

Financial Services NewsFlash

January 2009 No. 1/2009

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Fair value, is it fair?

In October 2008 the Indonesian Institute of Accountants, BAPEPAM and Bank Indonesia issued an announcement addressing a number of matters including the accounting for securities under Indonesian GAAP. This announcement allows for banks to reclassify securities from Trading / Available-for-Sale (AFS) to Held-to-maturity (HTM) and confirms that the Indonesian Institute of Accountants intends to issue guidance on the valuation of financial instruments similar to the Q&A recently issued by the US SEC/ FASB and FASB Staff Position FAS 157-3. The guidance on the valuation of financial assets has the potential to affect all organisations carrying financial assets (including banks, insurance companies, multi-finance companies, securities companies). Recently the Institute of Accountants released its guidance on the valuation of financial assets.

BAPEPAM-LK has also released several regulations which allows the use of the amortised cost valuation method for certain kinds of financial instruments for

mutual-fund companies and insurance companies. Several conditions are required to be met. Specific for the BAPEPAM-LK regulations for the insurance industry, there is no guidance as to whether these regulations should be applied only for the Ministry of Finance (MOF) reporting purposes or also applied for the statutory reports. In our view, this regulation should only be applied for MOF reporting purposes. Any reclassification of securities for statutory reports must be undertaken in compliance with Indonesian GAAP.

Reclassification of securities

Under current Indonesian GAAP, a security can be classified as HTM if an enterprise intends to hold the security to maturity. The standard makes it clear that an enterprise may not classify a security as HTM if there is any intention to sell the security in response to a number of factors including changes in market interest rates or liquidity requirements, changes in the availability and yield on alternative investments, changes in the funding sources terms, or changes in foreign currency risk. In our view, entities should not reclassify their securities portfolio into HTM if those securities portfolios are held to manage an entity's liquidity.

For entities whose securities are redesignated, under Indonesian GAAP, the securities must be reclassified at fair value. Therefore, on the date the security is redesignated, the existing fair value of an AFS security will become the cost base. Any unrealised gain or loss on a previous AFS security is required to be amortised over the remaining period to maturity. A transfer from AFS to HTM will not result in unrealised losses incurred prior re-designation being derecognised from equity. Any unrealised losses in equity on the date AFS securities are transferred are required to be amortised through to the income statement.

Another big challenge is PSAK 55 (revised 2006) which becomes effective from 1 January 2010. Upon adoption of this standard, entities should reclassify securities based upon the revised definitions with any transition adjustments being made to opening retained earnings. Under the new standard, the 'tainting' rules relating to HTM securities are severe. For example, if an enterprise sells a HTM security prior to maturity, generally speaking the enterprise is prohibited from using the HTM classification for all securities for 2 years. In our experience, most Financial Services organisations upon adopting the equivalent standard overseas do not use the HTM classification on the basis of the risks attaching to selling securities prior to maturity (and therefore they taint the HTM portfolio). We agree with this view and would recommend that Financial Services organisations avoid the use of the HTM classification for securities from 1 January 2010.

Determining the fair value of securities in dislocated markets

In the current market conditions, many challenge whether the available market value really represents active market value or not. Actually, there is no clear line between what is active market and what is not. By definition, an active market is represented by condition when transactions happen regularly and fairly. To determine whether a transaction happens regularly or not requires judgment and depends on facts and market conditions. On the other hand, fair transaction means it is not a forced transaction, it is not a forced liquidation or transactions occur based on distressed sales.

Inactive markets are indicated by several factors, which are significant differences between the ask price and bid price, limited numbers of bidding parties, significant volatility of the market price, low trading volume and significant decrease in trading volume and activities. However these indicators are not conclusive.

