Financial Services
NewsFlash

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In this issue

IFRS 9 Financial Instruments

As Indonesia adopts PSAK 50 and 55 (Revised 2006), there is further development at the international area regarding accounting for financial instruments.

Many users of financial statements and other interested parties informed the International Accounting Standard Board (IASB) that the requirements in the existing standard, IAS 39 (known locally as PSAK 55 (Revised 2006)) are difficult to understand, interpret and apply. They prefer something more principle-based and less complex.

The IASB, which inherited IAS 39 from its predecessor body, agreed to undertake a fundamental re-consideration of reporting for financial instruments. The IASB's plan is for IFRS 9 to ultimately replace IAS 39 in its entirety.

Classification and measurement of financial assets is addressed first in the new standard IFRS 9 because those requirements form the foundation of a standard on reporting financial instruments. The IASB's next steps involve:

- re-exposure of the classification and measurement requirements for financial liabilities;
- field testing of the proposed impairment approach for financial assets carried at amortised cost; and
- development of enhanced guidance on hedge accounting.

Simplification in accounting

The objective of the IAS 39 replacement project is to improve the decision-usefulness of financial statements by simplifying classification and measurement requirements for financial instruments. Accordingly, IFRS 9 adopts a principle-based approach to classification and measurement by reflecting the entity's business model and asset's cash flow characteristics.

It was not the IASB's objective to increase or decrease the application of fair value measurement, but rather, to ensure that financial assets are measured in a way that provides useful information to investors to help predict likely actual cash flows.

Based on the feedback from interested parties, the IASB concluded that measuring all financial assets at fair value is not the most appropriate approach to improve the financial reporting for financial instruments. It noted that amortised cost can provide useful information for particular types of financial assets in certain circumstances. In particular, the entity's business model for managing the financial assets as well as the contractual cash flow characteristics of the financial assets affect the predictive quality of cash flows.

With the above in mind, IFRS 9 requires financial assets to be measured at amortised cost if:

- the objective of the entity's business model is to hold the financial assets to collect contractual cash flows; and
- the contractual cash flows solely represents payments of principal and interest.

All other financial assets are to be measured at fair value.

One should take note that an entity's business model does not depend on management's intentions for an individual instruments. Instead, it is the business objective of the entity as determined by its key management personnel.

A single entity may have more than one business model for managing its financial assets. For example, an entity may hold a portfolio of investments that it monitors to realise fair value changes and another portfolio of investments that it manages to collect the contractual cash flows.

Therefore, whether an entity will have more or fewer financial assets measured at fair value as a result of applying IFRS 9 will depend on the nature of their business and the nature of the instruments they hold.

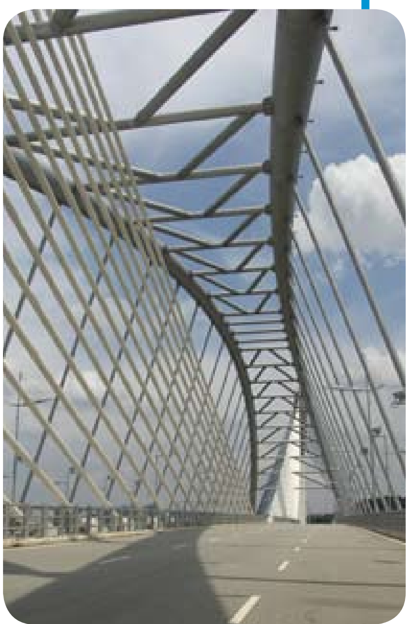
Way Forward

Accounting standards continue to evolve and change to meet market conditions and business considerations. At this point of time there is no formal plan yet from Indonesian accounting standard board on the timing to apply the IFRS 9.

Tax section

Allowable bad debt write-offs – a good news!

The Minister of Finance (MoF) issued a new regulation on requirements to claim bad debt write-offs for tax purposes. The regulation was dated 9 March 2010 and took effect retroactively from 1 January 2009.



