



Peer Review of the Audit Board of the Republic of Indonesia (BPK)

**Conducted by the Office of the Auditor-General of
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EXECUTIVE SUMMARY

Executive Summary

BPK has been working on a modernisation programme over the last five years. It has made good progress in implementing information technology systems and the development of training. The audit sector in Indonesia is complex and in need of major overhaul if BPK is to flourish as Indonesia's Supreme Audit Institution. BPK also faces enormous challenges in the next few years as public sector entities move to accrual accounting and new reporting requirements under new Indonesian State Finance Law.

In order to respond to these challenges, BPK needs to formulate a strategic plan for the next five years. The plan needs to have a heavy focus on building BPK's capability and capacity. There will need to be a number of essential building blocks if BPK is to succeed in this challenge.

Legislation and Mandate

BPK is still awaiting the passage of its own legislation, currently in draft form. It is essential that BPK has modern audit legislation that provides clarity and certainty over its mandate and properly reflects BPK's status as Indonesia's Supreme Audit Institution. Coupled with this is the need for a wholesale reform of the entire public audit sector in Indonesia. The current sector arrangements are complex and are inhibiting BPK from responding properly to the challenges in its environment.

Resources

It is unlikely that BPK has sufficient resources in order to meet the audit requirements of new State Finance law. Part of any overhaul of Indonesia's public audit sector may result in a redistribution of audit resources across the sector and to BPK. BPK will be stifled if it does not have sufficient and appropriate resource. BPK staff are part of the Indonesian public service system, and as such BPK has little flexibility in the deployment of its people and the reward and promotion of its talent.

Professional Standards

Another essential building block for change is the need for the Indonesian public sector to have a credible basis for financial reporting and standards that support this. With the imminent introduction of accrual accounting into the Indonesian public sector, it is vital that the reporting basis and standards be determined as a matter of urgency.

Similarly, BPK audit standards are in need of major overhaul, and the adoption of International Standards on Auditing would be a credible and immediate solution to this problem.

Audit Assurance

BPK undertakes a range of audits they describe as financial, performance and compliance audits. However, few of the audits we examined are internationally or professionally credible in this regard. For example BPK do not undertake financial audits that result in the expression of a conventional audit opinion, but rather, undertake a series of low-level compilation-type exercises. Similarly, performance audits are more compliance-type reviews. BPK needs to properly define its range of assurance products, which must reflect professional and international practice.

BPK will find the introduction of accrual accounting will place significant challenges on its ability and capacity to conduct financial audits. We also believe that performance auditing requires specialist resources and commitment - BPK auditors currently conduct both financial and performance audits. BPK may want to concentrate its efforts into financial auditing and/or develop a separate dedicated performance audit capability.

Audit Methodology

BPK does not have an audit methodology, but rather deploys audit manuals that have more of an administrative focus than a professional auditing one. An audit methodology is at the heart of sound professional auditing practice and provides a basis for the level and extent of audit work necessary to respond to audit risk.

Training and Development

BPK's training and development has to move to a proper needs based approach, and to support the introduction of an audit methodology, accounting and auditing standards.

Technology

BPK has made good progress in a short time in rolling out technology. Further opportunities exist in electronic work papers and practice management systems for BPK.

BPK faces a substantial challenge in order to make further progress professionally and administratively. These challenges cannot be underestimated, but above all will require commitment from BPK's Board and Management.

We received excellent cooperation from BPK throughout this peer review and are grateful for the assistance of all involved.

1 PUBLIC SECTOR AUDIT IN INDONESIA

There are a myriad of external audit, internal audit and inspectorate arrangements in place in the Indonesian public sector. These include:

- σ BPK – Indonesia’s Supreme Audit Institution (SAI)
- σ BPKP – Indonesia’s Finance & Development Supervisory Agency
- σ Internal Audit at a centralised level – Inspectorate General
- σ Internal Audit at a decentralised level – Bawasdas
- σ Internal audit at an entity level

A recent report of 16 February 2004, submitted to the Asian Development Bank (ADB) provides an excellent overview and stock take of these complex public sector audit arrangements, and it is not our intention to replicate the information contained in that report. In the report’s introduction, it states:

The public sector audit function in Indonesia, comprising external and internal audit, is beset with problems, all of which combine to make it uneconomical, inefficient, ineffectual and unable to fulfil its obligations. There exists unclear and ambiguous mandates, a virtual absence of oversight, a myriad of operational difficulties, and a failure to consistently comply with internationally acceptable benchmarks.

It is beyond the scope of this report to express further views on the wider audit sector in Indonesia, other than how we see this impacting on BPK itself. However, we endorse the views expressed in the report prepared for the ADB.

The ADB are encouraging a rationalisation of the whole Indonesian audit sector in order to:

- σ achieve greater role and mandate clarity between the various players
- σ strengthen BPK as the SAI
- σ redistribute the collective audit resource, particularly as between BPK and BPKP.

Again, it is beyond the scope of this peer review to comment on any audit sector rationalisation. BPK has many challenges for the future, not least of these being the need for greater resources in order for it to fulfil its mandate. One proposal that is being advocated in the audit sector is to re-define the role of BPKP, and in doing so rationalise the resources they have, including re-allocating some of BPKP’s resources to BPK – this proposal is currently being considered by the Indonesian Government. Our concern is that this period of proposed change is impacting on BPK’s ability to plan for its future, particularly the marshalling and deployment of sufficient resources, in order to respond to the challenges of new Indonesian State Finance Law.

However, we do not believe that this period of hiatus should deter BPK from advancing its plans, particularly if the recommendations of this peer review report are to be implemented in any way.

2 BPK'S ENABLING LEGISLATION

Mandate

BPK operates under the 1945 Constitution. In 1973, Indonesia enacted Law 5/73 to establish BPK as Indonesia's external auditor and SAI. Decentralisation Laws 22/99 and 25/99 expanded BPK's mandate to include 475 Regional Parliaments and authorised BPK to establish regional offices in each of Indonesia's 33 provinces. State and Regional-Owned Enterprises (SOEs and ROEs) are also included in BPK's mandate, though in the case of SOEs, Boards can appoint their own auditor where there is any private ownership. This appears to be an anomaly between BPK's law and that covering SOEs.

It is also unclear whether BPK's mandate includes subsidiary entities established by any of the public entities for which BPK is the statutory auditor – significant public resources are likely to be represented in these subsidiary entities, which are not covered by BPK audit.

Independence and funding

BPK is seeking to enhance its independence in two key ways by having:

- σ the Board appointed by Parliament rather than the President *and*
- σ its funding determined by Parliament rather than the Executive.

Both of these measures would significantly enhance BPKs' independence. BPK believes it is currently under-resourced to conduct the level and extent of auditing that it needs to in order to meet its statutory obligations. This problem will only be exacerbated as BPK endeavours to audit all of the entities in its mandate, and to appropriately respond to the challenges of accrual accounting over the next two years. Accrual accounting is being introduced under the new Indonesian State Finance Law. We have provided a comprehensive analysis of BPK's draft audit legislation against the INTOSAI Draft Charter of Independence. (See Appendix 3 of this report).

3 AUDITING STANDARDS

BPK has developed auditing standards based on those of the International Organisation of Supreme Audit Institutions (INTOSAI) and the United States of America's General Accounting Office (GAO). BPK's auditing standards are not fully developed and are currently being revised. Our review of BPK's standards currently in place indicates that they are heavily procedurally based in terms of audit administration and have a heavy compliance focus.

The auditing profession has been under significant scrutiny internationally and many jurisdictions have introduced onerous compliance, disclosure and public oversight regimes, both for preparers and auditors alike.

The International Federation of Accountant's (IFAC) International Audit and Assurance Standards Board (IAASB) is progressively rolling out International Standards on Auditing (ISAs). INTOSAI is moving from maintaining its own auditing standards by seeking to support the IAASB's development of auditing standards – in particular so that the IAASB's standards appropriately reflect the interests of the international public sector audit community.

ISAs represent best international practice for the auditing profession, particularly in areas of fundamental auditing practice such as:

- σ audit evidence
- σ documentation
- σ audit materiality
- σ fraud
- σ audit errors
- σ audit opinions
- σ audit planning
- σ control environment assessments *and*
- σ supervising the work of audit staff.

We entirely accept the need for BPK to develop its own auditing standards to cover:

- σ the application of ISAs generally in the Indonesian legislative environment
- σ topic areas not covered by ISAs *and*
- σ particular needs of BPK in order to comply with its legislative mandate.

However, we believe that BPK could benefit from adopting ISAs as the core of its own auditing standards, as these are internationally recognised, credible and readily available.

4 AUDIT METHODOLOGY

BPK has had a project developing its auditing standards with the assistance of KPMG, Ernst & Young and academics. However, it is apparent that BPK lacks a clear audit methodology. This manifests itself in a number of ways:

- σ It is not clear what audit opinion is being aimed for.
- σ There is no apparent assessment of audit risk and the appropriate level and extent of audit responses necessary in order to address those risks.
- σ Different approaches are being taken by BPK audit teams.
- σ Audit evidence is poorly documented, filed and referenced.

- σ There is no concept of audit confidence – that is the confidence level that is implicit in the audit opinion, and which underpins the level and extent of audit testing required in order to express that opinion.

An audit methodology should clearly outline:

- σ the audit confidence level (usually 95% confidence)
- σ the minimum requirements for an audit, including how audit planning, audit work papers and the audit summary is documented
- σ how audit materiality is determined and what is an acceptable level of audit risk and confidence, along with how these factors are documented
- σ how to develop an appropriate mix of audit work, in order to adequately address the audit risks identified. The mix of audit work would include:
 - the documentation of key accounting and management information systems
 - the identification of key controls in and around those systems, with audit walkthrough tests to verify the systems and controls in operation
 - an evaluation of the information systems control environment
 - an overall assessment of the control environment
 - the combination of audit compliance and substantive testing (key item testing, analytical review and sampling) procedures that are necessary in order to form a view on key account balances and transactions
- σ how audit errors are recorded, summarised and evaluated against audit materiality.

