Indonesia
Country Financial Accountability Assessment

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East Asia and Pacific Region
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Abbreviations/Acronyms

AG Accountant General
ADB Asian Development Bank
APBN National budget
AusAID Australian Agency for International Development
BAKUN Government Accounting Office
BAPPENAS Planning Agency
BI Bank of Indonesia
BPK Supreme Audit Board
BPKP Government’s Internal Audit Agency
CFAA Country Financial Accountability Assessment
CPAR Country Procurement Assessment Review
DG Director General
DPBN Directorate of Treasury and State Cash
DTUA Directorate of Budget Administration
GAO Government Accounting Office, United States
GAS II Government Accounting System, Release 2.0
GFS Government Financial Statistics
IFIs International Financial Institutions
IA Internal Audit
IG Inspector General
IMF International Monetary Fund
IT Information Technology
KARK Head Office of Government Accounting Office
KAR Regional Government Accounting Office
KKN Corruption, collusion, and nepotism
KPKN Treasury Office
KTUA Budget Administration Office (regional)
MOF Ministry of Finance
PAC Public Accounts and Audit Committee
PAN Annual Budget Realization Report
PPDIA Data processing center within DG Budget
PROPENAS Five-Year Plan
SAI Supreme Audit Institution
SOEs State-owned enterprises
SPM Payment order
SPP Payment request
SU Spending unit/project office
WB World Bank

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(CFAA)
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This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not be otherwise disclosed without World Bank authorization.
This report is a World Bank staff report, based on work done by a team of staff from the World Bank and the Asian Development Bank, and a Government of Indonesia Working Group. The Government Working Group carried out their work during March and April 2000. The fieldwork by the WB and ADB staff was conducted during April 2000.

A CFAA is a diagnostic tool the Bank uses to help Borrowers assess their country's private and public financial management systems. Its purpose is twofold:

(a) To help the borrower and the Bank assess and manage the risk that public fund will not be used for agreed purposes; and

(b) To support the Borrower in the design and implementation of financial management capacity building programs.

The preparatory work for the CFAA was organized under six working groups established under the coordination of the Ministry of Finance. The working groups were organized under the following subjects: (i) Control environment (including legal framework); (ii) Government accounting and financial reporting; (iii) Public auditing; (iv) Accounting profession in the public sector; (v) Project management; and (vi) Budgeting and Treasury. The Groups identified the main issues on budget management, treasury management, accounting, reporting and auditing as well as issues on accounting and auditing standards.

The field work commenced with a presentation of internationally accepted practices in budget management, accounting, reporting and auditing by WB and ADB staff. The Government Working Groups presented their findings and conclusions to the CFAA Team in a seminar held at the Ministry of Finance. This was followed by discussions with the officials of the Ministry of Finance, Ministries of Settlement and Regional Development, Health and Education, a visit to a regional office of Ministry of Settlement and Regional Development and MOF in Bandung and discussions with the Supreme Audit Agency (BPK) and the Government’s internal audit agency (BPKP).

The World Bank team would like to thank Mr. Nurhasmy and other officials of the Ministry of Finance, the officials of the central ministries, regional offices and other agencies visited, and the members of the Government Working groups for their valuable contributions to the CFAA report. The team also wishes to thank Mr. Jim Stevenson, IMF Budget and Fiscal Advisor at the Ministry of Finance for his valuable advice and guidance and World Bank Staff, Messrs. Bert Hofman, Robert O'Leary, Hilarion Bruneau and John Hegarty for reviewing earlier drafts and providing comments and suggestions.

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EXECUTIVE SUMMARY

Background

1. The Country Financial Accountability Assessment (CFAA) is part of the World Bank’s program to support the Indonesian Government’s efforts to reform the process of managing public resources, increase transparency in handling financial affairs, and combat corruption.

2. Since the onset of the financial crisis in 1997 and the subsequent fall of the Suharto regime, the public has demanded greater transparency and accountability from the executive branch of the Government. The present Government, which is the first democratically elected after decades of autocratic rule, is committed to change.

3. Hence the Government has passed or proposed several laws and regulations to reform the management of state finances, combat corruption, reform the private sector, and establish the rule of law. However, as stated by the President in his first accountability speech to Parliament, implementation of these reforms still remains problematic.

4. The CFAA contributes to these Government efforts by analyzing them and making recommendations for improvement.

The Control Environment

5. A sound control environment in any organization requires a leadership committed to principles of good governance; clear laws, regulations, and procedures that are enforced; a motivated work force; and timely reporting of financial and operational information to stakeholders. The assessment of the CFAA Team is that, judged by the above criteria, the control environment in Indonesia is weak despite a political leadership committed to improvement. The CFAA recommends the following Government actions to bring this improvement about: (a) Enacting a modern Budget Law; (b) Establishing a parliamentary Public Accounts and Audit Committee; (c) Initiating reforms to develop a professional civil service with a public sector accounting and auditing stream; and (d) Improving Government procurement laws and practices as recommended in the recently completed Country Procurement Assessment.

The Government Budget System

6. There are several aspects of the Indonesian budget process that militate against budget funds being distributed across programs in the best possible manner. The main focus is on reporting the cost of implementing existing policy with minimum reviews to achieve sound policy settings across all government programs. The revenue estimates and budget projections are not prepared within an integrated macro framework. There have been major gaps in budget coverage owing to off-budget funds. There is no unified framework for budgeting—the “routine” and development budgets are prepared separately. The budget system generates little information on program results.

7. Budget execution and monitoring remain weak. The highly detailed nature of the budget allocations implies tight control; however, in implementation, it is alleged that corruption, collusion, and nepotism result in considerable leakage of funds. Several agencies produce within-
year budget reports that are not reconciled. The annual financial reports to the Parliament are about two years behind schedule.

8. The CFAA’s proposals to improve budget preparation and management include: (a) accelerating the transition to a unified budget based on the GFS classification as proposed by IMF; (b) improving policy review by strengthening the political input into budget preparation; (c) developing integrated revenue estimates within a macro framework; (d) introducing performance-focused budget preparation by incorporating physical program outputs and performance indicators; (e) strengthening financial and performance management in spending agencies; and (f) streamlining reports.

Accounting and Financial Management

9. There are several agencies within the Ministry of Finance involved in the accounting and reporting of financial information. This fragmentation has resulted in none of the systems being able to produce a reliable and reconcilable set of accounts.

10. The payment agency of the Government carries out ex ante reviews of all payment requests. Several other agencies carry out ex post reviews of all payment orders. These reviews are limited to details such as arithmetic accuracy and sufficiency of supporting documents, with no significant added value.

11. At the spending ministry/agency level, there is no financial controllership function. The lack of segregation of key accounting duties in spending units and lack of oversight of these functions either by the ministry financial staff or central finance ministry staff is a serious weakness.

12. Although centralized under the MOF, Treasury and cash management functions are not well coordinated—with about 27,000 bank accounts maintained by various spending units to hold cash, and also unauthorized bank accounts maintained by the individual ministries to bank off-budget funds. Under IMF/Government Letter of Intent, the Government is required to take an inventory of these bank accounts. However, the progress has been slow.

13. There is a redundant and uncoordinated proliferation of computer systems for government accounting.

14. The Government should establish a strong financial management function by rationalizing and streamlining the current fragmented responsibilities within the MOF. The main recommendations are:

- Create a position of Accountant General in the MOF to provide leadership and expertise needed to coordinate and manage activities pertaining to accounting, treasury management, reporting, and information systems.

- Establish a modern financial controllership at the spending ministry/agency level to handle financial planning, budgeting, working capital management, accounting, and reporting.

- Improve treasury management by establishing improved forecasting of cash needs and issuing guidelines setting out clearly defined policies regarding the establishment of bank
accounts, minimum bank balances, policies for investment of excess cash, and policies
for authorizing government borrowing.

- Develop a practice statement of information technology (IT) policies and guidelines for
application by all public sector agencies.

- Develop a uniform financial management system to serve central government needs and
support the enhanced role of financial controllers at the ministries.

- Standardize annual reports to be produced by individual ministries and the central
government report to Parliament and to the public.

Government Auditing

15. The existing Audit Law, which established the functions of the Supreme Audit Board, is
deficient in many aspects. It does not require the Auditor General to have complete
independence, and it is unclear with regard to addressing key features such as the role,
responsibilities, authority, funding, reporting, communication with Parliament, and accountability
of the Supreme Audit Board. An amendment to the current law has been proposed but falls far
short of a modern audit law.

16. The previous Government created an audit agency by Presidential Decree to act as a
centralized internal auditor reporting to the President. This agency has also taken over some of
the external audit functions; such duplication is costly and ineffective.

17. Inspector General (IG) functions in ministries are not staffed with adequate trained
internal auditors. As a result internal auditing in ministries is ineffective.

18. The CFAA recommends that the Government take immediate action to revise the current
audit law by incorporating a well-functioning public accounts committee, an independent auditor
general, and clearly defined boundaries of responsibility for independent external auditing and
internal auditing.
1. **INTRODUCTION**

1. An era of rapid growth, economic and social gains, and a stable political environment came to an abrupt end in Indonesia following the onset of the financial crisis in 1997. The 30 years—a period of impressive social and economic progress—preceding the financial crisis was also a time of autocratic government, run by an administration widely known for corruption and nepotism and for suppression of basic human rights. The onset of the financial crisis in 1997 unleashed a public backlash against the ruling oligarchy and set in train a series of events that culminated in the election of the first democratic Government in Indonesia in 1999. The present Government came into power with a commitment to restore democracy, clean up government, and respond to the public aspirations for greater participation in the affairs of the state.

2. The Government is currently engaged in formulating reform policies affecting both the public and private sectors. However, as admitted by the President in his first accountability speech to the Parliament, this has not been an easy task. Dealing with a financial and economic crisis that remains unresolved, responding to the aspirations of an increasingly demanding populace (which is expecting early wins from the democratization process), cleaning up the public administration (which is widely known to be corrupt and inefficient), and establishing laws and a judicial system that would win international recognition and bring confidence would challenge any government to its limits.

3. A number of reform initiatives have been initiated since the fall of the Suharto regime. These include several laws dealing with corruption (Laws 28, 31, and 43 of 1999), decentralization (Laws 22 and 25 of 1999), and several other proposed laws to reform state finances and auditing. Other initiatives being discussed involve judicial reform, civil service reform, corporate governance, and state enterprise reforms. However, implementation of these initiatives is slow or virtually at a standstill. For example, the Government has not yet established an Anti-Corruption Commission as required by the laws passed. The regulations to decentralize central government activities are still being worked on although the decentralization has commenced staring January 2001.

4. The international donor community has been supportive of the Government's efforts to initiate democratic change and transparent governance. The World Bank (WB), the International Monetary Fund (IMF) and the Asian Development Bank (ADB) have provided jointly or individually policy advice on several aspects of public and private sector governance. These institutions have cooperated in producing several papers since mid-1998 on improvements to public sector financial management—some of these focus on issues related to the decentralization of budget management. The Country Financial Accountability Assessment (CFAA) is a continuation of those joint efforts to support the Government's push to reform the management of public finances and to improve the transparency and accountability of public resource use.

