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## Company Transfer Pricing Decision: An Empirical Study on Manufacturing Companies Listed in Indonesian Stock Exchange

Mukhtaruddin<sup>1\*</sup>, Rina Tjandrakirana<sup>2</sup>, Yulia Saftiana<sup>1</sup>, Achmad Irgi Riza Rizaldy<sup>3</sup>  
<sup>1</sup>Associate Professor, <sup>2</sup>Assistant Professor, <sup>3</sup>Alumni  
Accounting Department, Economic Faculty, Universitas Sriwijaya Palembang Indonesia

\*corresponding Author: yuditiz@yahoo.com

### ABSTRACT

This research aims to analyze the factors are affecting to transfer pricing applied decision. The factors are tax (TAX), bonus mechanisms (BM), tunneling incentive (TI), debt covenant (DC) and exchange rate (ER). Data was collected through purposive sampling method from 22 companies at conducted transactions with related parties in the manufacturing sector, listed on the IDX, within the 2013-2017, in the form secondary data, through companies' year-end financial report. However, hypothesis testing was carried out using a logistic regression method.

The result indicated that TAX, DC and ER significantly influence the decision to implement TP, while BM and TI had an insignificant effect.

**Keywords--** Bonus Mechanisms, Debt covenant, Exchange Rate, Transfer Pricing, Tax, Tunneling Incentive

### INTRODUCTION

#### Background

Multinational companies are organizations involved in offering products/services and other business activities in two/more countries [1], mainly through foreign direct investment (FDI). Furthermore, FDI requires the establishment of a subsidiary branch by a company from a particular country, in the jurisdiction of another, causing them to play the role of a holding corporation for the affiliates.

Multiple transactions between divisions occur in multinational companies [2]. Which involves the supply of goods/services to other departments within the same corporation, further evaluated based on the profit, return on investment (ROI)/residual income. Moreover, some prices must be determined when one segment of the company hands over goods/services for other segments within the company, as a form of

appreciation, to the divisions that initiated the process, called TP [3].

TP is included internationally to inter-company as the actual price related to the transactions between the holding company in the origin country and its subsidiary/between two subsidiaries, located in different countries and have their jurisdiction of taxation [1] [4].

Garrison et al. (2012) [3] state that the fundamental objective of TP is to motivate managers to act for the interests of the company, however, these changes alongside the involvement of their interests, which enables the transfer of goods/services across borders. Furthermore, the primary focus shifts to the companies' efforts in minimizing tax burdens, liabilities, and exchange rate risks.

Globalization and the rapid growth of international trade enhance the daily necessity of inter-company pricing for most businesses; however, the growth of cash deficit within a country ensues due to the frequent use of TP for tax avoidance. Therefore, tariff authorities make regulations and perform the enforcement of the arm's length standard as the top priority in conducting an audit to TP problems in the countries [5].

Organization for Economic Co-operation and Development (OECD) (1979) [41] recommends arm's length prices, charged over transactions, which occur between parties with excellent relationship, required to be proportional to the price agreed upon in similar transactions and situations, in the open market. In Indonesia, this special relationship has been regulated by the government through the Law Number 36 of 2008, Law of Value-Added Tax and Statement of Financial Accounting Standards No. 7.

Raby (2013) [5] stated that there is an excellent potential for disputes, regarding the report of an actual taxable income in a particular jurisdiction. Hence Tax authorities see TP as an easy target, with a tendency to produce a substantial increase in a country's revenue. However, this problem causes expensive cost and long handling time, which often produce double tax over the income of a company. Many countries suffer loss due to this inappropriate practice, to the Arm's Length

Principle, one of which is Indonesia, where several cases reported regarding the implementation of TP. Google, for instance, used TP as a means to avoid taxes in Indonesia and mass media reported the efforts that were made by the tax authorities to ensure that they fulfill tax liabilities as it should be and similar cases occurred in Europe [6]. Furthermore, utilizing a strategy known as Double Irish with a Dutch Sandwich, Google made Ireland and the Netherlands the final destinations for collecting their tax liabilities, where global income funds were sent, thus creating gaps in the tariff regulations. However, they are not yet taxpayers in Indonesia, although their digital advertising business transactions were huge [2], recorded at IDR 11.6 trillion in 2015.

Besides evaluating tax risk issues, mature initial planning for the determination of TP enhances the possibility for multinational companies to consider the implications beyond taxation. Raby (2013) [5] stated that the deliberation on the effects on company restructuring, supply chains, resource allocation, management compensation plans, and administrative expositions, toward legal obligations of the third party should also be deliberated. Furthermore, the implications of TP policies in organization accounting and behaviors have been the subject of increasing academic debates.