We believe that a clear audit methodology is the most essential building block that BPK needs to put in place in order to:

- σ undertake all audits on a consistent basis
- σ properly respond to the challenges of auditing a full set of accrual financial statements
- σ make proper assessments of audit risk
- σ undertake credible and sufficient audit work in order to support the audit opinion being expressed
- σ provide a sound basis for training

- σ have certainty over what a financial audit actually is
- σ undertake sufficient work in auditing systems and controls in order to make better assessments of the risk of corruption, collusion and nepotism (KKN) and design appropriate audit tests accordingly *and*
- σ produce better information for the preparation of BPK's management letters and reporting to stakeholders.

5 BPK'S AUDIT AND ACCOUNTING TECHNICAL CAPABILITY

We have identified a number of areas that indicate that BPK will need to establish a technical capability in order to deal with:

- σ the introduction of accrual accounting
- σ input into the development of financial reporting standards under the new State Finance Act
- σ providing assurance-based assistance to entities in moving to accrual accounting and compliance with financial reporting standards
- σ the need to adopt credible auditing standards *and*
- σ the need to introduce an audit methodology

BPK do not currently have this capability, however, we believe that it will be needed in order to address the issues outlined above. By this, we mean establishing a core group of people who have leadership responsibility for accounting and auditing policies, issues, advice, methodology and input into training. We do not see BPK's current research and development, evaluation and planning function as fulfilling these needs.

6 HUMAN RESOURCE CAPABILITY

BPK has had an emphasis on recruiting accountants under the term of the most recent BPK Chair. BPK has also been requesting additional funding to increase its staff numbers in order to respond to the need to audit SOEs and local government. BPK has been unable to secure the full funding and therefore resources it believes it needs.

Staff who are qualified accountants, or training to be accountants, are predominantly at auditor level – that is below supervisory or management levels. BPK has a number of layers of staff in their management ranks who cannot sign audit opinions because they are not qualified accountants. Accordingly, more junior staff sign the audit opinions. This creates an imbalance in the BPK hierarchy, whereby those that would normally be accountable for an audit in terms of their seniority and

experience are not the people who sign the audit opinion. This is an unusual situation, which we believe creates a number of problems.

The staff member's length of service is a key determinant in their seniority in BPK. This reflects BPK being part of the Indonesian public service and therefore its HR policies and procedures are those of the Indonesian public service. BPK therefore has no independence or flexibility in the way it recruits, retains or remunerates its people – it must follow the rules and regulations of the Indonesian Public Service. Ideally, part of any audit sector and or legislative reform will be to give BPK greater, if not complete control over its management of human resources, in order to give it greater operational flexibility and the ability to promote and reward its talented people.

BPK has a very hierarchical structure, with many layers of supervision and management. This, coupled with a “job-for-life” approach to employment, and promotion traditionally being based on seniority, means that BPK runs the risk that its talented younger staff become frustrated – the risk that they may leave will become heightened if there is improvement in the Indonesian economy and private sector employment increases. We were impressed with the energy and enthusiasm of many of the younger BPK staff that we encountered, including members of audit teams we interviewed as part of our review of audit files, and those involved in the modernisation project. We believe many of these people form the future of BPK for a number of reasons, in that they:

- σ are technologically literate
- σ have an appetite for change
- σ have energy and enthusiasm
- σ have less organisational capture *and*
- σ are keen to learn.

7 CORRUPTION, COLLUSION AND NEPOTISM (KKN)

BPK has been including an emphasis on corruption, collusion and nepotism – referred to as KKN – in its audit planning processes. Evidence of, or potential for KKN, is one criteria for selecting entities to be audited.

BPK's Inspectorate Division also undertakes reviews of BPK audits for evidence of fraud, corruption or state losses and reports instances to BPK's Board. We were informed that in 2003 there were few such reports made to the Board – around five or six reports.

In 2002, there were 177 reports that were copied to the Board, with some 1,050 findings. Of these, 23% had indications of corruption, 22% indications of general crime, with the balance having administrative-type findings. Of these findings, 39 were sent to the Attorney-General, 14 to the Police. The others were not referred to the Attorney-General or Police based on decisions of the BPK Board and senior managers. We were told less than 10% of those refereed have resulted in prosecutions.

BPK reports to Parliament an outline of the number of cases sent to the Attorney-General or Police, but does not track or report those cases actually resulting in a conviction. Parliament has not publicly released these reports.

A further concern in relation to KKN is where SOE audits are undertaken by public accounting firms. We were told that these firms have not identified any instances of KKN within the SOEs that they audit.

The audit and investigation of KKN should be a specialist area for BPK, and we are not convinced that BPK has sufficient specialist resources in order to undertake this kind of work – forensic accounting and auditing skills are a specialist area, and are essential to an effective and credible approach to auditing and investigating KKN. It is unclear what protocols exist between BPK and the Police and Attorney-General's Office in so far as KKN is concerned.

We believe BPK should:

- develop a specialist forensic audit capability in order to deal with incidences of KKN
- develop protocols with the Police and Attorney-General's Office in so far as KKN is concerned *and*
- report all instances of KKN to Parliament, and further reports the progress of Police and Attorney-General inquiries, prosecutions and Court convictions.

8 QUALITY ASSURANCE AND INTERNAL AUDIT

The BPK Audit Manual outlines the layers of review that are to be undertaken on audits, however, the Manual does not prescribe what has to be reviewed by each level of review. In the audit files that we reviewed, we observed inconsistent practices:

- There was not always evidence of reviews having been undertaken – that is, working papers had not always been signed-off as evidence of review *and*
- Where reviews had been undertaken, they varied as between the teams that we reviewed.

We are not convinced that the multiple layers of review are adding either quality or value. These multiple review layers further reinforce the heavily bureaucratic approach being taken to audits by BPK. There should be a rationalisation of the layers of review for a number of reasons:

- Reducing the layers of review reinforces the accountability for getting it right first time for the preparer of the work.

- The current layers of review are not working anyway, so reducing the layers of review does not increase risk or present a loss of quality.
- It goes part way to addressing the very hierarchical structure of BPK.
- It means the preparer of the work has closer contact with the ultimate owner of the product, and is more likely to be responsive to their needs *and*
- It will go some way to reducing the time lags that BPK has in the production of its reports.

We believe the starting point for reviewing layers of review is that a single level of review on a “one-up” basis is sufficient, and that there should be good reason as to why further layers of review are necessary.

BPK has an internal audit division that undertakes higher level and indepth reviews of audit work across the other BPK divisions. Having this kind of quality assurance review is an essential part of any professional auditing organisation, and it is important that this kind of function has clear mandate and accountability. In the case of BPK’s internal audit division, neither mandate nor accountability is clear for several reasons:

- We were informed of one instance where the internal audit report was challenged on the basis of mandate, effectively obstructing the completion of the review being undertaken.
- The reviews are not received or considered by the whole BPK Board, but rather by individual divisional heads and their Board Member *and*
- The review findings do not flow back into BPK’s education and training programme.

9 STRATEGIC AUDIT PLANNING

BPK have significant resources committed to research and development, evaluation and planning – all up some 70 people. In our view, the work of this group is largely ineffectual, and fails to deliver on a range of fronts:

- There is no strategic audit planning process in place that:
 - does environmental scanning to identify the key issues across the public sector
 - identifies key issues within sectors – for example the health or local government sectors
 - identifies the key risks
 - outlines a range of audit interventions to address theses risks

- compares the audit interventions on some kind of risk and pay-off basis
 - presents this information in a coherent, credible and logical form
 - forms the basis for BPK's work programme, for example:
 - Themes and issues that need to be considered or addressed in the planning for audits on a sector basis.
 - The performance audit programme.
 - Targeted investigations.
 - communicates this information to auditors.
- σ It has not prepared any plan for how BPK will respond to the new State Finance Law, particularly the impact of the public sector moving to accrual accounting in 2006, and BPK having to audit these accrual financial statements within two months of receiving them from clients.
 - σ The research and development process is cumbersome and bureaucratic, and it is hard to see the value that is being added by this function.

10 ELECTRONIC AUDIT WORK PAPERS

BPK have recently introduced computers into the organisation. These are being used in the preparation of audit plans and reports, and to some extent in the preparation of audit work papers. The computers are predominantly desk-tops, though a small number are lap top portable computers. We believe that BPK should aim to equip all audit staff with lap top computers to enable the introduction of electronic work papers. An electronic work paper package would:

- σ enable standardisation of all planning and reporting documents and audit work papers
- σ ensure work papers are reviewed properly and consistently
- σ eliminate the majority of hard-copy files
- σ provide for nationwide electronic storage and retrieval of audit files
- σ enable planning and work papers to be rolled forward from year to year
- σ enable the assimilation of sector-wide issues collection and reporting where appropriate *and*
- σ contribute to the rationalisation of levels of review.

11 EDUCATION AND TRAINING

BPK provides significant levels of training for its staff covering three areas of development:

- Induction and leadership training that is provided by the State Administration Agency.
- Functional auditor training for up to supervisor level *and*
- Technical training, covering audit types, sector-specific, and entity specific areas.

We visited BPK's Education and Training Centre in Jakarta. This is an impressive facility, both in terms of facilities and the accompanying infrastructure of trainers, staff and technology. This facility provides BPK with an excellent resource and has been one of the main applications of World Bank loan funding.

We have a number of impressions of BPK's approach to training more generally:

- BPK has a major training programme up and running. All staff undertake significant levels of training annually, though we are not persuaded of the value of this training. Staff seem to regard training more as a means of acquiring knowledge than of equipping them to do their job better or undertake new work
- All staff participate in this training as a matter of course, rather than it meeting individual training needs.
- The training is not always relevant to the work being undertaken by staff, and they do not necessarily apply the training on the types of audits or audit entities they are subsequently working on.