5. In the context of the ongoing reform initiatives described above, the improvement of public financial management is a key element in the Government's agenda. Sound financial
management practices should not only ensure that public funds are managed with due regard to efficiency, economy, and effectiveness but also act as a deterrent to fraudulent and corrupt practices. Therefore it was agreed that the CFAA will have the public sector financial management issues as its main focus.

6. The scope of the CFAA is to analyze the planning, budgeting, accounting, reporting and auditing for public expenditures, and make recommendations for improvement. Much work has already been done by the IMF, the World Bank and ADB on public accountability issues. This Report draws on these publications when they are relevant. The CFAA Team was conscious of the enormous challenge posed by having to improve central government financial management while responding to decentralization objectives required under Laws 22 and 25. The modus of decentralization and arrangements for accountability still remain undefined. The weaknesses observed at the national level in financial management practices and systems are generally magnified at the sub-national level. The situation is further complicated by a lack of trained and experienced staff at the sub-national level. The CFAA Team, therefore, recognizes that the improvements proposed should, over time, aim to build capacity at the sub-national level where up to 50 percent of public expenditure will be managed.

7. The following CFAA presentation is organized in four chapters in addition to this Introductory Chapter. Chapter 2 deals with the Control Environment, which includes the legal and regulatory framework as well as political oversight of public finances. Chapter 3 reviews budgeting and budget monitoring, Chapter 4 accounting and financial management, and Chapter 5 auditing and reporting. Attachment I summarizes the key recommendations and the CFAA Team's suggestion for sequencing implementation.

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1 The IMF, World Bank, and ADB are supporting improvements in private sector governance through other policy, lending, and technical assistance instruments.

2 IMF Papers on Fiscal Management, Decentralization, and Organization of MOF and Budget Management in the Short and Medium Term; World Bank papers on Public Expenditure Reviews (1998 and 1999); and ADB paper on Decentralization: Implication of Good Governance on Project Implementation.
2. THE CONTROL ENVIRONMENT

A. SUMMARY FINDINGS

8. The control environment represents the collective effect of various factors establishing and enhancing the effectiveness of specific policies and procedures. Such factors include the management philosophy and legal framework, methods of assigning authority and responsibility, control methodology, personnel policies and practices, and internal control. Internal control comprises policies and procedures established and maintained by management to assist in achieving its objectives in the following categories:

- Compliance with laws, regulations, policies, and procedures.
- The safeguarding of assets.
- The prevention and detection of fraud and error.
- The effectiveness of operations.
- The accuracy and completeness of accounting records.
- Timely preparation and reporting of financial information.

9. Judged by the above criteria, the assessment of the CFAA Team is that the internal control environment in Indonesia is weak because even though there are several laws and regulations\(^3\) in place dealing with state financial management, these are not enforced owing to systemic KKN (corruption, collusion, and nepotism). Additional factors include (a) poor law enforcement—lack of prosecution or sanctions under the civil service code of conduct—when mishandling of public funds is reported; (b) unclear roles, responsibility, and authority of various external and internal audit functions; (c) poor personnel policies and practices including the salary and incentive structure in the Civil Service; and (d) inadequate parliamentary oversight and lack of timely public reporting of financial information.

10. Although there is public commitment by the political leadership for clean and transparent public resource management and considerable debate in Parliament on the budget, media reports continue to highlight new cases of public fund abuse. In accordance with the Transparency International Survey, Indonesia is ranked the fifth most corrupt country out of 90 countries surveyed in 2000. As indicated above, a number of laws to make public officials accountable have been passed but enforcement continues to be a problem. The systems and practices are slow to change. Incentives to the civil servants to change their behavior are still largely not in place.

\(^3\) Law No. 3 of 1971 and Nos. 28/31 and 43 of 1999.
11. Before any technical improvements in financial management can be achieved, it is imperative that the Government set about creating the right environment for good governance. This would require reforms in the legal framework; designing human resource policies to develop a professional civil service; designing and implementing policies and procedures to ensure efficient operations; and building mechanisms to ensure compliance and enforcement of laws, regulations, and procedures.

B. THE LEGAL FRAMEWORK

12. The basic law on public finances in Indonesia is enshrined in Article 23 of the 1945 Constitution of the Republic of Indonesia, which requires that:

(a) The budget of revenues and expenditures shall be stipulated annually by law. In the event that the House of Representatives does not consent to the budget proposed by the government, the government shall operate under the budget of the previous year;

(b) All taxes required by the State shall be based on law;

(c) The types and values of currency shall be stipulated by law.

(d) Other matters of the finances of the State shall be regulated by law;

(e) In order to audit the accountability for the finances of the State, an Audit Board shall be established, the regulation of which shall be stipulated by law. The findings of such audits shall be conveyed to the House of Representatives.

13. The operation of the above law follows principles enacted in a 1925 Dutch Law, *Indische Comptabiliteitswet Stbl.* From time to time the Government has issued decrees for public financial administration, the latest being the Decree No. 16 of 1994 (revised by Decree No. 17 of 2000) Concerning the Implementation of State Revenues and the Expenditure Budget. These implementing laws and directives were inadequate in terms of addressing the requirements for the public financial management of a modern state. The Government, therefore, is proposing the amendment of laws relating to state financial management and is in the process of drafting new laws covering State Finance, Treasury Management, and Audit.

14. A modern budget law should aim to support a budget process that will (a) have a medium-term budget framework consistent with the government's macroeconomic management priorities; (b) include set annual sectoral and organizational spending limits that reflect the government's priorities; (c) establish clear responsibilities for ensuring effective management and accountability; (d) provide for reporting to the people through the parliament; and (e) require an independent audit of the legal compliance as well as the performance in achieving stated objectives.

15. The Government has submitted to parliament two draft laws which are a significant improvement over the current laws and show a large number of features worthy of a modern budget law. However, the drafts fall short of the objectives stated above and features of a modern budget law. The CFAA recommends that the State Finance Law and the Treasury Law be
combined and revised after taking into account the detailed comments provided by all interested parties. The Bank’s comments have already been sent to the Minister of Finance. ¹

**Parliamentary Oversight**

16. A pillar in the foundation of public sector accountability is the functioning of the Public Accounts and Audit Committee of Parliament (PAC). In Indonesia, the parliamentary oversight of state finances was totally absent during the Suharto regime. The annual budget approval was automatic and there was no formal review of the Auditor General’s annual reports. Recently, the Committee 9 of the current Parliament has assumed the role of PAC to a limited extent. The Committee 9 does not have adequately skilled support staff in the areas of finance, governance, and auditing. There is also no formal communication between the Auditor General and the Committee 9.

17. Parliamentary committees are established by Parliament to remove from the main business of Parliament issues that require a period of careful inquiry and which may necessitate the involvement of community members who are not members of Parliament. Without the existence of such committees to examine the detail of legislation and reports to the Parliament, the legislative processes would be seriously slowed down and its effectiveness eroded. This is particularly applicable in accounting, auditing, and governance issues—owing to the technical nature and complexity involved in these, parliamentarians may need some guidance. The establishment of a Public Accounts and Audit Committee ⁵ is of particular relevance for enhancing the effectiveness of the Auditor General.

18. The CFAA Team recommends that a functioning PAC be established by the inclusion of such a Committee in the State Finance Law or the proposed Audit Law (discussed in Chapter 5). The Committee could play a key role in assisting Parliament to enforce greater accountability of the executive government for the efficient and effective use of public funds.

**C. HUMAN RESOURCE DEVELOPMENT**

19. Sound laws, policies, and procedures alone will not ensure a sound internal control environment without a highly motivated, professional, and adequately remunerated staff. It is well known that the civil service pay is very low compared to comparable jobs in the private sector and that there is no performance measurement or incentive system in place. This has led to acceptance of corrupt practices and rent-seeking behaviors to supplement poor incomes. The Government should seek assistance from human resource development experts to improve personnel policy and practices, design a salary and incentive system to recruit and retain a professional civil service staff, and retrain the current group of civil servants to perform under the new personnel policy environment. As part of the initiative, the Government should develop a professional cadre of budget, treasury, accounting, and auditing staff to carry out the budget and financial management reforms. The Government may consider establishing a Professional, Executive, and Technical Class of the civil service with better pay and conditions to attract qualified and experienced professionals to the civil service. The issue of civil service reform is being addressed by the Government with assistance from the World Bank.

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¹ Letter from Mr. Mark Baird to His Excellency Dr. Bambang Sudibyo dated April 19, 2000.
⁵ An outline of the role and functions of such a committee is attached as Annex A.
D. REGULATIONS, POLICIES, AND PROCEDURES

20. Regulations, policies, and procedures that are clear and well understood by officials, and the training of civil servants in their application and enforcement are important aspects of a sound control environment. Much of this report addresses the financial regulations, policies, and procedures that need to be in place for improved public accountability. A strong public procurement function is an integral part of good governance. The financial management procedures of any country should incorporate regulations and procedures to ensure efficient and transparent procurement of goods and services for public use.

21. A Country Procurement Assessment Review (CPAR) was carried out by a team including members from the Government, WB, ADB, and the private sector. The main conclusion of the CPAR, which is reported separately, is that despite many initiatives by the Government, the current procurement system is not efficient or transparent, is not market driven, and is not consistent with internationally accepted principles and practices. CPAR has recommended a number of measures to improve the procurement system in Indonesia. It is essential that the recommendations be implemented to ensure efficient use of public funds.6

E. RECOMMENDATIONS

22. The main recommendations to improve the control environment are summarized below:

- Enacting a modern Budget Law by subjecting the proposed State Finance and Treasury Laws for further expert review and taking into account comments provided by the WB and other partners;
- Establishing by Statute a parliamentary Public Accounts and Audit Committee;
- Initiating reforms to develop a professional civil service, which should include a public sector accounting and auditing stream; and
- Implementing the recommendations of the CPAR.

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4. THE GOVERNMENT BUDGET SYSTEM

A. INTRODUCTION

23. Effective budget control requires managers of budget funds to be accountable for both financial management quality and program results. Financial accountability is the traditional aim of good budget processes. It is concerned with ensuring that budget funds are managed in accordance with relevant budget laws and regulations. However, it is now widely accepted that the accountability of budget managers should extend beyond the traditional focus on compliance with budget laws and regulations to include accountability for results.

24. This chapter reviews Indonesian budget processes to assess how far officials, spending ministries, and central agencies are accountable for financial compliance, as well as results of their management of budget funds. The review is divided into three sections, corresponding to the three main stages of the budget process:

- Accountability in budget preparation: This can be summarized as accountability for good program design. It requires that budget preparation processes embody an active policy review component, along with the more traditional dialogue on the level of funding to maintain existing policy settings;

- Accountability in budget execution: This requires agencies to ensure that their program delivery is efficient and cost effective. The funds should be available for efficient execution and internal management systems should be in place to ensure cost-effective service delivery; and

- Accountability for budget outcomes (monitoring and control): In order for budget agencies to be fully accountable for their use of budget funds they must report the costs of their activities and their outputs.

