

PROGRAM FIDUCIARY SYSTEMS ASSESSMENT

1. The Electricity Grid Strengthening—Sumatra Program will contribute to the power development plans for Sumatra of the State Electricity Corporation (PLN) as identified in the Electricity Power Supply Business Plan (RUPTL), 2015–2024. The strengthening of the region’s existing transmission and, more importantly, distribution networks supports plans to strengthen Sumatra’s transmission backbone and unite the various priority segments in the eastern part of the island. The strengthening of Sumatra’s power grid is also necessary given the ongoing interconnection between Sumatra and Java. A stronger transmission system with robust distribution networks will increase reliability of connections with industrial, commercial, and residential customers.

2. The program will be implemented with Asian Development Bank (ADB) financing using ADB’s results-based lending (RBL) modality and PLN’s financial management, procurement, and anticorruption systems. The fiduciary systems assessment was conducted in accordance with ADB’s policy and guidance on piloting RBL, and is intended to determine the degree to which the systems—for financial management, procurement management, and anticorruption measures—will be able to manage fiduciary risks and provide assurance that RBL program funds will be used for the intended purposes, with due consideration for economy and efficiency.¹

A. Information Sources

3. The assessment was undertaken from February to September 2015 and included a review of PLN’s financial management and procurement systems, and anticorruption mechanisms. The primary focus is on PLN as the executing agency for the program. The assessment is based on existing diagnostics, document reviews, and interviews with counterparts and development partner representatives.

4. The assessment was conducted with reference to relevant ADB guidance on financial management and, as required by ADB’s RBL staff guidance, it focuses on accountability and transparency, and covers critical financial management aspects, including funds flow, accounting, internal controls, financial reporting, and independent audit.² The procurement system assessment is based on ADB’s 2015 PLN procurement assessment report, focusing on the performance, practices, and status of procurement systems.³ The procurement assessment also benefited from the availability of counterpart staff at PLN overseeing procurement and a desk review of their procurement data and statistics. The anticorruption assessment relating to the implementation of good corporate governance is a follow-up to the 2002 decree of the minister of SOEs, subsequently amended in 2011 to provide the regulation on the implementation of good corporate governance in state-owned enterprises (SOEs).

B. Financial Management System

5. The program will use PLN’s existing financial management system and procedures, which ADB considers adequate and will allow PLN to implement the program effectively. PLN

¹ ADB. 2013. *Piloting Results-Based Lending for Programs*. Manila; ADB. 2013. *Staff Guidance for Piloting Results-Based Lending for Programs*. Manila.

² ADB. 2005. *Guidelines for the Financial Management and Analysis of Projects*. Manila; ADB. 2009. *Financial Due Diligence: A Methodology Note*. Manila; ADB. 2013. *Staff Guidance for Piloting Results-Based Lending for Programs*. Manila.

³ ADB. 2015. *Indonesia Country Procurement Assessment Report 2015*. Manila.

has significant experience in implementing projects and programs financed by development partners, including ADB, other international organizations, and commercial banks. Related procedures have generally been well implemented, and PLN has satisfactorily employed the funds flow and disbursement arrangements for ADB-funded programs.

6. Indonesia has a relatively well-functioning public financial management (PFM) system, as evidenced by the 2012 assessment of public expenditure and financial accountability.⁴ It showed that performance had improved in many areas—including comprehensiveness and transparency, predictability and control in budget execution, and external scrutiny and audit—but also that some specific areas continued to be very weak. These include the extent of unreported government operations, transparency of intergovernmental fiscal relations, multiyear budgeting, implementation of internal controls for payroll and nonsalary expenditure, the internal audit function, quality and timeliness of in-year budget reports, and the legislature's scrutiny of external audit reports. The government has been carrying out PFM reforms with development partner support for several years.

7. Indonesia's SOEs are not part of the PFM system, as they are governed by boards and follow private sector legislation and regulations. However, PLN and other large SOEs are fully government-owned, which implies financial accountability and a relationship vis-à-vis the government budget, as significant subsidies are allocated via the budget and Parliament approves a subsidiary loan agreement as a separate budget line. SOEs are required to submit quarterly financial statements to the Ministry of State-Owned Enterprises and to produce audited financial statements as part of their annual report. They must undertake regular financial assessments. SOEs generally comply with reporting requirements and the Ministry of Finance encourages compliance by following up on their preparation of fiscal risk statements.