As discussed elsewhere in this report, BPK will be facing major challenges in auditing in an accrual accounting environment. BPK's capability to appropriately respond to these challenges will to a large part require further education and training of its people. A comprehensive needs assessment is required in order to raise BPK's capability to conduct audits in this new accrual accounting environment.

We have raised a number of concerns in relation to how BPK conducts audits, based on our review of a range of audits. In order to address these concerns, BPK will need to embark on a refreshed education and training programme covering for example:

- Auditing standards
- Accounting standards
- Audit methodology
- Audit risk
- Documentation
- Supervision and review
- Quality assurance

12 THE CHALLENGES OF ACCRUAL ACCOUNTING

Indonesian Law 17 of 2003 on State Finance, prescribes new financial reporting requirements for state and regional government. In reporting against the 2006 budget year, state and regional governments will have to present audited financial statements within six months of balance date comprising:

- σ realisation report
- σ balance sheet
- σ cash flow report; and
- σ notes to the financial statements

These financial statements have to be audited by the State Audit Board (BPK). In addition, Law 17 requires that these financial statements are prepared on an accrual accounting basis for the 2006 fiscal year.

Law 17 does not prescribe the reporting basis for the preparation and presentation of the financial statements – for example International Generally Accepted Accounting Practice (GAAP) – but rather, states the accountability reports “shall be arranged and presented in accordance with the government audit standards.....arranged by an independent standard committee and stipulated by the Government Regulation after previously obtain consideration from the State Audit Board”

This new State Finance Law will represents a major step forward in the accountability and reporting framework for the Indonesian public sector and will present major challenges for public sector entities and BPK as auditor. BPK will be required to express an audit opinion on the financial statements within two months of receiving them from the client.

BPK estimates that it needs to significantly increase its staff numbers in order to deal with the workload – simply from a volume basis in terms of the number of audits. However, if BPK is to properly respond to the new accountability regime, particularly the move to accrual accounting, then a number of issues will need to be addressed, including:

- σ The capability of public entities to cope with the move to accrual accounting and tighter reporting timeframes – in order for BPK to complete audits within six months of balance date, then public entities will need to perform. A plan needs to be in place as to how BPK will work with public entities in order to achieve the outcome required under the State Finance Law.
- σ BPK itself will need to train its auditors in how to audit accrual based financial statements, processes and systems – this will be a significant change from auditing the predominantly cashed-based systems operating currently. Expressing an audit opinion on a full accrual set of accounts – especially the balance sheet – is a fundamentally different proposition from auditing a budget realisation report for example.

- The State Finance Law provides for BPK to have a role in the setting of reporting standards for public entities. These reporting standards will be an essential cornerstone in the new accountability and reporting framework contemplated under the new Law. High quality financial reporting can only be achieved when based on clear standards that are set by an independent standard setter following due process and have integrity and credibility. The move internationally is towards the harmonisation of financial reporting standards, and a range of jurisdictions are choosing to adopt International Financial Reporting Standards (IFRS).

BPK will therefore have an essential role in the development of reporting standards for public entities. Unless public entities prepare financial statements on an objective basis, such as for example IFRS, then BPK will have difficulty in expressing an audit opinion.

13 PRACTICE MANAGEMENT SYSTEMS

We believe there are four key corporate information management systems that we describe as ‘practice management systems’ (as distinct from audit systems) that will be important building blocks for BPK.

Resource planning and allocation system

BPK is a large organisation and undertakes a significant number of audits. An information system to drive resource planning and allocation is an essential tool in order for BPK management to:

- assess whether it has sufficient resources to undertake the audits it is required to do
- keep staff fully productive *and*
- understand peak work flows and to be able to smooth these as much as possible.

A resource planning and allocation information system will be an essential management tool to help BPK plan and manage the volume and timing of audits as required to be undertaken by the new State Finance Law.

Time recording System

BPK has no time recording system whereby staff record the time that they spend on:

- undertaking audits – that is the audit entity and key sections of the audit around planning, fieldwork, supervision and reporting
- formal training
- personal development

- σ corporate tasks
- σ administration *and*
- σ other functional areas – for example quality assurance.

A time recording system is an essential part of effective resource management, keeping staff accountable, managing productivity, and provides essential information for managers to manage. Time recording is a standard discipline in professional services organisations.

Audit tracking system

An essential management tool is a repository of information about all public entities for which BPK is the statutory auditor, including for example:

- σ Full details of the public entity – for example name, physical address, contact information, key individuals etc.
- σ Sector and Entity type – for example, Ministry, Municipality, SOE Company.
- σ The budgeted and actual audit hours.
- σ The type of audit opinion issued.
- σ The subsidiary entities and the same information set for these as for the parent *and*
- σ Who the lead auditor is, including BPK employees or the public accountant who signs the audit opinion.

The information provided by this kind of audit tracking system will be essential in order for BPK to:

- σ have a complete record of all audits for which it is the statutory auditor. It would also be essential for this information to be maintained, requiring robust systems and controls in order for auditors to keep the information held current and accurate
- σ ensure it has undertaken the audits it is required to *and*
- σ have proper management information about its own performance – this should be reported in BPK's own accountability reports to Parliament.

Document management system

BPK are developing a document management system, which with the introduction of computers, provides an essential part of BPK's knowledge management. This is particularly important given:

- σ BPK's geographically dispersed Offices
- σ the move to record more audit documentation in electronic form *and*
- σ the extent of training that is undertaken in BPK.

14 **BPK REPORTING**

Audit reports

BPK's audit reports reflect the narrow scope of the work undertaken in an audit and the assertions in the opinion. The work largely revolves around examining the compilation of financial reports and substantively testing in order to form a view on the existence assertion. Otherwise the audit report is heavily compliance based, identifying for example regulatory breaches in the compilation of the financial reports.

Accordingly, we believe these audit reports are of minimal assurance value to either the preparers or users of the financial reports, or wider stakeholders. BPK are not undertaking audits from a generally accepted view of auditing, and unless BPK changes to undertake full financial attest audits and issues audit reports accordingly, then BPK's audit reports will remain of limited assurance value and utility.

Management letters

BPK's management letters reflect the limited scope of BPK's audit work. The reports focus on discrepancies found, including audit differences (monetary errors) and regulatory breaches. Because BPK is not undertaking systems work and control testing, then its management letters are not offering recommendations for systems or control improvements. Similarly, because BPK's substantive audit procedures are relatively limited (focussed on auditing existence), then the audits are not identifying substantive issues for reporting in management reports.

From the audits reviewed, in the instances where we did note that significant issues had been identified, they had not flown through to the management letter in a clear and assertive manner. The auditors had not stood back from the individual issues identified and considered the bigger picture about what it all meant for the audit entity, and therefore what should be reported in the management letter.

SAI's have a valuable role to play in any system – whilst their primary focus must always be on providing credible, independent assurance, the nature of an audit means that auditors are often in a position to add further value to the audit entity by making recommendations that are seen to add value. Treading this fine line between providing independent assurance to the SAI's stakeholders and adding value to the audit entity is a challenge, but when the balance is right, then it can:

- σ enhance the real or perceived value of the SAI
- σ entrench the SAI as being a critical part of the system *and*
- σ provide job enrichment for auditors.

15 RESULTS OF OUR PEER REVIEW OF BPK AUDITS

BPK classifies its audits into four types:

- σ Financial audits
- σ Financially related audits
- σ Performance audits
- σ Investigations

In the sample of audits that we reviewed, we aimed to review a sample of the full range of audits conducted. We believe the current classification of audits is somewhat misleading. All of the audits that we examined have a heavy compliance focus and did not necessarily result in an audit opinion being expressed that would be associated with the type of audit undertaken.

Financial Audits

A financial audit should result in an audit opinion being expressed on a set of financial statements – even if the statements are a simple budget realisation report. However, the audits that we reviewed that were classified as financial audits were of a limited scope nature, and were primarily focussed on the compilation of the financial statements from the underlying ledgers. The extent of the underlying audit work was similarly limited to some substantive testing in order to verify the existence of a sample of transactions. There was no systems work undertaken. The resulting value of the audit report is that it is of minimal value from an assurance perspective.

The scope and planning for financial audits is prescribed in the audit manual. This means that audit planning is not tailored to the audit client – that is, there is no assessment of the client's:

- σ management control environment
- σ accounting and management information systems
- σ key controls
- σ issues and risks
- σ size and scale of business *and*
- σ financial statements and key account balances.

The audit manual also prescribes the time to be spent on an audit. This approach is unrealistic and bureaucratic. Such an approach to resourcing an audit means that the work undertaken bears no resemblance to that required in order to address the risks that may exist in the client.

Because of the constraints imposed by the scope and size of the audit, there is minimal room for staff to exercise their professional judgement – the key tool that any auditor has in conducting an audit.

Performance audits

BPK is at a very early stage in conducting performance audits. Most audits that have been labelled as performance audits are not performance audits. BPK had provided rudimentary training to staff in conducting performance audits. The performance audit manual is still being drafted and is incomplete.

SAI's who have credible performance audit capability have specialist performance audit units who undertake this work. We believe that it is unrealistic for BPK to expect financial auditors to also be able to conduct performance audits – while many of the characteristics of a good financial audit are common to a performance audit, they are really fundamentally different products.

We endorse the need for BPK to have a performance audit capability. Undertaking value-for-money auditing will be an essential component in providing broad-based assurance as Indonesia's public sector evolves and develops. However, we believe that BPK should concentrate its efforts in developing its financial audit capability as its first priority – this is clearly the most pressing need given the challenges of new State Finance Law.

This is not to say that BPK should abandon performance audit. Rather, it should take a less ambitious, and more realistic approach, to developing a performance audit capability, and concentrate this capability in a specialist performance audit group. As with financial audit, the key to making further progress is to have:

- a robust performance audit methodology (that goes further than INTOSAI standards)
- properly trained performance auditors
- take a pilot-based approach to rolling out performance audits and developing auditor capability *and*
- intensive peer review and independent quality assurance mechanisms in place that feed back into the ongoing training and development of performance auditors.