In response to taxpayers' major concerns (especially in the financial service sector, e.g. banking), the MoF has removed one of the requirements for an allowable bad debt write-off for tax purposes, i.e. the bad debt write-off was taxable on the debtor side. Other main requirements remain unchanged. They are as follows:

- The bad debt is related to normal business transactions in line with the taxpayer's business operation and did not result from related-party transactions; and
- The taxpayer submits a list of bad debt write-offs to the tax office in a prescribed format; and
- The collection case of the bad debt write-off has been filed with the district court or the relevant government body, or there is a debt forgiveness agreement between the debtor and creditor, or an announcement has been made in a publication, or the debtor acknowledges that the debt has been written off.

Transfer pricing rules – development and what to prepare

The ITA now requires that corporate taxpayers disclose more detailed information on related-party transactions in the corporate income tax return for 2009 and after. Specifically the disclosures include:

- Business details of the related parties that the taxpayer transacted with;
- Details of the nature and value of the taxpayer's related-party transactions;
- Details of the pricing methodologies applied to set/review the price of the taxpayer's related-party transaction, and the rationale for the selection of these methodologies;
- Disclosures on the transfer pricing documentation the taxpayer has prepared to demonstrate that the related-party transactions have been arranged at the arm's length principle. The documentation should cover business profile, function and ownership structure, type of transactions and any similar transactions with independent parties, analysis of OECD comparability factors, and the application of the most appropriate transfer pricing method.

There has been some experience that the ITA rejects the filing of the 2009 corporate income tax returns with no transfer pricing disclosure whereas in fact the corporate taxpayers have related-party transactions. That said, there is no other way to address this matter than completing the disclosure forms.

In the recent public tax seminars presented by the ITA officers, they indicate that there may be intensive enforcement in the form of transfer pricing focused audits. Taxpayers with significant related-party transactions and the profit performance is considered 'not realistic' may be the main target of the transfer pricing focused audits. In addition, after a delay for several years, the ITA is likely to issue a regulation on Advance Pricing Agreements.

In response to this development, taxpayers with significant related-party transactions should anticipate potential tax audits. Given the time restriction to complete the requested tax data once the ITA has issued tax audit instruction letters, it is highly recommended that taxpayers start reviewing their transfer pricing documentation and consider what additional documentation is required to defend their transfer pricing position.

Benchmark ratios related to taxpayers' performance

The ITA has recently issued two circular letters regarding benchmark ratios related to the taxpayers' performance. The benchmark ratios are prepared for selected industry and cover inter alia ratios of gross, operating, pretax, and net profit margins. So far, banks, finance leases, pension funds, and non-life insurance have been included in the list of industries with benchmark ratios. The table below provides the benchmark ratios for the foreign exchange banks:

Year	Gross Profit Margin	Operating Profit Margin	Pre-tax Profit Margin
2005	66.93%	32.41%	33.46%
2006	64.13%	28.61%	28.95%
2007	63.87%	29.02%	29.51%

The benchmark ratios are intended by the ITA to systematically monitor and detect tax non-compliance by taxpayers for further analysis. The ITA will evaluate taxpayers' performance by reference to the benchmark ratios and other metrics. Companies whose actual financial performance deviates significantly from the standard ratios and other metrics are more likely to be subject to further analysis by the ITA, which may continue with a tax audit process if the taxpayers cannot provide satisfactory explanations to the ITA.

Nevertheless, the ITA acknowledges that where taxpayers' performance is lower than the benchmark ratios as referred to in the circular letters, this does not necessarily mean that the level of the taxpayers' compliance is poor. The benchmark ratios cannot be used as part of the ITA's enforcement process but rather is a supporting tool to be used by the ITA in reviewing taxpayers' compliance at the preliminary level.

Amended VAT law – some concerns

On 1 April 2010 the amended VAT law came into effect. While some implementing regulations on the amended VAT law have been issued, more regulations are still expected to give guidance on how to comply with the law.