8. **Fund flow arrangements.** ADB will, based on a government guarantee, sign a loan agreement directly with PLN. PLN will prepare withdrawal applications for submission to ADB, and disbursements will accordingly be made directly to PLN. PLN will merge the ADB loan funds with other resources; it will not be required to identify transactions or payments related to any specific funding source. The management of funds will be based on PLN's ordinary system for budget preparation, funds release, execution, and accountability. Given PLN's financial management systems, this arrangement is adequate and acceptable to ADB.

9. **Planning and budgeting.** PLN has clearly defined budgeting procedures. PLN's head office determines the annual budget based on proposals submitted by the units, which also formulate multiyear investment programs. The shareholders approve PLN's annual work plan and budget at the general meeting of shareholders represented by the Ministry of State-Owned Enterprises. Parliament approves PLN's investment program, funded through the subsidiary loan agreement as a separate budget line in the government's annual budget (APBN). Amendments to the budget composition may occur if the government introduces a revised budget (APBN-P), the dollar–rupiah exchange rate or the Indonesian crude price for oil fluctuates, or external policy developments affect the macroeconomic assumptions underlying the work plan and budget. Budget amendments are made once a year and require approval. PLN's planning and budget function is deemed acceptable.

⁴ Government of Indonesia and Development Partners. 2012. *Indonesia: Repeat Public Expenditure and Financial Accountability Report and Performance Indicators*. Jakarta.

10. **Accounting and internal control.** PLN applies the Indonesian Financial Accounting Standards (PSAK), which are gradually being converged with the International Financial Reporting Standards and the Interpretation of Financial Accounting Standards (ISAK). Indonesia is working to minimize significant differences between the standards, including their interpretation. According to the external auditor, PLN had, as of the end of 2013, adopted all new and revised financial accounting standards and interpretations relevant to its operations and effective for accounting. PLN regularly updates its manuals to reflect the PSAK; it has internal rules and regulations on financial management and accounting.

11. PLN's accounting system is computerized and incorporated in a SAP-based enterprise resource planning (ERP) system. As 7 of 10 PLN subsidiaries are not yet using the ERP, PLN's consolidated financial statements are still being generated using a spreadsheet. However, checks and balance are in place to mitigate the risk of human error in the manual consolidation. Present controls include that a supervisor must clear all adjustments to entries and that all adjustments are logged. In addition, PLN's external auditors perform the consolidation function independently and, thus, are able to identify any errors in consolidation during the annual audit. PLN is working to transition to full computerization in the near term.

12. Accounting and finance staff are trained to apply the ERP system and understand it well. The system has safeguards in place to maintain the confidentiality and integrity of the accounting and financial data, including segregation of duties, level of authorization in line with duties and functions, and dedicated user password to restrict unauthorized access. PLN has an effective cash management system, and the Finance Department is authorized to investigate reconciliation deviations, if detected.

13. The SOEs are required to establish a system of internal control and supervision. PLN has pursued the development of an internal control system based on the approach developed by the Committee of Sponsoring Organizations of the Treadway Commission. Duties are appropriately segregated within the accounting and finance functions. The processing of invoices is generally appropriate, and earlier issues with slow payment processes have been resolved. PLN has a document retention policy based on the accounting regulations.

14. The majority of PLN's units and divisions use a new asset management system, which contains detailed records of fixed assets that are reconciled with the control account. A physical inventory check is conducted annually and checked by the external auditor. However, no guidelines and procedures are in place to ensure that assets are recorded immediately after acquisition. The external auditor has frequently noted delays in recognizing and recording the transfer of fixed assets from construction-in-progress accounts.

