**CURRENT ADVANCED RESEARCH ON SHARIA FINANCE AND ECONOMIC WORLDWIDE (CASHFLOW)**

# CORPORATE GOVERNANCE'S ROLE IN SHAPING TRANSFER PRICING PRACTICES

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***Abstract***

*This study aims to uncover evidence on the impact of tax, bonuses, company size, tunneling incentives, profitability, corporate governance, and sales growth on transfer pricing. This research is based on existing data and utilizes a selective sampling technique to gather data from 49 manufacturing firms listed on the Indonesia Stock Exchange between 2015 and 2020. The findings suggest that the size of a company and its corporate governance practices play a role in influencing transfer pricing. On the other hand, factors like taxes, bonuses, profit margins, and sales growth do not seem to impact transfer pricing decisions. The size of a company may impact management's choices regarding transfer pricing activities with affiliated entities.*

***Keywords:*** *Transfer Pricing, Tunneling Incentive, Bonus Mechanism, Corporate Governance, Tax*

## 1. INTRODUCTION

In order to fulfil its operational needs, the company needs to make several transactions. One of the transactions carried out is the purchase of goods or services. Determining the price in this transaction is known as transfer pricing. Transfer pricing transactions extend beyond the exchange of physical products and services to include the trading of intangible assets. Transfer pricing is usually an alternative in corporate tax planning due to its ability to alleviate the financial strain of taxes. The company will take advantage of the differences in tax rates between countries. The decision of the company to use transfer pricing as a tax strategy is justified. However, transfer pricing can be one of the causes of the government's inability to achieve state revenue targets through taxes (Nazihah et al., 2019).

The transfer pricing case in Indonesia once occurred at PT Adaro Energy Tbk., a public company engaged in the coal sector. Global Witness found indications of tax avoidance by PT Adaro Energy Tbk. This company is suspected of having transferred its profits from mining in Indonesia to its subsidiaries abroad. This transaction is estimated to have occurred from 2009-2017, with an estimated loss of US$ 14 million per year. This case caused PT Adaro Energy Tbk. To be involved in legal issues. Transfer pricing issues prompted researchers to conduct a study entitled "Tax, Tunneling Incentive, Bonus Mechanism, and Other Factors Affecting Transfer Pricing".

This research develops the research of Nazihah et al. (2019), and is expected to benefit managers, the Directorate General of Taxes, the government, academics, and further researchers. Based on the background described, this research aims to test and prove the effect of tax, tunneling incentive, bonus mechanism, firm size, profitability, sales growth, and corporate governance regarding the pricing of inter-company transactions.

## 2. LITERATURE REVIEW

### 2.1. Agency Theory

As stated by Jensen and Meckling (1976), there is an agency relationship due to a contract that describes the association between one party (principal) and another party (agent) who will provide services on behalf of the principal. Therefore, the principal gives responsibility for making decisions to the agent (Godfrey et.al., 2010). However, this does not rule out the possibility that the agent will always make decisions in the principal's interests. For example, when an agent is given the authority to make decisions, the agent uses it to transfer the principal's wealth. The behaviour of agents who have the opportunity to transfer the principal's wealth is closely related to transfer pricing. In transfer pricing, the company will transfer profits to another company to get low tax costs. This activity must be overseen because it does not rule out the possibility of efforts to commit irregularities for employees who see opportunities from transfer pricing activities (Maulana et al., 2024; Siahaan et al., 2023a, 2024).

### 2.2. Transfer Pricing

Transfer pricing relates to pricing goods or services traded between divisions in a company or between affiliated companies. It entails moving revenue or profits from a nation with a high tax rate to a country with a lower tax rate. Due to this difference in tax rates, the company will benefit from paying lower tax burdens. However, transactions with related parties cannot always be classified as transfer pricing. In the OECD (2012), related party transactions are indicated as transfer pricing if: (1) A business from one nation involved in the agreement is involved in overseeing, contributing financially, or exerting influence over a business from another nation that is also part of the agreement and (2) an individual who holds a stake, whether through direct ownership, indirect investment, or decision-making authority, in a company that is legally obligated by an agreement.