Existing literature attempts to demonstrate the factors that influence a companies' decision to conduct TP, which leads to tax avoidance because tariffs and import cost have a strong influence on the operations of multinational organizations [7]. Clausing (2003) [8] proved the existence of a significant relationship between tax rates in the United States and the implementation of TP and same result was also obtained by Lo et al. (2010) [9], which concluded that taxes influence TP decisions on companies registered in China. Furthermore, Sikka & Wilmot (2010) [10] stated that applying TP was in response to values, which were set for selfish reasons, to increase personal profit, therefore causing social impoverishment, by avoiding tax payment.

Raby (2013) [5] stated that tariff influences companies' decisions to implement TP through BM, which is a form of appreciation, attributed to employees, managers and directors in a company, in order for them to act in the interests of the company as a whole. However, BM is very dependent on accounting income as the related beneficiaries make all efforts possible to pursue optimal profit, through the implementation of supportive accounting methods, e.g., the determination of TP. Transfer pricing enables the relocation of profit between companies that possess unique relationships. Hence, managers implement it at a higher level price than the market value to

optimize profit. Therefore the administrator obtains the desired bonus.

TI is the act of controlling shareholders who have power over a company to obtain personal profits, by causing loss to the minor shareholders as a result of those actions. Tunneling is carried out by transferring assets and profit from restrained companies to others owned by the major shareholders [11]. TI is generally carried out by foreign businesses that act as the controlling shareholders in a company, using TP to transfer the profit. The significant investors determine those entitled to take office at the top level of the company, hence, freely influencing the transactions of the company, including the conduction of TP for personal interests.

DC is an agreement between creditors and debtors, who provide the limitations of a financial ratio, which are impossible to violate. Hence, adopting this technique involves choosing accounting methods that protect the company from failure on paying debt/default [12]. Furthermore, companies on the verge of its violations prefer accounting methods that supports shifting profits to another company and TP is one of such ways capable of saving them from defaulting on debt and avoiding damages, by transferring profit from owned companies to those involved in DC [13]. However, the influence of DC on companies' decision to implement TP is usually measured, using Debt to Equity Ratio (DER).

ER is the value of a country's currency toward others, which undergoes fluctuation [14] that probably affects companies, in term of foreign currency transactions, translations, and risks. However, company managers indirectly influence the entire profitability, in term of foreign currency translations as the profit/loss reports make the conversions of foreign currencies complex, therefore, by manipulating TP, companies alter the income/price of the cost of goods sold between divisions/subsidiaries.

Previous researches proved the influence of BM, TI, DC, and ER on a companies' decision to implement TP, while Lo et al. (2010) [9], stated that TAX, BM, and TI enables firms to transfer profits to subsidiaries registered in China. However, there is a significant influence on the action of managers, offered bonuses about the operational profits of local companies [5]. Conversely, Watts & Zimmerman (1990) [27] explained the debt/equity hypothesis, which predicts that a high debt/equity ratio causes managers to perform accounting methods to enhance profit. Chan et al. (2004) [15] illustrated that managers consider the influence of ER on the TP decision they make, which contradicts the

research by Marfuah & Azizah (2014) [16] that shows the opposite.

Various researches suggest that further analysis is conducted on factors that influence companies' decision to implement TP [7] [17-19]. The manufacturing sector was then chosen as the object of this research because they are listed on IDX, with capitals mostly from foreign countries, hence possessing quite a substantial internal connection with the holding companies abroad [20].

Previous researches show that TAX was measured by the Effective Tax Rate (ETR), which is the total of the organizations' duty burden over its pre-tax income [21]. However, the total weight of tariff is obtained by reducing deferred tax liability, hence, based on the law, if this measurement is below the regular rate and then there is a possibility of tax avoidance [22]. Previous researches used GAAP ETR as a proxy, while this research substituted TAX with Cash Effective Tax Rate (Cash ETR), which is a measurement of money, paid for tariff, over the pre-tax profit [23], not influenced by the changes in estimation, such as valuation allowances/tax cushions. Furthermore, Cash ETR also calculates the tax benefits from the employees' stock options, while GAAP ETR does not [24]. Also, BM measurement is different from the previous researches, illustrated by the implementation of the dichotomy approach, where value 1 is attributed if there is an increase in net profit of the current year toward the previous year and vice versa for the value of 0.

## REVIEW OF THE LITERATURE

### Agency Theory

Jenson&Meckling (1976) [25] define agency relation as a contract where the main party involves the other factions in running service activities on their behalf, by delegating decision-making authority to the agent. However, problems surface as a result of differences in interests between parties, shown when an agent decides only to improve personal welfare through agency cost, regardless of the interests of the main party. Jensen & Meckling (1976) [25] defined agency cost as the sum of monitoring and bonding cost, as well as residual loss. However, there are four problematic areas caused by agency conflict, which include

moral uncertainty, profit retention, risk avoidance, and time horizons [26].