15. **Financial reporting.** The ERP system is used for financial reporting and generally functions well, but among other challenges, the system cannot automatically compare budgets and actual expenditures at year-end, and does not produce lender-specific reports (which are instead prepared manually). PLN does not ordinarily prepare separate financial reports for each funding source, but it does prepare separate reports on program transactions to development partners on a quarterly basis using interim financial reports. PLN's reports do not include physical targets. In 2014, PLN started implementing the pilot project, Internal Control over Financial Reporting, which indicates potential spending-related risks.

16. **Internal audit.** PLN's internal audit is governed by a charter and carried out by its Internal Supervisory Unit, which is responsible directly to PLN's president director, and works closely with the Audit Committee of the Board of Commissioners. The Internal Supervisory Unit

has offices in all 13 PLN regions with 184 personnel (although an external quality assurance review recommended a total of 220 auditors). Most auditors are qualified internal auditors. Internal audits utilize risk-based annual work program monitoring, which generally includes development partner-supported programs and projects. PLN's management usually takes prompt follow-up action on internal audit issues. PLN's internal audit function is deemed acceptable.

17. **External audit.** PLN's financial statements are subject to external audit by a private firm, which is rotated as part of PLN's audit policy. External audits are based on the national audit standards issued by the Indonesian Institute of Public Accountants. The external audit is to obtain reasonable assurance about the quality of the financial statement and determine if it matches with the books of accounts. No significant accountability issues have been identified in recent audit reports, and the audit opinions for 2012, 2013, and 2014 have been unqualified. Also, no audit reports are outstanding under existing ADB operations. The State Audit Agency audits only PLN's subsidy calculations.

18. **Human resource capacity.** PLN's Finance Department has five main divisions; this appears to be an appropriate structure. The functional lines of responsibility are suitable, and the divisions are adequately staffed. The accounting and finance staff are generally well-qualified with most officers, particularly senior staff members, holding relevant degrees and having extensive experience in business accounting, program accounting, and financial management. Some accounting and finance staff have participated in training and have experience with ADB loan disbursement procedures. PLN has formulated a human resource strategic plan and road map, which is being implemented up to 2016.

19. **Program financial reporting and external audit arrangements.** A private firm will audit PLN's annual consolidated financial statements to international standards. Audit opinions will be issued in accordance with the International Standards on Auditing.⁵ The external auditor will prepare a separate program disclosure to certify actual program expenditure,⁶ and procurement eligibility computation.⁷ PLN will submit the annual audited financial statements and the program disclosure to ADB within 1 month of approval by the relevant authority. PLN publishes its consolidated financial statements and the independent auditor's report in its annual report. Financial management risks and mitigation measures are outlined in Table 1.

Table 1: Financial Management Risks

Risk Type	Risk Description	Risk Rating^a	Mitigation Measures
Inherent Risk^b			
Country-specific	Overall weak country financial management system, especially for budget execution, accounting and reporting, and budget credibility	M	Continuation of PFM reforms in line with the GFMRAP, the RPJMN, and other line ministry and agency plans, and supported where relevant by the PFM MDTFA new PEFA-based PFM performance assessment in 2016 will take stock of the PFM reform progress and develop a new reform action plan on that basis

⁵ ADB and PLN will agree on detailed financial reporting and external audit requirements for the program at loan negotiations; they will be documented in the program implementation document.

⁶ The amount of program expenditure for the previous year(s), current year, and cumulative.

⁷ Net procurement from ADB member countries is at least equal to the value of ADB disbursements.

Risk Type	Risk Description	Risk Rating^a	Mitigation Measures
Agency-specific	Some of PLN's procedures for accounting and financial reporting have weaknesses, including the lack of computerization across all entities	L	Design and implement a financial management action plan to address identified weaknesses and risks
Overall Inherent Risk		L-M	
Control Risk^c			
Accounting and internal control	To prepare consolidated financial statements, PLN staff use manual methods to consolidate spreadsheets	M	PLN is working to transition to ERP in the near term. Present controls include that adjustment to entries require clearance from a supervisor and that all adjustments are logged
Financial reporting	The ERP system cannot automatically produce budget tables and compare these with actual expenditures at year-end	L	ICOFR is being implemented as a pilot project and will provide a quarterly report per organizational unit, including mitigating actions where relevant
	To prepare consolidated financial statements, PLN staff use manual methods to consolidate spreadsheets	M	PLN is working to transition to ERP in the near term. Present controls include that adjustment to entries require clearance from a supervisor and that all adjustments are logged
Overall Control Risk		M	
Overall Risk		M	

ERP = enterprise resource planning, GFM RAP = Government Financial Management and Revenue Administration Project, ICOFR = internal control over financial reporting, MDTF = multidonor trust fund, PEFA = public expenditure and financial accountability, PFM = public financial management, PLN = *Perusahaan Listrik Negara* (State Electricity Corporation).

