



The Second Asian Roundtable on Corporate Governance

The Role of Disclosure in Strengthening Corporate Governance and Accountability

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Corporate Governance in Indonesia

**Hong Kong, China
31 May – 2 June 2000**

*(The views expressed in this paper are those of the author and do not necessarily
represent the opinions of the OECD or its Members countries, the ADB or the World
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CORPORATE GOVERNANCE IN INDONESIA

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Abstract

This paper, which is divided into five parts, describes the current status of corporate governance in Indonesia. The first part, The State of Corporate Governance in Indonesia, discusses the ownership structure in Indonesia, which is largely dominated by families or a few shareholders. It also discusses the two-board system in the country and the ineffectiveness of such a system in many of the boards. The rest of part I describes the role of audit committees in Indonesia, unfair practices found in business community, lack of transparency and disclosure and lack of risk management practices.

The second part is about efforts being conducted to introduce and implement corporate governance in Indonesia. Such efforts include, developing a national strategy for corporate governance reform, conducting educational events on corporate governance for the public, conducting pilot projects to implement corporate governance principles in the industries, carrying out regulatory reform within the capital market, establishing the Forum of Corporate Governance in Indonesia, and managing technical assistance from the international community.

Part three of the paper deals with Indonesian accounting standards, in particular the history of accounting standards in Indonesia, the standards setting process, the initiatives to harmonize with the international standards, and challenges encountered in implementing the standards.

Part four addresses the auditing standards and the audit profession in Indonesia. It starts with the historical background of the standards and proceeds to the harmonization process, the challenges found in implementing the standards, and the mechanism that exists within the profession to ensure that auditors reach a certain level of competence and fulfill their professional responsibility.

Part five discusses disclosure practices in Indonesia. It elaborates the legal foundation of disclosures in Indonesia, and some disclosure items such as capital structures, ownership of the companies, voting rights, information on the boards, related party transactions, risks, mergers and acquisitions and environment reporting

*The authors wish to thank Mr. Hadori Yunus, Ph.D., Mr. Djoko Susanto, Ph.D, Mr. Ahmadi Hadibroto, Ms. Ety Retno Wulandari and Mr. Djohan Pinnarwan for reviewing and providing inputs for this paper. Thanks are also due to research assistants: Ms. Melanie, Ms. Maria and Mr. Arief Basuki. Dudi M. Kurniawan is the Executive Director of IAI (the Indonesian Institute of Accountants) and Nur Indriantoro, Ph.D. is IAI's Chair of the Accounting Standards Board. The views presented on this paper, unless otherwise mentioned are those of the authors and do not necessarily reflect those of IAI nor its Accounting Standards Board

The State of Corporate Governance in Indonesia

Ownership structure

An issue in corporate governance is ownership structure or control of companies. A study by La Porta et al on publicly listed companies has shown that, among others, family control is more common in countries with poor shareholder protection while the widely held company is more common in countries with good shareholder protection¹

In Indonesian publicly listed companies, it is not uncommon to find control by families or by limited number of shareholders. One study showed that 67.3% of publicly listed companies was family held while only 6.6% was widely held². Another study by the Asian Development Bank found out that in Indonesia, on average the top five largest shareholders control from 57 to over 65% of the company shares³. This concentration in ownership and control creates risks in corporate governance.

Through majority ownership in state-owned enterprises, the government is also a major player in the Indonesian economy. While some of the bigger and better managed state-owned enterprises have successfully gone public⁴, many others are still struggling with poor performance characterized by low profitability, unfocused operation, red tape intricacies, lack of customer and market orientation, low productivity and low asset utilization⁵

Roles of the Board of Directors and Board of Commissioners

Another issue in corporate governance relates to the structure and effectiveness of the boards of directors. In contrast with companies under the common law system in which

¹ La Porta, Lopez-de Silvanéz, Shleifer and Vishny, "Law and Finance" (1998) *Journal of Political Economy*, as quoted by Ramsay and Stapledon "Corporate Governance: An Overview of the Key Issues and Debates" ASIC Corporate Governance Training Program, Sydney March 20, 2000

² Claessens, Djankov and Lang, "Who Controls East Asian Corporations?" *World Bank Working Paper* (1999), as quoted by Ramsay and Stapledon "Corporate Governance: An Overview of the Key Issues and Debates" ASIC Corporate Governance Training Program, Sydney March 20, 2000

³ FCGI, "*The First Position Paper of the Forum for Corporate Governance in Indonesia*", April 2000

⁴ such as PT Timah (a tin producer, PT Indosat (a satellite telecommunication company) and PT Aneka Tambang (a mining company)

⁵ Mochtar, Syahriél, "Who Wants to Buy Cash Cows?" *Info Bank*, September 1999

there is only one board (that is the Board of Directors) , companies incorporated under the Indonesian Company Law has two boards (thus called the two-board system):

- the Board of Commissioners (Komisaris) that performs the supervisory and advisory roles, and
- the Board of Directors (including management) that performs the executive role.

Thus, someone who is called a "director" in an Indonesian setting is actually part of the executive team, whereas in other jurisdictions they might be part of the supervisory/advisory team or part of the executive team.

Under the Indonesian Company Law, the duties of the Board of Directors is:

- to manage the company in the interest of the company, consistent with the objectives of the company, and
- to represent the Company both in and outside the courts of law⁶

While the duties of the Board of Commissioners is

- to supervise the performance of the Board of Directors and policies made by the board, and
- to provide advice to the Board of Directors ⁷

There have been critics about the effectiveness of the Board of Directors as well as of the Board of Commissioners. In practice it is often found that the duties of the two Boards are not clear and blurred. Moreover, in many Indonesian companies typically controlled by families or few individuals, there is often little separation between ownership and management. This may result in management acting in the best interest of a few major shareholders rather than in the best interest of the company.