According to Feinschreiber (2004) five methods can be used to determine transfer pricing, namely: (1) comparable uncontrolled price method, usually used for tangible assets, intangible assets and services; (2) resale price method, used to evaluate the profitability of distributors and producers, (3) cost-plus method, carried out by adding up the costs to obtain the property with a profit mark up over costs, (4) profit split method, used to determine the distribution of profits from controlled transactions, and (5) transactional net margin method, used to test the fairness of the transfer price set.

### 2.3. Tax and Transfer Pricing

The government imposes taxes on individual and corporate taxpayers and permanent establishments. Companies resort to transfer pricing in order to alleviate the impact of the high tax burden on their finances, which will cause the tax authorities to have difficulty maximizing revenue from the tax sector (Nazihah et al., 2019). Transactions involving transfer pricing for goods or services occur when companies within the same group lower their prices or shift profits to countries that have lower tax rates (Arifin et al., 2020).

Ha1: Tax influences transfer pricing

### 2.4. Tunneling Incentive and Transfer Pricing

Tunneling refers to the practice of reallocating company assets and profits for the personal benefit of the majority shareholder, leaving the minority shareholders to suffer the financial repercussions (Hartati et al., 2014). Two things influence the behavior of majority shareholders to carry out tunneling incentives: the ownership arrangement of the business and the financial resources at its disposal (Sari, 2012).
Ha2: Tunneling incentive influences transfer pricing

### 2.5. Bonus Mechanism and Transfer Pricing

Businesses typically implement bonus systems to enhance the productivity of their employees in order to ensure steady growth in the company's profits on an annual basis (Sulistyawati et al., 2020). Companies usually give bonuses when employees achieve specific targets. Bonuses include allowances, commissions, sales incentives, and employee welfare (Mispiyanti, 2020). Giving bonuses can influence management to increase company profits. Managers will try to manage company profits in such a way as to get bonuses by doing transfer pricing (Yulia et al., 2019)
Ha3: Bonus mechanism influences transfer pricing

### 2.6. Firm Size and Transfer Pricing

Firm size combines several factors, for example, several employees, branch offices, and production capacity (Merle et al., 2019). According to Sulistyowati and Kananto (2019), company size is a value that describes the size of a company. The company's total assets can be determined by firm size (Yulia et al., 2019; Winarta et al., 2024). The amount of company assets is directly proportional to firm size. Big enterprises typically engage in transfer pricing due to their extensive size and global network of subsidiaries.
Ha4: Firm size influences transfer pricing

### 2.7. Profitability and Transfer Pricing

The company's profitability refers to its capacity to earn revenue (Jonathan & Siahaan, 2023; Prayudiawan & Pamungkas, 2020). In its operations, the company wants to maximize profits and prosper shareholders. If the company's profitability increases, there is a shift in profits (Bava & Gromis, 2015). Profit shifting can be done by transfer pricing. Companies with high profits will also get higher tax rates than those with lower profits (Arifin et al., 2020).
Ha5: Profitability influences transfer pricing

### 2.8. Sales Growth and Transfer Pricing

Sales growth is the term used to explain the rise in sales between two different time periods (Kennedy et al., 2008; Rakhmawati et al., 2024). Low sales growth indicates a decrease in company profits due to a decrease in operations. Conversely, high sales growth will increase the company's chances of avoiding taxes by manipulating transfer pricing (Anggraeni & Lutfillah, 2019). Transfer pricing is carried out by companies to reduce the tax burden. When sales growth increases, the company's profit also increases, and the tax burden increases.
Ha6: Sales growth influences transfer pricing

### 2.9. Corporate Governance and Transfer Pricing

Corporate governance is related to the responsibility of shareholders, board members, commissioners, and managers to create competitive performance in achieving the company's vision (Siahaan et al., 2023b; Subagiastra et al., 2016)). The vision that the company wants to achieve is to gain profit and prosper shareholders. One component of corporate governance is audit quality. The quality of a company's audit is essential because the financial records of the corporation serve as a vital resource for obtaining data for shareholders. Good corporate governance can also improve the company's compliance with the law. In addition, with good corporate governance, stakeholder control over transfer pricing decisions will be greater (Anggraeni & Lutfillah, 2019).
Ha7: Corporate governance influences transfer pricing

## 3. RESEARCH METHODS

This research is centered on manufacturing firms that are publicly traded on the Indonesia Stock Exchange between the years 2015 and 2020. The sampling method used is purposive, and the findings are detailed in Table 1.