Financially-Related Audits (FIRA Audits)

BPK undertakes a large number of FIRA audits. Again we question the validity of this line of assurance work in the absence of a proper strategic audit planning process and the under-developed state of financial and performance auditing in BPK. We believe that the resources that are currently put into FIRA audits would be more usefully deployed in undertaking fully scoped and planned financial audits using a robust financial audit methodology.

APPENDIX:1

PEER REVIEW TEAM

The peer review was conducted by three employees of the Office of the Auditor-General of New Zealand.

Terry McLaughlin – Executive Director of Audit New Zealand

Audit New Zealand is a business unit of the Office of the Auditor-General of New Zealand and conducts annual statutory audits of many of New Zealand's public entities. The Auditor-General is the statutory auditor of all public entities in New Zealand. Public entity audits not conducted by Audit New Zealand are conducted by public accounting firms on behalf of the Auditor-General. Terry McLaughlin is the leader of Audit New Zealand and reports to the Auditor-General.

Ken Boddy – Audit Director Audit New Zealand

Ken is an Audit Director in Audit New Zealand and is responsible for a portfolio of audits and is experienced in a wide range of sectors. As Audit Director, Ken has responsibility for leading the audits in his portfolio and signing audit opinions on behalf of the Auditor-General.

Tony Uttley – Associate Director Audit New Zealand

Tony is an Associate Director in Audit New Zealand, and as such he signs audit opinions for lower risk audits and plays a lead role in higher risk audits in his portfolio, which also covers a wide range of sectors.

APPENDIX:2

PURPOSE OF THE PEER REVIEW

The peer review was commissioned by the previous Chairman of BPK, Satrio Budihardjo Joedono. The peer review comes at the end of a five-year modernisation programme for BPK, funded by the World Bank. The Chairman's term and that of his Board has expired and a new Board is soon to be appointed. The Chairman wished to have an independent peer review conducted that can be picked up by the incoming Chairman and Board of BPK. The peer review report will be tabled in the Indonesian Parliament.

Peer review scope and approach

This is an all-encompassing review of BPK, covering enabling legislation, parliamentary accountability, organisational design and capability, and the planning, design, implementation and delivery of audits.

The review was conducted in two phases. The first stage was a planning and scoping exercise and entailed interviewing all members of BPK's Board and senior management, together with the assembly and analysis of key documents and material. A number of high-level findings arose from this phase and formed the basis of phase two of this peer review.

Phase two comprised further interviews with key BPK people, but was primarily focussed on the review of a sample of audits recently conducted by BPK. Key planning and reporting documents from these audits were translated into English, and the review team interviewed the audit teams in order to:

- σ gain an appreciation of the purpose of the audit
- σ assess compliance with BPK's audit manual
- σ identify key issues and risks and inquire as to how these had been addressed in the audit file
- σ assess the quality of audit evidence
- σ consider how the audit relates to the overall plan of work undertaken by the audit group that the team belongs to *and*
- σ consider the impact that the audit has had and who it was reported to.

Sources of evidence

- σ Audit case studies covering each of the audit divisions in BPK and including a selection of the different types of audit undertaken by BPK – financial audits, financially related audits, performance audits and investigations.
- σ Review of BPK' audit manual and technical guidance material.
- σ Interviews with all members of the BPK Board and senior management.
- σ Interviews with the audit teams undertaking the audits reviewed.

- σ Analysis of reports on BPK and the wider audit sector in Indonesia undertaken by the Asian Development Bank.
- σ Analysis of Indonesian audit and state finance legislation.
- σ Meeting with the Indonesian Central Accounting Office, Ministry of Finance.

APPENDIX:3**ANALYSIS OF DRAFT INDONESIAN AUDIT LEGISLATION AGAINST THE INTOSAI DRAFT CHARTER OF SAI INDEPENDENCE**

This analysis is based on copies of legislation and draft legislation provided to the review team. The legislation in each case consists of numbers sections or articles and “elucidation notes”.

The focus is on:

- the *Draft Act Regarding the State Audit Board* (dated May 8, 2003) (“the Draft Act”), which we understand is intended to update the mandate and independence of the BPK
- the Law Regarding Audit of Management and Responsibility of the State Finance (“the Audit Law”) – which we understand has been newly enacted though for financial audits, the Act does not take effect until 2007 and
- the Law of the Republic of Indonesia Number: 17 Year 2003 on State Finance (“the State Finance Act”).

The Draft Act has not yet been enacted. Where necessary for the sake of contrast we have made references to other existing law, including the *Act of the Republic of Indonesia Number 5 of the Year 1973 on the Supreme Audit Board* (“the 1973 Act”).

The analysis uses principles contained in the draft INTOSAI charter on independence of Supreme Audit Institutions. This has yet to be ratified by INTOSAI and is the subject of ongoing work by an INTOSAI Committee, and so must be regarded as provisional, and merely a convenient basis for assessing the independence of the Indonesian SAI. The draft principles in this form were, however, endorsed by the 17th UN/INTOSAI Symposium on Government Auditing (April 2004).

We have confined our focus to the central government responsibilities of BPK. There are equivalent provisions in the legislation for regional bodies, which we have not examined.

1 CORE PRINCIPLE 1 – AN APPROPRIATE AND EFFECTIVE CONSTITUTIONAL/STATUTORY/LEGISLATIVE FRAMEWORK AND *DE FACTO* APPLICATION PROVISIONS

1.1 Legislation spells out in detail the extent of the SAI’s independence

Article 2(1) of the Draft Act says:

State Audit Board is a State Institution which is independent and autonomous.

This provision is broadly consistent with other SAIs’ statutory and constitutional guarantees of independence. It largely updates section 1 of the 1973 Act.

1.2 The SAI’s constitutional/statutory/legal framework ensures that it is independent as whole

BPK sits within the legislative branch of government. Article 12(1) of the Draft Act says that the practice of selecting BPK members is “regulated” by the House of Representatives.

Article 13 of the Draft Act provides that members are “elected” by the House of Representatives. The term “election” is unusual. Use of the alternative term “appointment” or “recommendation for appointment” would remove any inference of the role of BPK member being politicised.

The elucidatory note also refers to appointments being “legalized” by the President. Provisions that make appointment and dismissal Presidential acts are not uncommon – cp the Public Audit Act (NZ) which provides for the Auditor-General to be appointed by the head of state on the recommendation of the House of Representatives, even though by convention and in practice the appointment is regarded as “parliamentary”.

The House now holds the power of dismissal (Article 16 of the Draft Act). This is a change from the 1973 Act, which provided for “discharge” by the President and “declaration” of ongoing ineligibility by “the Government”.

However, as with the “election” provision, the elucidatory note refers to suspension being “legalized administratively with Decree of President as State Head”.

On their face, these provisions are satisfactory from an independence point of view. However, any assessment of independence must also take into account the wider constitutional and socio/political culture of the state – particularly as regards the degree of influence and authority which the House holds vis-a-vis the President, and whether the President would be expected by constitutional convention to follow the results of a parliamentary election of BPK members.

1.3 The SAI has available sufficient resources (human, material and monetary)

The budget of the BPK is approved by the House, after being submitted to the House by the BPK itself (Article 25 of the Draft Act). It appears that the BPK’s budget is

automatically included in the Government's Budget. This is a positive change in terms of independence from the Executive.

Under article 9(3) of the Audit Act and article 7(4) of the Draft Act, BPK is empowered to employ "experts" and external auditors.

The staffing arrangements are otherwise not clear. Article 9 of the Draft Act says that members of the BPK are "assisted by Staff consisting of Civil Government Servants". There is also a reference in article 7(4)(e) of the Draft Act to BPK being authorised to "develop Functionary Position of State Finance Auditors". The exact meaning of these terms is not clear for example the extent to which BPK can determine what staff it needs, and/or to engage its own staff, and to determine what arrangements exist as regards terms and conditions of employment, remuneration, etc. The 1973 Act provided (section 17) that the officers of the BPK were to be civil servants.

These arrangements are critical to the degree of *de facto* independence required by Core Principle 1.

2 CORE PRINCIPLE 2 – INDEPENDENCE OF SAI HEADS, INCLUDING SECURITY OF TENURE AND LEGAL IMMUNITY IN THE NORMAL DISCHARGE OF DUTIES

2.1 The Head of the SAI is appointed, re-appointed or removed by the Legislature or by the Head of State or approved by the Legislature

See 1.2 above as to the "election" of BPK members.

Article 11 of the Draft Act provides that the BPK consists of a Chairman, two Vice-Chairmen, and 10 Members. Under Article 12(4) to (7), the members of the BPK, once elected by the House and "legalized" by the President, elect their own Chairman and Vice-Chairman – subject to the results of the election being "submitted" to the President.

This approach is not unique – the President of the Board of Audit of Japan is selected in this manner. The system ensures that – subject to Presidential oversight as discussed above – the selection of the head of the SAI is ultimately a parliamentary act.

2.2 The Appointment is for a sufficiently long and fixed term to allow the Head of the SAI to carry out their mandate without fear or retribution

The qualifications for election are set out in article 13 of the Draft Act, and require a candidate to be:

- a) *Indonesian National;*
- b) *Being pious to God The One and Only;*
- c) *At least 35 years of age;*
- d) *Being faithful to The Republic of Indonesia and Constitution 1945;*

- e) *Having educational degree of at least S-1 or D-IV majoring in accounting and or state finance and or audit and or civil/criminal law;*
- f) *Not being doubtful on independence of his opinion and honesty.*
- g) *At least 2 (two) years leaving any positions as officials at the state finance management environment.*

Under Article 14 of the Draft Act, members serve a 5 year term, which is renewable up to a retiring age of 65.

Termination and suspension provisions are set out in articles 15 to 18. Importantly in independence terms, there is no provision for summary termination or suspension, and there are two important protections:

- σ Suspension from duty (by the House) may only be with the approval of the Supreme Court (article 17(3)).
- σ The member has an opportunity to “self-defend” before being terminated “inequitably” (ie for misconduct reasons) under article 16(2).