On the other hand, especially in bankruptcy cases, there may be too little protection for members of the Board of Directors. Under the Indonesian Company Law, board members

⁶ Article 1(4) and Article 82 of the Indonesian Company Law

⁷ Article 1(5) and Article 97 of the Indonesian Company Law

can be held jointly and severally liable for losses caused by the board's fault or negligence, and the burden of proof to dismiss allegation of fault or negligence lies on the board members⁸. Considering the risks inherent in any decision making process, this may prove to be too onerous for the board members. There should be a rule, such as the business judgment rule in Australia, that releases the members of the Board from such liability as long as they have satisfied criteria such as: making the decision in good faith, having no material personal interest in the subject of the decision, well informed about subject of the decision, and having a rational belief that the decision was made in the best interest of the corporation⁹.

The Boards of Commissioners have also often been regarded as ineffective. This might be attributed to the fact that many board members lack the required competence and fail to maintain independence (thus, in many cases, also fail to protect the interests of stakeholders other than those of the major shareholders). In a lot of instances the members of the boards of commissioners are appointed due to their close relationship (including family ties) with the major shareholders, due to their ownership of a large number of shares or due to their previous high position in the bureaucracy. The issue of independence also arises when the remuneration of Board of Commissioners is determined by the Board of Directors.

It is also worthy to note that within the companies it is not common to find an audit committee, a remuneration committee, an appointment committee nor similar organizational units that support good corporate governance.

Audit Committee

At present enterprises in Indonesia are not required to set up an audit committee. The banking industry, did for a certain period (1995-1999) have a regulation that stated that every bank should have an audit committee. Unfortunately the regulation, which was

⁸ Article 90 (2) and article 90 (3) of the Indonesian Company Law

⁹ Armson, Emma and Sandra Patch, "Current Government Initiatives in Corporate Governance" a paper presented in ASIC Corporate Governance Training Program, Sydney March 20, 2000

issued by Bank Indonesia (the Central Bank) as one of the regulators in the banking sector, was revoked. In its place, Bank Indonesia has subsequently issued another regulation that requires banks to have a Compliance Director whose responsibility is to define and take measures to ensure that the banks meet prevailing rules and regulations.

The revoked regulation was in many respects reflect ideal characteristics such as:

- The audit committee is an independent body responsible to the Board of Commissioners.
- It should consist of at least three persons, one of whom is a party independent from the management, with no ownership interest and no conflicting interest.
- The audit committee's main responsibilities include: approving internal audit charter, serving as liaison between the management and the external as well as the internal auditors, ensuring that external and internal auditors are capable of performing their duties effectively and ensuring the bank's compliance with existing rules and regulations¹⁰.

Some people criticize the replacement of audit committee regulation with the Compliance Director requirement. In their view it was a setback in several respects:

- Compliance Director is responsible to the President Director, rather than to the Board of Commissioners as the Audit Committee did. It has been widely understood that independence could be better maintained when the reporting is done to the Board of Commissioners.
- The scope of responsibility of the Compliance Director is more limited than that of the Audit Committee. The Compliance Director mostly deals with compliance issues, whereas the audit committee not only deals with compliance but also with internal audit issues, external audit issues, and organizational and performance effectiveness.

In short, the compliance director was not a proper substitute to an audit committee.

¹⁰ Gunadi, Eddie.M. and Toto J Alamsjah, "Compliance Director Replacing Audit Committee", *Media Akuntansi*, December 1999 – January 2000, pp. 51-53

Recently, under the Corporate Governance Framework proposed by the National Committee for Corporate Governance, it was recommended that the Board of Commissioners of an enterprise establish an Audit Committee whose duties include:

- Promoting corporate discipline and a controlled environment to prevent fraud and abuse
- Improving the quality of financial disclosure and reporting
- Reviewing the scope, accuracy and cost effectiveness of the external audit and the independence and objectivity of the of the external auditors
- Reviewing internal control systems and day to day performance of the company's internal auditors¹¹.

Fair business practices

The economic crisis that started in 1997 revealed the business environment which was not conducive. For example, there were abundant practices of asset markup. No wonder a lot of companies experiencing troubled debt had difficulties selling their assets since their assets' fair values were much lower than their book values.

Internal acquisitions was another issue. It is not uncommon to find a company acquiring shares of another company at an exorbitant price, way above the fair value of the shares. What was often (deliberately) not disclosed was, that the acquirer is related to the acquiree (sometimes indirectly through a grandfather or great-great grandfather type of relationship, or transactions among entities within common control) thus making it possible for the acquisition to happen at an unfair price.

Transparency and disclosures

Transparency and disclosures were poor. A 1999 survey by Pricewaterhouse Coopers, in which the respondents were institutional investors in Singapore, showed that among a dozen countries in the Asia-Australia region, Indonesia ranked very low in the perceived

¹¹ National Committee on Corporate Governance, *Framework Code of Good Corporate Governance* (1999)

standard of disclosure and transparency ¹²(As a matter of fact, according to the survey, Indonesia also ranks very low in other areas such as accountability to shareholders, board processes and auditing and compliance) ¹³

In one example, a major bank did not disclose to the public that it was in a very troubled financial situation and that the probability of surviving the dire situation was very remote. Instead of disclosing the situation, the bank put an advertisement in the newspaper expressing its optimism that it could survive the threat of liquidation. A short while later the government froze the bank's operation on the ground that the bank was no longer fit to operate. ¹⁴

Risk management practices

Poor risk management practices were a factor significant in contributing to and worsening the economic crisis in Indonesia. In the banking industry, for example, loans were channelled with little consideration for credit worthiness, and later proved to be uncollectible. Many loans were secured with assets that turned out to be worth much less than their originally assessed amounts. Many others were not secured at all. From the debtors' side, loans in foreign currencies were not hedged, so when the exchange rate of rupiah to the dollar plunged, the debtors found their debt in foreign currencies, when translated into rupiahs, skyrocketed to more than 300%.