### Positive Accounting Theory

Accounting standards are the result of complex interactions between the accounting standard-setting body and company management, by attempting to release the resources they possess, in order to influence the determination of ethics, which continues up to this day. Previous researches proved the existence of enormous pressure on the accounting standard-setting body, which has led to the reorganization of its regulatory board [28].

Demski (1988) [30] suggested that the accounting method selection theory tries to predict what happens and further applies it to transactions. This philosophy explains and forecasts the policies chosen and how the companies' react to the new standards. Furthermore, firms choose an optimal set of strategies that most probably minimizes the contract costs, described as a compromise within the regulatory body, while considering the effects of opportunistic behavior [27].

### Transfer Pricing and Tax

Multinational companies often send goods between the holdings and branches, and the objective and selection of the TP method used domestically are determined separately from the technique practiced internationally [31]. However, the primary aim of its determination is to motivate managers to act by the interests of the company as a whole, which changes when the goods and services, sent across international borders. In this case scenario, the goals of global TP shifts is to minimizing tax, liabilities and exchange rate risks, which also increases the competitive position of the company and enhances companies' relations with foreign governments. Furthermore, the organization focuses on determining transfer pricing that is capable of reducing the total tariff burden and strengthen its subsidiaries abroad [3].

The administration of high tax liability to companies encourages the implementation of strategies to minimize it [20], of which TP is a method. Therefore, companies often make efforts to transfer the profit earned in countries with high tax rates to those with lower charges.



### Bonus Mechanism

Bonus is financial compensation, reward/return, which exceeds the expectations of the recipient, given to employees, company executives, prospective employees, and shareholders. However, deferred salary payments, insurance plans, non-qualified share options, limited dividends, share appreciation rights, performance designs, and bonus mechanisms are generally known as forms of compensation. Furthermore, this mechanism and performance design are very dependent on the income, and income-based BM is the most common way conducted by companies to reward company executives.

Watts (1977) and Watts & Zimmerman (1978) [28-29], stated that BM encourages managers to choose accounting procedures, capable of increasing the current value of rewards obtainable. However, this strategy is applied by companies, to attribute returns to the directors, referring to the companies' overall profits [32]

Saifudin&Putri (2017) [32] reported that the technique improves the performance of their employees, which ensures a higher turnover every year. Therefore, if the shareholders consider the performance of the directors as excellent, a reward is granted to the related administrator, generally in cash bonus/in the form of shares.

### Tunneling Incentive

TI involves<sup>20</sup> the control of shareholders by promoting the transfer of assets and profit of the company. Hence achieving income for personal interests, by harming minor investors that eventually bear the cost charged [33] [34]. Conducting TI involved selling intangible assets/securities from the firms controlled by the major stakeholders to other companies they possess, at prices below the market value, hence, imposing losses on the marginal stakeholders of the<sup>7</sup>ading company [20].

Johnson et al. (2000) [11], use the term tunneling, which refers to the allocation of a firm' resources to the controlling shareholder, classified into two forms. First, this involves the major investors, transferring resources, from the company, for personal benefit, only through the transactions, with the value determined by them, including

contracts and sale of valuable assets to the controlling shareholders. Second, they increase personal shares without making an asset transfer, by issuing dilutive shares, boycotting the non-controlling shareholders, insider trading, gradual acquisition/other discriminatory financial transactions.

### Debt Covenant

Debt agreements are intended to limit the involvement of managers in investments and financing decisions, capable of reducing the value of debt holder claims [12]. DeFond&Jiambalvo (1994) [12] explained that this technique, shaped in accounting numbers and covenant violations are disadvantageous. Hence company executives at the verge of infringement, take accounting decisions that reduce the possibility of defaulting on debt payment.

The DC hypothesis is the main implication, tested from positive accounting theory<sup>18</sup> which states that managers are encouraged to make financial reporting verdicts that diminish the possibility of violating deals in their companies' debt agreements. However, the strength of this encouragement depends on the cost of breaching the DC, which is a default technical cost.

### The Framework

Multinational companies use TP as a strategy to solve tax problems, by transferring the revenue reported, to subsidiaries in countries with low rates [1], thus, enhancing the capability to avoid high tariff burden in a particular jurisdiction. However, this causes significant problems for the specific country's tax authorities, especially those with high charges. Furthermore, the government department must be more careful in monitoring the implementation of TP to prevent more significant loss for their country.