^a Risk ratings: N = negligible, L = low, M = moderate, S = substantial, H = high.

^b Inherent risk is the susceptibility of the program financial management system to factors arising from the environment in which it operates, such as country rules and regulations, and the agency's working environment (assuming the absence of any counterchecks or internal controls).

^c Control risk is the risk that the program's accounting and internal control framework is inadequate to ensure that funds are used economically and efficiently and for the purposes intended, and that the use of funds is properly reported.

Source: Asian Development Bank.

20. **Financial management action plan.** Actions are recommended to address identified financial management challenges and related fiduciary risks (Table 2). ADB and PLN will discuss and agree on a financial management action plan prior to loan negotiations. The final agreed plan will be applied as a rolling plan, and be regularly reviewed for progress and updated when required. This will include addressing any identified new issues.

21. **Conclusion.** The financial management assessment indicates moderate fiduciary risk. While some financial management weaknesses and shortcomings have been identified for PLN, these are, as such, relatively minor and can be effectively addressed through the proposed mitigation measures and actions. Based on these being fully and properly implemented, the financial management arrangements are considered adequate.

Table 2: Financial Management Action Plan

Risk Description	Risk	Action Item	Period	Responsibility
Accounting and internal control: Manual consolidation using spreadsheets is applied to prepare PLN's consolidated financial statements, which implies the risk of human error	Moderate	All entities to transition to computerization (ERP)	2017	Information System Division
Financial reporting: Consolidated financial statements are not system-generated, but prepared through spreadsheets	Moderate			
Financial reporting: the ERP system cannot automatically produce budget tables and compare these with actual expenditures at year-end	Low	Develop ERP system to produce budget tables with comparisons to actual year-end expenditures	2016	Information System Division

ERP = enterprise resource planning, PLN = Perusahaan Listrik Negara (State Electricity Corporation).
Source: Asian Development Bank.

C. Procurement System

22. The in-depth procurement assessment of PLN was guided by the RBL guidelines (footnote 1, Supplementary Appendix 5), which presents indicative questions for assessing RBL program fiduciary systems to ensure that an adequate procurement system exists to support a principle-based program. These guidelines had to be adapted to special circumstances since this RBL is the first in Indonesia and the first in the power subsector by any of the multilateral development banks. This is also the first time that an SOE will be the executing agency for an RBL. The assessment utilized the Indonesia draft Country Procurement and Sector Report, information obtained from PLN staff using the questionnaires provided in the ADB RBL staff guidance document, and a desk study on PLN's procurement system including a review of procurement data provided by PLN.

23. Procurement for the program will include equipment for transmission and distribution networks, civil works, and installation services. PLN will use a variety of procurement methods, including open competitive bidding, framework contracts, and direct contracting through open book. The procurement of large transformers is excluded from the RBL program, as the contracts will exceed the \$30 million limit for goods contracts.

24. The assessment finds that the procurement framework, as expressed in PLN's BOD General Guidelines for Procurement, is appropriate and follows best practices used by utility companies around the world. The framework provides the overall principles for procurement, a procurement strategy, and detailed procedures. The overall objective of the procurement strategy is to increase value for money for the organization, which is identified as the correct balance of the six rights: quality, quantity, location, time, socioeconomic impact, and price. The right price is only considered once the other five rights are complied with. The socioeconomic goals of the procurement process may include social, environmental, or other strategic objectives; and can include building national capacity to supply PLN by utilizing domestic products, suppliers, and contractors. A key matter for PLN in implementing the procurement strategy is to conduct extensive market research and to identify appropriate sourcing strategies depending on the supply market, the overall expenditure for different spending categories, and the importance of those goods and services to PLN operations. As an analytical framework,