The Indonesian Institute of Accountants has recently issued a technical bulletin on determining the fair value of securities in inactive market, including guidance on

how to determine such inactive market. In our view, the technical bulletin issued is similar with that issued by FASB and US SEC and we believe it is unlikely to significantly change the fair value of Government Bonds classified as Trading or AFS. The guidance provides a good example on how to determine fair values in dislocated markets. Assuming certain financial assets are trading in illiquid markets, the guidance says that a Discounted Cash Flow analysis can be prepared using an appropriate risk adjusted discount rate based upon all available evidence (e.g. last market price, risk premiums for similar instruments, etc). However, in times of market dislocation it is not appropriate to conclude that all market activity represents forced or distressed sales. This needs to be assessed based upon the facts and circumstances.

In the case of Indonesian Government Bonds, organisations will require strong evidence to demonstrate that market transactions are not representative of arms length transactions between willing buyers and willing sellers. In addition, even if organisations can demonstrate this, any discount rate should be risk adjusted for any non-performance or liquidity risks. Therefore, in our view, any discount rate used is likely to be close to the current market rate.

Conclusion

We would advise you to consult with your External Auditor and/or Advisor prior to changing either the classification of securities or the basis of determining fair value.



Tax Update

Maximize Tax Savings

With the Global Financial Crisis and its potential impact on Indonesia, it is anticipated that business conditions generally will be softer. As a result, revenue in 2008 may be lower than 2007. Cash flow management will become crucial. As one component of cash flow is tax, the following actions should be considered:

- Undertake a full review of your business and the impact of taxes. Is the tax policy and strategy in line with the current business conditions?
- Tax planning: Are there any potential tax savings and planning opportunities which can be maximized in accordance with the new income tax law?
- Better anticipation of tax audit in the future. Are there any areas to be improved in managing future tax audits better and more efficiently? Consider the new General Provision Law which requires data to be provided within one month in a tax audit. If there is a failure to provide such data, any additional information/data will not be considered later in resolving any dispute between tax payers and the tax auditors (i.e. at the objection and / or appeal level).
- Managing installments (monthly corporate tax). Would there be any potential corporate tax overpayment? If yes, what are the main contributions to this overpayment? Is it possible to ask for reduction or even exemption for installment or the withholding tax (if applicable)?

Life insurance companies: The impact of the market turmoil on the technical reserve

Life insurance companies with unit linked products have for some time been enjoying deductibility as a result of the increase in technical reserves resulting from the increase in the value of their unit linked products, despite the fact that most of these assets are generating final-taxed income which is not taxable for corporate tax purposes.

With the current market turmoil, the value of these assets is decreasing and consequently so are the technical reserves. This decrease in technical reserves has significantly altered the position of the life insurance companies, from consistently increasing technical reserves deductible expense to a significant decrease of the technical reserve which is taxable for corporate tax. Therefore, it is expected that a number of life insurance companies will have a different outlook on their corporate tax calculation this year. The tax losses that have been accumulating throughout the years could be significantly decreased or even wiped out.

All companies: Tax issues pertaining to expenses related to final taxed income

We observed that there are lots of on-going disputes on this matter and they are now at the Tax Court level. In addition, the Indonesia Tax Authority also proposed self-review by certain tax payers, e.g. securities companies.

For several years, the Directorate General of Tax (DGT) has been attacking insurance companies with final taxed investment income, with tax assessments made on the basis that the expenses related to this income are non-deductible for corporate tax purposes. This issue has also recently been raised with a securities company, which also had significant final taxed investment income.

The underlying dispute is not about the concept itself. It is more about the methodology that the DGT uses to make such assessments. Most of the insurance companies use the directly related investment expenses to come up with the non-deductible expenses, while the DGT uses a prorata basis from the final taxed income as opposed to the total turnover and has applied this prorata basis to the total operating expenses. The difference is quite significant, considering that investment income is susceptible to market conditions, whereas the related expenses are less volatile, and therefore a prorata basis may not reflect the actual cost of deriving such investment income.

As more insurance companies are taking further steps to fight on this matter, the DGT is also responding to the situation. We would recommend that, at a minimum, insurance companies have a detailed analysis prepared in order to identify the investment related expenses as their defense.

Developments in Islamic Finance

Indonesia

One of the key challenges from a tax point of view, is for ensuring tax neutrality for Islamic Finance i.e, so that it can have the same treatment as conventional financing.