The key changes specifically related to financial service industries are as follows:
- Deliveries of taxable goods under the Islamic financing scheme are deemed to take place from the supplier of the taxable goods directly to the buyer;
- Financial services, which are exempt from VAT include:
  1) fund raising and placement;
  2) financing activities (included those arranged under the shariah principle), i.e. leasing with option, factoring, credit card, and consumer finance;
  3) pawning/pledge;
  4) underwriting; and
  5) insurance (excluded services supporting insurance activities such as agent, loss adjuster)
- VAT administration; and
- Export services and intangible goods.

There have been discussions between some industry associations and the ITA on the application of the VAT law. For the financial services industry, concerns are more about the scope of financing activities, which are subject or exempt from VAT. For example: for banks, whether or not all fee based income (e.g. fund remittance fee, clearing fee, guarantee fee) fall under the scope of financing activities, which are exempt from VAT.

The other concerns are about the timing for issue of tax invoices and an administration burden for banks to issue tax invoices on a timely basis despite there is still a view among the banking people that disclosing customer information in the tax invoice may be contrary to the bank secrecy law.

By law, tax invoices must be prepared at the time the taxable service is delivered. With a relatively large number of customers, this provision gives significant impact to a daily operation of banks administratively.

The banks expect that the ITA will issue a concessionary rule to address the banks' concerns on the issue of tax invoices.

The law allows for VAT on export taxable services to be zero rated. However, the current implementing regulation provides that only the following types of export services are subject to zero rated VAT:
- Toll manufacturing services with certain requirements among others the manufactured goods must be exported;
- Repair and maintenance services attached to movable goods utilised outside the Indonesia customs area; and
- Construction services attached to immovable goods located outside the Indonesia customs area.

We learnt from an ITA official that there are two reasons behind the limitation of the type of export services with a zero rated VAT. They are as follows:
- To avoid the abuse of VAT law; and
- For the ITA to make it easy to evidence that the services are utilised outside the Indonesia customs area.

Please refer to Islamic Finance section below for more elaboration on the VAT application on *shariah* transactions.

Islamic Finance – application of VAT

The amended VAT law, which came into effect on 1 April 2010, provides some provisions on *shariah* transactions. The provisions are meant to create a level playing field as with conventional transactions. In this regard, the tax office considers that a *shariah* transaction constitutes as a financing scheme. The tax office disregards the legal structure of the *shariah* transaction and acknowledges the substance of the *shariah* transaction as a financing scheme.

In fact there is no tax incentive/relief for shariah transactions compared to the conventional transactions. The tax implication will be the same as the conventional transaction. Take the *murabaha* transaction as an example. If the purchase of the asset is subject to VAT under the conventional transaction, the purchase of the asset under the *murabaha* transaction is also subject to VAT. However, as the *murabaha* transaction is considered as a financing scheme, there is no longer a deemed delivery of taxable asset from 'creditor' to 'debtor' and thus will not give rise to VAT exposure.

Unfortunately the provision only deals with *murabaha* transactions. There is no clarity at this stage as to the scope of *shariah* transactions.

The application of tax treaty rules – a further development

Upon the issue of new rules on the application of Indonesian tax treaties (PER-61 and 62), there have been significant concerns on how to comply with the new rules. For taxpayers PER-61 and 62 are not clear enough in several areas but we expect more clarification to be issued by the ITA.

In addressing the taxpayers' concerns, the ITA issued an amended PER-61 and a further implementing regulation (Circular No. 114). The main changes in the amended PER-61 and Circular No.114 are as follows:

- Foreign tax office is only required to certify the tax residency status;
- Page 1 of Form-DGT 1 is valid for 12 months and can be used for multiple transactions with the same Indonesian taxpayers;
- Page 2 of Form-DGT 2 is valid for 1 month and can be used for multiple transactions with the same Indonesian taxpayers within the relevant month by attaching detailed transactions;
- Foreign currency can be mentioned in the certificate of domiciles (CODs);
- 50% rule applies only to payments to third parties that are intended to pass through the income to the actual beneficial owner.

Some concerns below remain unaddressed by the ITA:

- Definition of active business;
- The application of look-through concept;
- Refund procedure; and
- The use of COD forms issued by foreign tax authorities.