PLN uses the Kraljic Portfolio Purchasing Model to categorize spending and classifies its procurements in strategic, bottleneck, leverage, and routine categories to develop the appropriate sourcing strategy. PLN has implemented several framework contracts for equipment to improve efficiency, secure supply, and achieve better value for money through fostering economies of scale.⁸ Open competitive bidding is the default procurement method for works and engineering, procurement, and construction contracts. To ensure quality of supply and of contractors, PLN has a list of pre-approved vendors that meet PLN-set financial and technical requirements.

25. ADB must consider two key issues for implementing an RBL using PLN's procurement system—local content requirements and direct contracting through open book, which are integral parts of PLN's procurement system. ADB should accept these conditions when deciding to use the RBL modality because the RBL policy clearly states that implementation relies on country systems not ADB's Procurement Guidelines.

- (i) **Local content requirements.** The requirement for local content for equipment means that only suppliers with manufacturing facilities in Indonesia are eligible to bid for and receive contracts. Several multinational firms do have manufacturing facilities in Indonesia and PLN is actively encouraging foreign firms to either open facilities or expand the line of equipment they manufacture in Indonesia.⁹
- (ii) **Direct contracting through open book.** For direct contracting, only suppliers that are preselected by PLN are eligible to supply goods and services. Although competition is sacrificed, open book contracting brings other benefits, such as security of supply and, according to PLN, value for money. Under the program, only 6.0%–6.5% of the procurement spending for distribution equipment is anticipated to go through the open book system.

26. While PLN's overall procurement framework is appropriate, PLN will face several risks in managing procurement under the program. ADB's procurement assessment identified the following procurement risks:

- (i) **Procurement and market capacity.** As investment in distribution and transmission will be significantly increased during implementation, it may strain capacity both internally in PLN and in the supply markets. While ADB is processing the RBL, other partners are likely to support the distribution and transmission program. PLN is investing heavily to meet the ambitious goals of the power subsector development program.
- (ii) **Institutional capacity.** Careful monitoring is needed of the absorptive capacity of PLN and, perhaps more importantly, the capacity of the private sector to deliver. The increase in investment in both transmission and distribution may result in (a) lack of qualified contractors to carry out installation and works contracts, and (b) supply risk for equipment categories especially where only limited suppliers are available. PLN should actively use a procurement monitoring and spending profiling system to identify capacity issues (whether internally or externally), and to develop mitigating measures and action plans should capacity issues arise.

⁸ Developed by Peter Kraljic: P. Kraljic. 1983. Purchasing Must Become Supply Chain Management. *Harvard Business Review*. Vol. 61. No. 5.

⁹ This includes e.g., ABB, Siemens, Alstrom, Schneider, and Crompton Greave, which all have contracts with PLN.

- (iii) **Fraud and corruption.** All large-scale procurement must include suitable safeguards against fraud and corruption. PLN has taken several important initiatives to curb corruption within the organization, and significantly strengthened internal controls. To strengthen PLN's oversight and detection mechanism, the program action plan includes a procurement monitoring framework outlining a spending profile for the program. Every quarter, PLN will report on the procurement monitoring framework indicators to the BOD, value for money committee, and ADB. It will also provide the updated spending profile.

27. The key to managing procurement risk in this and subsequent RBLs with PLN is to have all procurement monitored at the corporate level. PLN's procurement guidelines require that PLN introduce a procurement monitoring system, including an expenditure analysis of procurement. A procurement monitoring framework is available as a Supplementary Linked Document.¹⁰ By implementing this for the program, both PLN and ADB can adequately manage procurement risks and take corrective action if necessary (Table 3).