Under the existing VAT Law, the underlying Islamic Finance transactions are generally considered as “trading” in nature and therefore subject to 10% VAT on the gross value of the transaction.

If Islamic Finance is interpreted as financing rather than trading per se, there may be no 10% VAT (and thereby ensure tax neutrality). The draft of the VAT Law is going to be discussed and is likely to be approved by Parliament.

As for income tax, the new Income Tax Law No. 36 Year 2008 which has been approved by Parliament and is effective as of 1 January 2009 states that:

- Income from activities based on Shariah is subject to Income Tax.
- Tax treatment of activities based on Shariah compliance will be regulated by a government regulation.

Islamic finance tax developments in other countries are:

United Kingdom (UK)

Some of the UK's new approaches in relation to Islamic Finance include:

- Religion neutral – no mention of Islamic finance
- Key concepts – providing alternative finance arrangements
- Deeming approach – precise and self contained in tax definitions
- Override of specific obstacles – specific override in Islamic finance legislation

France

The French Government has just published the tax incentives promised last November relating to Murabaha transactions and Sukuk.

In essence these measures provides for:

- a French withholding tax exemption + transfer tax incentive upon real estate transfers for Murabaha transactions
- a French withholding tax exemption + security for the tax deductibility of the payments made with respect to the Sukuk.

We note that a few weeks ago 3% of a major French Company (Suez Environnement) was acquired by Quatari Diar + Q Invest for circa 300ME. This transaction has been structured as a Murabaha. Whilst the stake invested is not that important, this transaction is one additional sign that Islamic Finance may grow very quickly in France.

Morocco

There will be an amendment to the tax law so that there is no longer double registration duties on Murabaha and the like relating to immovable properties.



Final income tax for all transfers of Land & Building (L&B) rights

In early November 2008, the President issued new Government Regulations. Any transfer of L&B rights will be subject to 5% final income tax and the tax withheld will not be treated as a prepayment of income tax.

This new regulation will be effective starting 1 January 2009. This means that the tax will be based on the gross transaction value instead of on the margin/profit element.

PSAK 50 / 55: Accounting for financial instruments

With the implementation of these Accounting Standards from 1 January 2010, it is suggested that organisations proactively consider the tax implications.

At this time there remains a lack of clarity around the transition adjustments required upon adoption of these standards. However, it is likely that transition adjustments will be made directly against retained earnings. The question will arise whether these adjustments are taxable.

In addition, while generally speaking tax follows accounting, there are likely to be some areas where the tax treatment is not clear. For example, the recognition of interest income and interest expense will change from an accrual basis to an effective interest rate method and the provision for loan losses will change from the Bank Indonesia standardized approach to an 'incurred loss' methodology.

Considering the magnitude of the transition adjustments and impact to future earnings, we recommend the involvement of tax specialists in assessing the impact of the adoption of these standards.

PSAK 50 (Revised 2006) and 55 (Revised 2006) implementation

On 30 December 2008, the effective date of PSAK 50/55 was deferred from 1 January 2009 to 1 January 2010. These standards were deferred as a result of the efforts required by the Financial Services sector to comply with the requirements. It is a demonstration of the complexity of the standards and time it takes to properly prepare for the adoption.

Many organisations have commenced implementation projects in order to comply with the standards. Due to the impact of these new PSAKs for the banking industry, banks in Indonesia have allocated a significant amount of time and effort for this project. But these standards will impact other non-banking industries.

In our experience, several common themes consistently appear in successful implementation projects. These themes are an integral part of each phase of the implementation and can serve as checks for ensuring the value and sound design of each task.

Project sponsor

For these projects to be successful, people across the entire organization need to be engaged and committed to the project. These projects will affect many parts of the organization. For example, in a bank the key functions involved include Finance, Human Resources, Risk Management, Credit, and the Business Units. Many people have conflicting demands, and priority needs to be given by management and staff across the organization to achieve success. Having a senior project sponsor who can clear roadblocks and emphasize the importance of the project is of significant assistance.

