.

Continued.....



BPK under the laws of 1973 and 2006

Comparison of BPK during the new order regime and the Reform Era

9. Follow-up on findings	No regulation	Conducted by state officials, its implementation is monitored and reported to BPK and there is a penalty for any party failing to take follow-up measures.
10. State Indemnity	No regulation	Stipulated by BPK, the procedure is determined by BPK
11. State finance audit standards	Stipulated by BPK, without any consultation with the Government, academicians and professionals	Stipulated by BPK after consultation with Government, academicians and professionals.
12. The Use of Public Accountant to audit the public sector: Government, SOEs and enterprises owned by provincial and local governments.	Conducted by issuing 'cover letter'	Regulated according to BPK rules. Public accountants are trained in the standards and regulations on state finance auditing and certificates and permits are issued to those who pass the examination.
13. Regulation on state finance audit	No authority and the Parliament has no Public Accountability Committee	As the authority, BPK can issue regulations on state finance audit
14. Immunity, legal protection aid and security assurance	No regulation	<ul style="list-style-type: none"> a. BPK Members cannot be prosecuted for performing their duties, obligations and authorities. b. BPK members, auditors and other parties working for and on behalf of BPK obtain legal protection and security assurance from the relevant authority. c. BPK is entitled to legal aid at the state's cost in the event of lawsuit arising out of the performance of its duties and authorities.