Article 18 of the Draft Act is worth particular mention, as an anti-corruption measure. It provides:

1. *Members of State Audit Board are prohibited directly or indirectly to become owner of entire or part or to become guarantor of business entity which conducts business to obtain profit or advantage on the state finance encumbrance.*
2. *Members of State Audit Board are prohibited to double position at other State Institutions environment, and other boards managing state finance.*
3. *Members of State Audit Board must release temporarily from membership of political parties.*

This is supported by detailed oath provisions in article 19 of the Draft Act and an offence provision in article 27:

Anyone who deliberately uses information, materials and or documents obtained in accomplishing duties of State Audit Board by exceeding his authority, is sentenced to [imprisonment of up to 3 years and a fine]”.

As regards auditors themselves, the Audit Act contains two offence provisions:

- σ Deliberately using documents beyond authority (article 25).
- σ Deliberately not reporting criminal findings made in the course of an audit (article 26).

There are also satisfactory provisions in the Draft Act in respect of immunity of BPK members:

- σ Under article 22(1), BPK members may not be the subject of police investigation except by order of the Attorney-General with the approval of the President.
- σ Any capture and arrest of an BPK member for certain offences is subject to time limits for detention and a requirement to report the arrest to the Attorney-General and the President (article 22(2))
- σ Members are immune from being “alleged before Court due to conducting duties, obligations or authorities according to this Act” (article 23).

The article 22 protections are virtually identical to those in the 1973 Act. However, the article 23 immunity appears to be new. Its scope is unclear – it appears to cover both civil and criminal action. There are two exceptions:

- σ Beach of confidentiality (this is not at all well translated but I think this is what it refers to – it implies a civil suit).
- σ Violating the offence provision in article 27 (deliberately using information in excess of authority – set out above).

3 CORE PRINCIPLE 3 – A SUFFICIENTLY BROAD MANDATE AND FULL DISCRETION IN THE DISCHARGE OF SAI FUNCTIONS

3.1 The SAI is empowered to investigate the use of public monies or assets by a recipient regardless of its legal nature

BPK’s basic mandate is in Article 3(1) of the Draft Act:

State Audit Board is obligated to audit the management and accountability of state finance, either conducted by the Government, Bank Indonesia as well as other Boards.

Article 1(1) of the Audit Act defines an audit to mean:

a process of identification of cases, analysis, and evaluation conducted independently, objectively and professionally based on the standard auditing to evaluate truth, accuracy, credibility and dependability of information concerning the management and responsibility of state finance.

The term “state finance” is defined in article 2 of the State Finance Act.

Article 2(2) of the Draft Act confirms that BPK has exclusive mandate in respect of auditing state finances. While internal audit functions are mandated by article 9 of the Audit Act, these must be submitted to BPK (article 9(2)).

Article 3(1) of the Audit Act expressly links these provisions.

Under article 5 of the Draft Act, BPK gives opinions on:

- the “appropriateness” of financial reports, together with “the records for improvement”
- “advice and suggestions of improving actions on the problems in order to increase the performance of the organizational unit audited” *and*
- recommendations to “decrease or economize the expenditure and to simplify the state finance management”.

See also article 30 of the State Finance Act, which requires BPK to audit the financial report on the implementation of the State Budget.

3.2 The SAI is empowered to investigate the collection of revenues owed to the Government

There is no express reference to auditing revenue collection. However, in the State Finance Act, the State Finance and State Budget are said to include income (including tax revenues, non-tax revenues and grants) as well as expenditure and financing (articles 2 and 11). As noted above, article 30 of the State Finance Act requires BPK to audit the financial report on the implementation of the State Budget.

3.3 The SAI has the power to audit the legality and regularity of the government accounts and entities

The definition of an audit (see para 3.1 above) does not include evaluating authority. However, Article 22 of the Audit Act contains provision for BPK to audit alleged losses suffered by the state or municipality, and to issue claims for compensation. This is subject to a specific mandate provision (article 22(5)) which applies the power to public utility companies and public limited liability companies which are majority owned by the State.

Article 8 of the Draft Act similarly empowers BPK to “assess and stipulate amount of state loss” resulting from “law violation and or Treasurer’s negligence”. The exact scope of this provision is unclear, but it appears to confer an investigatory mandate in respect of both illegal and negligent state action resulting in financial loss.

Article 13 of the Audit Act provides for BPK to conduct investigative audits to “disclose indication that gives rise to loss to the state/municipality and/or indication of a crime”.

3.4 The SAI has the power to audit the quality of financial management and reporting

This is implicit in the definition of an audit and BPK’s reporting powers.

3.5 The SAI has the power to audit the economy and efficiency of government operations

Article 4 of the Audit Act confers power to undertake “financial, performance, and special purpose audits”. A performance audit is an audit on the management of state finances, which could include audit of economy, efficiency, and effectiveness.

A special purpose audit is not defined, so could presumably mean any review or investigation that complies with the Audit Act definition of an audit.

3.6 Except when specifically required to do so by Legislation, the SAI does not audit government policy but restricts itself to the audit of policy implementation

There is no specific exclusion on this ground.

3.7 While being respectful of the laws enacted by the Legislature which apply to it, the SAI is free from direction and interference by the Legislature and the Executive in the selection of audit issues

There are several indicators in the legislation to support this principle:

- The general statement on independence and autonomy in article 2 of the Draft Act.
- The independence and consultation provisions in articles 6 to 8 of the Audit Act.
- The reference to BPK submitting its own work plan to the House of Representatives for budgeting purposes (para 1.3 above).

However, there is no express statement that protects BPK from interference by the Legislature (or indeed the Executive) in respect of its work plan. It would be desirable to have this spelt out in the legislation.

3.8 The SAI is free from direction and interference by the Legislature and the Executive in programming, planning, conduct, reporting and follow-up of its audits

Article 6 of the Audit Act provides that BPK can independently plan and conduct audits, as well as determining schedules, methods, and preparation of reports. It must take account of requests, suggestions and opinions of auditees, and information from the government, central bank, and community when planning audits (articles 7(1) and 8).

The legislation is contradictory as regards the power to fix auditing standards. Article 32 of the State Finance Act provides for government audit standards to be “arranged by an independent standard committee and stipulated by Government Regulation after previously obtain consideration from the State Audit Board”. We understand this to mean that there is an independent government-appointed committee responsible for setting auditing standards, which must consult with the BPK, following which it promulgates standards which have the force of law.

This is in conflict with article 5 of the Audit Act, which requires audits to be conducted in accordance with auditing standards that are set by BPK in consultation with the government.

This is again inconsistent with the Draft Act, article 7(4)(a) of which authorises BPK to stipulate national government auditing standards but without any reference to consultation.

Whatever the correct position, there does appear to be sufficient autonomy in respect of auditing standards.

3.9 The SAI is free from direction and interference from the Legislature and the Executive in the organisation and management of its Office

See comments under para 1.3 above.

3.9.1 The SAI is not involved, or seen to be involved, in any manner, whatsoever, in the management of organisations that it audits

See para 2.2 above, which refers to the independence provisions of articles 13(g) and 18 of the Draft Act.

3.9.2 The SAI ensures that its personnel do not develop too close a relationship with entities they audit

This would be expected to be covered by internal codes of conduct for staff, which ought to be consistent with the independence provisions for BPK members themselves.

3.10 Although the SAI has full discretion in the discharge of its responsibilities, it is responsive to the interests and wishes of the Legislature and cooperates with governments that pursue improvements in the use and management of public funds

It is not possible to assess this principle from the legislation. See the comments in para 3.2.1 and 3.2.2 above, which provide the basis for a practical assessment of the relationships between BPK and the Legislature, the Executive, and other stakeholders.

3.10.1 The SAI applies the same standards to its own operations that it applies to the organisations that it audits, in particular:

- σ **application of appropriate audit standards to its work *and***
- σ **adherence to a code of ethics both of which are consistent with INTOSAI good practice**

Again this is a matter for internal control and regulation.

3.10.2 The SAI provides evidence of the economy, efficiency and effectiveness of its operations

There is no indication about this in the legislation.

3.10.3 The SAI has established an appropriate internal audit function

Again this is a matter for internal control and regulation.

3.10.4 The SAI is prepared to voluntarily submit itself to some form of review of its performance, and independent audit of its accounts, appropriate to its environment and respectful of its independence

This is not a legislative matter. We encourage BPK to continue with a programme of peer review in the future.

3.10.5 The SAI submits an annual activity report to the Legislature and other state organisations as required by the Constitution, statutes or legislation and makes this report available to the public

The legislation does not, as far as we can see, provide for an annual report on operations – but see the requirement to report on the audit of state finances (para 5.1 below).

4 CORE PRINCIPLE 4 – UNRESTRICTED ACCESS TO INFORMATION

4.1 The SAI has unfettered, full direct and free access, on a timely basis, to all the documents and the information necessary for the proper discharge of its statutory responsibilities

Access to information is covered by article 10 of the Audit Act and article 7(1) and (2) of the Draft Act, which give powers to:

- σ seek explanations from individuals, government organisations, Bank Indonesia, and other boards, relating to the management and accountability of state finances
- σ ask for and copy documents
- σ access data *and*
- σ conduct audits on site, and to have access to “ledgers, calculations, accountability, evidences, letters and other registers”.

4.2 The SAI has adequate powers to obtain these documents and information from the persons or entities that have them

Article 11 of the Audit Act provides for BPK to summon an individual for the purpose of requesting information.

Under article 24 of the Audit Act and article 16 of the Draft Act, failure to comply with a requirement to provide documents or explanations is an offence punishable by fine or up to 18 months imprisonment. Article 24 also has offences concerning avoiding or obstructing audits and deliberately refusing to respond to a summons.

Provision of false information is also an offence, punishable by fine or up to three years imprisonment.

See also article 7(4)(c) of the Draft Act, which appears to give BPK power to determine rules relating to the destruction of archive material.