Creditor protection

Under an outdated law that dated back to 1905¹⁵, there is little protection for creditors and other stakeholders since in practice it was very difficult to declare a company bankrupt. This situation was later improved when the old Bankruptcy Law was replaced with a

¹² determined by a range of factors: disclosure of information in a timely manner, avoidance of selective disclosure during meeting with major investors, broad market disclosure to transnational investors, disclosure levels are above home country requirements, etc.

¹³ Pricewaterhouse Coopers (in collaboration with the Singapore Exchange), *1999 Survey of Institutional Investors*

¹⁴ Djawahir, Kusnan M., "Investors Calls on the Liquidated Public Banks" *Swa Magazine*, pp. 66-67, May 5, 1999

¹⁵ Staatsblad No. 217 of 1905 juncto Staatsblad no. 348 of 1906

government regulation in 1998¹⁶ that makes it more reasonable for the court of law to declare a company bankrupt .

Efforts to develop Corporate Governance

Initiatives to develop Corporate Governance practices in Indonesia includes:

- Developing a national strategy for corporate governance reform, including setting up the National Committee for Corporate Governance
- Conducting educational events on corporate governance for the public
- Conducting pilot projects to implement corporate governance principles in the industries
- Carrying out regulatory reform within the capital market
- Establishing the Forum of Corporate Governance in Indonesia that provide inputs for NCCG's efforts
- Instituting a fit and proper test for directors and commissioners
- Technical assistance from the international community

Developing a national strategy for corporate governance reform

The strategy is guided by, among others, the commitment made by the Indonesian government to the International Monetary Funds as the country's major lender as outlined in a Letter of Intent signed in January 2000. The initiatives includes setting up the NCCG (National Committee for Corporate Governance).

Established by the Decree of the Coordinating Minister of Economics, Finance and Industry on August 1999, the NCCG's main responsibility is to recommend a national framework for the implementation of good corporate governance, that includes:

- Codifying corporate governance principles, that resulted in a draft Code for Good Corporate Governance
- Initiating regulatory reform to support the implementation of the code
- Developing institutional framework to implement the code¹⁷

¹⁶ Government Regulation That Substitutes A Law No. 1 of 1998 on Changes to the Bankruptcy Law

The draft on Code for Corporate Governance was submitted to the government in October 1999 is currently under review. The draft elaborates the following items¹⁸:

- Responsibility of shareholders and the General Meeting Of Shareholders
- Function, structure, responsibility, activities, appointment and remuneration of Commissioners and Directors
- Internal and external audits, information access and confidentiality aspects
- Function, qualification, responsibility and role of Compliance Officers
- Stakeholders' rights and participation in monitoring corporate management
- Disclosure of information about corporate actions and on the implementation of good corporate governance
- Information confidentiality and prevention of improper use of information

In general, the principles outlined in NCCG's Code for Corporate Governance are consistent with OECD's Corporate Governance Principles.

It has also been suggested that to support implementation of the proposed Code, a reform in the regulatory environment is required. In that respect initiatives proposed by the NCCG includes¹⁹:

- Amending Company Law to accommodate corporate governance principles
- Amending Company Registration Law to ensure transparency of corporate information.
- Improving accounting standards, including regulations on the formation of Audit Committees and Compliance Officers
- Improving regulations on disclosure
- Improving Capital Market Rules , including support of a new Financial Supervisory Agency, which is part of the new Central Bank Law
- Improving Articles of Association

¹⁷ Anwar, Jusuf (the Chairman of NCCG) "Corporate Governance: a Prerequisite to Indonesia's Economic Revival" (2000) a paper presented on Panel Discussion on Corporate Governance, Jakarta, March 2000

¹⁸ ibid

- Improving banking sector regulations
- Forming an Institute of Directors to train and certify Directors

To develop institutional framework for implementing the code there has been efforts:

- The Code of Good Corporate Governance has been submitted to the government as a private sector initiative to be used as a reference to regulate various corporate sectors, supporting professions and the training of managers
- The Code will be implemented very much like an industry standard (e.g. ISO 9000). In addition, regulators will adopt parts of the code for sectoral regulation.
- Independent rating institutions will rate individual company's compliance as part of public control mechanism²⁰

Conducting educational events on corporate governance for the public

The concept of corporate governance is fairly new in Indonesia. To introduce the concept to the public there has been several educational events such as :

- A conference titled "The Importance of Corporate Governance", jointly conducted by the World Bank, the Jakarta Initiative, the Capital Market Society of Indonesia and the Jakarta Stock Exchange in April 1999
- A panel discussion on Corporate Governance jointly conducted by Ernst and Young, IAI-KAM (the Indonesian Institute of Accountant's Management Accountants Compartment²¹) and IFEA (the Indonesian Financial Executives Association)
- Recognizing the relevance of corporate governance in strengthening business infrastructure in Indonesia, IAI has planned to adopt corporate governance as the underlying theme for its national convention in September 2000, with expected attendance of more than 1200 accountants

¹⁹ ibid

²⁰ ibid

²¹ IAI currently is spearheaded by a National Council that coordinates various committees and four compartments (respectively for public accountants, management accountants, public sector accountants and academicians).

Conducting pilot projects to implement corporate governance principles in the industries

There are major publicly listed companies that have implemented corporate governance principles in Indonesia, such as:

- PT Astra, one of the biggest conglomerates in Indonesia
- PT Indosat, a major telecommunication company
- PT Timah, one of the largest tin producers in the world

PT Timah even went one step further, that was to have its corporate governance practices assessed by an international accounting firm. The key governance issues assessed were: definition of roles and powers, code of conduct, board and management appointments, board skills and resources, board independence, business/community consultation, strategy-setting, risk management and procurement control²².