B. BUDGET PREPARATION

Budget Structure and Preparation Procedures

25. Indonesia currently operates a dual budget system, comprising the following:

- A “routine” budget, accounting for about 65 percent of budget outlays and including personnel expenditures, subsidies to state-owned enterprises (SOEs), payments to local governments, and subsidies for petroleum, rice, and power; and
A development budget, accounting for the remaining 35 percent of outlays and including investment projects, social safety net spending, and defense spending. The development budget comprises both capital and recurrent spending associated with development projects. Donors currently fund some 40 percent of the development budget.

Preparation of the budget is initiated by an assessment of the macro fiscal environment by the Bureau of State Budget Analysis within the MOF. A budget circular then requests spending proposals from ministries. The lead-time for budget preparation is unusually long: the routine budget preparation begins in May with a budget circular containing guidelines to be used for costing operational expenses.

The budget proposals are submitted to the Director General (DG) Budget in June of the year preceding the budget year. Preparation of the routine budget is largely focused on fine-tuning the costing of established programs in the light of changes in prices and other factors through the use of “norms.” Following receipt of budget proposals from ministries, negotiations take place between the DG Budget and the proposing ministry on costing issues rather than policy review issues. DG Budget allocates budget ceilings in September. Ministries then proceed to prepare their budget in detail.

The development budget is submitted to DG Budget and the Government's planning agency, BAPPENAS and requires clearance by both agencies. Although a five-year plan (PROPENAS) for development projects is prepared, the annual budget does not necessarily contain all the projects in the five-year plan. DG Budget advises BAPPENAS on the total ceiling for the development budget. Following this, consultations take place between BAPPENAS and the proposing ministries to finalize the development budget within this ceiling.

The final budget is presented to the Cabinet in September and following Cabinet approval it is presented to Parliament. In the past, the parliamentary approval was automatic. However, since the election of the current Parliament, the budget has been coming under increasing scrutiny and debate and MOF officials spend a great deal of time explaining and defending the budget.

Assessment

There are several aspects of the Indonesian budget preparation process that prevent budget funds being distributed across programs in the best possible manner. The following paragraphs comment on the principal shortcomings that need to be addressed.

Budget coverage

The revenue estimates and budget projections are not prepared within an integrated macro framework. In the past there have been major gaps in budget coverage in Indonesia.

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7 The circular contains numerous costing norms to guide ministries in costing their budget bids
8 The budget year commences in the following January.
9 This corresponds to allocative efficiency in the World Bank trichotomy. These defects in budget processes prevent agencies from being held accountable for the best possible apportionment of budget funds between competing programs and projects.
including the existence of off-budget funds and foundations and state-owned enterprises that are not accountable through the normal budgeting process. However, progress is being made in bringing the non-tax revenues into the budget-reporting framework.

32. The budget process is heavily focused on bureaucratic rather than policy review procedures. Policy-level reviews offer a potentially huge scope for improving the social benefit flowing from the budget outlays. However, at the moment no single agency appears to be responsible for the achievement of sound policy settings across all government programs. Historical budgeting prevails for the routine budget, and the main focus is on reporting the cost of implementing existing policy rather than the effectiveness of that policy for review purposes.

**Absence of a unified budget**

33. The rationale of dual budgeting (that is, separate routine and development budgets) is to fast-track a part of the budget that (arguably) requires less scrutiny during budget preparation owing to the absence of new policy initiatives. However, the result is that some two-thirds of public spending is excluded from annual review. As a result an increasing share of the routine budget is likely to compare unfavorably in terms of cost effectiveness with projects competing for inclusion in the development budget.10

34. The absence of a unified budget produces sub-optimal decisions when budget cuts and change of spending priorities are forced upon the Government—following the Asian crisis, for instance. Accountability of the budget system in the full sense depends on the extent to which budget allocations have responded to these changing needs and circumstances. This is arguably a substantially more important issue than the narrower question of whether possibly rigid budget allocations that fail to reflect changed priorities are disbursed in accordance with established budget procedures.

35. The separation of routine and development budgets is paralleled by the separation of responsibility between the MOF and BAPPENAS. As a result Indonesia suffers from a seemingly ubiquitous problem: the coexistence of separate ministries of finance and planning. This is a failure to effectively coordinate the role of the MOF in preparing the annual budget and the role of the planning agency in preparing the five-year plan.

36. MOF is mainly an accounting and financing agency and possesses little program sector expertise. While BAPPENAS has built up program sector expertise, it has limited incentive to critically review the details of project costing since it does not directly determine annual budget allocations. Since DG Budget executes and monitors the development budget, responsibility for optimizing the development budget is split.

**Absence of information on programs and outputs**

37. The budget system generates little information on program results. This makes it hard to identify those programs for which at least some of the funds could be better spent elsewhere. Identifying those programs for which increased funding would yield greater social benefits is not

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10 Otherwise expressed, the rate of return on marginal expenditures in each budget cannot be equated
easy. The absence of performance information makes it difficult to hold budget planners accountable for the best distribution of budget funds.

38. The budget process produces information on outputs for the development budget. However, these are not linked to the budget preparation process, and the budget system is not well adapted to ensuring that the policy settings being funded are the best ones possible.

39. In short, there is a long way to go before budget preparation in Indonesia is performance focused—in other words, focused in such a way that would enable the budget preparation processes to deliver the best possible policy settings (as well as ensure that budget execution complies with finance laws and regulations).

**Budgeting with a medium-term perspective**

40. A key aspect of budget processes is the extent to which budget preparation focuses only on the needs of the next annual budget, or takes account of more strategic macro and program goals. The need to adopt a medium-term timeframe is particularly important in the policy review process during budget preparation. This is to ensure that new spending commitments are entered into only after full consideration of their outer-year financial burden.\(^{11}\)

41. Budgeting within a medium-term framework can involve relatively sophisticated processes such as budgeting within a rolling-forward-estimates framework. However, particularly with the move to decentralization, this is some way off in Indonesia.

42. In the meantime budgeting within a medium-term perspective requires the rigorous costing of new budget proposals over a three- or four-year period following implementation, and inclusion of this information in the policy review process. This would normally require the cost estimates proposed by the program ministry to be vigorously tested by the sector experts in the MOF.\(^{12}\)

**C. BUDGET EXECUTION**

43. Accountability of budget execution relates mainly to the effectiveness with which funds are disbursed on each program rather than whether the level of funds is appropriate per se.\(^{13}\) This is a question of operational efficiency of budget execution.

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\(^{11}\) Proposing ministries have a strong incentive to conceal higher levels of budget lock-in in future years in order to get their new policy proposals accepted.

\(^{12}\) Since the MOF does not currently have sector expertise this would need to develop as part of the broadening of the MOF's focus from purely financing issues to policy management issues.

\(^{13}\) Operational efficiency can be influenced by budget preparation; for example, if excessive operating funds are voted to an agency it is likely to waste funds rather than operate efficiently and return unused funds to the budget.
Operational efficiency can be compromised by two types of factors:

- Agency management systems are poor. This can result in agencies being unable to organize to disburse the funds allocated to them before the close of the budget year, or in agencies receiving larger budget allocations than strictly necessary to deliver their programs. The latter can result in inefficiency and wastage of funds within the agency (such as end-of-year “spend-ups”) and leakage of funds due to corruption.
- Agencies cannot get full or timely access to their full budget allocations during the course of the budget year, resulting in the underspending of formal budget allocations. This can result from inadequate cash allotments during the course of the year (owing to shortages of cash in the Treasury, or delays caused by the pre-audit of individual disbursements by outside agencies).

The budget execution commences in January and allocations are made by DG Budget to each individual spending unit. The budget execution procedures are relatively streamlined and effective in ensuring that expenditures conform with authorized allocations. Payment requests (SPP) from individual spending agencies are forwarded to Treasury offices (KPKNs). Although the Treasury offices do check the regularity of the request, payment orders (SPMs) are processed relatively rapidly.

While there is limited external pre-audit of payments transactions, somewhat unusually there is extensive external post-audit of those transactions. Each payment request from a spending agency, when processed by KPKN, generates five copies of the payment order (SPM), which flow to three other agencies within the MOF—KTUAs (Budget Offices), PPDIA (Data processing center) and BAKUN/KARs (accounting offices). Since this is at the primary transaction level it generates an enormous paper trail across central coordinating agencies (that is, including KPKNs). These systems are further discussed in Chapter 4, Accounting and Financial Management Systems and Practices.

Assessment

The highly detailed nature of the budget allocations gives the appearance of reasonably tight control of operational spending at the budget preparation stage. Large numbers of “norms” guide the level of operational funding required for each program. However, in implementation, it is alleged that considerable leakage of funds is associated with corruption, collusion, and nepotism (KKN).

In common with a number of countries, Indonesia has experienced slower than planned disbursement of funds. It is noteworthy that the budget deficit for 1998–99 and 1999–2000 markedly undershot the planned level. This reflected underspending by a sub-group of ministries.

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14 This can be either because they are allocated excessive funds for operating expenses during budget preparation or because they use their allocations ineffectively during budget execution.
15 A regulation requires payment requests to be processed within eight hours of receipt of complete applications.
16 In fiscal 1998–99 the Housing and Human Settlements and Regional Development sector disbursed only 60 percent of its budget while sectors such as defense overshot their budget allocations substantially. (Indonesia—Public Spending in a Time of Change, World Bank, December 1999, p.4.)
(particularly those responsible for social programs), as well as lower than budgeted debt-servicing costs.\textsuperscript{17}

49. Under-disbursement is a serious defect in budget execution, since it undermines even the most painstaking and effective budget preparation process. The underspending is not a result of insufficient or delayed cash allotment during the course of the year. This suggests that underspending of budget allocations may be caused by management problems in particular program delivery areas. Associated with this is the need to improve disbursement processes and monitor impediments to planned program execution \textit{within} individual spending agencies. Increasing the responsibility and capability of spending agencies is a key recommendation of this Report.

\section*{D. \textbf{MONITORING AND ACCOUNTABILITY}}

\subsection*{Existing Monitoring Systems in Indonesia}

50. Budget monitoring systems typically divide into those for reporting financial outcomes and those for reporting program performance. As there are no performance-based budgets in Indonesia, the current reporting consists of financial monitoring reports prepared by DG Budget.

51. Financial monitoring requirements are twofold:

- Within-year monitoring. This is important for identifying possible overspending as the budget year progresses, particularly in demand-driven programs such as assistance for the unemployed. This information provides valuable input into the supplementary budget process later in the budget year.

- Post-budget monitoring of the outcome of the full year against budget estimates. This is important for diagnosing shortcomings in budget execution processes such as underspending of budget allocations by individual ministries. It is also necessary for assessing the impact of the government sector on the economy as a whole.