**Table 1. Sample Selection Procedure**

| No. | Description | Description Number of Companies | Total Data |
|---|---|---|---|
| 1. | Manufacturing companies were consistently listed on the Indonesia Stock Exchange from 2015 to 2020. | 134 | 804 |
| 2. | Manufacturing companies that did not publish financial reports consecutively from 2015 to 2020. | -7 | -42 |
| 3. | Manufacturing companies that do not publish financial statements with a fiscal year-end of December 31. | -1 | -6 |
| 4. | Manufacturing companies that do not use the rupiah currency consistently during 2015-2020. | -30 | -180 |
| 5 | Manufacturing companies that do not consistently experience profits during the period 2015-2020. | -47 | -282 |
| | Number of manufacturing companies used as samples. | 49 | 294 |

Source: Data Processing Results

Measurement of each research variable uses a reference proxy, such as the Tax variable, one way for the government to generate funds in order to enhance the progress of the country is by using state revenue. Referring to the research of Sulistyowati and Kananto (2019), the effective tax rate can represent tax. This study uses the effective tax rate formula by Lanis and Richardson, namely Income tax expense/Income before income tax. Furthermore, the Tunneling Incentive (TI) variable is represented by share ownership, which is a percentage. The tunneling incentive is assessed by the proportion of foreign ownership in the company, specifically when it reaches 20% (Anggraeni & Lutfillah, 2019). That is by the Financial Accounting Standards Statement (PSAK) No.

15 of 2013 which states that an entity is deemed to have significant influence, either directly or indirectly, if it owns 20% or more of the company. The Bonus Mechanism (BM) variable affects management performance. The bonus mechanism is given to all parties involved in the interests and profit of the company (Aryati & Harahap, 2021). The bonus mechanism is evaluated using the Net Profit Trend Index (ITRENDLB) calculation (Nazihah et al., 2019): Net profit for period t/Net profit for period t-1.

The size of a firm or Firm Size (FS) is determined by the value of the company's equity, sales, and assets (Dewinta & Setiawan, 2016). The size of a company is determined by calculating the logarithm of its total assets. By transforming total assets into a natural logarithm, the disparity between big and small businesses is reduced, resulting in a more evenly distributed set of data (Nazihah et al., 2019). The Profitability (PRO) variable describes the company's efforts to receive profit from its business (Arifin et al., 2020). The return on assets ratio is used to evaluate the company's profitability. A low ratio indicates that the company's profit is also low. This provides the company with potential opportunities to move funds in a way that may lead to increased scrutiny regarding their transfer pricing practices (Arifin et al., 2020): net income/total assets. Additionally, the variable Sales Growth (SG) signifies a rise in revenue between different time periods. The company will profit more if sales grow (Anggraeni & Lutfillah, 2019). The sales growth variable is measured by the formula (Salesit - Salesit-1) / Salesit-1). As for the Corporate Governance (CG) variable, where the company's audit quality represents the company's corporate governance. Hiring auditors from a prestigious firm like the Big Ten Public Accounting Firm (KAP) is believed to enhance corporate governance for companies. The study examines corporate governance using a dummy variable. So, if the company's financial statements are audited by KAP The Big Ten, it will be given a value of 1. If a non-Big Ten KAP audits the company's financial statements, it will be given a value of 0. represents tax. This study uses the effective tax rate formula owned by Lanis and Richardson.