Initiatives within the Capital Market

To improve corporate governance regime within the capital market, Bapepam (The Capital Market Supervisory Agency) as the regulatory agency has issued various rules and regulations, including²³

- A regulation requiring public companies to have Independent Directors and Independent Commissioners
- Regulations that relate with method of voting shares²⁴
- Comprehensive rules on responsibilities for Board of Directors and Independent Auditors with regard to financial reporting and penalties for non-compliance
- Regulations on disclosure of related-party transactions

²² Hardjapamekas, Erry Riyana (President Director of PT Timah), "Corporate Level Initiatives and Implementation of Good Corporate Governance" (2000) a paper presented on Panel Discussion on Corporate Governance, Jakarta, March 2000

²³ outlined in the Letter of Intent as a commitment to the International Monetary Funds, January 2000

²⁴ such as: Preemptive Rights, Capital Increases When There Is No Preemptive Rights, Conflict of Interests on Certain Transactions, Material Transactions and Change in Major Line of Businesses, Merger and Consolidations, Planning and Conducting the General Meeting of Shareholders, Basic Principles in Articles of Association, Report on the Use of Funds Obtained from a Public Offering, Repurchase of Shares

Overall, Bapepam has issued 136 rules to complement the Capital Market Law, 2 Government Regulations and 4 Ministerial Decrees that dealt with the capital market. A Bapepam study in 1999 that compared OECD's corporate governance principles with the regulatory framework in Indonesia resulted in the conclusion that many major areas in the regulatory framework has covered corporate governance principles²⁵

To improve public reporting infrastructure Bapepam is developing an internet-based reporting system that will enable the public to access Bapepam rules and regulations and the financial statements of publicly listed companies online.

Instituting a fit and proper test

Learning from the lessons in the banking industry in which banks collapsed due to poor management and dominance of owners, the government has established a mechanism to ensure that the team that governs and manages certain institutions, such as banks and state-owned enterprises, consists of competent people with good character. Under the mechanism, a person nominated as a director, a commissioner (and owner, in case of a bank) has to undergo a series of investigation on his or her character, technical and leadership capabilities to prove that s/he is fit and proper to undertake his or her responsibilities as a director or commissioner (or owner, in case of a bank). In one instance in the banking industry, of the 700 directors, commissioners and owners of "A" class banks taking the test, 38 (or around 5%) failed. Directors and commissioners that failed the test were asked to resign while bank owners failing the test must reduce or sell their shares to parties unrelated to them²⁶.

Technical assistance from the international community

An example of technical assistance from the international community is the Acorn project (in which Bapepam has been appointed as the Indonesian counterpart), a program

²⁵ Herwidayatmo (Chairman of Bapepam), "Corporate Governance: Rules and Regulations in the Indonesian Capital Markets" (2000) a paper presented on Panel Discussion on Corporate Governance, Jakarta, March 2000

²⁶ Bank Indonesia, *Press Release: The Results of Fit and Proper Test for Banks Under "A" Category*, August 1999

organized by the Australian Securities and Investment Commission to develop good governance within the Australasia region. There are projects in the planning as well, including by the World Bank, by the Asian Development Bank and by the Indonesian Netherlands Association.

Accounting Standard Setting and Implementation of the Standards

History of accounting standards in Indonesia

The history of accounting standards in Indonesia can be divided into three phases, from 1973 to 1984, from 1984 to 1994 and from 1994 to date. In 1973, a tentative committee was formed to gather and codify generally accepted accounting principles that would provide a reporting infrastructure to support the stock market, which was being activated by the government as part of the strategy to increase the flow of funds into Indonesia.. The committee relied heavily on the work of Paul Grady of the American Institute of Certified Public Accountants in the U.S²⁷. A year later, in 1974, the Indonesian Institute of Accountants established a committee called the Accounting Principles Committee to set accounting standards. The standards, which was then called the Indonesian Accounting Principles, did not have any major changes for the next ten years, that was until 1984. In a way, it was understandable since the number of companies listed in the stock markets was less than 25.

In 1984 the Accounting Standards Committee in Indonesia conducted a major revision of the standards codified in the Indonesian Accounting Principles. Within the next few years, the Committee promulgated additional statements of accounting standards and released interpretation of the statements.

Almost a decade later, from 1992 to 1994, for the second time the Accounting Standards Committee conducted a major revision on the standards that resulted in 35 PSAKs (Statements of Financial Accounting standards) which were mostly harmonized with the

²⁷ Grady, Paul, "Inventory of Generally Accepted Accounting Principles for Business Enterprises," *Accounting Research Study No. 7*, American Institute of Public Accountants, (1965)

International Accounting Standards issued by the International Accounting Standards Committee.

In line with the rapid growth in the number of companies listed in the stock markets, which increased to more than 200 by the early 1990's, the need for a set of comprehensive and high quality standards had also increased. It became evident that the investors, creditors and other constituents of the standards needed more transparent information. The Accounting Standards Committee responded to these needs by developing additional standards and revising some older ones, supported with funding from the World Bank loan. The due process procedures were improved, requiring the standards to be exposed to the constituents for comments and public hearing sessions to be conducted before they were approved.

By the time the economic crisis hit Indonesia in August 1997, the accounting profession in Indonesia had had 38 PSAKs (Statements of Financial Accounting Standards) in effect. At that time around 17 other new standards were still in the process of being developed, some of them were receiving comments by the constituents whilst awaiting approval from the committee; some others were still in the early deliberation of the due-process procedures. By the end of 1998, the standards in effect increased to 55 statements.

The standards themselves regulated almost all transactions and events that affected companies in Indonesia. Some of the standards even regulated transactions or events that have not been addressed by the International Accounting Standard Committee. Examples of such standards are: standard for real estate²⁸, standard for land²⁹, standard for mutual funds³⁰, standard for joint operating activities other than joint ventures³¹, and standard for cooperatives³².

²⁸ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 44: Accounting for Activities in Real Estate Companies

²⁹ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 47: Accounting for Land

³⁰ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 49: Accounting for Mutual Funds

Harmonization with international accounting standards

In 1994, IAI (the Indonesian Institute of Accountants) declared its commitment to harmonize its accounting standards with the international accounting standards, in particular those issued by the IASC (International Accounting Standards Committee). As a first step, and to make sure that the standards promulgated by IAI are consistent with those promulgated by the IASC, IAI adopted IASC's "Framework for the Preparation and Presentation of Financial Statements".