Table 3: Risk Profile and Mitigation Measures

Risk Description	Risk Assessment	Mitigation Measures
Market capacity and supply risk issues may cause price fluctuations	Substantial	The procurement monitoring and spending profile should be used actively to identify lack of competition or above normal contract prices due to market failure
Procurement delay	Moderate	Upgrade the e-procurement function and improve the capacity of the project management office and the procuring entities. The proposed procurement monitoring framework will provide early warnings if procurement under the program experiences systemic delays
Institutional capacity	Moderate	Accelerate PLN's ongoing programs and initiatives to improve institutional capacity and professional development for key staff. PLN has eight corporate strategic initiatives to this end
Fraud and corruption	Substantial	Upgrade the capacity of the internal auditor. The procurement monitoring framework, combined with spending profiles of the program, will be used to detect warnings and suspicious patterns in contract awards

PLN = Perusahaan Listrik Negara (State Electricity Corporation).

Source: Asian Development Bank.

D. Anticorruption System

28. Since the program is part of PLN's overarching generation expansion program, it will be implemented in accordance with the legal framework and through institutions designed to protect PLN from corruption risks, while aiming to become a continuously growing and competitive SOE. PLN has developed a structure and system of good corporate governance (GCG) by adhering to its principles in accordance with the rules and the regulations, as well as best practice. In 2011, the minister of SOEs amended the 2002 decree to provide the regulation, Implementation of Good Corporate Governance in SOEs. The regulation states "SOE shall carry out its operations by adhering to GCG principles of transparency, accountability, responsibility, independence, and fairness."

¹⁰ Procurement Monitoring Framework (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

29. PLN has included GCG in its daily operations to achieve its goal of becoming a company that continues to grow and improve with quality services and working processes, and a strong code of conduct. The objectives of GCG include

- (i) control and direct the relationship between the company structures, employees, customers, business partners, and the community and environment to ensure that the interests of all parties are fulfilled;
- (ii) encourage and support the development of PLN;
- (iii) manage resources with strong fiduciary oversight;
- (iv) improve risk management;
- (v) enhance accountability to stakeholders;
- (vi) prevent any deviations in the management of PLN;
- (vii) improve the working culture of PLN; and
- (viii) improve PLN's image.

30. PLN is fully committed to realizing these objectives. The following regulations are the basis of GCG implementation in PLN:

- (i) Law 31/1999 on the Eradication of the Criminal Act of Corruption and Law 20/2001 on the Amendment to Law 31/1999.
- (ii) Law 19/2003 concerning SOEs.
- (iii) Regulation of No. PER-01/MBU/2011 concerning the Implementation of Good Corporate Governance in SOEs as amended by Decree of MSPE No. PER-09/MBU/2012 dated 6 July 2012 which states
 - (a) Transparency is openness in decision-making process and disclosing material and relevant information about the company.
 - (b) Accountability is clarity of function, implementation, and responsibility of the company so that corporate governance shall be implemented effectively.
 - (c) Responsibility is the suitability of corporate governance against laws and regulations as well as principles of a healthy corporation.
 - (d) Independence is the condition in which the company is professionally managed without any conflicts of interest and influence or pressure from any parties that is not in accordance with the laws and principles of a healthy corporation.
 - (e) Fairness is justice and equality in fulfilling the rights of stakeholders that are based on agreements and laws.
- (iv) Decree of the Secretary of Ministry of State-Owned Enterprises No. SK-16/S.MBU/2012 dated 6 June 2012 concerning Indicator/Parameter for Assessment and Evaluation of Good Corporate Governance Implementation in State-Owned Enterprises.
- (v) Law No. 1/1995 concerning Limited Liability Company as amended by Law No. 40/2007 dated 16 August 2007.
- (vi) PLN Board Manual of December 2010 outlining the relationship and working framework between the Board of Commissioners and the Board of Directors signed by all members.

31. ADB has a fiduciary responsibility to ensure that its loans and other forms of financing are used only for the purposes for which they were granted, in accordance with the Agreement Establishing the Asian Development Bank. To uphold that obligation, ADB developed guidelines to prevent or mitigate fraud, corruption, and other prohibited activities in RBL operations

financed in whole or in part by ADB. The Guidelines to Prevent or Mitigate Fraud, Corruption, and Other Prohibited Activities in Results-Based Lending for Programs were explained to and discussed with PLN.