52. Within-year budget monitoring in Indonesia involves multiple disbursement tracking systems operated by several accounting and reporting agencies within the MOF. In addition, each ministry prepares monitoring reports for the budget monitoring of its activities. Post-budget monitoring reports prepared for submission to Parliament are generally delayed by about two years.

\subsection*{Assessment}

53. There is a gap in the Indonesian budget monitoring and reporting system. None of the systems operated by different MOF agencies provide "rapid response" reports on budget realization as the budget year progresses.

\textsuperscript{17} The delays are attributed (Indonesia Public Expenditure Report, P6) "(i) delays in the disbursement of foreign loans; (ii) delays in allocating spending authority to project and program implementing units in government; and (iii) the prohibition of domestic financing of the fiscal deficit." The report also notes that problems in managing the social safety net programs contributed to the undershoot in budget realization.
54. The absence of such reports is in part due to the favorable fiscal position enjoyed by the Indonesian budget authorities prior to the Asian crisis. However, the need for sound monitoring during the course of the budget year is now much greater. While post-budget year reports on budget realization are available from the Accounting Office (BAKUN), they are distributed only after a two-year lag. The availability of performance reports is even more restricted.

55. At the spending ministry level, several reports are produced but they are more in the nature of payment summaries for control of spending against individual allocations. These reports are of very little value in terms of helping managers control program delivery efficiency or revealing weaknesses in accountability.

E. RECOMMENDATIONS

56. The Indonesian budget process has served well in controlling the budget spending within the overall allocations, in a relatively stable fiscal environment. With the burden of a large debt-servicing requirement following the Banking crisis and the need to expand social safeguard programs, the current process needs to be revamped to avoid large-scale borrowing to finance the budget deficit.

57. The CFAA recommends the following actions to improve budget preparation and management.

- Accelerate progress to a unified budget based on GFS classification as proposed by IMF;
- Develop integrated revenue estimates, including customs, tax and other revenues, within a macro framework; and
- Improve policy review by strengthening the political input into the budget preparation process. This may also involve budgeting on a portfolio basis (rather than a sector basis as at present), with individual ministers assuming greater responsibility for fine-tuning the policy mix in their respective portfolios.

Introduction of Performance-Based Budgeting

58. One of the features of international budget reform since the 1980s has been pressure to make the bureaucrats who deliver public services more accountable to program clients and to the Government for quality and service delivery. Reflecting this, good international practice involves identification of performance indicators for each program. These cover both the efficiency with which funds are used, and the nature of the outputs that result. Results-focused budgeting has only recently begun receiving attention in Indonesia. The introduction of results focused budgeting will also enhance accountability under the proposed decentralized budget environment. The actions recommended are:

- The introduction of performance-focused budget preparation process by incorporating physical program outputs and performance indicators is recommended.
- Devolution of greater financial flexibility to spending agencies coupled with the introduction of performance based budgeting.
Improvement of financial management capability at the spending ministries to improve budget management (as discussed below and in Chapter 4).

**Budget Management**

59. In order to address weak budget management, the CFAA recommends giving spending agencies greater financial flexibility, while simultaneously requiring greater accountability for the use made of this increased freedom. The devolution of financial control will also help to strengthen an environment of professional management. This should be achieved by the following steps:

- Strengthen financial and performance management in spending agencies.
- Install accounting and management systems that enable the agency to (a) allocate funds between different categories of operating expenses rather than having these allocations externally determined; and (b) internalize the pre-audit and post-audit checks currently undertaken by external agencies.
- Require that the spending ministries develop indicators of cost-effective use of funds, together with an appropriate financial and performance reporting system.

**Budget Reporting**

60. Macro-level budget reporting needs to be improved both in its content and its timing. The CFAA recommends the following:

- All macro-level budget reporting should be made based on the GFS classification, which will allow reporting of recurrent and capital expenditures and the financing of the budget.
- Budget reporting should be streamlined by eliminating overlapping components of the government accounting system (discussed in Chapter 4). This would allow timely reporting budget expenditures during and at the end of the year.
A. INTRODUCTION

61. Accounting is the means by which economic transactions are recorded for fiduciary as well as management control purposes. It is, in effect, the language of business. For more than 500 years, businesses have used double-entry bookkeeping framework to record economic transactions as they occur regardless of any cash movement.

62. Government accounting has been traditionally undertaken on a cash basis because of the way a government plans and budgets for its operations. A government accounting system normally reflects the nature of the budget and parliamentary approval process: moneys for government operations are approved by Parliament on an annual cycle; any amount unspent at the end of the financial year reverts back into the consolidated fund. As the budget is an ex ante financial plan of government activities for the year, a budget realization report to Parliament is an ex post account of the result of these operations. Thus ideally there should be an integrated government accounting and information system, which is the glue that binds and facilitates the management process.

63. In Indonesia, where the government accounting and budgeting systems are fragmented, the challenge is to develop an integrated management information system that meets the needs of all key stakeholders.

B. ACCOUNTING AND PROCESSING FOR REVENUE AND EXPENDITURES

64. There are several agencies within the MOF involved in the accounting and recording process. Their main functions are as follows:

- The Directorate of Treasury and State Cash (DPBN) formulates policies and implementation guidelines for treasury, cash management, and verification functions; and monitors the cash position and status of implementation of guidelines.

- The Directorate of Budget Administration (DTUA) is responsible for monitoring foreign loans/grants, loan repayment, and providing data analysis of the government budget and information for the preparation of the government Budget Realization Report. DTUA is also responsible for ensuring that actual expenditures\(^\text{18}\) incurred at the MOF head office level are sent to PPDIA and BAKUN for monthly processing.

- The Data Processing Center (PPDIA) located in Bandung is responsible for processing budget data, preparing the monthly Budget Realization Report (based on reports received

\(^{18}\) These expenditures include subsidies to state-owned enterprises, interest and loan payments, foreign currency borrowings, and so on.
from Regional budget offices), formulating the DG Budget information system development plan, and providing guidance in computer technology.

- The Treasury offices (KPKNs) are responsible for authorizing the budget for routine and development expenditures for each spending unit/project office (SU); verifying payment requests (SPPs) against supporting documents before issuing a payment order (SPM); monitoring of the cash position; accounting for and recording tax and non-tax revenue; and preparing the Budget Realization Report for the areas under their coverage. KPKNs prepare daily reports for DPBN on aggregates of revenue received and SPMs issued based on the bank accounts maintained by KPKNs in commercial banks. There are about 126 KPKNs in the country.

- The Regional Budget Administration Office (KTUA) is responsible for the verification of SPM reports and revenue/expenditure reports issued by KPKN and the preparation of weekly and monthly summaries of revenue and expenditures reports (P6, P7, and P8) for review by DPBN and DTUA. KTUA controls 4–5 KPKNs within a region. There are about 35 KTUAs in the country.

- The Government Accounting Office (BAKIJN) is responsible for keeping records of government operations and preparing the government Annual Budget Realization Report (PAN) for audit by the Supreme Audit Board (BPK) before their presentation to Parliament. Information on monthly payments/receipts occurring in Jakarta is received and processed by KAR K, a unit of BAKUN’s head office based in Jakarta. BAKUN has 16 regional offices (KARs), which are responsible for collecting and processing information on individual receipts and SPMs from regional KPKN/KTUAs.

### Accounting for Expenditure

65. The accounting for expenditures is carried out by the Ministry of Finance through DG Budget and DG Accounting (BAKIJN) for central control purposes. In addition, ministries have finance bureaus to oversee budget and accounting. Both development (DIP) and routine (DIK) budgets are detailed right down to individual line items for each spending unit and project office. The heads of SUs or project managers can initiate expenditure commitments and authorize payments without reference to Ministry finance bureaus or central budget administration units. Thus the functions of most of the ministerial and central units are merely that of data collection and monitoring of spending against allocations.

66. As described above, PPDIA and BAKUN are the two data processing centers within the MOF. PPDIA processes revenue and expenditure transactions on a daily basis and prepares budget realization reports, which are compared with the approved routine (DIK) and development (DIP) budgets. The Regional Budget Administration Offices (KTUAs) are responsible for preparing weekly and monthly summaries of revenue and expenditure reports (P6, P7, P8). PPDIA verifies payment orders and revenue receipts against reports on tax revenues (P6) and reports on budget expenditures (P7). KTUA data are used when there is a discrepancy, which mainly arises as a result of incorrect coding. The monthly budget realization reports prepared by PPDIA are generally published about two months after the month being reported.

67. BAKUN is responsible for preparing government accounts that incorporate budget revenues and expenditures and other government financial transactions. BAKUN regional offices

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19 P6: report on tax revenues based on economic classification and non-tax revenues deposited by the line ministries;  
P7: report on budget expenditure based on economic and institutional classification; and  
P8: report on aggregate of wages paid by local governments.
also process revenue receipts and payment orders, and prepare monthly reports of revenue and expenditures and an annual budget realization report (PAN) quite independently of PPDIA and DTUA. BAKUN is responsible for preparing annual government accounts for audit purposes. These reports are currently prepared about two years after the close of the financial year reported.

68. In addition to the above MOF agencies, each individual ministry relies on manual records maintained by SUs and finance bureaus to prepare monthly reports for management information and year-end budget realization reports. The ministry finance staff are responsible for budgeting, accounting, treasury, and payroll activities of their respective ministries.

Accounting for Revenues

69. Government tax revenues are recorded by KPKNs based on copies of bank receipts supporting funds deposited into government bank accounts. Five copies of bank receipts are sent to various offices for recording and verification purposes. About 3,000 bank accounts with four government-owned commercial banks are currently opened by KPKN upon approval by DPBN. These bank accounts are used for depositing tax revenues only.

70. Line ministries can open bank accounts for depositing non-tax revenues generated by the ministry with the Minister of Finance’s approval through DPBN. Hard copies of bank receipts are sent to KPKN for accounting purposes.

71. Bank receipts for tax and non-tax revenues are used by KPKNs to summarize daily government revenues; daily summaries and copies of individual receipts are sent to various offices (namely KTUA, PPDIA, DPBN, and KAR) for further verification and accounting in the same way as accounting for expenditures through SPMs.

72. Although KPKN and KTUA monitor daily closing cash balances of expenditure and revenue bank accounts, neither office reconciles the record of receipts and payments with bank statements. Reconciliation is a very basic control feature for any cash accounting system.

Assessment

73. The fragmentation of government accounting systems between a number of units with none of the systems able to produce reliable and reconcilable sets of accounts to enable timely monitoring and year-end reporting to Parliament is a deficiency that needs to be rectified as soon as practicable. This fragmentation is made worse by the plethora of sub-systems for important tax revenues that operate independently of other government accounting systems. Additionally, since the Supreme Audit Agency, BPK only recently acquired the mandate of auditing tax revenues, it leaves room for some doubt as to whether all government revenues have previously been fully accounted for and whether appropriate and prompt actions are taken to pursue defaulting taxpayers.