The accounting standards were mostly adopted from the International Accounting Standards with necessary adjustments to accommodate the unique legal, social and political environment existing in Indonesia. For topics on which the IASC has not issued a statement on, IAI refers to, among others, standards from the United States, such as the Statements of Financial Accounting Standards, Accounting Principles Board Statements, and Accounting Research Bulletins. Some other standards are developed by IAI in cooperation with industry associations and regulators in Indonesia.

Implementation of the standards

While there are few studies, if any, concerning the implementation of the standards in Indonesia, there is an indication that the real challenge is not in producing the standards, but in making them known to the public and implementing them in business practices. The main efforts to ensure the standards are publicly known are through IAI's Continuing Professional Education Program, in which a significant part is allocated to deal with new accounting standards, and through articles published in IAI's professional journal, the *Media Akuntansi*. Accordingly, there is no reason for practicing accountants for lacking knowledge in the newly promulgated standards.

³¹ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 12: Accounting for Interests in Jointly Controlled Assets and Operations

³² Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 27: Accounting for Cooperatives (1997 Revision)

Nonetheless, some practicing accountants, especially in small firms, complained that the accounting standards are too difficult to implement in the companies they audited. Among those standards are standard for derivative instruments and hedging activities³³ and standard for stock-based compensation³⁴. Some others considered that there is already a standards overload situation in Indonesia, pointing out that some standards rule transactions very few companies encounter. Such standards include standard for tollroads³⁵ and standard for revenues in telecommunication services³⁶.

From time to time, accounting standard-setting and the Accounting Standards Committee in Indonesia face various challenges. For instance, when the crisis hit Indonesia, some companies listed in the stock market that had large amounts of their debts in foreign currencies (thus suffering from heavy losses when translating those debts into the severely depreciated rupiahs) lobbied for less stringent standard for reporting the debts. They proposed that debts in foreign currencies be accounted for using either the historical exchange rate that resulted in no exchange rate loss, or using the prevalent exchange rate and capitalizing the loss as an asset, i.e. deferred charges, that will be charged off as expense in the future. Considering that either case would hide important information on the performance of the companies, the Accounting Standards Committee declined the proposal and was firm in their view that the companies should account for the debts using the current exchange rate prevailing on the balance sheet date. However, an Interpretation issued by the Committee³⁷ did allow foreign exchange losses on debts to be included in the carrying amount of a related asset when they meet several conditions³⁸, and as long as the adjusted carrying amount does not exceed the lower between the recoverable amount and the replacement cost of the asset in question. On the other hand,

³³ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 55: Accounting for Derivative Instruments and Hedging Activities

³⁴ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 53: Accounting for Stock-Based Compensation

³⁵ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 37: Accounting for Tollroads

³⁶ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 35: Accounting for Revenues from Telecommunication Services

³⁷ Indonesian Institute of Accountants, ISAK (Interpretation of Financial Accounting Standards) No. 4: Interpretation of Paragraph 32 of the PSAK No. 10 regarding Allowed Alternative Treatment for Foreign Exchange Differences

³⁸ that a severe devaluation has occurred and hedging is impractical

Bapepam (the Capital Market Supervisory Agency) provided an option for the companies to fully capitalize the foreign exchange loss as a valuation account of the related debt³⁹. The Accounting Standard Committee was of the opinion that instead of allowing public companies to report the foreign currency transactions as mandated by Bapepam, it would be better if Bapepam revised some of the rules and regulations especially related to the delisting criteria for companies affected by the economic crisis.

Improvements in due process procedures

In 1998 the accounting profession strengthened the standard setting process by changing the structure of the Accounting Standard Committee. The committee was transformed into the Accounting Standard Board with more authority and was for the first time supported by a number of full time staff. The due process procedures were improved by requiring more steps in the deliberations and more stringent criteria in accepting the issues to be addressed and in putting them into the agenda of the Board. The period to comment on the exposure drafts of the accounting standards was extended to allow sufficient time for the public to understand the concept and to submit their inputs. The new standards-setting process also resulted in the establishment of a new council, the Financial Accounting Standards Advisory Council, whose duty is to advise the Accounting Standards Board on issues to be developed as accounting standards (and existing standards that should be revised) and to raise funds for standard-setting. The advisory council represents wider constituencies that includes regulators, public accounting firms, business entities, and state-owned enterprises.

Public Sector Accounting Standards

At present, Indonesia has not established a separate set of accounting standards for public sector. Reporting standards used in public sector are mostly based on a very old, outdated Treasury Law that dated back to the 19th century⁴⁰ and PSAKs (Statements of Financial Accounting Standards) promulgated by IAI, some of which may not be suitable for public sector reporting. To improve transparency and public accountability

³⁹ Bapepam Rule No. VIII.G.10, Accounting for Transactions in Foreign Currencies

⁴⁰ Indische Comptabiliteit Wet, an 1864 law enacted by the Dutch Government when Indonesia was its colony

the government is proposing a set of legislation on State Treasury, State Financial Management and Audit of State Financial Management. In addition, the government is also planning to promulgate a separate set of accounting standards for public sector. The responsibility for standard-setting will likely be assigned to the National Accounting Office, a unit within the Ministry of Finance.

IAI as the professional body is planning to set up a new unit within its Public Sector Accounting Compartment to provide inputs to the upcoming public sector accounting standards. IAI is also anticipating the possibility that, in the future, the government will delegate the authority to promulgate public sector accounting standards to IAI as the professional body.