Despite complaints from taxpayers on the lack of clarity in many areas, the ITA is firm about applying the tax treaty rules. To give more clarity, the ITA is compiling all potential issues around the application of the tax treaty rules. It is expected that the ITA will issue further clarification in the near future.

Article 25 monthly income tax installment – beware of potential tax overpayment

Starting from the 2010 tax year the corporate income tax rate reduces from 28% to 25%. There is a concern about the potential corporate income tax overpayment at year end, particularly if the Article 25 monthly income tax installment for 2010 is based on the 2009 corporate income tax rate and/or where in 2010 the business performance is not so good as it in 2009.

As an important cash flow component for taxpayers, it is worthwhile to manage Article 25 monthly income tax installment to ensure there is no tax overpayment at year end. One consideration may be to seek an exemption or reduction of the Article 25 monthly income tax amount from the tax office.

Article 21 on severance payment – new rate structure

On 16 November 2009, by issuing Regulation No. 68/2009, the Government of Indonesia introduced a new Article 21 income tax rate structure on severance payments. This new tax rate structure took effective on the same date as the issue of the Regulation No. 68/2009. Compared to the prior regulation, the new tax rate structure is more simple and attractive. The table below provides a comparison of tax rates applicable for severance payments starting from 16 November 2009 and before.

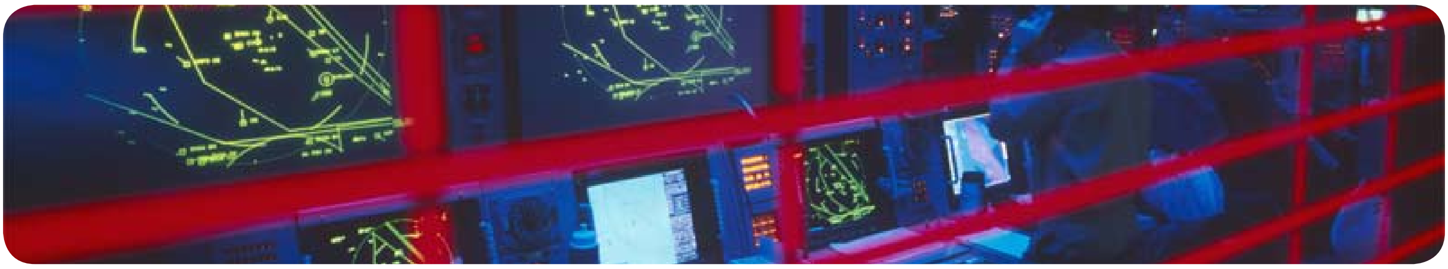
16 November 2009 onwards		1 January 2001 - 15 November 2009	
Gross income	**Tax rate**	**Gross income**	**Tax rate**
On the first Rp 50 million	0%	On the first Rp 25 million	0%
On the second Rp 50 million	5%	On the second Rp 25 million	5%
On the third Rp 400 million	15%	On the third Rp 50 million	10%
On the fourth and over Rp 500 million	25%	On the fourth Rp 100 million	15%
		On the fifth and over Rp 200 million	25%

The Article 21 income tax on severance payment is final in nature.

Some features under Regulation No. 68/2009, which are not available under the prior Regulation:

- The new tax rate structure applies if the severance payments are made within two calendar years; and
- In the situation where the severance payments are made exceeding two calendar years, the severance payments which are made after the two calendar years are subject to Article 21 income tax at a progressive tax rate as follows:

Gross income	Tax rate
On the first Rp 50 million	5%
On the second Rp 200 million	15%
On the third Rp 250 million	25%
On the fourth and over Rp 500 million	30%



Indonesia-Hong Kong tax treaty

On 23 March 2010 the Government of Indonesia has entered into a tax treaty with the Government of Hong Kong. The tax treaty will enter into force after each country gives a written notification of the completion of the procedures required by its law for the entry into force of this Agreement. It is anticipated that the tax treaty will be in effect on 1 January 2011.