## 4. RESULTS AND DISCUSSION

According to Ghozali (2018), descriptive analysis offers a summary of data, showcasing various aspects such as the mean, standard deviation, variance, minimum and maximum values, total sum, range, kurtosis, and distribution skewness. The findings of the descriptive statistical analysis for this research are outlined in Table 2. A total of 294 data points were utilized in this study. Prior to conducting the outlier test, it was discovered that the residual data did not follow a normal distribution based on the normality test results. Thus, an outlier test was deemed necessary. After the outlier test was carried out, there was a change in the amount of research data to 288. On the other hand, after the outlier, the test results revealed that the residual data did not follow a normal distribution. Thus, the next test will use the data before the outlier test, which was 294 data.

The research conducted involved performing three traditional assumption tests: one for multicollinearity, another for heteroscedasticity, and a final one for autocorrelation. Upon examination, it was found that there was no evidence of multicollinearity among the independent variables used in the study. However, heteroscedasticity was observed in the variables of firm size (FS), corporate governance (CG), and sales growth (SG). Furthermore, the regression model employed in this research also exhibits

autocorrelation. The examination of hypothesis in this study was conducted through the analysis of various statistical measures such as the R-value, adjusted R2, F test, and t-test. The correlation coefficient analysis results indicate a weak and positive relationship between the dependent and independent variables. The analysis of the coefficient of determination reveals that 5.7% of the change in the dependent variable can be attributed to variations in the independent variable, with the remaining 94.3% being influenced by other factors not accounted for in this study's regression model. The F test results suggest that the model utilized in the research is appropriate. Furthermore, the collective impact of the independent variables on the dependent variable, transfer pricing (TP), is evident. Table 3 displays the findings of the t-test conducted in this study.

**Table 2. Descriptive statistics**

| Variable | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| TP | 294 | 0 | 0,976097 | 0,173398 | 0,269429 |
| TAX | 294 | 0 | 3,698518 | 0,283601 | 0,245701 |
| BM | 294 | 1,51% | 2562,62% | 129,03% | 172,76% |
| FS | 294 | 20,279549 | 33,494533 | 28,803072 | 2,011883 |
| TI | 294 | 8,77% | 92,66% | 65,07% | 18,51% |
| PRO | 294 | 0,000282 | 1,383481 | 0,094234 | 0,11468 |
| CG | 294 | 0 | 1 | 0,64966 | 0,47789 |
| SG | 294 | -1 | 0,540114 | 0,037188 | 0,173667 |

Source: Data Processing Results

**Table 3. t-Test Results**

| Model | B | Sig. | Description |
|---|---|---|---|
| TAX | -0,093 | 0,144 | Not Affected |
| BM | -0,003 | 0,702 | Not Affected |
| FS | 0,021 | 0,010 | Affected |
| TI | -0,019 | 0,830 | Not Affected |
| PRO | -0,056 | 0,695 | Not Affected |
| CG | -0,114 | 0,001 | Affected |
| SG | 0,164 | 0,069 | Not Affected |
| Constant | -0,309 | 0,204 | |

Source: Data Processing Results

The results of the t-test indicate that there is a significance level of 0.144 for the tax variable. This level of significance surpasses the α value of 0.05. Therefore, it can be inferred that Ha1 is rejected, indicating that there is no impact of tax on transfer pricing. Although the company's tax burden can be reduced by transferring pricing, the company's decision-making process remains unaffected by whether or not transfer pricing actions are taken. Although tax is one of the main motivations behind transfer pricing, in many cases, the impact of its influence could be elusive because of variations

in tax regulations across different nations, or as a result of major corporations crafting highly effective tax approaches.

Furthermore, the bonus mechanism variable has a significance value of 0.702. This significance value is more significant when compared to the α value of 0.05, so Ha2 is not accepted. Therefore, it can be inferred that the bonus system has no impact on transfer pricing. Although there is a bonus mechanism in the company, it does not affect the company's management to carry out transfer pricing. Bonus mechanisms may not directly affect transfer pricing because bonuses are often based on broader performance (such as overall profitability) rather than intra-company transfer price manipulation.