Current efforts by the Board

While there are certainly minor discrepancies and inconsistencies among the Indonesian accounting standards, they might still be considered complete and of high quality. The Accounting Standards Board is continuing its efforts to align some standards that are considered inconsistent, fill the gap for transactions or events not addressed by current standards and revise standards which are considered not up to date. At present the board is revising accounting standards that in several reports, including one by UNCTAD, are mentioned as not going far enough to support disclosure and transparency, such as the standards on segment reporting⁴¹, and banking⁴². In keeping up with the recent development in the international accounting standards, the Board is also updating or developing new accounting standards, such as on provision and contingencies, discontinuing operations and intangibles. Working together with other units within the Indonesian Institute of Accountants, the Board keeps its commitment to help educate financial communities through involvement in continuing professional education and other activities.

⁴¹ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 5: Reporting Financial Information by Segments

⁴² Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 31: Accounting for Banking

Auditing standards and the auditing profession

Auditing standards in Indonesia is part of a set of professional standards for public accountants⁴³ that consists of auditing standards, attestation standards, accounting and review standards, consulting services standards, quality control standards and code of professional conduct.

Harmonization of auditing standards

Since 1994, IAI (the Indonesian Institute of Accountants) has committed to harmonize its professional standards with international-level standards. Currently, in promulgating auditing standards IAI mostly adopts the Statements on Auditing Standards issued by the AICPA (American Institute of Certified Public Accountants). The decision to adopt the SASs is made on consideration of the quality of the standards and the fact that the AICPA set of standards covers virtually all important areas of professional practice. In some areas in which the AICPA has not issued a pronouncement on, IAI refers to the International Standards on Auditing promulgated by the International Accounting Practices Committee of the International Federation of Accountants

Due-process procedures in standards-setting

The auditing standards are promulgated by the Public Accountants Professional Standards Council through a due process procedure. Consisting of practitioners from large as well as small accounting firms, the council is positioned under Public Accountants Compartment, a compartment within the Indonesian Institute of Accountants. The due process procedure starts with research on issues to be developed into professional standards. Then an early draft is written and is discussed within the Council. The draft is subsequently improved and discussed again. The process is repeated until the Council is satisfied with the quality of the draft. Subsequently, the draft is released as an exposure draft, awaiting comments from the practitioners and other constituents. Afterwards, the Council studies inputs for the draft, and accommodates them as necessary. Finally, the draft is approved and released as a statement.

⁴³ Indonesian Institute of Accountants, Professional Standards for Public Accountants (1999)

The challenges in auditing standards

In general, the accounting profession in Indonesia is satisfied with its professional standards. However, like in the accounting standards area, the challenges in auditing standards lie less on the quality or the quantity of the standards than on educating the profession and implementing the standards. In education, in spite of the mandatory Continuing Professional Education program a public accountant undertakes, there are indications that there are members of the profession that have not fulfilled their professional responsibility to study and master new pronouncements in a timely manner. On the other hand, IAI as the professional body should take more proactive measures (for example by improving its Continuing Professional Education Program and developing new learning tools) to facilitate practitioners so that they can learn the standards easier, faster, and more effectively.

It is also considered a challenge to promote the standards within the academic community. It is not unusual to find colleges and universities not updating their curriculum with the development in Indonesian professional standards. As a matter of fact, some of the lecturers and students might be more familiar with the United States standards than the Indonesian standards, since the auditing textbooks used are mostly from the US.

Implementation of the standards is also another area often highlighted in the profession. There is an indication that many practitioners find it more difficult, or more challenging, to implement certain standards, in particular auditing standards arising from the need to close the so-called "expectation gap".

The economic crisis that started in Indonesia in 1997 resulted in many businesses collapsing and revealing previously undetected frauds in many companies. Consequently, auditors began to feel the heat. Public started blaming the auditors as one the major parties responsible for not being able to prevent the crisis. They expected the auditors to have been more cautious and vigilante; giving the public adequate warning about possible markup of assets, frauds, and going concern issues. From the auditors' perspective, they

often feel it was hard to deal with the pressure from management's inclination to windowdress their company's performance. Auditors also feel they have little control in cases of asset markups since their judgement on the values of assets largely depends on the work of other professionals, such as the appraisers.

Disciplinary procedures

It has been said that independence and code of ethical conduct constitute the crown of the auditing profession. Independence is defined within the auditing standards as part of the general standards and is further elaborated in the code of ethical conducts.

There is a mechanism within IAI that exists to ensure that the professional standards are applied as appropriate, independence is maintained and the code of ethical conduct is observed. Within IAI's Public Accountants Compartment there is a judiciary council called BP2AP (Judiciary Council for Public Accountants) whose duty is to review complaints made by the public regarding the application of professional standards and the code of ethical conduct by the public accountants. When a complaint is filed, the Council undertakes a due-process procedure to investigate whether a public accountant has breached the professional standards or the code of ethical conduct. Like in many other countries, this is a very complicated and lengthy process that could take up to more than one year (even though the suggested timeframe is three months at most). The Council gathers evidence, conducts hearings with the party filing the complaint and the public accountant alleged of violating the standards, determines which rule has been breached and determines appropriate sanctions.

In the past, the Judiciary Council has issued punitive decisions for public accountants for misconduct ranging from insufficient communication with other auditor (s), insufficient working paper to support an audit opinion, failure to maintain independence and objectivity, soliciting and inappropriate advertising, to failure to observe ethical code of conduct.

At the appeal level, to complement the Judiciary Council within the Public Accountants Compartment, there is the Council of Honor. The council, which is set at as a unit of IAI's National Council, consists of senior officers from the government, and various industries, as well as from the public accountants community. It handles cases that need further deliberations after being processed at the Judiciary Council level. Also within IAI's National Council, there is a unit called Professional Ethics and Disciplinary Committee that coordinates efforts to ensure compliance to professional standards and code of ethical conduct by members of all compartments within IAI.

Outside IAI, institutions responsible for overseeing the accounting profession includes government agencies: BPKP (the Supervisory Body for Finance and Development) and DJLK (the Ministry of Finance's Directorate General of Financial Institutions). BPKP is responsible for conducting limited peer review of the accounting firms, while DJLK oversees that the accounting firms fulfill their license and administrative requirements.