Project management

Strong project management skills are critical to the success of a PSAK 50/55 implementation project. Throughout the project, people from different departments with varying skill sets will need to be engaged in numerous workstreams concurrently over an extended period working towards a number of different deliverables and with many interdependencies. The project management function brings a sense of focus and uniformity to the process, while acting as a driver to push the process forward. A Project Manager or Advisor with IFRS/PSAK 50 (Revised 2006) and 55 (Revised 2006) expertise is critical to assist in an efficient implementation. This means using resources with the skills that understand: project objectives, roles and responsibilities, milestones and timing, interdependencies, technical issues and measures of project success.

Communicating with key stakeholders

An effective strategy for communicating with key stakeholders generates necessary familiarity with and acceptance of the implementation of PSAK 50 (Revised 2006) and 55 (Revised 2006). Delivering key messages in an appropriate style is important to gain buy-in

from internal and external stakeholders for upcoming changes. Ideally, moving to the new PSAK's should be invisible to the bank's stock price. The underlying fundamentals of the business have not changed, what has changed is the way that financial performance and position are reported. Often many organizations believe this is a change in accounting, but overlook the impact on their people (remuneration structures tied to financial measures) and shareholder / analyst communications.

Knowledge transfer

Effective knowledge transfer is achieved primarily through two ways:

1. Training. Individuals both inside and outside the financial reporting function, across multiple levels of the organisation, will require some degree of training on PSAK 50 (Revised 2006) and 55 (Revised 2006). The level of details and the timing will impact the quality and volume of the learning retained.
2. Teaming. Organisations who engage external advisors need to ensure that they work side-by-side with the advisors. Ideally the Advisors role is to transition knowledge.

Process changes

Implementation project requires extensive reviews on the possibility of system and process changes in the organisation. The breadth and significance of the changes will vary, as will the time, cost, level of testing, and region / subsidiary / branch coordination. The necessary system changes can be important in making the new PSAKs part of the organisation's daily operations. Because of the complexity associated with the system change, addressing system consideration effectively and early is highly recommended.

Linkage with Basel II project

With the ongoing project of implementing Basel II, banks may take advantage of the linkage between the new PSAKs with Basel II. This can be done through performing analysis of the synergies and differences between the new PSAK's and Basel II requirements, identify disclosure items that will need to be reconciled between the new PSAKs and Basel II, and define change management approach from standardize to advance for Basel II.

Prepare early

Early assessment prior to launching the implementation project can be very useful, in particular in the following areas:

- Understand which performance measures will be affected, how they will compare with those of competitors, and how to translate them properly for investors and analysts.
- Evaluate the operational implications for tax planning, information technology systems, internal controls, business processes, and other daily activities to establish sustainable processes.
- Size up the impact on employees, taking into consideration potential changes in roles, responsibilities, and forms of compensation.
- Consider future impact of transactions and products initiated with stakeholders today and determine what the implication to the agreements and potential amendments.

Conclusion

We are actively working with a number of organisations on their transition towards the adoption of these standards. We would be happy to talk to you in more detail on how we could assist you.



Implementation Quality Assurance of Enterprise Wide IT-solutions

In general, about one third of companies that implement enterprise-wide IT-systems are not satisfied with the implementation result. “Not satisfied”, in this context, means that major issues arise as a result of the implementation. “Major issues” can vary from “parts of the system working improperly” until “total failure”.

Good performing companies usually have taken a number of Project Management precautions that significantly increases the chance of a successful implementation. Our advisory practice fully acknowledges this: the better proper precautions are taken prior to, and during the implementation; the higher the success rate.

Enterprise wide systems will affect the whole enterprise

In the beginning of the 80s, a new revolution took place in IT: the development of enterprise-wide IT-solutions. The initial enthusiasm made place for disillusion: numerous implementations failed... and numerous efforts didn't even make it until the implementation phase.

25 years later, the main reason of implementation failure is still valid, although the benefits of such systems are obvious: a contribution to integration of business processes, and significant efficiency advantages. Implementation often fails, or does not bring the full range of benefits, because organisations are not aware of the impact on the business.