The firm size variable has a significance value of 0.010. This significance value is smaller when compared to the α value 0.05, so Ha3 is accepted. In addition, the unstandardized coefficient value is 0.021, which indicates a positive influence of the firm size variable on transfer pricing. The size of a firm can affect the decision-making process carried out by management. In addition, large companies will also earn more significant profits than small companies. That can lead companies to transfer pricing transactions to other companies with unique relationships. Larger companies tend to have more subsidiaries or affiliates in different countries. That provides more opportunities and incentives for transfer pricing to manage cross-border taxes and profits. Larger companies also tend to have more significant resources to implement complex transfer pricing strategies and be better able to deal with transfer regulations—strict pricing across jurisdictions. The tunneling incentive variable has an essential value of 0.830. This significance value is more excellent when compared to the α value of 0.05, so Ha4 is not accepted. That means that tunneling incentives do not affect transfer pricing. That shows that although majority shareholders want to get high returns, they do not reduce the rights of minority shareholders by conducting tunneling incentives.

Incentive tunneling may occur when a parent company or manager shifts wealth from a controlled entity to another entity. Still, it is a practice usually associated with poor corporate governance. In a healthy context, this may not be common or seen as a significant factor in transfer pricing. The significance level of the profitability variable is 0.695, which larger than the α value of 0.05, resulting in the rejection of Ha5. Consequently, it can be deduced that there is no impact of profitability on transfer pricing. The company will not conduct transfer pricing to obtain profit but for the parent company's needs and subsidiaries or divisions within a company. High or low profitability does not necessarily affect the need or opportunity to use transfer pricing. Highly profitable companies may already pay high taxes and have no strong incentive to avoid them through transfer pricing. The corporate governance variable has a significance value of 0.001. This significance value is smaller when compared to the α value of 0.05 so that Ha6 is accepted. In addition, there is an unstandardized coefficients value of -0.114 which indicates that there is a negative effect of the corporate governance variable on transfer pricing. This is because companies that have good governance will have tighter supervision so that transfer pricing transactions will be reduced. Corporate solid governance typically includes a strong oversight structure and strict compliance policies, influencing how transfer pricing is managed. Good governance may promote transparency and accountability, thus preventing transfer pricing manipulation that could harm shareholders or the government. Conversely, weak governance may provide opportunities for management to exploit transfer pricing for personal gain or the

company's short-term interests. The sales growth variable has a significance value of 0.069. This significance value is more significant when compared to the α value of 0.05, so it is not accepted. That means that sales growth does not affect transfer pricing. That shows that although sales growth can cause an increase in company profits, companies do not necessarily carry out transfer pricing to reduce the increasing tax burden due to increasing company profits. Sales growth may not directly affect transfer pricing practices because it relates more to day-to-day operations and market strategies than financial strategies between entities.

## 5. CONCLUSION

According to the findings of the study, firm size and corporate governance influence transfer pricing. Meanwhile, other variables, such as tax, bonus mechanism, tunneling incentive, profitability, and sales growth, do not influence transfer pricing. Firm size and corporate governance influence transfer pricing because both directly relate to the firm's ability to manage and utilize transfer pricing strategies. Meanwhile, although necessary, other variables, such as taxes and profitability, may not have the same solid or consistent direct influence in the context of this study. This research has some constraints: the range in independent variables can only account for 5.7% of the dependent variable; the leftover data is commonly not normally distributed; there are issues with heteroscedasticity in the variables related to firm size, corporate governance, and sales growth, and there is also an autocorrelation problem in this study.

Recommendations that can be made in further research are: including additional independent variables that can explain the dependent variable transfer pricing, such as debt covenants and intangible assets; increasing the duration of the study to collect more research samples and address the issue of skewed residual data (Hair et al., 2010); and conducting logarithmic measurements on variables experiencing heteroscedasticity problems (Ghozali, 2018).

Suggestions for Further Research Further research is needed to explore why variables such as tax and profitability are not significant and whether there are moderating or mediating factors that may influence these results. Research across industries or countries may also provide a broader perspective.

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