In order to obtain optimal profit, firms focus on tax uncertainties and some other factors. However, Lo et al. (2010) [9] reported that BM, based on the use of overall profit, to motivate managers to implement accounting methods that can transfer profits and TI, which influences the actions of controlling shareholders who utilize TP for gaining personal benefit.

Furthermore, other factors such as DC and ER also provide an insight into the execution of TP. Furthermore, the DC hypothesis (Watts&Zimmerman, 1990) [27] showed that a higher DER enhances the tendency of violating debt covenants, which therefore triggers managers

to apply accounting methods to increase profit. ER fluctuation further influences this choice as it uses risk for the companies, who try to avoid it. Based on the explanation above, the research framework obtained was as follows [14]:

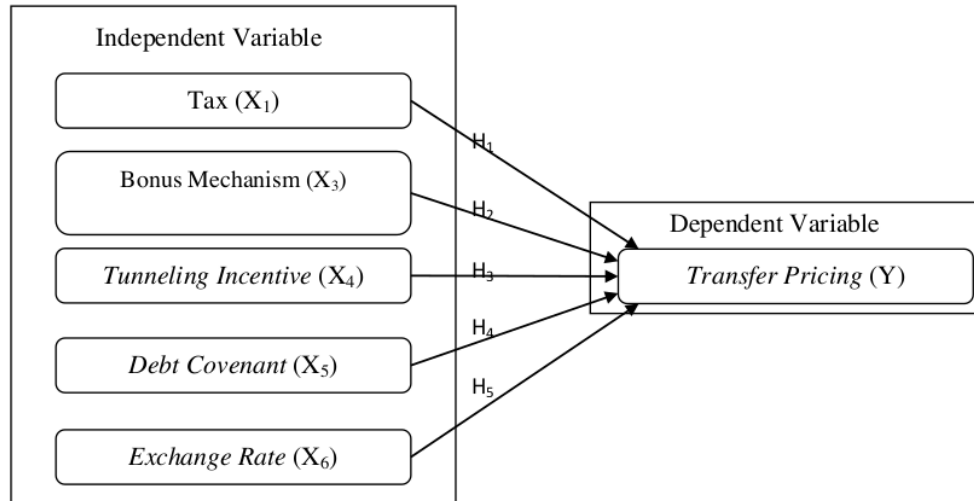


Figure 1: The framework.

**Development of Research Hypothesis**  
*The Influence of Tax on Companies' Decision to Implement Transfer Pricing*

TP is intended to motivate employees to act for the interests of the company [3]. However, the expansion conducted by multinational firms causes a change in the original objectives, which is to ease the tax burden. Furthermore, the companies perform transactions across the boundaries of a particular jurisdiction by transferring the profit earned to the territory with looser tariff regulations. Clausing (2003) [8], Lo et al. (2010) [9], Yuniasih et al. (2012), [20] Marfuah & Azizah (2014) [16], Noviasatika F. et al. (2016) [35], Saraswati&Sujana (2017) [34], Tiwa et al. (2017) [36], Sari & Mubarak (2018) [37] have proven that TAX influences companies decision to implement TP, due to the high burden in a country. Therefore, the hypothesis formulated is  
H<sub>1</sub>: Tax influences companies' decision to implement transfer pricing

**The Influence of Bonus Mechanism on Companies' Decision to Implement Transfer Pricing**

BM encourages managers to choose procedures and perpetuate accounting practices to increase their rewards [28] [29]. Saifudin & Putri (2017) [32] stated that the TP decision is influenced by this technique, in an attempt to improve the performance of their employees, hence ensuring the elevation of profit obtained every year. Furthermore, companies that desire a big bonus by altering the reported profit. Raby (2013) [5] reported the implication of TP policies in management accounting and organizational behavior, which has become the subject of academic debate. Saifudin & Putri (2017) [32] and Lo et al. (2010) [9] proved that BM significantly has a positive influence on the implementation of TP, considered as one of the firms' choices. The hypothesis proposed is  
H<sub>2</sub>: Bonus mechanism influences companies' decision to implement transfer pricing

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**The Influence of Tunneling Incentive on  
Companies Decision to Implement Transfer  
Pricing**

Claessens *et al.* (2000) reported that pyramid structures and cross-ownership among companies, enhanced control in all countries in East Asia, where voting rights consequently exceed the cash flow rights, practiced in Indonesia, Japan, and Singapore.

Furthermore, single shareholders control more than two-thirds of the firms. Hence, separation of management from ownership control is rare and top-level administration of about 60% of companies, not widely owned, are affiliated with the family of the significant shareholders. This discovery, therefore, provides an insight into the ability to control shareholders, hence encouraging a take over from minor i<sup>28</sup>stors.