Frequently made mistakes are: insufficient project preparation; business owners insufficiently involved in the project, and an IT infrastructure which is not ready for the new solution.

This article provides a number of best practices, particularly from a project management point of view. These practices are applied by companies that have been proven to be successful with IT system implementations.

The practices discussed in this article are:

- Establish a foundation for strong application project management.
- Develop a plan and project charter to keep implementation on target.



- Establish a method for tracking and resolving problems promptly during implementation.
- Convert existing data for compatibility with the new application.
- Build, test, assess, and refine a prototype of the application.
- Reengineer business processes to work more effectively with the new application.
- Reengineer IT operating procedures to fully meet the

requirements of the new IT environment.

- Plan for contingencies that might require a project revamp or shutdown.
- Hire a knowledgeable implementation partner with industry experience.

Establish a foundation for strong application project management

Roughly 33 percent of IT projects fail to deliver expected value to stakeholders and result in \$70 billion in wasted money each year.

Much of this can be attributed to inadequate or unclear definition of objectives, expected benefits, and scope of implementation in the minds of key stakeholders. As a result, when the project is delivered, an objective and quantifiable measurement of project success is virtually impossible. Companies that succeed with technology initiatives establish strong project governance and a project management infrastructure before embarking on a new application or systems project. They clearly define up front the project's scope, underlying assumptions, and benefit expectations.

Develop a plan and project charter to keep implementation on target

Leading companies establish a series of ongoing milestones--and appoint a person responsible for overseeing each one--to ensure that the implementation team stays on target. While these milestones are flexible, they offer a useful starting point in terms of an implementation schedule. These companies also understand that there are many work streams associated with a large-scale implementation, such as defining requirements, developing training materials, and converting data from existing systems.

A detailed project plan helps protect against "scope creep," a term used to describe the uncontrolled expansion of goals that sends projects to off track. Functionality changes that come with this expansion inevitably result in time and cost overruns making scope creep the scourge of implementation. Sometimes it even leads to project shutdown. Scope creep typically occurs when an implementation team loses sight of the original business objectives of the application. A checklist of milestones, based on those objectives, helps ensure timely implementation.

Establish a method for tracking and resolving problems promptly during implementation

Any software implementation project experiences problems, whether in defining business requirements or in performing application testing. Experienced project managers maintain an issues log to record, track, and monitor problems encountered throughout the duration of the implementation project.

A successful implementation also requires timely decision making, which can be a problem in an organization with many layers of hierarchy. Leading companies take one of two approaches in dealing with the need for decisive action during implementation. Many progressive companies empower their implementation teams to make the necessary decisions required for a smooth, successful implementation. These companies define a framework for decision making, setting clear rules and assigning authority for action at varying levels and allowing the project to flow without having to wait for approval on problem resolution from every level. Under this plan, team members do not have to wait for a senior manager to sign off every time the team hits a roadblock; team members resolve the problem themselves and move ahead. In the alternative approach, companies that believe senior management input is imperative to successful implementation appoint a team of senior executives to assess progress and solve problems as they arise.

Convert existing data for compatibility with the new application

One of the most time-consuming, least-discussed aspects associated with the deployment of a new software application is conversion of data from an existing system to the new system's specifications. In many cases, the company must start from scratch: locate the data, decide how to configure it, and then enter it into the new system. Best practices companies anticipate this phase of implementation and prepare for it by building in the time and resources required to convert data.

Older systems often use data fields that have assigned values--sometimes referred to as coded values. Frequently, multiple uses have been made of coded values, making data conversion complex. Careful data analysis is necessary before undertaking conversion to meet new application needs. Companies analyze how data fields are currently used, what type of data is attributed to each value and how data fields will be converted to the new system. They also consider potential problems that could arise for each value. Many

companies find that existing fields must be converted manually, a laborious and time-consuming effort that may take many years and may not be completed until well after the application itself has been implemented.

Data conversion proved to be the most challenging aspect of an enterprise wide work management project undertaken by a large electric and gas utility. The new system required combining data from applications for managing accounting, inspection, asset record, and regulatory activities. Analysis in preparation for data conversion revealed that none of the systems in place maintained data in the same way. Each system was programmed to support data for individual departments. Making the conversion required significant manual entry, verification, and error correction.

