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Determinants of transfer pricing decision at manufacturing companies of Indonesia

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ABSTRACT

This paper examines the effect of tax avoidance, bonus mechanism, debt covenant, tunneling incentive, audit quality, multinationality, foreign ownership, and company size on transfer pricing. This research population is all manufacturing companies that list at Indonesia Stock Exchange on the period of 2016-2018 but the collected data are on a period of 2015-2019. The sampling technique uses a purposive method to obtain 275 samples in the observation period of 2016-2018. The method of this research involves descriptive statistic test, classical assumption test, and hypothesis test. A regression test is used for testing the hypotheses. The result of the research shows that tax avoidance, debt covenant, and company size have a significant effect on transfer pricing decision. The factors are multinationality, foreign ownership and audit quality also have a significant effect on transfer pricing decisions. Meanwhile, bonus mechanism and tunneling incentive do not significantly affect transfer pricing decisions. Conclusions from this research is a lot of factors involved in the transfer pricing decision. One from inside the company and the others from an outside company. Transfer pricing is a tool to achieve certain goals. The purpose of transfer pricing can be categorized as internal goals and external goals. The manufacturing companies when deciding about transfer pricing must be careful because there are two perceptive about transfer pricing. One perceptive from a business that transfer pricing is something useful because a company can save money related tax but the other perceptive from the government side, transfer pricing has believed to be able to have reduced or even disappearing potential for a country's tax revenue..

Introduction

The Rapid growth of the activity of the business as well as related business which happens between companies in various countries, bring existence the globalization of the economy that made an impact rising transaction transnational (cross-border transaction). Trade transaction conducted by Southeast Asian countries had long ago been facilitated by trade organizations such as ASEAN *Free Trade Area*, ASEAN Branch of *Word Trade Organization*, and ASEAN *Economic Community*. Economic development in ASEAN region had become borderless and given greater opportunity to many companies to extend their market shares. The companies in Indonesia were not exceptional to this situation. Systematically, the companies were forced by this situation to conduct various forms of transactional shift in order to maintain their income and profitability. One form of such shift is *transfer pricing*, which is often conducted among companies that are closely related (affiliated) (Wier, 2020). Problem often occured with *transfer pricing* is that different countries may apply different tax rates. Such difference often forces multinational companies to make *transfer pricing* decision based on transactional price applied in privilege relationship they have with other companies (Drake *et al*., 2019; Wier, 2020).

The multinational companies see transfer pricing is a strategy that is quite effective in order to win the competition in the global market. Setiawan (2013) stated that transfer pricing carried out by companies is a way to transfer revenue from the country has high tax rate to the country has lower tax rate. The main goal of multinational companies is to obtain maximum profit by minimize and reduce the amount of tax paid that must paid to government. Previously, the practice of transfer pricing was only used by companies

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to assess performance, but gradually this practice was misused by companies in order to maximize profit so because of that transfer pricing is connected as a bad thing. Transfer pricing can make problems related custom duties until unfair business competition. From the government side, transfer pricing is considered as decision that cuts a country's tax revenue because multinational companies will shift their tax obligation in countries that have lower tax rate. *Transfer pricing* is done by shifting the profit to the as minimum as possible tax rate (Pil, Furusawa, & Ishikawa, 2020). Different regulation in different countries always becomes important issue because it can affect company profitability (Pil et al., 2020).

The practice of transfer pricing is permissible if it is still under the prevailing tax regulations. However, it has become an international issue that many companies practice transfer pricing that violates tax regulation, causing state losses due to tax revenue. The phenomenon about the transfer pricing case happen in 2016 where the tax director general of the finace ministry stated that there are two thousand multinational companies who operating in Indonesia did not pay corporate tax income for ten years because the companies loss profit. The company's loss because they transfer taxable revenue from Indonesia to other country who has lower tax rate.

Research that aims to determine the factors that influence transfer pricing decisions has been done a lot, but the results are still not consistent. Rachmat (2019) examined the effect *tax avoidance on transfer pricing, where the results tax avoidance gives significant impact.* The management does *transfer pricing* in order to pay tax liability as minimum as possible (Rachmat, 2019). Different findings were given by Saifudin *et al.* (2018), Rosa *et al.* (2017), Melmusi (2016) and Mispiyanti (2015), which showed that tax did not affect *transfer pricing* decision because the company's subsidiary was established mostly to supply raw materials needed by the main company.

Literature Review

Theoretical and Conceptual Background

Bonus mechanism is a form of reward given to company manager (company director) during general meeting of shareholders (RUPS) because the manager has produced good performance on current year (Purwanti, 2010). However, performance measurement based on company earning sometimes makes the management become opportunistic. This position was supported by Rachmat (2019), Saifudin *et al.* (2018) and Melmusi (2016), which they found that bonus mechanism affects *transfer pricing.* Conversely, Faizi (2018), Rosa *et al.* (2017), and Cristea (2016) generally said that bonus mechanism does not affect *transfer pricing* done by the company.

Debt covenant is a contract made by creditor to minimize any activity that can damage loan value and loan recovery. *Debt covenant* helps the management to improve profit and asset by reducing the possibility of contract renegotiation over debt. Rosa *et al.* (2017) said that *debt covenant* affects *transfer pricing.* If the loan level of the company is high, then the company can improve the level of its profit and asset. In the other hand, Cristea (2016), conversely, found that *debt covenant* did not significantly affect *transfer pricing* decision.