74. KPKN carries out ex ante reviews of all payment requests. The verification is limited to legality checks, sufficiency of supporting documents, and arithmetic accuracy. The IMF has commented on the heavy bureaucracy and voluminous paperwork that typify the government payment system at the KPKN. It has also been noted that the repetitive verification of payment documentation may have the unintended consequence of diluting the accountability of line ministries, which should have the primary responsibility of raising valid and proper legal claims for payment and applying all prepayment checks before sending invoices for payment.
Therefore, it is suggested that the functions of KPKN and KTUA be merged and that PPDIA be removed from the verification cycle.

75. Although BAKUN is the accounting agency charged with the production of the government annual financial reports, it appears that BAKUN staff view this responsibility as one of controlling the process rather than ensuring the quality and integrity of the numbers. However, BAKUN claims that it has recently started to assist in the accounting process as the spending units do not have the capacity to move from the old single-entry system to the new double-entry system. There is also an urgent need for leadership in accounting and financial management matters at the highest level, particularly during times of great change.

76. Current budget implementation procedures assign budget authority to SU/Project offices once the budget is approved. Under these arrangements, project managers are appointed to carry out functions relating to project specification, the selection of the tender committee, contract negotiation, work certification, and payment authorization with very little oversight from either the sector ministry or the central ministerial authorities. Sound internal control procedures would require segregation of the above responsibilities under a project manager with adequate functional oversight. It is not clear that these functions are properly segregated. Even if they are, the project manager wields enough unchecked influence in the appointment of staff—both financial and procurement—that their independence and integrity become questionable. The CFAA Team was informed that the perks of the jobs are such that many project managers spend all of their career in these term positions rather than seeking a structural civil service appointment.

77. At the level of spending ministries, the finance bureau finance staff at the head office act in a clerical role rather than as a finance team that could add value to the management of the ministries. Once the DIK/DIP are approved, the focus is shifted to SUs to deliver services and to account for these transactions. Head office finance staff receive transactional records in a predetermined format to enable recapitulation of the same data into monthly reports for management information purposes.

78. The lack of a modern financial controllership function at the ministerial level is a serious weakness of the internal control procedures. Each ministry should have a financial controller (or finance director) in charge of all financial matters who is part of the senior management team. The functions that should come within the purview of the financial controller include financial planning, budgeting, working capital management, accounting, and reporting. An appropriate financial management information system is critical in this reorganization.

79. The creation of a financial controller function with appropriate systems and support tools should also be a prerequisite for ensuring transparency and accountability following decentralization of the budget to the sub-national level.

C. TREASURY AND CASH MANAGEMENT

80. There are about 3,000 bank accounts in use at various branches of government-owned commercial banks to service government retail banking needs, that is, the collection of government revenues. Balances in these accounts are swept twice a week to the state operational account (Account 501) maintained at provincial branches of Bank of Indonesia (BI). The commercial banks therefore have the use of “free” cash for an average of three days a week. This free cash is to compensate the banks as the government currently does not pay for transactional banking services provided by the commercial banks. It is understood that this arrangement is under review at present by DPBN.
81. Approved by the MOF and monitored by KPKN, line ministries open bank accounts to collect non-tax revenues. It is not clear how many of these accounts exist, given the recent attempt by DPBN to close some of them. IMF has commented on the existence of "unauthorized/off-budget" bank accounts maintained by line ministries.

82. There are about 27,000 accounts maintained by ministry spending units with government-owned commercial banks to cater to day-to-day transactional banking needs. The Government also keeps moneys at post offices in remote locations. These accounts are used by KPKNs and project offices to pay for government expenditures. These expenditure accounts have annual ceilings set by DPBN at the beginning of each financial year. The decision on the annual ceiling for each account is made by DPBN on the basis of historical usage and balances, and the current year budget approval. Currently, the maximum total of all expenditure accounts is RP500 billion.

83. On request of SUs, reimbursements to expenditure bank accounts are made by transfers from the state operational account 501 maintained at a BI branch and monitored by KPKN/KTUA. Reimbursements of foreign-financed project expenditures are requested by KPKN directly against the project's special reserve account through DTUA.

84. The state operational account 501 at KPKN is linked to DG Budget account 500 at the BI head office. This bank account is managed by DPBN with a daily sweep feature for surplus funds from account 501 and transfers made on request by a KPKN/KTUA.

85. The DG Budget account also has a daily sweep to General Treasury Account 502 (BUN account) at the BI head office. DPBN staff state that account 502's balance has always been positive on a daily basis. This account is under the direct control of the Director of DTUA. Instructions for transfers to and from account 502 are given by the Director to BI.

86. Current monitoring practices of DPBN and KPKN consist of looking at receipts and payments made and previous day closing bank balances. As payments are normally made by direct transfers to suppliers' bank accounts, the time lag could be immaterial. However, the lag on the receipt side may be significant as funds are held by commercial banks for a minimum of three days before being transferred to account 501.

Assessment

87. Current cash management practices seem to be of a short-term nature as transfers to and from various bank accounts including the BUN account are decided on the basis of daily SPMs issued and receipts notified by the banks, and without any established procedures for forecasting commitments made by line ministries. It is thus necessary to ensure that the BUN balance remains significantly positive at all times to meet unknown commitments. As holding excess cash increases borrowing costs, a feature of modern treasury practices calls for forecasting cash requirements on a daily, weekly, and monthly basis. Cash forecasting is critical to ensure that unnecessary cash surpluses or borrowings are minimized. Sound treasury management practices would require that cash forecasting procedures with expenditure commitment information provided by line ministries, particularly those with significant project expenditure be established. These forecasts will be improved over time as ministries gain a better understanding of their own spending patterns and future commitments.

88. Currently there are a large number of accounts held with four government-owned commercial banks to handle government transactional requirements. There is the potential to reduce the "idle" cash in government bank accounts through a reduction in the number of banks
and bank accounts without a significant impact on services given the advanced technology already in use by commercial banks. Although it may be argued that a "float" of Rp500 billion (about US$65 million) is reasonable given the size of the Budget (Rp 200 trillion), any effort to reduce this cash balance while improving the transparency of the relationship between Government and commercial banking would be a worthwhile exercise.

89. A more serious consequence of the current banking arrangements are the accounts maintained for banking non-tax revenues by the individual ministries. Although the ministries are required to include these in their budget and account for them, it is uncertain that this is being done. The practice of maintaining off-budget funds, in the past, has been a main source of KKN and was conducted with the acknowledgement of the political leadership. Under the IMF/Government Letter of Intent, the Government is required to take an inventory of these bank accounts. So far, though, progress has been slow in producing an inventory.

D. GOVERNMENT FINANCIAL MANAGEMENT INFORMATION SYSTEM AND INFORMATION TECHNOLOGY

90. At present, two systems are in use to record government financial operations: PPDIA’s system and BAKUN’s Government Accounting System (GAS). Other systems may be considered part of the government “information system” as they contain data that clarify/support the inputs into the two formal accounting systems. These include systems used for recording tax and customs and excise revenues, and the manual systems maintained by line ministries.

91. PPDIA uses an ORACLE database. The application software is written and maintained by a team of 30 programmers, including 3 senior programmers. The application software operates under a single entry system in which receipts and payments are recorded with no corresponding entry regarding cash movement in the bank. The Chart of Accounts used by the PPDIA system is the same as that of BAKUN, DTUA, and the line ministries as they all share the same source documents.

92. BAKUN is currently testing the new government accounting system (GAS II), which is a distributed system, for full implementation on January 1, 2002. The implementation plan of GAS II calls for the availability of computer terminals in regional offices of large ministries, and for BAKUN’s regional accounting offices (KARs) to service the needs of smaller line ministries.

Assessment

93. The GAS II system described above, in theory, has all the modules necessary to establish a reliable government financial management information system. However, in practice the system is not fully working and some programming problems remain unsolved. Some of the larger ministries have installed terminals for direct input of information; the mission was subsequently informed that these ministries were unable to use the system due to the programming problems referred to above. The system was developed by a Jakarta-based international firm, which has not helped in resolving many of the problems currently preventing full utilization.

94. While there is duplication of functions, there is also significant fragmentation of systems—with no agency providing oversight of activities in connection with accounting for Government financial operations to ensure that revenues are accounted for, expenditures are properly recorded, cash balances are verified against bank statements, and timely and reliable
financial information is produced. The perception is one of "free for all" system development by various parties with little coordination—or consideration given to the needs of other stakeholders within the MOF.

95. As previously noted, there are at least four other systems within the MOF providing details that support entries into the PPDIA system and GAS II, namely systems under the control of DG Tax, DG Customs & Excise, DG Financial Institutions, and DG State-Owned Enterprises. Reconciliation between these systems and the accounting system is critical to ensure the integrity of the annual PAN reports and budget realization reports used for monitoring within-year spending and for other planning purposes. However, it is not clear that this important task has been recognized and allocated to any unit or agency.

96. This perception is confirmed when reviewing the World Bank draft Implementation Completion Report (ICR) on the development of GAS II. The draft ICR identified a number of weaknesses in the design of GAS II under the Second Accountancy Development II Project, namely, system complexity, lack of human capacity and incompatibility with the existing budget system. In addition, it would appear that GAS II was designed and developed primarily to meet BAKUN's needs with little consultation with other key stakeholders even though there is recognition that the system would require the cooperation of other parties for its inputs.

97. Although BAKUN is responsible for the preparation of the Government budget realization reports for presentation to Parliament, it seems to view this task as one of controlling the process rather than ensuring the quality and reliability of the numbers. BAKUN must rely on other agencies, which may not view producing timely and reliable financial data as their day-to-day priority. In addition, the lack of overall financial management skills and responsibility in line ministries makes BAKUN's task much more difficult. This situation may be attributable to the fact that neither BAKUN nor any other agency has been assigned the primary accounting role with clearly defined authority and responsibility.

E. FINANCIAL REPORTING IN THE PUBLIC SECTOR

98. The legal framework underlying budget management and accountability of public funds is based on a law enacted in 1925. There are minimal requirements relating to reporting on the operations of the central government cash funds. The Government is currently considering two draft laws to update and improve fiscal management and accountability. However, the proposed provisions regarding reporting on financial operations of the Government and its agencies can be further improved to facilitate the openness and transparency desired by the President and Parliament.

99. Article 21(1) of the draft State Finance Law requires that "the President conveys his accountability in the form of the Central Government’s Budget Calculation annexed by the Central Government’s Balance Sheet and financial statements of state enterprises and other agencies to the People’s Representative Council immediately after the fiscal year end." The Governor/Regent/Mayor are similarly required to report to the Regional Legislative Council. Article 22(1) then states that the form, composition, and contents of the state finance accountability as described in Article 21(1) will be stipulated in laws and regulations.

100. The draft State Treasury Law does not add any more detail except that it assigns the responsibility of preparing the Calculation of the Budget and Balance of all Ministries/Institutions.