Build, test, assess, and refine a prototype of the application.

Prototyping can be compared to test driving an automobile. It is an initial attempt to fire up the software and run it through its paces. Progressive companies understand the value of prototyping new applications to ensure that the final product meets business requirements and allows effective user interaction. Some companies also use prototyping to test the scalability of a new application well before they implement an upgrade.

Most companies do not expect prototyping to go smoothly. Anticipating problems as a normal part of this phase, they select for prototyping a single area that mirrors the company as a whole. They may choose to concentrate on a particular branch of the company, a specific plant site, or an individual product line.

Prototyping also allows a group of end users to get a jump on training, report back to their peers, and provide the developers with feedback. That two-way communication offers the developers further insight as they fine-tune the application before implementation.

Reengineer business processes to work more effectively with the new application

In some cases when a software application does not coincide with the way a company is running its business, it may make better sense to reengineer the business process than to change the software. Changing a business process often allows a company to take better advantage of an application's functionality and boost efficiency.

Reengineer IT operating procedures to fully meet the requirements of the new IT-environment

Generally, the implementation of a new IT system will lead to an increased dependency on IT-processing. This will result in an increasing emphasis on operating procedures in the IT-environment, as a basis for reliable IT-processing, prompt responses to any IT-related problems, proper prevention of IT-disruptions to a certain extent, and appropriate IT disaster recovery planning.

These IT operating procedures will include:

Infrastructure Controls

IT Operating System - security and stability over the hardware on which the IT system processes.

Database - security and control over the data stored by the IT system.

Network - security and control over how the IT system is accessed by the organisation.

General Controls

Change Management - controls over how the IT system is maintained once in a "production state".

Operational Resiliency - business resumption and disaster recovery plans in the event the IT system is unavailable.

Backup/Recovery - routine back-up and recovery procedures to ensure the IT system can be restored from short/long outage.

Security Administration - overall security administration and monitoring over access to the IT system.

Computer Operations - controls over the "day-to-day" support of the IT system and related processing activities.

Plan for contingencies that might require a project revamp or shutdown

In theory at least, a software project should never reach the stage at which a shutdown is the only option. In the worst-case scenario, a company might have to pull the plug to stem a project that is hemorrhaging money because starting from scratch would be cheaper. To



prevent such a drastic measure, successful companies predetermine the circumstances that might require a project revamp. These conditions might include:

- Recurring time and budget overruns.
- Project team unwillingness to take ownership of the project.
- Lack of communication between the implementation team and top management.
- A deadlock between representatives of IT and business users on the implementation team.
- Escalating bills from an external consultant who adds no value to the project.
- An application that fails to provide the required functionality.
- Extreme difficulty in populating the application database.

Hire a knowledgeable implementation partner with industry experience

Not every company has the internal resources or experience required to ensure a successful software implementation.

To bridge that gap, leading companies apply the principle:

Specialise in what you will need on an ongoing basis...

... but outsource in the areas where you just need "one off" expertise and support.

They may turn to an implementation partner, typically a firm with implementation experience that has the knowledge, industry expertise, and professional staff to ensure a successful implementation.

An effective implementation partner is not a hardware or software vendor. Its focus is on the company's best interest, rather than a product. The ideal partner will offer:

- Experience in overseeing large-scale implementations and helping companies fix troubled implementations
- Deep knowledge of software capabilities
- Technical skills sufficient to integrate software with other systems in the organization
- The business acumen needed to maximize the software's contributions to fulfilling a company's business needs.

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Code of conduct The way we do business*

Putting our values in action

Excellence

Delivering what we promise and adding value beyond what is expected.

We achieve excellence through **innovation, learning and agility.**

Teamwork

The best solutions come from working together with colleagues and clients.

Effective teamwork requires **relationships, respects and sharing.**

Leadership

Leading with clients, leading with people and thought leadership.

Leadership demands **courage, vision and integrity.**

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