Several features under the tax treaty:

- **Dividend**
  The applicable of withholding tax rate for dividend payments is 5% for the substantial holding investment and 10% for the portfolio investment.

- **Branch Profit Tax (BPT)**
  The applicable BPT rate is 5% of the net profit after tax.

- **Interest**
  The applicable withholding tax rate on interest is 10% of the gross amount of the interest. Some interest payments are exempt from tax if it is paid to certain government bodies/institutions listed in the tax treaty.

- **Royalties**
  The applicable withholding tax rate on interest is 5% of the gross amount of the royalties.

- **Time test for a Service Permanent Establishment (PE)**
  A service PE is defined to include furnishing of services by an enterprise if the services continue (for the same or connected project) for a period or periods aggregating more than 183 days within any twelve-month period.

- **Exchange of information**
  The scope of information exchange is restricted to "taxes covered" by the tax treaty and the information exchanged shall not be disclosed to any third jurisdiction for any purposes.

IT: Who Supervises the Specialist?

Ask a random number of people in your organization about the main pillar of information security, and many of them will mention information technology. Not surprisingly, financial institutions are heavily dependent on information technology. The IT department is often expected to set the tone for security, creating and implementing a secure IT environment and be the main contributor to information security. In reality, IT itself often becomes a main information security risk. IT specialists can abuse their high privileged access rights to the system. It is a threat that is often underestimated.

Recently, a well known international bank was struck by surprise when a former IT specialist stole the data of about 20,000 clients. The specialist tried to sell data from Swiss bank accounts to the French tax authorities. It was only after the French authorities became suspicious about the source and contacted the bank that the breach of security was discovered.

This is just one example that illustrates the power IT specialists have, a power that often comes close to absolute power. Nowadays, most banks have security policies and procedures, and many banks put a lot of effort into their implementation. IT specialists often play a crucial role in the development and implementation of such procedures. Ironically, in many cases IT stays outside these implementation efforts. Why does that happen? There are several reasons.
First of all, the IT department often succeeds in convincing management that IT specialists don't fit within a tight security concept. Some high privileged IT specialists will always be required, and it is the nature of their work to be able to bypass regular security. Suppose the IT system has a failure. Shouldn't IT be available at all times, for immediate problem resolution?

Secondly, there is a historical legacy. Some decades ago, it was common practice that systems were accessible for IT specialists without any limitations. The risks, however, were lower because of the lower level of technology, systems integration, and remote access to IT systems.

The third reason is "cultural". Strong controls may reduce the perceived power of IT professionals. They may even get annoyed when they are suddenly forced to be accountable, something they never were before. Excuses will be made to avoid implementation of enhanced security: "It will limit the operational effectiveness"; "It will cause decrease of system performance" are comments frequently made. And management, having no response to such arguments, agrees.

Secure IT systems based on modern technology are developed while complying with a number of basic rules.

1. The need for direct database access by IT specialists to correct errors made by employees is almost zero. Only in very limited cases should this be necessary.
2. IT systems have automated facilities to record such events, and these records should be inspected by staff independent from the IT department.
3. For the most critical data, dual custody is possible; allowing the IT department to access this data only after someone independent from the IT department has granted access to the IT system.

Security audits performed by PricewaterhouseCoopers show that these basic rules are often violated. The main reasons are limitations in IT systems (usually of an older generation) that require direct access to data by IT specialists, and a lack of awareness of the importance of implementing procedures to grant and to monitor such access. This puts a number of banks at an increased reputational risk.

Code of conduct The way we do business*

Putting our values in action

Excellence	Teamwork	Leadership
Delivering what we promise and adding value beyond what is expected.	The best solutions come from working together with colleagues and clients.	Leading with clients, leading with people and thought leadership.
We achieve excellence through **innovation, learning and agility.**	Effective teamwork requires **relationships, respects and sharing.**	Leadership demands **courage, vision and integrity.**

This summary is not intended as professional advice. It is suggested to always consult with your usual PwC contact.

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