Infrastructure to ensure competence of professionals

To ensure that the members of the profession reach a certain level of competence and that competence is maintained, IAI sets up programs such as the USAP (Public Accountants Certification Exam) and the CPE (Continuing Professional Education) Program. For an accountant to be able to open his or her own public practice, s/he is required to pass the Public Accountants Certification Exam. The two-day rigorous program encompasses five subjects⁴⁴ and has a stringent pass rate of around 30%. Once a public accountant obtains his or her license to practice, s/he is required to continuously update his or her knowledge through a CPE program that involves a minimum of 30 hours per annum and 120 hours per triennium.

Future priority: Quality Assurance System

In view of IAI becoming a self regulating profession, it is high time to consider moving away from oversight by government agencies towards creating infrastructure within the

⁴⁴ The five subjects are: Accounting Theory and Practices, Auditing and Professional Services, Accounting and Information Systems, Taxation and Business Laws, Management Accounting and Financial Management

profession to ensure that the accounting firms fulfill their professional responsibilities. In this regard, the priority is to set up a quality assurance system. While IAI has planned to set up such a system, it's going to take maybe another year or two before the system is up and running.

Disclosure

Legal foundation of disclosures in Indonesia

Regulations that govern disclosures in reporting submitted by an Indonesian enterprise include:

- Law No. 3 of 1982 regarding Company Registration
- Government Regulation No. 64 of 1999 regarding Annual Financial Statements of a Company
- Bapepam rules (for publicly listed companies)
- Presentation and Disclosures of Financial Statements: A Guideline for Publicly Listed Companies⁴⁵

The Company Registration Law

The Company Registration Law aims to create a listing of companies in Indonesia and to make information on those companies accessible to the public; thus supporting transparency within the business community. Under the Law, information that should be reported to the Ministry of Trade and Industry consists of, among others:

- the name and trademark of the company
- the date of incorporation
- the company's products and main line(s) of business
- personal details of the members of the Board of Directors and Board of Commissioners, and
- the amount of capital authorized, issued and paid in⁴⁶

⁴⁵ The Jakarta Stock Exchange, the Indonesian Institute of Accountants and the Association of Issuers, *Presentation and Disclosures of Financial Statements: A Guideline*, (2000)

⁴⁶ Article 11 of Law No. 3 of 1982 regarding Company Registration

Unfortunately there are some weaknesses embedded in the Company Registration Law and its implementation. Among others things, there is a lack of monitoring and measures taken to ensure that the companies report the required information in an appropriate and timely manner. The NCCG (National Committee for Corporate Governance) has identified key issues for reform, including: changing the law to ensure that information is more available to the public, strengthening the law to ensure reliable and timely data collection, overhauling current system for lodging, storing and retrieving information⁴⁷. The NCCG has also recommend short-term measures to improve the Company Registration Law and its implementation, including: codifying new Company Registration Law, emphasizing the need to avoid duplications in authority and responsibilities, promulgating implementation regulations for new Company Registration Law and conducting educational events on the revised Company Registration Law.⁴⁸

Government Regulation No. 64 of 1999

Government Regulation No. 64 of 1999 regarding Annual Financial Statements of a Company is widely considered a major step in promoting transparency and accountability in Indonesia. It adds value to various stakeholders in several ways. First, it expands the base of companies that are required to make their reports available to the public. In the past only listed companies are required to submit an audited financial statement. Under the new regulation, companies required to file audited financial statements include those:

- Incorporated under Law No. 1 of 1995 regarding Company Law
- That accumulate funds from the public
- That issue a debt instrument
- That have a total assets or net assets in excess of 25 billion rupiahs

Under the regulation , information to be reported includes a set of audited financial statements (that consists of a balance sheet, an income statement, a cash flow statement,

⁴⁷ The National Committee on Corporate Governance, *Draft Matrix of Corporate Governance Framework and Areas for Reform*

⁴⁸ *ibid*

a statement of changes in equity, and notes to the financial statement that include a list of the company's liabilities and a list of capital participation) and a company profile.

Second, the Government Regulation No. 64 of 1999 regarding Annual Financial Statements of a Company also changes the way information is disseminated to the public. It has now become easier for the public to access the information through several mediums, including through the internet and by obtaining hard copies at local Company Registry Offices.

Bapepam rules

Bapepam rules dealing with governance and non-financial disclosures include:

- Preemptive Rights (Bapepam Rule IX.D.1)
- Conflicts of Interest on Certain Transactions (Bapepam Rule IX.E.1)
- Material Transactions and Changes in Major Line(s) of Business (Bapepam Rule IX.E.2)
- Mergers and Consolidations of Public Companies and Issuers (Bapepam Rule IX.G.1)
- Planning and Conducting the General Meeting of Shareholders (Bapepam Rule IX.I.1)
- The Main Articles of Association of Companies Offering Their Equities to the Public and of Publicly Listed Companies (Bapepam Rule IX.J.1)
- Disclosure of Information the Must Immediately be Made Public (Bapepam Rule X.K.1)
- Report on the Use of Funds Received from Public Offering (Bapepam Rule X.K.4)

Presentation and Disclosures of Financial Statements: A Guideline for Publicly Listed Companies

Another effort to improve quality of disclosure is being conducted by the Jakarta Stock Exchange, in collaboration with IAI (the Indonesian Institute of Accountants) and AEI (the Association of Issuers). With support by Bapepam, the three institutions are developing presentation and disclosures guidelines for public companies in 22 industries.

The guidelines are based on, among others, Bapepam rules, industry regulations, and generally accepted accounting principles.

Some disclosure items related to corporate governance

Capital Structures, Major Ownership of the Companies and Voting Rights

Under the Company Registration Law, an enterprise should disclose the amount of capital authorized, issued and paid in, while Bapepam rule IX.J.1 stipulates that for a publicly listed company the shares issued should be paid in full⁴⁹.