Lo *et al.* (2010) [9], Yuniasih *et al.* (2012) [20], Marfuah & Aziz<sup>10</sup> (2014) [16], Mispuyanti (2015) [38], Noviasatika F. *et al.* (2016) [35], Saraswati & Sujana (2017) [34] suggested that TI influences a companies' decision to implement TP, however some studies are not in support. The hypothesis formulated is

*H<sub>3</sub>: Tunneling Incentive influences companies' decision to implement transfer pricing*

**The Influence of Debt Covenant on Companies'  
Decision to Implement Transfer Pricing**

Positive accounting theory estimates companies on the verge of DC violations, frequently chose accounting methods, capable of increasing profit, in an attempt to loosen debt problems [28]. However, DC is an instrument intended to limit managers from investment and financial decisions, capable of reducing the claim value from the debt holders. Furthermore, defaulting on debt is unavoidable hence directors continue to make decisions that enhance profit, with the hope to improve the bargaining position of the company, during a renegotiation [12], one of which is TP. This technique enables managers to transfer profit from high-taxed jurisdictions to a low one, to ease<sup>11</sup> tariff burden and obtain optimal revenue. The research conducted by Rosa *et al.* (2017) [13] indicated that DC has a positive influence on TP, while Sari&Mubarok (2018) [37] stated the opposite. The hypothesis to be tested is

<sup>24</sup> *H<sub>4</sub>: Debt covenant influences companies' decision to implement transfer pricing*

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**The Influence of Exchange Rate on Companies'  
Decision to Implement Transfer Pricing**

The cash flows of multinational firms are generally denominated in currencies, about the value of the dollar (Marfuah & Azizah, 2014) [16], as every currency differs in its value with time, due to fluctuation in exchange rates. Furthermore, Marfuah & Azizah (2014) [16] stated that these different ERs later influences TP practices in multinational companies because of constant instability. Hence the amount of cash needed for transactions is also uncertain. Garrison *et al.* (2012) [3] call the act of companies trying to minimize this uncertainty by conducting TP, an ER risk.

Chan *et al.* (2004) [14], stated that exchange rate fluctuations are influenced by three factors, two of which affects the companies' financial reports. (1) Foreign currency transactions. (2) Extraterritorial money translations. (3) ER risks. Furthermore, the division managers generally do not possess direct control of the profit and loss incurred using this technique because the translation process is conducted in the holding companies, at the end of the financial year, hence, this does not directly influence the financial reports of the subsidiary, which have not been consolidated. However, the profit/loss reports make this process complex, by involving the use of the average value of ER, to influence companies' revenue, through TP decisions.

The research conducted by Chan *et al.* (2004) [14] proves that exchange rates influence the choice to conduct TP, while Marfuah & Azizah (2014) [16] indicated a positive but not significant relation, hence, it is necessary to re-examine this effect. The hypothesis formulated is

*H<sub>5</sub>: Exchange rate influences companies' decision to implement transfer pricing*

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**RESEARCH METHOD**

**Population and Samples**

The population used in this study<sup>33</sup> are manufacturing companies, registered at IDX from 2013 to 2017, using a *purposive sampling* technique, with criteria, (a) Listed manufacturing companies and published of financial statement for five-year observation period. (b) financial reports reflect the sample firms conducted transactions. (c) the test companies were under the control<sup>5</sup> of foreign companies. (d) the model organisation did not experience loss during the observation period. (e) The sample companies had profit/loss data with exchange rates gap, and (f) the firms used rupiah currency in presenting their financial reports. Furthermore, 22 companies fulfilled the

requirements, with 110 observations (22 samples x 5 years of observation).

### Definition of Operational and Variable Measurement Dependent Variable

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The dependent variable applied in this research was TP, proxied by the existence of sales to the parties with a special relationship. Here, companies require the value over sale transactions with these parties, to fulfill their interests [3]. Furthermore, this technique is measured using a dichotomy approach (*dummy* variable), where value 1 is attributed to a transaction with related parties overseas and value 0 if there are no foreign deals.

### Independent Variables Tax

According to Law Number 28 of 2008 Article 1(1), tax is a mandatory contribution to the country, which an individual/entity owes, compelled by law, not received by direct compensation and is further used for the nations' needs to maximize the prosperity of its citizens. The tax in this study was proxied by *Cash Effective Tax Rate (Cash ETR)*, which is a measurement of cash paid for a tariff on pre-tax profit [23].