The State Finance law and the State Treasury Law.
to the MOF (Article 33 (3)), and of the Calculation of the Budget and Balance of Ministry/Institution to the Ministry/Institution (Article 33 (1)). Note that the Minister is not mentioned as the responsible party for this purpose.

101. The above provisions reflect the current arrangement that the ministries and institutions are required to prepare budget realization reports but only for submission to the Minister of Finance as part of the government PAN reports. Thus neither line ministers nor ministries’ heads are called to account publicly for their use of public funds.

Assessment

102. Public accountability is possible only when the public have information on government operations and the results thereof. Without information the public cannot make any judgment as to the success or failure of the government and its agencies. Annual, and sometimes more frequent, financial reporting has been a generally accepted mechanism used by private sector organizations to discharge managerial accountability to shareholders. The same principle should apply to the public sector.

103. Current arrangements require a great deal of information to be prepared by all government institutions, but circulation is limited to selected agencies for review and assessment. Thus there is a lost opportunity to educate and inform the community of the plans and the achievements of the government.

F. RECOMMENDATIONS

Financial Management

104. CFAA recommends establishing a strong financial management function at the MOF to provide leadership and expertise needed to coordinate and manage activities pertaining to accounting, treasury management, reporting, and information systems. Such a function should be complemented by the establishment of financial controllership in sector ministries. These controllership functions would be key to ensuring financial management in the proposed decentralization of the budget to sub-national governments. Rebuilding financial management capacity in a country as large and diverse as Indonesia will take time. Therefore, the Government should appoint persons of integrity, professionalism, and public acceptance to lead this effort.

Accounting and Processing for Revenue and Expenditures

105. The CFAA recommends the creation of a position as Accountant General (AG) to be responsible for all government accounting, payment authorization, management of bank accounts, and financial reporting. The Accountant General would manage all functions currently carried out by BAKUN, DPBN, and part of DTUA at the head office. The Accountant General would provide the leadership and expertise needed to coordinate and manage activities pertaining to accounting, reporting, and information systems. The fragmented systems used to account for expenditures and revenue should be brought under the control of AG as soon as practicable.

106. The functions currently carried out in the Regions by KPKN, KTUA, and KAR should also be consolidated into Regional offices under the management of the Accountant General. This would result in the combination of treasury management and accounting functions under the
new position of Accountant General. The Regional offices will provide an accounting transaction service to the Regional spending units of the central ministries and eventually to the decentralized regional spending units.

107. In order to improve overall financial control and accountability while increasing financial flexibility at the ministry and provincial government levels, there is a need to establish a modern financial controllership with responsibility for financial planning, budgeting, working capital management, accounting, and reporting. Developing Controllship capacity at the devolving line ministries will be a significant step toward establishing transparency and accountability for budget management at the sub-national government level. Given the importance of this function, the mission recommends that the financial controller role be piloted in one or two large ministries and several provinces so that a template can be created for use in other ministries and provinces.

108. Following the establishment of the above functions, the Accountant General should establish clear financial procedures providing for segregation of duties for procurement, contract management, and payment authorization. The ministry Financial Controller and the Accountant General would provide oversight of these functions to ensure that sound internal control processes are followed in an area in which there is widespread corruption under the current system. The recently completed CPAR also recommends the creation of a Public Procurement Office to carry out oversight of the procurement responsibilities of project managers.

**Treasury and Cash Management**

109. The Accountant General should also take responsibility for the management of central government cash assets. All banking activities, authorization and management of the operation of bank accounts, and all payment transactions should be the responsibility of the Accountant General. The Accountant General should install the following procedures to improve cash management:

- Issue new treasury management guidelines setting out clearly defined policies regarding minimum bank balances to be held in the Treasury's central (BUN) account, policies for the investment of excess cash, and policies for authorizing Government borrowing;
- Establish quarterly and annual forecasting of cash needs, taking into account receipts, expenditures, and commitments for all Government financial activities; and
- Issue guidelines for the authorization of bank accounts and their control by agencies of the national and sub-national governments.

**Government Financial Management Information System and Information Technology**

110. It is recommended that the proposed Accountant General's office be responsible for establishing a uniform financial management information system for accounting and reporting of the public sector financial activities. The Accountant General should undertake the following:

- Develop a practice statement of information technology (IT) policies and guidelines for application by all public sector agencies, excluding SOEs;
- Assess the strengths and weaknesses of PPDIA and GAS II systems to determine the suitability of either system to ensure that current requirements for financial accounting and reporting are met reliably and in a timely fashion;

- Develop a financial management information system to serve the central government needs based on the above assessment; and

- Develop financial management systems to support the enhanced role of financial controllers at sector ministries.

Financial Reporting

III. The standardization of the financial reporting requirements is recommended by incorporating the following in annual reporting regulations:

- Determine the form and content of annual reports to be prepared by Government agencies. The Reports should include audited annual financial statements and financial and non-financial indicators to show progress toward meeting key success factors established to monitor performance.

- Determine the form and content of the Government's annual report to the Parliament.

- Formulate guidelines for Government agencies on the dissemination of financial and performance accountability information to the public.
6. GOVERNMENT AUDITING

A. INTRODUCTION

112. Auditing is, first and foremost, a function that serves accountability. It can be one of the most cost-effective means of promoting transparency and openness in the way governing bodies operate and improve their performance. Public reporting on government effectiveness and efficiency is fundamental to good governance. Auditing can also help to combat corruption and act as a potent deterrent to waste and abuse of public funds. This section reviews the Government auditing institutions, and their functions and effectiveness.

113. There are two main institutions carrying out external audits in Indonesia: the Supreme Audit Agency (BPK) which reports to Parliament, and an audit agency (BPKP) created by a Presidential directive to carry out external audits of ministries and report to the President. As both these institutions have adopted Government Auditing Standards (1994) issued by the Government Accounting Office (GAO) of the United States, the assessment is conducted following the GAO model (see box below).

| GAO exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government. GAO conducts audits and evaluations of virtually every federal program, activity, and function and issues summary reports about its work and activities. The Comptroller General’s Annual Report, for instance, provides the Congress and the public an overview of GAO’s activities and highlights GAO’s work on major national issues. GAO also publishes an annual report on recommendations that it has made but that, for various reasons, have not been adopted. In addition to its audits and evaluations, GAO provides many other services. They include establishing financial policies, conducting special investigations, providing legal assistance, and providing staff support to congressional committees. Independence and evidence are two key factors in the reliability of GAO’s products. Under the U.S. model, each government department has its Inspector General who identifies financial management and internal control weaknesses hindering the achievement of missions and program objectives. |

114. There seems to be general consensus in the professional community that certain constraints on the workings of supreme audit institutions and internal audit agencies in some developing countries may limit their ability to function effectively. This is the case in Indonesia, where there is a lack of a legal mandate, impairment of independence, and insufficient numbers of qualified, competent, and well-trained staff. The challenge is to upgrade the audit law, establish a public accounts committee, and staff the supreme audit authority and the internal audit function with qualified and experienced audit professionals.
B. AUDIT LAW

Act No. 5 of 1973

115. Act No.5 of 1973 (the existing law) establishes BPK as the Supreme Audit Board. A draft of a new audit law is presently being considered. Both the existing and the proposed laws were reviewed by the CFAA Team with the objective of determining whether the laws would result in an effective and independent auditing function that would deliver a high quality auditing service to the government.

116. The existing law mainly covers the procedures for establishing the BPK Board and the appointment of the seven members to the Board. Under this act, the Board has a chairman who acts as the Auditor General and a vice chairman who serves as the Deputy Auditor General. The other five members directly manage each of the five directorates that are responsible for conducting the audit assignments.

117. The existing law does not adequately support effective auditing. The law does not require that the Auditor General have complete independence—and it is not sufficiently clear and supportive with regard to addressing key features such as the role, responsibilities, authority, funding, reporting, communication with Parliament, and accountability of the Supreme Audit Board.

118. The existing law states that the President makes the appointments to the Board based on nominations of Parliament. However, no mention is made of how candidates are to be selected or nominated. This has resulted in a lack of transparency over the appointments.

119. The existing law does not prohibit politicians or persons actively involved in politics from being appointed as Board members. The perception of independence and credibility of the Supreme Audit Board is thus undermined.

120. The process of removing the Auditor General or a Board member is not adequately addressed in the existing law. The President has the power to dismiss a Board member if the eligibility criteria for appointment as stated in article 8(3) are breached. It is more appropriate that a Public Accounts Committee rather than the President exercise this power.

Proposed Draft Audit Law

121. The proposed draft contains 33 articles consolidated in 11 chapters. The thrust of the draft is on the implementation of audit procedures. The draft cannot be viewed as a law by itself, rather, it appears to be an "addendum" to the existing law. The draft supplements the existing law with additional provisions relating to the procedures to be followed in conducting audits. There are no provisions in the proposed draft for the following:

- Legal status of BPK;
- Powers, responsibilities, duties, qualifications, and selection process of Board members;
- Independence of the key appointees;
- Creation, role, and function of a Public Accounts and Audit Committee (PAC) to provide oversight to accounting, auditing, internal control, and governance within the public sector;
- Auditor General’s relationship with PAC;
C. Audit Institutions and Functions

BPK—Supreme Audit Board

122. By virtue of Article 23 of Indonesia's Constitution of 1945 and by Act No. 5 of 1973, BPK was established as the Supreme Audit Board. Under Act No. 5 of 1973, BPK's constitutional authority was specifically formulated. It is empowered with:

- Auditing the accountability of the Government in regard to state finance;
- Auditing the entire implementation of the state budget; and
- Reporting the results of the audits to Parliament.

123. The Constitution of 1945 accords BPK the same status as the President's Office. Though the existing law permits BPK to audit all state finances (government agencies and SOEs), the audit scope is often interpreted as being applicable only to the national budget (APBN), owing to different interpretations of laws and regulations. At present, BPK also audits local government.

124. The BPK board comprises seven members who actively manage the audit functions. The Chairman is the Auditor General. The Board members are appointed for a term of five years by the President from among candidates nominated by the Parliament. There are five directorates within BPK, four covering central ministries and the fifth covering SOEs and the central bank. In addition, BPK has five Regional offices responsible for auditing provincial and city government operations.

125. The Auditor General decides on audit priorities based on current political issues that are of importance to the Government. The audits are then prioritized in an annual work program and approved by the Board. The thrust of these audits is compliance with financial regulations and procedures. BPK spends about 70 percent of its resources on auditing Government budget expenditure.

126. BPK prepares an audit report at the conclusion of each audit. This is reviewed by the responsible Board member and a final report is sent to the Head of the agency audited and the relevant Minister. BPK does not provide an audit opinion on individual ministries audited. A semiannual report summarizing major recommendations and audit findings is prepared for submission to Parliament. BPK also audits the annual financial report prepared by BAKUN for submission to Parliament.