Publicly listed companies are also required to disclose significant ownership in the company. Bapepam Rule No. VIII.G.7, for example, determines that the names of shareholders that own 5% or more of the company's shares and the names of directors and commissioners that own shares in that company should be disclosed⁵⁰. Thus it should be relatively easy to find out about the capital structure and major ownership in a publicly listed company.

Voting rights are regulated by each company as set out in their Articles of Association

Information on the Boards

The Company Registration Law requires information on the full names of the members of the board of directors and the board of commissioners (including their aliases, and previous names, if any), identity card number, current address, date and place of birth and nationality⁵¹. PSAK No 1 also requires disclosure of the names of the board of commissioners and the board of directors⁵².

For publicly listed companies, the Jakarta Stock Exchange has issued recommendation to disclose the following items:

⁴⁹ Bapepam, Rule No. IX.J.1, The Main Articles of Association of Companies Offering Their Equities to the Public and of Publicly Listed Companies

⁵⁰ Bapepam, Rule No. VIII.G.7, Guidance for Presentation of Financial Statements

⁵¹ Article 11 of Law No. 3 of 1982 regarding Company Registration

⁵² Ikatan Akuntan Indoensia, PSAK (Statement of Financial Accounting Standards) 1 Presentation of Financial Statements (1998 Revision) paragraph 74

- The names of the board members
- The remuneration package for board members and list of elements that make up the total remuneration package⁵³

In the future, items that could be considered to be disclosed may include:

- Qualifications and experience of the members of the boards
- Which stakeholders a member of the board is representing, if any
- Whether a member of the board also serves as a member of the board in other companies

Related party transactions

Under PSAK No. 7⁵⁴, a company should report transactions with its related parties. According to the standard, "parties are considered to be related if one party has ability to control the other party or exercise significant influence over the other party in making financial and operating decisions". Examples of related parties are: the holding companies, subsidiaries, fellow subsidiaries, and key management personnel. In a related party transaction, information that should be disclosed includes: the nature of the relationship between the company and the related party, the types of transactions, and other relevant items such as volume of transactions, outstanding items, and pricing policies. The disclosure about related party transactions is also supported by Bapepam rules, and Stock Exchange rules.

While the regulation infrastructure exists to ensure disclosure of related party and related party transactions, it is unfortunate that in many companies the rules have not been properly observed. Monitoring of related party transactions is often difficult since a lot of companies have complex ownership structures that involve cross ownership of shares

⁵³ Jakarta Stock Exchange, the Indonesian Institute of Accountants and the Association of Issuers, *Presentation and Disclosures of Financial Statements: A Guideline*, (2000)

⁵⁴ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 7 *Disclosures of Related Parties*

with other companies within their own groups. Moreover, many of those companies are reluctant to disclose their relations with each other.

In several examples, again in the banking industry, certain banks have been known to channel their loans to companies within their own groups. The amount channelled to affiliated parties can reach up to 90% of the bank's outstanding loan and this is not transparently disclosed to the public⁵⁵

Risks

There is very limited requirement on disclosure of risk in Indonesia. While Bapepam rule provides a recommendation to disclose risk (among others that a company may disclose risks arising from competition, supply of raw materials, international regulatory environment, and government policies)⁵⁶ they are not considered mandatory. It is very seldom to find disclosure of risks in financial statements of Indonesian companies.

Mergers and acquisitions:

Under a Bapepam rule, when a merger or an acquisition is considered as an event that may affect the price of securities or decision of an investor, information about the merger or the acquisition should be reported within two working days after the event occurs⁵⁷

Under the Company Law, a plan for merger should be disclosed through a formal document that elaborates, among others:

- The names of companies involved in the merger
- Reasons to merge and explanations by the boards of directors of companies involved in the merger
- Method of converting shares of companies involved in the merger into shares of the new company resulting from the merger

⁵⁵ Djawahir, Kusnan M., "Investors Calls on the Liquidated Public Banks" *Swa Magaines*, pp. 66-67, May 5, 1999

⁵⁶ Bapepam Rule VIII.G.2 Annual Report

⁵⁷ Bapepam Rule X.K.1 Disclosure of Information that must be made Public Immediately

- Proposal to amend the existing Articles of Association or draft of Articles of Incorporation
- Balance sheet and income statement for the last three years of each company involved in the merger
- Other information relevant to the shareholders⁵⁸

The law also requires that, before it is put into effect, the plan for merger be approved by the General Meeting of the Shareholders of the companies involved in the merger⁵⁹

In similar fashion, in an acquisition, there should be a plan for acquisition detailing the name(s) of the acquiring party and the name(s) of the acquired company (or companies), and the reasons and explanations for the acquisition⁶⁰

Environment reporting

Currently there is no specific requirement on environment reporting. The closest thing can be found in the PSAKs. PSAK No. 8 Contingencies and Events After the Balance Sheet Date requires accruing or disclosing future events that has a probability of taking place and resulting in a loss for the company⁶¹. Such a situation can be found, for example, when the company is being sued for polluting the environment.

Conclusion

The economic crisis that hit Indonesia since August of 1997 has taught hard lessons. Many believe that poor governance is a factor significant in contributing to the rise of the crisis. Efforts are being done to introduce corporate governance in Indonesia; at this early stage, education and socialization of the corporate governance concept become critical. Indonesia still has a long way to go; while it has already some regulation

⁵⁸ Article 100 (2) of the Company Law

⁵⁹ Article 100(3) of the Company Law

⁶⁰ Article 101 of the Company Law

⁶¹ Indonesian Institute of Accountants, PSAK (Statement of Financial Accounting Standards) No. 8 Contingencies and Events After the Balance Sheet Date

infrastructure in place, the bigger challenge is to ensure they are effectively implemented. Efforts should be directed not only at developing rules and regulation supporting corporate governance, but also to promote corporate governance as practices guided by moral responsibility that will eventually be paid off by the market

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