### Bonus Mechanism

BM is used by companies to motivate employees, hence improving their performance, in order to improve the profit obtained yearly. Furthermore, if the owners/shareholders of a firm consider that the performance of the directors is excellent, rewards are allocated, usually, after overall profit obtained is assessed (Saifudin&Putri, 2017). BM is measured using a dichotomy approach, through the net profit trend index formula (ITRENDLB), which is the percentage of the take-home revenue of the current year (t) to that of the previous year (t - 1) (Saraswati&Sujana, 2017) [34], where value 1 is assumed if ITRENDLB is greater than 1, and value 0 is the opposite.

### Tunneling Incentive

TI is an action conducted by the controlling shareholders, transferring assets/profit for their interests, which is generally disadvantageous to the minor investors [20]. Furthermore, this technique is proxied by the percentage of share ownership by

foreign companies of 20%/more, as the major stakeholders. However, ownership by foreign companies possesses the potential to implement TP, to minimize tax.

### Debt Covenant

*Debt covenant* states the limits for particular financial ratio, which must not be violated by the debtors, carried out to limit the involvement of managers in investment and financing decisions, with a propensity to further reduce the claim value of debt holders [12]. Generally, company administrators, on the verge of DC violation, make decisions to implement accounting methods that prevent defaulting on debt, by involving TP. However, DC is proxied using DER.

### Exchange Rate

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ER is the value of a country's currency toward another. Therefore, it has two components, domestic and foreign money. Fluctuations experienced by ER causes risk for the companies, and Chan *et al.* (2004) [14] reported that this variation further influences financial reports by affecting foreign currency transactions, translations and also ER risks, avoided by the companies through the utility of TP.

### Data Analysis Method Logistic Regression Test

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Logistic regression is an analytical tool used to measure the influence of independent constant on the dependent dummy variables.

### Determination Coefficient Test

The Determination Coefficient Test on logistic regression, with the purpose to know the influence of the combination of both variables, utilizing Nagelkerke's R square, which is a modification of the Cox and Snell coefficients, ensuring that the values vary from 0 (zero) to 1 (one).

### Research Model

The parameter estimation used *Maximum Likelihood Estimation (MLE)*, with the logistic



regression model formulated by the following equation:

$$TP = \alpha + \beta_1P + \beta_2MB + \beta_3TI + \beta_4DC + \beta_5ER + \varepsilon$$

Notes:

TP = Transfer Pricing. Value 1 is given if there is a transaction with the related parties abroad and value 0 for the opposite,  $\alpha$  = Constant,  $\beta$  = Regression coefficient, P = Tax, MB = Bonus Mechanism. Value 1 is given if the trend index value of net profit (ITRENDLB) is greater than 1 and value 0 is the opposite, TI = Tunneling Incentive, DC = Debt Covenant, ER = Exchange Rate and  $\varepsilon$  = Exchange Rate

DATA ANALYSIS AND DISCUSSION

Data Analysis

Determination Coefficient Test

The determination coefficient test is intended to identify if the independent variables are capable of explaining the variation of the dependent, using the Nagelkerke's R square value, with the results as presented in table 1;

Table 1: Results of Determination Coefficient Test.

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	77,459 <sup>a</sup>	,145	,251

a. Estimation terminated at iteration number 7 because parameter estimates changed by less than, .001.

Source: Results of data processing

Table 1 show that the value of Nagelkerke's R Square is 0.251 and Cox & Snell R Square is 0.293, which indicates that the ability of independent variables (TAX, BM, TI, DC, and ER) to explain the dependent variable (TP) is 0.251/25.1% and the remaining 74.9% is due to other factors outside the scope of this research model.

Hypothesis Test

The parameter estimation used Maximum Likelihood Estimation (MLE), and H<sub>0</sub> states that the independent variables do not affect the various responses observed in the population. Hence, the test on the hypotheses was conducted by comparing the probability value (sig) with the level of significance ( $\alpha$ ), and the results presented in table 2.

Table 2: Hypothesis Test Results.

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 <sup>a</sup>	P	6,940	3,105	4,996	1	,025	1033,110
	MB (1)	,061	,627	,009	1	,923	1,062
	TI	1,611	1,248	1,666	1	,197	5,009
	DC	-1,129	,493	5,243	1	,022	,323
	ER	-9,153	4,634	3,901	1	,048	,000
	Constant	-,062	1,184	,003	1	,959	,940

a. Variable(s) entered on step 1: Taxes, MB, DC, ER.

Source: Results of data processing

The results of hypothesis test on the logistic regression coefficient produced the following models:

$$TP = -0,062 + 6,940TAX + 0,061MB + 1,611TI - 1,129DC - 9,153ER + \varepsilon$$

Table 2 shows the probability value and Wald statistic of every independent variable, where TAX has a value of 4.996, which is higher than chi-square distribution of 3.841 and probability of

0.025, far smaller than the significance level of 0.05. Furthermore, this means that the hypothesis which stated that TAX influences TP is accepted. Hence, it possesses a significant and positive influence on companies' decision.