5 CORE PRINCIPLE 5 – THE RIGHT AND OBLIGATION TO REPORT ON THEIR WORK

5.1 The SAI is not restricted from reporting the results of its audit work

Under article 4 of the Draft Act, BPK submits the audit results on the management and accountability of state finances to the House of Representatives, following which the report becomes public.

Article 15 of the Audit Act also provides, simply, that “an auditor shall make an audit report on completion of an audit”, and may make interim reports. Specific reporting provisions for particular types of audit are in article 16.

In addition, BPK has power under article 7(3) of the Draft Act to give such opinions to the House of Representatives, a regional representative board or legislature, the Government, Bank Indonesia, or other boards, “that are required due to their work specifications”.

This appears to be a wide-ranging power to report, which is not fettered in any way that appears under the legislation.

Under article 6 of the Draft Act, BPK can refer to the “State Police and/or Court” any matter suggesting criminality arising from an audit. This is replicated in article 14 of the Audit Act, which requires BPK to report the results of an investigative audit conducted under article 13.

5.2 The SAI is required by law to report annually on the results of its audit work

See para 5.1 above.

6 CORE PRINCIPLE 6 – THE FREEDOM TO DECIDE ON CONTENT AND TIMING OF THEIR REPORTS AND TO PUBLISH AND DISSEMINATE THEM

6.1 The SAI is free to decide on the content of its audit reports

There appear to be no restrictions in this regard.

6.1.1 The SAI is free to make observations and recommendations in its audit reports, taking into consideration, as appropriate, the views of the audited entity

There appear to be no restrictions in this regard. However, there is no provision in the legislation for audited entities to express their views before a report is made.

6.1.2 Legislation specifies minimum audit reporting requirements of the SAI and, where appropriate, specific matters that should be subject to a formal audit opinion or certificate

Minimum requirements for audits are set out in article 16 of the Audit Act.

6.2 The SAI is free to decide on the timing of its audit reports except where specific reporting requirements are prescribed by law

Article 30(1) of the State Finance Act requires the audit report on the implementation of the State Budget to be completed at least 6 months after the end of the financial year.

Article 17 of the Audit Act contains time limits (two months) for the completion of Audit reports on government and local govt financial statements.

6.3 The SAI cooperates to the extent possible to accommodate specific requests for investigations or audits by the legislature as whole or by the Government

This aspect is not specifically addressed by the legislation.

As discussed in para 3.2.1 above, it may be worth considering a formal consultation process on the BPK's proposed work programme, with any suggestions from the parties consulted being taken into consideration before finalising it.

6.4 The SAI is free to publish and disseminate its reports once they have been formally tabled as required by law

See article 4(3) of the Draft Act, discussed above. This reflects article 19 of the Audit Act, which provides that all reports submitted to legislative institutions are to be made public (with the exception of "reports containing national secrets").

A power for BPK to disseminate reports once they have become open to the public is implicit.

7 CORE PRINCIPLE 7 – THE EXISTENCE OF EFFECTIVE FOLLOW-UP MECHANISMS ON SAI RECOMMENDATIONS

7.1 The SAI submits its audit reports to the Legislature or governing body of the auditee, as appropriate for review and for follow-up with specific recommendations for corrective action by the Executive or management

Both the Audit Act and the Draft Act have impressive follow-up provisions. See in particular:

- article 20(1) to (3) of the Audit Act, which requires officials to follow up recommendations in audit reports, and provide a response and clarification to BPK within 60 days of the report – this is supported by article 20(5), which imposes “administrative sanction” on officials who fail to carry out follow up activity as required;
- article 21 of the Audit Act, which requires legislative institutions to follow up recommendations “by way of discussion in accordance with their jurisdictions”, and to seek clarification or further investigation, or to request the Government to undertake follow up;
- article 4(1) of the Draft Act, which imposes a similar duty on “Representatives Institutions (sic), President as head of Government, Bank Indonesia and other Boards” to follow up BPK’s audit results on the management and accountability of state finances, as reported to the House under article 4(1); and
- article 6(2) of the Draft Act, which imposes a duty on the “Police and or Court” to follow up a report on a matter of criminality referred to it by BPK under article 6(1).

7.2 The SAI has its own internal system of follow-up to ensure that its observations and recommendations have been properly addressed.

Article 20(4) of the Audit Act requires BPK to monitor follow-up activity under the article.

A similar requirement exists for compensation claims under article 22 of the Audit Act (see para 3.1.3 above – article 23(2)).

7.3 The SAI submits follow-up reports to the Legislature or Governing Body at the auditee, as appropriate, for its consideration and for its action even when the SAI has its own statutory power for follow-up and sanctions

Presumably, the powers to report set out in the legislation could be exercised repeatedly or on a follow-up basis.

8 CORE PRINCIPLE 8 – FINANCIAL MANAGERIAL/ADMINISTRATIVE AUTONOMY AND THE AVAILABILITY OF APPROPRIATE HUMAN, MATERIAL AND MONETARY RESOURCES

8.1 The SAI has access to the necessary and reasonable human, material and monetary resources, which is not under the control or the direction of the Executive

See para 1.3 above. The practical arrangements would need separate investigation as part of your review.

Note that the 1973 Act provided for the appointment of a Secretary-General of BPK by the President, on the recommendation of BPK (section 16). This appears not to have been replicated in the Draft Act.

APPENDIX: 4**SUMMARY OF FINDINGS FROM REVIEW OF AUDITS CARRIED OUT AS PART OF THE 2003 AUDIT PLAN**

This appendix is based on discussions with members of the audit teams (up to Team Leader level) and review of certain limited documentation. The findings noted were then discussed with Auditama responsible for the assignment.

Auditama Keuangan Negara: 1

Entity/Audit Object: Indonesian State Police – Budget Realisation Report (BRR)

Type of Audit: Financial audit

Audit Coverage (per plan): 7,014,042 million Rupiah

Documents Reviewed: Audit programme and audit report (English translation provided)

Overview of work carried out**Nature and reasons for the assurance work undertaken:**

The objective was to gain assurance as to the accuracy of the compilation of the Indonesian State Police BRR and the department's compliance with central directives on the preparation of that financial report. This and other similar audits are done to provide a basis for an opinion on the overall government accounts.

Areas of audit emphasis

The requirements of the Directive of the Minister Of Finance Number 195/KMK.012/2001 dated 15 May 2001.

Extent of work

- σ Review systems and procedures established in respect of the preparation and compilation of the BRR.
- σ Substantively validate the arithmetic accuracy or otherwise of the compilation.

Summary of major findings

- σ Errors were identified in quoting total budget and in the aggregation of the Budget Authorisation Report.
- σ Authorisation and fund transfer processes were not completed in a timely manner.
- σ Inaccuracies were noted between the summary and accompanying explanatory notes.
- σ Non-tax revenues for one month were not transferred to the State Treasury in accordance with the directed due date.

Links to audit manual

- σ Planning reflected Audit Manual requirements.
- σ Standard planning documentation for such assignments was utilised but adapted to reflect the particular circumstances.

Observations on actual practice and expected practice:

Engagement scope

The scope of the assignment did not extend to gaining assurance as to whether or not the financial information included in the BRR was a fair reflection of the reported transactions in aggregate. No opinion was expressed as whether or not the BRR fairly reflected the transactions of the department.

The classification of the assignment as a “financial audit” is somewhat of a misnomer as it was not intended to provide assurance as to the fair presentation of the financial transactions of the department but merely to the aggregation of balances. It would be more appropriately referred to as a “compilation review”.

Planning and risk assessment observation

The planning documentation did not address risks or issues identified in prior compilation review assignments.

The planning of such assurance related assignments would normally address risks such as significant departures from regulations and compilation errors noted in the prior year’s compilation review.

Working papers

Variability was noted in work paper file format. Work paper file content was generally on an exception basis (adverse findings). Where review objectives were met in respect of specific compilation assurance procedures it was practice not to formally record work done and concluded to that effect.

The results of all assurance procedures need to be recorded to provide sufficient appropriate evidence as to the completion of the procedures and the conclusions drawn from the evidenced obtained. Without this, an independent reviewer cannot gain assurance from the file that all audit procedures have in fact been completed.

Review

Evidence of “one up” review of working paper was not recorded. (It is acknowledged that the Audit Manual only requires this on general financial audits, that is, those resulting in the issuing of an independent audit opinion on the financial statements presented.)

Normal professional requirements in respect of independent assurance related assignments require that the work of staff be subject to a one up review to provide comfort that the work has been completed as planned and provides sufficient appropriate evidence to support the conclusions reached.

Linkage to other audit work

There was no connection between the BRR compilation review assignment and other assignments carried out on the Indonesian State Police. There was no linkage made between the capital expenditure figures included in BRR and the asset management review. We understand that the asset management review comprised one-directional testing of assets (from physical asset to the asset register).

The integration of assurance procedures mitigates the risk of errors going undetected. Bi-directional testing (from physical assets to the fixed asset register and from the fixed asset register to the physical asset) provides greater assurances that assets acquired still exist and remain in the custody and control of the department.

Review of key systems

Significant financial systems used by the department to collect, record, analyse and report transactions, and the key controls within those systems, are only reviewed by BPK on a cyclical basis due to resource constraints.

While acknowledging that this was a compilation review and did not include auditing the underlying transactions, the noted cyclical approach to conducting an independent external review of the significant financial systems and key controls within them further limits the assurance on the integrity of the information reported. It also does not enable BPK offer recommendations for system improvements.

Auditama Keuangan Negara: 2

Entity/audit object: Ministry of Forestry – Licensing and financing of plantation forest development in Jakarta, Riau and South Sumatra

Type of audit: Performance audit

Audit coverage (per plan): 1,919,980 million Rupiah

Documents reviewed: Preliminary audit result, draft programme and audit report

Overview of work carried out

Reasons for the audit

The development programme for forestry had a high economic, social and ecological impact, the financial amounts and risks involved were high, and there were indications that the physical progress had not met expectations.