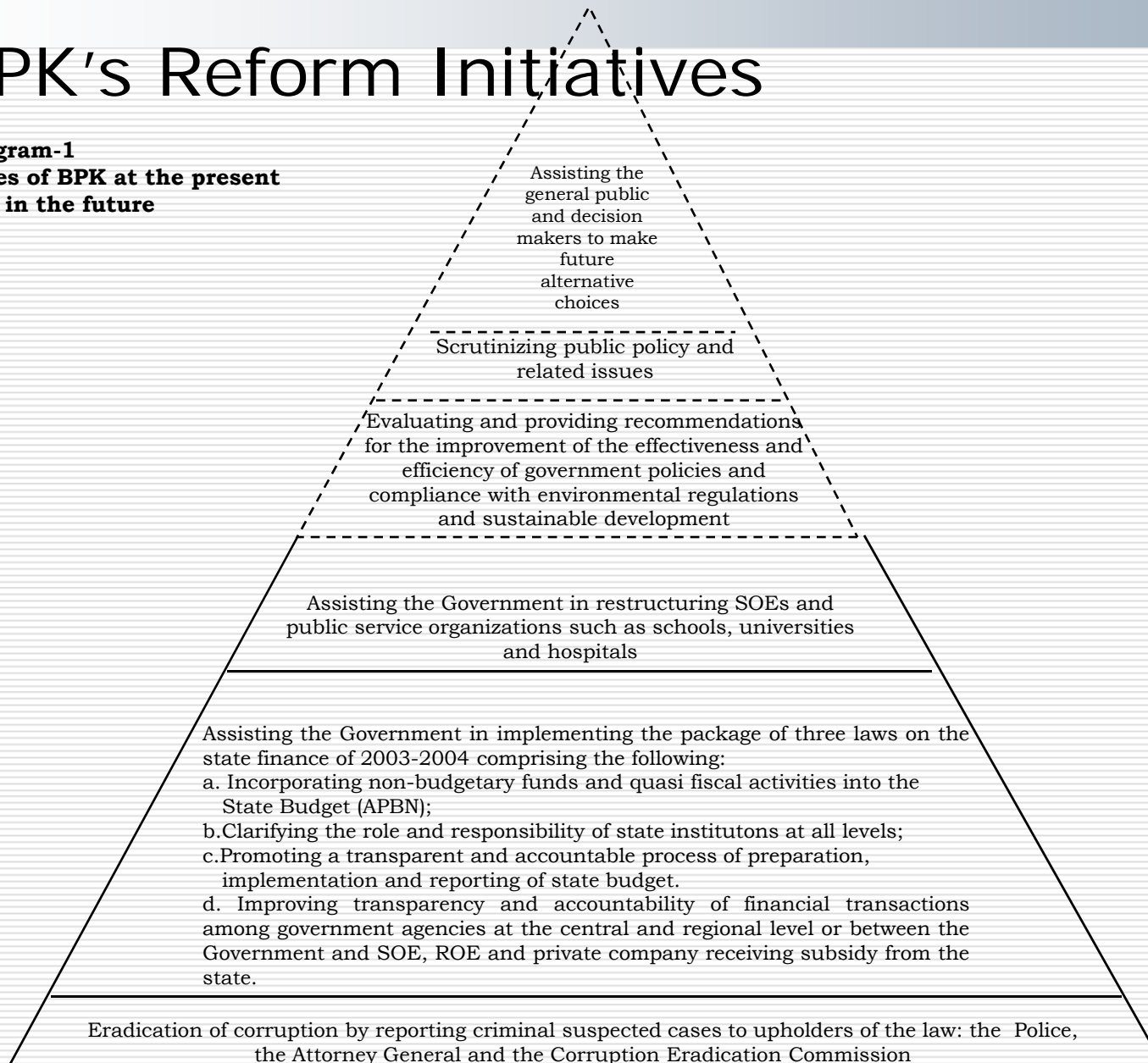
2.4.3 BPK Reform Initiatives

- Prior to the enactment of the new law, BPK had started its reform initiatives since 2005 to achieve the goals of the fiscal system reforms:
 - Adoption of Strategic Plan and Implementation Plan for the year of 2005-2010;
 - Four roles have been performed (three lower layers of the triangle in Diagram-1):
 - To closely cooperate with law enforcement agencies in efforts to eradicate Corruption, Collusion and Nepotism, both at the central and local governments, Bank Indonesia, the central bank as well as legislative and judicial branches of the government;
 - To improve transparency and accountability of state finance, a new Standard for Government Accounting issued in April 2005 and Government Auditing Standard released in March 2007;
 - To encourage and assist the Government in implementing the package of three laws on State Finance of 2003-2004;
 - To restore the constitutional rights of BPK by persuading the Parliament to amend laws on tax, mining and non-tax revenues;
 - To encourage and assist the Government in conducting institutional reforms, including the restructuring of SOEs and public service entities, such as public schools/universities and hospitals, and the restructuring of foundations as well as business entities of the military and the police.



BPK's Reform Initiatives

Diagram-1
Roles of BPK at the present
and in the future





Future Roles of BPK.....

- Future roles of BPK are indicated in three upper layers of the triangle in Diagram-1:
 - To gradually improve performance audit and provide views and opinions on the long-term trends to be put forward for further consideration by the legislative, executive branch, and the public at large in the decision making process;
 - Starting from 2008, BPK will outsource part of audit work of the public sector to eligible Public Accounting Firms. BPK will train, certify and monitor their audit work.



3. BPK's Audit Opinion on Government Financial Reports for Fiscal Years 2004-2007

- BPK gave a disclaimer opinion on the Financial Statements of both the Central Government and most of local governments for four consecutive fiscal years, from 2004 to 2007. Some major weaknesses found include the following:
 1. Weaknesses in the internal control system, including the lack of financial statement reports and unreconciled amount among related accounts;
 2. Incompatible government's technology information system;
 3. Poor implementation of Government Accounting Standard;
 4. Absence of integrated Treasury Single Account;
 5. Invalid data on the existence of government assets and liabilities;
 6. Insufficient knowledge in the field of accounting by accounting staff throughout government entities;



BPK's opinion

7. Vague interpretation of "cost recovery" calculation in oil and gas industry;
8. Lack of compliance with prevailing laws and regulation in public finance, including the management and use of agencies' "own levies", and revenues from user charges and other non-tax revenues.



4. BPK Initiatives to Promote Transparent and Accountable Public Finance

- The shift towards double entry accounting, from cash basis to accrual basis of public budget and to a performance based and multi-year budget has been very slow. So has been the progress towards the realization of the treasury single account.
- To expedite the implementation of the package of three laws on State Finance of 2003 2004, BPK has taken the following six initiatives:
 - First, to require all government agencies to submit a Management Representation Letter (MLR) to BPK signed by the Minister/head of the agency concerned. The MRL states that the financial report submitted for audit by BPK was prepared in line with the Government Accounting Standard of April 2005. To promote quality assurance, the financial report should be checked first by the internal controller of the Ministry/government agency concerned before it is signed by the Minister/head of the government agency;
 - Second, to adopt a consolidated Treasury Single Account in order to allow the Minister of Finance to know public financial position at all time. Financial consolidation including the incorporation of non-budgetary funds and quasi-fiscal operations into state budget and treasury account;
 - Third, to clarify the roles and responsibilities of state institutions at all levels, including schools, hospitals, state-owned enterprises, foundations and business activities linked to the military and the police.



4. BPK Initiatives to Promote transparent and accountable

- Fourth, to require all government agencies to prepare their own Action Plans for improving audit opinion of BPK on their financial reports. The Action Plan consists of programs to: (i) improve the accounting system toward accrual basis; (ii) modernize an integrated and consolidated computer system; (iii) update the inventory of public assets and debt stock; (iv) meet schedule of financial reporting as set in the three laws on public finance of 2003-2003; (v) empower internal controller; and (vi) enhance personnel in the field of accounting;
- The fifth initiative of BPK is to help government agencies to implement their Action Plan. For example, BPK has been actively encouraging the government to transfer accountants from BPKP to line ministries and regional governments. BPK also encourages government agencies to establish link with the Accounting Department at leading Universities to help solve the shortage of public accountants;
- The sixth initiative of BPK is to advise both the national and local Parliaments and the House of Regional Representatives to establish Public Accountability Committee with the aim of monitoring the implementation of state finance reforms and the annual budget, as well as follow up on audit findings.



THANK YOU