BM has a *wald statistic* value of 0.009, smaller than *chi-square distribution* of 3.841 and probability of 0.923, which is higher than the significance level, indicating that the hypothesis which states that BM influences TP is rejected; hence, it does not significantly influence decision making.

TI possessed a *Wald statistic* value of 1.666, smaller than the *chi-square distribution* of 3.841, with a probability of 0.197, which is higher than the significance level of 0.05 — therefore indicating that the hypothesis, which states that TI influences TP is rejected; hence, it does not significantly influence the firms' choice.

DC had a *wald statistic* value of 5.243, perceived as more significant than the *chi-square distribution* of 3.841, with the probability of 0.022, which is smaller than the significance level of 0.05. Therefore indicating that the hypothesis, which states that DC influences TP is accepted, hence, it can be said that DC significantly and negatively impacts on companies' decision to implement TP.

ER had a *wald statistic* value of 3.901, more significant than *chi-square distribution* of 3.841, with a probability value of 0.048, which is smaller than the significance level of 0.05. However, this means that the hypothesis which states that ER influences TP is accepted. Hence, ER significantly has a negative influence on a firms' decision to implement TP.

## DISCUSSION OF THE RESEARCH RESULTS

### Tax on Companies' Decision to Implement Transfer Pricing

The first hypothesis stipulates that TAX influences companies' decision to implement TP. Based on the logistic regression test, correlation was positive. Hence the hypothesis was accepted.

High tax rates encourage firms to implement various types of strategies, capable of minimizing duty liabilities, in order to optimally achieve profit and one of which is TP. Furthermore, companies are allowed to carry out this technique if they obey the applicable laws. However, multinationals use it as a tool to avoid tax, during transactions with related parties, located in different countries, which is detrimental to the local tax authorities [3].

The objectives of selecting transfer pricing method domestically are determined separately from the foreign concept [31], because it is used locally, to align the goals of each division within a company.

However, international transfers possess the goal of shifting TP to subsidiaries, capable of minimizing their TAX.

The incidence of huge profits results in more substantial TAX, which further encourages the implementation of TP, capable of minimizing the profit earned. Firms conduct this practice by transferring with related parties, who are involved in tangible and intangible assets, services, finance/allocation of burden/burden-sharing arrangements [5]. Hence, indirectly reducing the possible profits obtained by their subsidiaries/affiliated companies.

The results of this research align with the study conducted by Clausing (2003) [8], Lo *et al.* (2010) [9], Lin & Chang (2010), Yuniasih *et al.* (2012) [20], Indrasti (2016) [39], and Saraswati & Sujana (2017) [34] who concluded that TAX significantly has positive influence on managements' decision to implement TP. Conversely, the results are inversely correlated with the research conducted by Mispuyanti (2015) [38], Rosa *et al.* (2017) [13], and Saifudin & Putri (2017).

### The Influence of Bonus Mechanism on Companies' Decision to Implement Transfer Pricing

The second hypothesis is, "BM affects a firms' decision to implement TP," shown by the trend index value of net profit. Based on the logistic regression test, there was no correlation, which means that the hypothesis was rejected.

Forms of compensation include deferred salary payments, insurance plans, *non-qualified* stake options, limited portion, share appreciation rights, and the income related plans, which comprises performance designs, and bonus mechanisms. Furthermore, an income-based bonus mechanism is the most common technique adopted by companies to reward executives.

The results of the study concluded was different from the *bonus plan hypothesis* [27], which stated that company managers who have BM, possibly use accounting methods that can increase reported profit in the current year. However, this occurs in firms that do not experience a consistent increase in profit over the years [13]. Therefore, TP is applied to ease tax liabilities, paid in order to obtain optimal profit. Hence, taking this decision is not only influenced by the bonus.

The results are appropriate with Mispuyanti (2015) [38], Indrasti (2016) [39], Saraswati & Sujana (2017) [34], and Rosa *et al.* (2017) [13], who concluded that BM does not affect the choice of a firm to implement TP. However, Lo *et al.* (2010) [9], and Saifudin & Putri (2017) [32] do not agree with this hypothesis.

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### The Influence of Tunneling Incentive on Companies' Decision to Implement Transfer Pricing

The formulated H3 stipulates that TI influences companies' decision to implement TP, indicated by the controlling shareholders. However, based on the logistic regression test, it was shown that there was no correlation. Therefore, the hypothesis was rejected.