127. BPK currently employs 2,800 staff—150 of which are CPAs and 400 hold an accounting diploma. Around 200 recruits come from the state undergraduate school, following a three-year course run by the MOF. BPK's recruitment policy is to employ graduates who have majored in engineering, economics, computing, and business.
BPKP Internal Audit agency

128. The legislation establishing BPKP, the Government's internal audit agency, is Presidential Decree No. 31 of 1983 and Instruction 15 of 1983. Under these decrees BPKP has the following roles and responsibilities:

- Formulating and preparing control plans and programs;
- Implementing general control over the management of government finance; and
- Implementing controls over departmental activities.

BPKP is headed by a Chairman who is a permanent employee of the Government and who is eligible to retire at age 60. For administrative purposes BPKP reports to the Ministry of State Secretary in the President's Office. BPKP operates through seven directorates and has 26 Regional offices.

129. At the national level, BPKP is responsible for formulating the government's audit supervision strategy and policies for auditing all government activities. Its tasks are as follows:

- Conduct comprehensive audits (economy, efficiency, effectiveness, financial regularity, and compliance) of government agencies at the provincial and central levels.
- Perform financial statement audits of SOEs.
- Perform audits of externally funded loan projects including World Bank and ADB-funded projects.
- Monitor performance accountability of government agencies.
- Conduct training for Inspector Generals of the internal audit functions of Ministries and agencies as well as for provincial and local governments.
- Develop audit guidelines for financial and performance audits and auditing standards for use by all government internal audit agencies as well as the internal audit departments of SOEs.

130. Although BPKP was established as an internal audit agency of the Government, it has taken on the role of the external auditor for all foreign-funded projects and majority of the SOEs. Also as the BPKP is independent of auditee ministries, it has assumed the role of external auditor in relation to these ministries. However, BPKP provides guidance to the internal audit staff of individual ministries including conducting training programs and examinations to assess the proficiency of internal auditors.

131. There is very little coordination between BPKP and BPK in planning and conducting audits. However, BPKP coordinates its work with the internal audit service of the ministries audited. BPKP's audit plans are discussed and agreed on between senior management of BPKP and the Secretary General and the Inspector General of the individual ministries.

132. BPKP's reporting line is directly to the President. The current President has displayed a greater commitment to supporting BPKP's operations than previous Presidents. In the past, though the legislation required BPKP to report to the President, in practice, BPKP reported to the Vice President and no action was taken on audit findings. Now, a quarterly report is furnished to the President of all significant findings. An annual report consolidating the information in the quarterly reports is also submitted to the President. Outstanding audit recommendations that have not been implemented or rectified are included in the annual report. The President is currently taking a greater interest in these reports. However, these reports are not published and therefore are not available to the public.
BPKP has approximately 8,000 staff in total with about 200 in each of the 7 directorates in Jakarta and about 250 audit staff located in each of the 26 provincial offices. Of the total staff, 76 percent have an undergraduate degree in accounting and 5 percent hold Master’s Degrees. In an effort to improve professional skills, BPKP staff are required to take a minimum of 120 hours of training in every two-year period, through in-house training courses. Training assistance is also provided by the World Bank, ADB, and AusAID, an Australia-based donor organization.

Inspector General (IG)

Each ministry has its own unit tasked with conducting internal audits headed by an Inspector General. The Inspector General (IG) reports to the Minister. The IG unit's work plan is developed in conjunction with BPKP.

The IG department in each ministry is responsible for implementing the internal audit plan of the ministry. The planning process begins with a meeting of the senior management of BPKP and the Secretary General and IG of each ministry during the last quarter of the year to decide on the strategies and audit plan for the following year. The President attended this year's annual planning meeting (for the first time in the country's history) and delivered the keynote address. A follow-on meeting between BPKP and IGs is arranged to agree on the audit focus and finalize the audit plan. Work to be undertaken by IGs is identified to avoid overlap. Coordination between BPKP and IGs also takes place at the provincial level during the planning phase.

Ministerial decrees authorize the IGs to conduct audits. All IGs submit audit reports to the Secretary General of the auditee ministry, BPKP, BPK, and the regional head office. Monthly meetings are held with the minister to update him on important current issues. The ministry at each province is normally audited twice a year, though some are audited once a year. A quarterly report containing an introduction, findings, analysis, recommendations, and personnel status is submitted to the minister.

Assessment

Independence of the Auditor General

The BPK Board has full discretion to set audit priorities and determine the audit's scope, approach, and methodologies. However, the Board has not been effective owing to the following:

- Because of limited budget allocation by Parliament, BPK does not have adequate resources to enable it to discharge its responsibilities;
- Auditees can refuse to have an audit conducted by BPK in response to the ambiguous nature of the existing audit laws/regulations;
- The Board is not authorized to publicize the reports it issues;
- Work procedures between BPK and the Parliament in communicating, reporting, and implementing audit results and findings remain undefined;
- Audit restrictions are imposed on BPK because of clauses in banking laws;
- Only limited financial audits are carried out on SOEs as the same audit is implemented by BPKP; and
- Resources (capacity and funding) are limited, with less than 10 percent of qualified accountants in BPK.
138. In addition to the above, several of the current Board members are former parliamentarians, who each manage one of the operating directorates within the institution. The previous President made these appointments in October 1998. At the time of appointment to the Board, these members resigned their parliamentary positions. Such appointments may seriously undermine the independence of BPK and have the potential to give rise to conflicts of interest. Moreover, these Board members are actually directing the conduct of fraud investigations. Two issues emerge as a result of this responsibility: first, professional proficiency, if the audit is done by people who are not professionally qualified, and second, whether neutral and unbiased reporting is possible given this set-up.

139. The purpose of having an independent audit function is to ensure that audit reports issued can be relied on as unbiased, factual statements of the activity audited. This perception of independence can become clouded when the Board of BPK is mainly composed of officers who have been closely associated with political parties.

**Duplication of external auditing**

140. Currently both BPK and BPKP perform financial statement audits of state-owned enterprises and agencies. BPKP is acting as the de facto supreme audit authority and conducts the majority of the financial statement audits of the state-owned enterprises. BPKP also issues an audit opinion on externally funded loan projects. BPK, the Supreme Audit Board, is not involved in the audits of financial statements of loan projects. Both BPKP and BPK sometimes audit the same organization. This duplication of external auditing service is costly. It also tends to create inconvenience in the organizations audited, and thus ends up being ineffective.

141. International Financial Institutions (IFIs) require the financial statements of loan projects to be audited by auditors acceptable to the institutions. In Indonesia, the Bank has currently accepted BPKP as the auditors. BPKP reports to the President and was established more as an internal auditor for the government. BPKP has over 8,000 staff and thus has more resources and capacity to undertake an extensive auditing program.

142. BPK, by contrast, has 2,800 staff members, and does not conduct as comprehensive a program of external audits as does the BPKP. However, in view of its constitutional powers BPK as the supreme audit authority must be responsible for conducting the external audits of all government agencies and state-owned enterprises. BPK does not have adequate numbers of properly trained and skilled auditors, and therefore lacks the capacity to discharge all of its obligations as the supreme audit authority. This shortcoming will need to be addressed to ensure that capacity is increased and staff are trained over the coming years to enable BPK to fully function as the supreme auditor.

**Duplication of internal auditing**

143. The CFAA Team noted that the IG units were not adequately staffed with trained professional internal auditors. The majority of staff working in the IG units possess an educational background related to the particular sector rather than an accounting discipline.

144. The CFAA Team concluded that the internal auditing function as presently carried out in each ministry is ineffective. The scope of audit coverage does not adequately address the assessment of the control framework established by management. IG will need to focus more on
the evaluation of control environment adequacy. The current approach is mainly focused on verifying the authenticity of supporting documentation for expenditures.

145. The ministerial decree under which responsibilities have been assigned to IG needs revision. A new charter embracing the activities of a modern internal auditing function will need to be prepared. A copy of a modern internal audit charter is attached as annex B of this report.

146. Both IG and BPKP conduct internal audits of each ministry. This results in a duplication of internal auditing efforts. Generally accepted practice is for the internal audit function to be placed within each organization as a service to management. Internal audit thus becomes a control mechanism whose objective is to ensure that the control framework established by the management of each organization is adequate and working as intended. It is therefore appropriate that IG units continue to perform the internal audit activity. However, as IG units do not have adequately skilled and experienced internal auditors, consideration could be given to obtaining these skills from the outside.

D. RECOMMENDATIONS

Audit Law and Public Accounts and Audit Committee

147. The CFAA recommends that Audit Law No. 5 of 1973 be revised to incorporate a well-functioning public accounts committee, an independent auditor general, and clearly defined boundaries of responsibility for independent external auditing and internal auditing. A summary of the main matters that should be included in the revised draft is given below:

- The role, duties, responsibilities, and authority of the Auditor General must be specified in greater detail.
- The Auditor General must be given complete discretion in the discharge of his/her responsibilities, including the appointment of staff and their conditions of service and remuneration.
- A Public Accounts and Audit Committee of Parliament (PAC) that would work closely with the Auditor General must be established.\(^{21}\)
- Funds for Auditor General’s work must be provided separately by Parliament on the basis of budgeted estimates submitted by Auditor General to the PAC for approval.
- A more transparent process must be embodied in the law over the method of appointment and removal of the Auditor General and the other board members.
- The Auditor General should be appointed for a fixed term of office, normally five to seven years with no reappointment at the end of the term. He/she should be prohibited from accepting any related senior public sector appointments for a period of at least two years after his or her term of office is completed.
- The educational and professional qualifications and personal attributes such as integrity and honesty for the appointment of Auditor General and for board members must be clearly stated. Persons who are politicians or persons who have been or who are currently actively involved in politics should be disqualified from being appointed.
- The Auditor General’s rights to full, free, and unrestricted access to information, explanations, records, documents, property, and personnel must be stated. Penalties must be included for providing false information to Auditor General or preventing him or her from access to information.

\(^{21}\) An outline of the role and functions of such a committee is attached as annex A.
• Confidentiality of information acquired during audits must be safeguarded.
• Accountability of Auditor General must be established by the law requiring an independent audit to be undertaken of his/her performance at regular periods, perhaps once in three years.
• The Auditor General must report to Parliament and not the executive.
• The format of the accounting reports should be clearly defined either in the State Finance law that is presently being drafted or in the proposed audit law.

Audit Institutions

148. The CFAA recommends the establishment of a single agency as the Supreme Audit Institution (SAI) responsible for all external audits, budgetary funds of national and sub-national governments, foreign-funded projects, and state-owned enterprises. The SAI should be staffed by an adequate number of qualified and experienced professionals to carry out its mandate. The revision of the Audit Law recommended above should facilitate the creation of the SAI. The staffing of the SAI is a subject that would need further study, given that the current pool of audit professionals are divided between BPK and BPKP. The mission recommends that PAC should take the initiative in creating and staffing the SAI with technical assistance from interested donors.