Areas of audit emphasis

The successfulness of licensing and arrangements for the distribution and repayment of replanting fund loans. A third area was identified in the draft plan we reviewed – the effectiveness of the implementation of the development programme – but this was not reflected in the audit programme.

Extent of work

Evaluation of licensing effectiveness, financial distributions, debt repayments and financial condition of the programme.

Summary of findings

The overall finding was that the performance was unfavourable.

Links to audit manual

Several approaches were taken that have not yet been approved for inclusion in a BPK manual or guidance material.

Observations on actual practice and expected practice

Scope of engagement

The preliminary audit result and programme clearly explained the reasons this audit had been selected. The draft programme we reviewed was amended to reduce the scope, felt necessary on the basis of limited resources and capability to complete the full scope originally planned and proposed.

We endorse the clear explanation for the selection of this project. We encourage BPK to consider additional capability building for this kind of project, using inhouse resources, contracting appropriate external contractors or a combination thereof.

Power to invest

The arrangements that were set up to implement forestry policy involved indirect investment by the Ministry of Forestry (“The Ministry”) in private companies, as the Ministry would have been prevented legally from investing directly. We saw no formal legal assessment as to the impact or appropriateness of the arrangements.

We question the legality and appropriateness of the Ministry establishing and controlling another entity to enter into arrangements that the Ministry is not legally empowered to do itself.

One of the issues reported as a finding of the project was that some funds were transferred from the Ministry to PT INTI, but that these were not used for the purpose they were intended and were retained within the company. We were told that there was no mechanism for these funds to be returned to the Ministry, and that, as the Ministry of State Owned Enterprises now oversees the company, this could complicate matters further. Again we saw no formal assessment of the legal issues around this transfer of funding.

We would recommend appropriate cross-disciplinary working on projects of this type, and in this case we felt that legal input would have been useful.

Workpapers

The project made use of some electronic workpapers, and the layout, documentation and referencing on the file appeared comprehensive. We did note however that this file differed from the format of some of the other files we reviewed, and were informed that Auditama 2 supplements BPK’s standards and guidelines in certain areas.

We recommend that consistent standards be applied across the whole of BPK, and that appropriate enforcement be maintained through the various review processes.

Audit methodology

We were told that this performance audit was one of the first such projects completed. As a result, a number of the approaches taken were new, and not reflected in the current procedures.

For example, we noted an approach taken to prioritising areas of work and using this as a basis of converting the findings to an overall assessment as an audit conclusion (in this case “unfavourable”).

We believe that the validity of this approach, and the reporting of linkages from the assessment to the detailed work that supports it could be challenged, and would encourage continued exploration (and documentation in policies and guidance) of appropriate methodologies in this area.

We have discussed this matter with the Research and Development unit and were concerned to hear that they had little substantive input into the new guidance that Auditama 2 requested help in preparing. We also understand that no formal benchmarking of the approaches taken across other audit jurisdictions was undertaken before preparation of the draft guidelines.

Reporting

The findings were reported to the Ministry of Forestry and not the Ministry of State Owned Enterprises. We encourage reporting to all relevant stakeholders for projects of this kind that have significance across different agencies.

BPK Internal audit review

The team informed us that BPK's Internal Audit reviewed this project, and only raised one issue – relating to missing documentation that the auditee could not provide. On the basis of the point raised, the audit finding relating to this was relegated from a major issue to a minor issue. The team were unclear what standards Internal Audit had followed in carrying out their review.

We have discussed the matter with Internal Audit, and they have confirmed there were no major findings, and that the review was limited in nature.

Auditama Keuangan Negara: 2

Entity/audit object: Regional Accounting Office of Medan

Type of audit: FIRA

Audit coverage (per plan): 20,451,561 million Rupiah

Documents reviewed: Audit programme and audit report (English translation provided)

Overview of work carried out by BPK:

Reasons for the audit

The objective was to gain assurance as to the accuracy of the compilation of the BRR and the department's compliance with central directives on the preparation of that financial report. This and other similar audits are done to provide a basis for an opinion on the overall government accounts.

Areas of audit emphasis

The work largely comprised checking the consolidation of numbers at regional level back to supporting papers and "source documentation", being numbers reported by lower level departments.

Extent of work

Extensive substantive checking was performed, on the basis that the controls could not be relied on.

Summary of findings

The audit findings were reported "internally only", that is to the auditee and to the team that summarises the overall findings for the government accounts.

Links to audit manual

Planning reflected Audit Manual requirements.

Observations on actual practice and expected practice

Engagement scope

We noted that this audit was described as "Financial Information Related Audit" in the annual plan, unlike the similar file we reviewed for the State Police that was described as financial audit.

In reality the project was similar to the State Police audit and was a confirmation of the compilation of numbers from lower levels of the organisation, with no attestation of those numbers or the underlying systems that generated them. The assessment of internal controls was accordingly limited to a consideration of how the compilation of numbers at regional

level had been conducted, and in fact it was concluded that these controls could not be relied on, so a fully substantive audit was carried out.

We were told that the audit was used as a basis, along with others, for the audit of and opinion on the overall government accounts, and that this opinion was ultimately disclaimed.

We spoke to the Research and Development unit, who confirmed that guidance notes for the audit of the overall government accounts are still in the process of being finalised.

We recommend that the different sorts of audit be clarified, then individual projects appropriately classified, with appropriate guidance material available to assist the teams.

Audit file structure

We noted that the file layout was again different from those we reviewed from other Auditamas, although it appeared in good order. We saw evidence of sign-off and review.

Auditama Keuangan Negara: 3

Entity/audit object: Audit of Management of the UNDP Partnership Grant for Government Reform In Government Institutions and NGOs in Jakarta.

Type of audit: Financial audit

Audit coverage (per plan): Rp43,338 million

Documents reviewed: Audit programme and audit reports of three audits (English translations provided).

Overview of work carried out

Ascertain the nature and reasons for the assurance work undertaken

The objective was to gain assurance as to the accuracy and bona fide nature of transactions associated with the above partnership funding and compliance with funding requirements and local regulations. The audit was requested by the Ministry of National Planning and Development.

Areas of audit emphasis

Transactions, supporting documentation, conditions of contract, local regulations.

Extent of work

Review systems and procedures established in respect of the preparation of Statements of Account.

Substantively validate the bona fide nature of transactions

Assess compliance with funding requirements as well as applicable relevant regulations.

Summary of major findings

- σ Governance and accountability arrangements unclear.
- σ Systems of control were inadequate.
- σ Inadequate documentation for expenditure.
- σ Indications of conflicts of interest – board members acting as advisors.
- σ Full-time state employees working in additional positions.
- σ Questions of lawful authority for the execution of contracts.
- σ False signatures.
- σ Suggestions of excessive payment for goods.

Observations on actual practice and expected practice

Engagement scope

We were told the request to audit was not detailed, and that therefore the usual process for planning was followed, and documented in the programme. We were also told that the programme was discussed with and had input from interested parties before being finalised, and endorse this approach.

The team explained to us that the governance was quite complex, given the number of different agencies involved combined with the structure, and that this contributed to difficulty in determining appropriate criteria for the audit to proceed. It also meant that agreeing the final report was difficult and took some time, although we believe a proactive approach was taken in this regard.

We endorse the active approach taken on this assignment, in gathering input and feedback from interested parties.

Reporting

We noted the overall conclusion on internal controls as being inadequate, and that this was backed up by a detailed list of findings. It was refreshing to see a robust report, and believe the findings and judgements behind were clearly explained in the report. We were told that this was the result of a decision that the report be drafted on a different basis to other reports, given the nature of the stakeholders. We endorse the straightforward and robust style of reporting used for this project.

Extension of testing

The substantive testing that was carried out was reasonably extensive, although we saw no formal consideration of the potential for other issues in those areas not tested, given the internal control conclusion and the other findings.

We would normally expect to see a formal consideration of the potential extrapolation of findings, although we were told that this possibility was raised verbally at the time the findings were presented.

We believe there were grounds for pursuing further certain of the matters raised. For example, one of the findings related to a potential breach of the public service code of conduct, either by individuals or by their employers or both. We do acknowledge however that the follow-up of the findings had not been completed.

Auditama Keuangan Negara: 5

Entity/audit object: PT Industri Telekomunikasis Indonesia (PT INTI) and associated entities.

Review of financial performance, financial position, management procedures and governance. Assess aspects of efficiency and effectiveness.

Type of audit: FIRA

Audit coverage (per plan): Review of prime source documentation, physical and procedural examinations, review of sales, financing and investing activities, and account balances.

Documents reviewed

Audit programme and audit report (English translation provided)

Overview of work carried out:

Reasons for the audit

BPK conducted the audit of the financial statements of PT INTI for the year ended 31 December 1998 and issued a qualified audit opinion due to the entity not providing for a doubtful debtor of Rp136,087 million.

Subsequent to 1998 the financial statement audit has been conducted by a firm of Chartered Accountants. Unqualified audit opinions were issued on the financial statements for the years ended 31 December 2000, 2001 and 2002.

As part of its oversight of the financial results and position of State Owned Entities audited by private sector Chartered Accounting firms, BPK noted a significant reversal in operating results of PT INTI for the year ended 31 December 2002. For that period a net loss before tax of Rp 63,982 million was recorded compared with a net profit of Rp65,185 million before tax for the prior period. In light of the above factors the BPK Board approved a FIRA review.

Areas of audit emphasis

The Statements of Financial Performance for the years ended 31 December 2000, 2001 and 2002 and the Statements of Financial Positions as at those dates.

Extent of work

Summary of major findings taken from planning and report findings.