TI is the activity that gains the major investor's maximum profit, by causing loss to non-controlling shareholders, conducted through the transfer of tangible/intangible assets, by setting a price below the market value [19]

The results concluded that IT did not significantly influence companies' decision to implement TP, indicating that the controlling stakeholders did not infringe their control rights on management, for personal interest [32]. The firms used as samples were controlled by an affiliated foreign company, without the existence of unique relationships, e.g., by blood. Hence, all decisions taken are agreements at the organizational level, and an attempt to maximize personal profits becomes irrelevant [36]. Furthermore, if the controlling shareholders continue to do this, the performance of the subsidiaries/branches sustain an impact because of the feeling of insufficient benefits.

Previous research by Saifudin & Putri (2017) [32], Tiwa *et al.* (2017), and Rosa *et al.* (2017) [13] who conclude that TI does not influence companies' decision to implement TP agree with this study. However, Dyanty *et al.* (2012) [40], Marfuah & Azizah (2014) [16], Noviasatika F. *et al.* (2016) [35] do not support this hypothesis.

### The Influence of Debt Covenant on Companies' Decision to Implement Transfer Pricing

The formulated H4 stated that DC influences companies' decision to implement TP due to significant values in DER of a firm. Furthermore, based on the logistic regression test, which showed a negative correlation, the hypothesis was accepted. DC is a debt contract intended to limit the activities of managers, therefore minimizing their involvement in investments and decisions that are capable of reducing the claim value of debt holders [12]. However, the violation is possible if the company is not able to remunerate through, e.g., DER. Furthermore, this was proposed by Watts&Zimmerman (1990) [27], who stated that a higher DER enhances the tendency to implement accounting methods that can avoid violations in DC, e.g., TP.

The results indicate that DC has a negative influence on companies' decision to implement TP, supporting the theory of *debt/equity hypothesis*. Therefore, there is a relationship with low values for DER. Furthermore, this was due to the motivation to achieve a better DER value through the implementation of accounting methods that can

level optimal profit.

The results of this research are supported by Rosa *et al.* (2017) [13], who concluded a significant correlation, while Sari & Mubarak (2018) [37] do not agree.

### The Influence of Exchange Rate on Companies' Decision to Implement Transfer Pricing

The fifth hypothesis stipulates that ER influences companies' decision to implement TP, indicating that, an increase in the profit/loss ratio of the exchange rate gap on pre-tax revenue of a firm enhances this choice. However, based on the results of the regression test, a negative correlation was observed. Therefore the hypothesis was accepted.

The cash flows of multinational companies are generally denominated in currencies, relative to dollar value, which differs at the exponent of time. Furthermore, this results in uncertain ER fluctuations, which influences TP practices [16]. The management considers this option with/without incentives because of its effect on profitability [14]. Furthermore, ER had a negative correlation with the implementation of *transfer pricing*, indicating that a lower exchange rate disparity on pre-taxed profit/loss of companies, enhances the section of TP implementation. However, this happens because a low rate indicates a trade quotient gap loss, whose value interferes in the achievement of optimal profit. Chan *et al.* (2004) [14] reported that TP is conducted to intervene in low ER values. The results of this research are therefore in line with Chan & Lo (2004), and Chan *et al.* (2004) who concluded that *exchange rate* has a significant correlation with the application of TP, while Marfuah & Azizah (2014) [16] disagree with this claim.

## CONCLUSION AND SUGGESTION

### Conclusion

The formulation of the problems, objectives, literature review, hypothesis, and data analysis conducted in this research draw the following conclusions:

- 1) TAX has a substantial positive influence on companies' decision to implement TP. Hence, a more significant tariff promotes this choice.

- 2) BM does not affect a firms' decision to implement TP. Therefore, there was no correlation with the current year's profit.
- 3) The choice to apply TP is not due to TI because foreign controlling shareholders, impose this preference.
- 4) DC significantly has a negative influence on a companies' decision to execute *transfer pricing* due to lower DER.
- 5) ER also impacts a negative effect on the implementation of TP, enhanced by a lower exchange rate.

#### Limitation and Suggestion

In this study, limitations were in terms of the research samples, the variables included, and the measurement used, which include:

- 1) Only 22 research samples from manufacturing companies listed on IDX were involved in this investigation, due to the absence of relevant data related to the variables in other firms. Therefore, future research should expand the population size to other sectors.
- 2) Only secondary data, taken from financial reports were used, therefore, providing room for less accurate results, which are incapable of proving the existence of fraud in companies. It is recommended to add primary data in future studies by conducting direct interviews and distributing questionnaires to selected firms.
- 3) Nagelkerke's R Square value of 0.25/25 percent, indicates that the independent variables (TAX, BM, TI, DC, and ER) explains the dependent (TP), therefore, 74, 9% was due to other factors, outside this study model. Future investigations should be capable of adding other variables, such as company behavior.

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