149. The CFAA also recommends that IG units be staffed with qualified and experienced audit professionals. This can be achieved by retraining some of the existing staff who have the potential to develop into audit professionals. There is a pool of expertise in internal auditing within BPKP that can be transferred to the IG units to strengthen capacity.

150. The CFAA recommends that a new mandate and methodologies for internal audit be developed, and a comprehensive training program be prepared to upgrade skills necessary for this function to perform effectively. A risk-based approach in evaluating the adequacy of internal control systems will also need to be developed.

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22 Annex B attached to this report contains details of a modern audit charter. This can be used as a guide in developing a new internal audit charter for the IG function.
**Attachment 1**

**Key Recommendations - Suggested Phasing for Implementation**

<table>
<thead>
<tr>
<th>Key Recommendations</th>
<th>2001</th>
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<tr>
<td><strong>Improving the Control Environment</strong></td>
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<td>1. Enact a modern Budget Law by combining the proposed State Finance and Treasury Laws.</td>
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<td>2. Establish by Statute a Public accounts and Audit Committee of the Parliament</td>
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<td>3. Develop a public sector accounting and auditing stream within a professional civil service.</td>
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<td><strong>Reform the Government Budget System</strong></td>
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<td>4. Accelerate progress to an unified budget based on GFS classification</td>
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<td>5. Improve policy review by strengthening of the political input into the budget preparation process.</td>
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<td>6. Develop integrated revenue estimates including customs, tax and other revenues within a macro framework.</td>
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<td>7. Introduction of performance based budgeting</td>
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<td><strong>Strengthen Financial Management</strong></td>
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<td>8. Appoint an Accountant General (AG) within the Ministry of Finance at the level of Director General</td>
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<td>9. Establish streamlined Government accounting under AG by consolidating functions currently carried out by KPKN, KTUA, KAR, BAKUN and PPDIA</td>
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<td>10. Establish a financial controllership function within sector ministries to coordinate planning, budgeting, accounting and reporting.</td>
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<tr>
<td>11. Issue Treasury management guidelines and consolidate cash management under AG</td>
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<tr>
<td>12. Establish quarterly and annual forecasting of cash needs including receipts, payments and commitments.</td>
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### Strengthen Financial Management (Contd.)

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<td>13</td>
<td>develop an IT strategy and a practice statement for public sector agencies</td>
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<td>14</td>
<td>develop integrated financial management information system to serve central government needs</td>
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<td>15</td>
<td>Develop financial management information systems to support the enhanced role of financial controllers at sector ministries</td>
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<td>16</td>
<td>Standardize form and content of Annual Reports to be prepared by the Government agencies</td>
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### Strengthen Government Auditing

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<td>18</td>
<td>Revise the current Audit Law No. 5 of 1973 to incorporate features of a modern public accounting and auditing law.</td>
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<td>19</td>
<td>Following the enactment of the above law, reconstitute the Supreme Audit Agency to be responsible for all external audits of budgetary funds of national and sub-national government.</td>
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<td>20</td>
<td>Under the new law, redefine the functions of internal audit units within sector ministries.</td>
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<tr>
<td>21</td>
<td>Develop and implement a comprehensive professional development plan for both external and internal auditors.</td>
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ANNEX A. THE ROLE AND FUNCTIONS OF THE PUBLIC ACCOUNTS COMMITTEE

Introduction

1. Public Accounts Committees became necessary owing to the difficulty parliamentarians were having in dealing with financial management issues relating to the government's performance. The members of Parliament have an important role to play in ensuring that the government is managing the financial resources entrusted to it prudently and effectively for the benefit of the citizens who have appointed them. Government is accountable to Parliament. This accountability would require that appropriate accounting and internal control systems be established and that the financial reports submitted to Parliament be attested by the Auditor General. Parliamentary Accounts Committees established by statute act as the watchdog of government expenditure, promoting the efficient and effective implementation of government policy and ensuring greater accountability of the executive government to Parliament and the Public.

Role

2. The Committee achieves this objective by examining the reports of the Auditor General and by examining the financial affairs of government agencies and state enterprises. The role of the committee is to ensure that the framework of financial accountability has been properly established, is being correctly implemented, and that appropriate corrective action has been taken when necessary.

3. The membership of the Committee is usually drawn from the elected representatives of Parliament and excludes Ministers (this is because the major role of the Committee is to investigate the operations and statutory authorities over which Ministers have control). The Committee provides a filtering mechanism for Parliament through which important financial matters are dealt with outside Parliament, usually with expert assistance.

Functions

4. The functions of the Committee can be categorized as follows:

Examine—

- The accounts of receipts and expenditure of the Government;
- The finances of Government authorities; and
- All Auditor General reports.

Report—

- To Parliament any matters from the accounts examined, or related matters, which the Committee believes requires Parliament’s attention;
- Any alterations to public sector accounts thought desirable, either to their form or to the accounting methods used;
- Any improvements thought necessary to the process of controlling and accounting for public money;
- To Parliament any concerns of the Committee that stem from its responsibilities associated with the Audit Office; and
On the performance of the Audit Office to Parliament.

*Inquire*—into any matter referred to it by Parliament or initiate its own inquiries. Apart from private meetings of Committee members, most of the Committee's inquiries are open to the public after advertising in the press throughout the country. Members of the public are also encouraged to provide written submissions or appear before the Committee should they be able to provide relevant assistance. It is common for the Committee to travel extensively throughout the country to conduct its inquiries in locations where the operations of the government are found.

*Monitor—*
- The operations of the Auditor General's Office;
- The resources needed by the Auditor General's Office;
- The reports of an independent auditor appointed to report on the Auditor General's Office; and
- The budget of the Auditor General's Office and make recommendations to Parliament.

*Determine—* Parliament’s audit priorities and communicate these to the Auditor General.

The Committee must be directly involved in the selection process of the Auditor General and the board members of the Audit Office.

**Follow-Up**

5. To ensure that the conclusions of the Committee are taken seriously by departments and statutory authorities, formal procedures exist to monitor Committee recommendations. Recommendations of a policy nature should elicit a response from the government, and those related to administrative or management matters are dealt with by a Finance Minute. The procedure for getting a response to administrative recommendations made by the Committee in its reports to Parliament is as follows:

- The Committee’s chairperson, on tabling the reports in Parliament, forwards a copy of the report to the responsible Minister and the Minister of Finance. Upon receiving the report, the Minister of Finance and the responsible Minister (or head of an authority) are asked to consider the report’s findings and recommendations and implement the findings—or give reasons for not implementing them.

- The Minister of Finance seeks replies from departments about progress in the examination and implementation of the Committee’s recommendations.

- The Minister of Finance, via a Finance Minute, replies to the Committee by providing a detailed response to the recommendations. The reply, or Minute, is in the form of a report to Parliament.
ANNEX B. INTERNAL AUDIT MANDATE

1. Internal audit (IA) is an additional control tool that is used by the government to ensure that the systems of internal control established by the management of each institution are working as intended.

Definition of Internal Auditing

2. IA is an independent appraisal function, established within each organization to examine and evaluate the effectiveness and efficiency of the internal controls established by management to manage risks. It normally is independent of line management. Its purpose is to assist an organization and its executive management in the effective discharge of their responsibilities. It is an additional internal control established by executive management or the Board of Directors to ensure that management in their day-to-day operations are applying the systems of internal control.

Definition of Internal Control

3. Internal control is a process affected by each organization’s executive management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
   - Effectiveness of operations;
   - Reliability of financial reporting; and
   - Compliance with applicable laws, regulations, policies, and procedures.

Since managers have to rely on people to keep the internal control systems operating, the system of internal control can deteriorate. This is a main reason why internal auditing should be independent of the operations it reviews, and why it should not be involved or engaged in line authority and responsibility. It should also be recognized that IA is a staff function and should not control or direct action. IA’s responsibility is of an advisory nature: to provide information as a basis for decision making and action by line management.

4. Internal auditors can be a powerful aid to management by evaluating the internal control systems and by pointing out weaknesses. They are also in a position to provide assurance to the Executive Management and the Board of Directors that management is conducting its affairs in line with the strategies and policies set by them. Their expert knowledge of risks and internal controls should also be of considerable value when new systems or procedures are being developed.

5. Providing a professional auditing service, whether it is external or internal, requires a knowledgeable, skilled, and well-trained auditing staff. An audit, if properly used, can bring enormous benefits to the organization as a whole. From the perspective of Executive Management, keeping the audit independent and professional will help ensure that it produces objective and unbiased advice. Such reporting will provide an additional measure of confidence that management is not conducting operations outside its authority—in other words, in a way that could lead to financial losses or other problems that may damage the reputation of the institution.
6. With the all-around knowledge that auditors acquire of an organization, the audit process can also assist in educating other staff members in the identification and application of good internal controls. IA can also be used as a training ground for staff members who have the potential to move into senior management roles. With the recent experience in several countries in the region where institutions are facing large losses due to bad financial management practices, the increasing demand for auditing services and sound internal control systems has been fully recognized. The current trend is for establishing and strengthening the internal audit activity.

7. The primary objective of IA is to assist members of management in the effective discharge of their responsibilities. To this end, IA will furnish them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. IA will also be proactive and will advise management on internal controls when new systems, procedures, and operations are being contemplated. In carrying out their duties and responsibilities, members of IA will have full, free, and unrestricted access to all activities, records, property, and personnel.

8. Specific objectives of IA are as follows:

- Review functions, activities, operations, and programs within the institution at appropriate intervals to determine whether they are properly carrying out planning, directing, organizing, and controlling in accordance with management instructions, policies, and procedures—and in a manner that is consistent with the organization’s objectives and high standards of administrative practice.
- Determine the adequacy and effectiveness of the organization’s systems on internal accounting and operating controls.
- Review the reliability, timeliness, and integrity of financial and operational information, as well as the methods used to identify, measure, classify, and report such information.
- Review the established systems to ensure compliance with those policies, plans, procedures, laws, and regulations that could have a significant impact on operations and reports; determine whether the organization is in compliance; and suggest changes and improvements to policies when required.
- Review the means of safeguarding the assets, and as appropriate, verify the existence of such assets.
- Appraise the economy and efficiency with which resources are employed, identify opportunities to improve operating performance, and recommend solutions to problems when appropriate.
- Review operations and capital expenditure projects to ascertain whether results are consistent with established objectives and whether the operations or projects are being carried out as planned.
- Participate in the planning, design, development, implementation, and operation of major computer-based systems to ensure that:
  - the needs of users have been clearly specified;
  - adequate internal controls have been incorporated in the systems;
  - thorough system testing is performed at appropriate stages; and
  - system documentation is complete and accurate.

IA should also conduct periodic audits of computer service centers and make post-installation evaluations of major data processing systems to determine whether these systems meet their intended purposes and objectives and whether they are secure, effective, and efficient.
9. IA must also send reports to those members of management responsible for taking corrective action on the recommendations. The Auditor General must be given a copy of all reports submitted by IA to its management.