- σ Sales for the year ended 31 December 2002 decreased by 70% compared to the prior period with only 42% of that budgeted for being achieved.
- σ Operating expenses for the period ended 31 December 2002 increased by 18% over the previous year and increases in other expenses (including foreign

- exchange transaction losses and previous year 'profit and loss corrections') were Rp21,129 million higher.
- σ A provision of Rp122,813 had been made in 2001 for 100% of the outstanding balance of the doubtful debtor which gave rise to the 1998 audit qualification.
 - σ Receivables of Rp140,156 million due after 2002 were the subject of rescheduling including one arrangement with a Creditors' Committee. (Result of economic crisis).
 - σ General and Administrative Expenses increased in the 2002 period by Rp17,499 in relation to unbudgeted staff bonus payments.
 - σ PT INTI had made a Rp20,000 million equity investment in 2001 which was questioned as to whether or not it had been based on adequate due diligence processes and was in the best interests of the Company. This was particularly in light of previous similar investments that had required provisions amounting to Rp33,418 million.
 - σ An amount of Rp240 million had been paid to joint venture partnership consortium in 1997 as the contribution of PT INTI to its establishment. This payment was purportedly made by the Directors on the instructions of the former State Economic Development Agency, BPIS However the partnership was never formed and PT INTI had not taken any active steps to recover the advance.
 - σ Sales contracts were deficient in that commission rates were not specified.
 - σ Sales commissions were misclassified as part of cost of goods sold.
 - σ An inter group insurance payment of Rp95 million was made for which no supporting insurance policy documentation was received.
 - σ Bank guarantees were not sought in respect of significant credit sales.
 - σ The Company had no formal policy in respect of Credit sales.
 - σ Cost of goods sold in 2001 and 2002 exceeded sales revenue by Rp3,784 million and Rp38,335 million respectively.
 - σ At 31 December 2002 in five business units high inventory levels existed. These contained damaged and technologically obsolete stock for which a write down of Rp88,443 million or 61% of value was made.
 - σ In aggregate 2001 and 2002 physical inventory deficiencies, relative to accounting records, of Rp1,774 million were recorded.
 - σ Certain travel expenses were not considered to represent value for money and others lacked appropriate supporting documentation.

Links to audit manual

Planning documentation made reference to the Government Accounting Standard (SAP) and the Audit Management Manual.

Observations on actual practice and expected practice

Engagement scope

The work conducted was thorough and reporting on individual specific matters was detailed.

The report met good practice in that it clearly and thoroughly addressed a significant number of major findings on an individual basis.

Reporting

In a number of instances the report prefaced major findings, which indicated serious issues in respect of management control and governance, with a statement that the internal control systems were ‘generally adequate’ or ‘has been effectively implemented’. It is considered that the introductory comments were inconsistent with the findings that followed and detracted from the report in that they could create confusion in the mind of a reader. The findings did not support the introductory assessment given. BPK, through its reporting, has the potential to be a catalyst in improving State Sector financial and operational management performance. Unless reporting is accurate and focused that potential will not be fully realised.

While it is acknowledged that cultural considerations often lead to negative commentary being preceded by a positive introduction, the practice detracts significantly from the findings being communicated. Reporting of an independent professional view requires that findings be presented in an objective and unambiguous manner.

Overall conclusion

The report comprehensively addressed a significant number of major findings. However, no overall conclusions were drawn from the evidence gathered and collective specific findings. These have implications for external financial reporting, management control and governance. To illustrate, did the extent, nature and quantum of the matters noted raise a question as to whether in fact earlier external financial statement did present a fair reflection of the results of operations and financial position.

Evidence obtained from the various procedures applied in such a review provide the basis for those undertaking the assignment to make overall summary conclusions. This is similar to individual audit procedures in an attest audit providing the basis for the overall opinion on a set of financial statements

Our expectation was that overall conclusions would have been drawn from the findings and presented to the readers of the report.

The report did not consider the impact of the findings on the “Company health indicator” that we were told is used by the Ministry of State Owned Enterprises to assess the health of companies in its portfolio. We understand that this indicator is based on audited financial statements.

Auditama Keuangan Negara: 4

Entity/audit object: Regional Government Budget Outturn – City of Medan. The 2002 Regional Government Revenue and Expenditure Outturn against budget (APBD), confirmation of the opening cash balance and verification of the closing cash balance. Assurance as to compliance with Regulatory requirements.

Type of audit: Financial Audit

Audit coverage (per plan):
Routine Payments Rp542 billion
Capital Payments Rp182 billion
Revenue Rp751 billion

Documents reviewed: Audit Plan, Audit Report, Audit Opinion (English translation provided)

Overview of work carried out

Ascertain the nature and reasons for the assurance work undertaken:

This was the first audit of the APBD of the City of Medan undertaken with the objective of expressing a formal opinion on that document.

Areas of audit emphasis

Substantive testing of opening and closing bank balances, reconciliation of the bank account, accuracy and completeness of the compilation of the APBD, accuracy of the compilation of receipts and payments, and that accounting had complied with regulations.

Extent of work

Testing was directed at ten of the thirty divisions and focused on the documentation held within the Treasury and Finance areas and the documentation underpinning the build up of the (consolidated) APBD.

Summary of findings

A qualified Audit Opinion ('except for opinion') was issued. The exceptions from the APBD providing a fair reflection were in respect of:

- σ Revenue Sharing from the Regional Government Company Account included an amount of Rp187 million not actually received.
- σ Non Tax Revenue Sharing Account adjusted byRp289m due to receipt not being recorded.
- σ Emergency Fund Account negatively adjusted by Rp2,994 million as the receipt from the National Disaster Contribution comes from the APBD Fund.

- σ Transport Sector budget negatively adjusted by Rp3,000 million due to misclassification.

Several other financial related matters of lesser significance relating to the incorrect or non recording of data, misclassification, breach of approval processes and funds not being applied strictly in accordance with the intention of their provision.

The Report also addressed:

- σ The absence of Regional Government Principles of Financial Management as required by the State Parliament
- σ Non compliance with Regulations promulgated in respect of the frequency and timeliness of the provision of accounting information
- σ The lack of staff in the finance area as well the need for training of existing staff
- σ Instances where appropriate supporting documentation was absent
- σ Expenditure that was unlawful in the that the application of funds were for purposes specifically prohibited.

Links to audit manual

The planning and audit were done in accordance with the Audit Manual and Audit Guidelines. This included the requirement to obtain a minimum 30% coverage.

Observations on actual practice and expected practice

Presentation of unaudited financial statements

There is currently no requirement for the financial statements of the City Of Medan to be audited when presented to the Regional Parliament. The unaudited financial statements presented to the Regional Parliament contained material errors, hence the reason for the Audit Opinion referring to the 'positive' and 'negative' adjustments made in the audited financial statements.

We would expect the accountability requirements placed upon the City of Medan would specify the presentation of audited financial statements.

Sample selection

The approach focused on the substantive testing of transactions underlying the aggregate consolidation data of ten of the thirty divisions within the City of Medan. The testing was on a sampling basis as addressed below.

Professional practice would normally dictate that testing (sampling) be across the entire population of transactions. The approach applied assumes that the ten divisions selected were representative of whole population. There was no evidence to support the validity of such an assumption.

Extent of sampling

Sampling was directed at high value transactions to obtain the minimum 30% coverage required in the Technical Guidance Manual. The 30% minimum coverage was based on a monetary attribute approach, which is for example, to cover 30% of receipts or payments. There was no scientific or statistical rationale to support the level of testing adopted or indication of the level of confidence to be achieved in conjunction with other audit procedures.

The auditor must select sample items in such a way that the sample can be expected to be representative of the population as a whole. Under accepted standards the methodology applied and audit testing undertaken is expected to produce a 95% level of confidence that the financial statements are materially correct.

Review of controls

The reviews of systems of control were restricted to those in the Finance Division established in respect of the recording and compilation of aggregate transactional returns.

In an attest audit on external accountability financial statements generally accepted auditing standards dictate that the key financial systems be reviewed to ascertain the degree to which those systems can be relied upon to provide assurance that transactions are real, authorised, complete, appropriately classified and disclosed. The evaluation of significant financial systems and key controls within them is fundamental to an efficient audit, particularly in large complex organisations.

Audit materiality

Materiality was determined in accordance with the Methodology and was based on 5% of expenditure. No rationale was provided to justify this figure. Given no review and testing of key financial systems and controls was conducted and substantive testing directed at only ten of thirty divisions, the adoption of a 5% materiality figure is considered an aggressive approach.

Audit resourcing

The staff resource allocated to the assignment was in accordance with the 'standard' of twenty five days for a City or thirty days for a Province. Professional practice would dictate that individual audit assignments be individually scoped and resources allocated to enable sufficient appropriate evidence to be obtained to support an opinion following account being taken of such factors as the client, its circumstances and other relevant environmental factors. Such an approach will be essential with the implementation and initial audits under full accrual accounting.

Move to accrual accounting

Formal Audit Opinions are not mandatory on Regional Government Accounts until 2006. The Regional Office of BPK in Medan was attempting to be proactive and to 'push the boundaries' and hence obtained approval for the approach adopted.

The initiative and positive approach is acknowledged, however, the implementation and auditing of full accrual accounts will present a multitude of challenges not encountered under the existing cash accounting system. To prepare for this we would expect 'pilot audits' to be conducted under a professionally robust methodology on full accrual accounts to better prepare and provide a more informed basis for scoping audit resource requirements.

Audit methodology

While the assignment was carried out in accordance with the current methodology and technical guidelines, the approach adopted and applied is considered to provide very limited confidence that other material errors did not go undetected.

The expression of an independent opinion on external accountability financial statements requires a scientifically defensible audit methodology. The current methodology and technical guidance is considered to neither meet the needs of BPK, Parliament, the clients audited nor generally accepted professional standards.

Entity preparedness for accrual accounting

The requirement and legally imposed timeframe in which BPK has to express opinions on the 2006 financial statements of the entities it audits presents a daunting, if not unachievable, challenge to the organisation, its audit clients and the staff of both. The position that many local government entities are yet to implement computer based accounting systems to handle the change to full accrual accounting and the apparent lack of suitably qualified and experienced financial management staff in auditee organisations will place greater demands on BPK and its staff resources.