Tunneling incentive is a concentrated ownership held by certain entity over the right of control and the right of cash flow in the company because the entity acts as a controlling shareholder. Ming *et al.* (2005) asserted that when the company has a surplus of financial resources, then the controlling shareholders would shift company resource for their interest rather than distribute it as dividend (Faizi ,2018; Noviastika *et al.,* 2016; Mispiyanti, 2015). Majority shareholders always do monitoring on company management in order to get good company performance. But, Saifudin *et al.* (2018) and Rosa *et al.* (2017) found that *tunneling incentive* does not have effect on *transfer pricing* transaction.

Audit quality is performance level achieved by auditor in the process of auditing financial statements (Damayanti *et al.* 2016). If audit quality is high, then it is difficult for the company to avoid the excessive tax (Rosa *et al.,* 2017). In contrast, Noviastika *et al.* (2016) discovered that audit quality does not have significant effect on *transfer pricing.*

Several factors that also influence *transfer pricing* are multinationality, foreign ownership and company size. Multinationality represents the effort of the company to establish its branches in various countries. Multinationality is done usually for the goals of efficiency and tax reduction (Omar & Zolkaflil, 2015). Multinational companies mostly do *transfer pricing* because this helps the companies to attain its goals (Lanis & Richardson, 2013).

Foreign ownership is usually found in the companies that have concentrated ownership structure. Controlling shareholders can use their supervisory function on the management and that is why these shareholders have better position than managers and even have better access to information than other shareholders. *Transfer pricing* decision is surely under the supervision of controlling shareholders. If the company has large number of foreigners that hold controlling shares, then these foreigners always attempt to put their influence on *transfer pricing* decision to ensure that this decision optimizes company profit (Kiswanto *et al.* 2014). But Melmusi (2016) discovered that foreign ownership does not have significant effect on transfer pricing.

Company size is related with the size of the company compared to other companies in the industry. Company strategy is greatly affected by the position of company in the industry where the company belongs to. Large companies have various kind of stakeholders that supply the companies with huge fund. Therefore, such companies will always take into consideration of any decision that can help them to achieve optimum profit, including *transfer pricing* decision. Company size becomes one reason why the company decides to do transfer pricing (Lanis & Richardson, 2013; Schandlbauer, 2017; Halim, 2019). In contrast, Melmusi (2016) proves that company size does not affect transfer pricing.

Positive accounting theory and agency theory form the basis of this research. Positive accounting theory will direct how management decisions in choosing accounting methods that can make profits run high or low according to the company's need and conditions. Watts et al. (1986) explained that there are three hypotheses in positive accounting theory. The first is the bonus plan hypothesis, second the debt covenant hypothesis, third is the political cost hypothesis. Agency theory explains a conflict of interest in the relationship between shareholders and management so that it requires an alignment of interests between the two parties (Jensen et al.,1976).

Agency Theory

Agency theory explains a conflict of interest in the relationship between shareholders and management so that it requires an alignment of interests between the two parties (Jensen et al.,1976). The difference in interests between the two parties has caused each party to try to maximize their benefits. Agency cost is effort to reduce agency problems and divided cost into monitoring cost, bonding cost and residual cost.

Positive Accounting Theory

Positive accounting theory will direct how management decisions in choosing accounting methods that can make profits run high or low according to the company's need and conditions. Watts et al. (1986) explained that there are three hypotheses in positive accounting theory. The first is the bonus plan hypothesis. The company will choose an accounting method that can increase profit for the current period. Second, namely the debt covenant hypothesis, if the company gets closer to the debt agreement violation, the accounting method is chosen, shifting profits from the future period to the present period. The third is the political cost hypothesis, wherein a high political cost, the company will choose an accounting method that can delay reported earnings from the present period to the future.

Transfer Pricing

Transfer pricing is a strategy used by the company to win the competition at global market over limited resources. This strategy involves shifting income from the company in the country with relatively higher tax rate to the company in the country with lower tax rate. Main purpose of *transfer pricing* is to minimize tax duty. Companies that have internal relation one another often do *transfer pricing*. As a corporate strategy, *transfer pricing* decision is made not only based on financial aspect but also on considerations of efficiency, effectiveness, volume of transaction and resource, and improvement of image and benefit (Pendse, 2012; Wier, 2020; Pil & Ishikawa, 2020). For the government, however, *transfer pricing* is considered potentially reducing national tax income (Setiawan, 2013). Tax authority comprehends *transfer pricing* through the principle of *arm's length* (Harimurti, 2007), and this principle comprises of two elements, namely fairness and privilege relationship.

Tax Avoidance

It was already stated in Taxation Act No.36/2008 that tax is a mandatory contribution that tax payers must pay without expecting direct return from this payment, and that the outcome of this contribution will be used to finance governmental expenses for the favor of people prosperity. For a company, tax is a cost and therefore the presence of tax is affecting cash flow and profit (Mardiasmo, 2011; Supriyati, 2011). Tax avoidance is an effort made to legally and safely minimize taxes by taxpayers where the methods and techniques used tend to take advantage of the weaknesses (gray area) contained in tax laws and regulations (Suandy,2011). Two indicators are used to measure good financial performance, namely how effective the tax rate is applied by the company and how good the company is in managing taxation issues (Cahyadi et al., 2018). Usually, many companies consider tax as a problem and they do anything toward tax avoidance, which among others is through *transfer pricing*. The companies do *transfer pricing* by shifting its tax duty to a country with lower tax rate. A multinational company often does *transfer pricing* to minimize its global tax duty (Rachmat, 2019).

Bonus Mechanism

The bonus mechanism is a given a reward by shareholders or company owners to the company's board of directors because the company's performance is to obtain a net profit or a predetermined target (Hansen et al., 2005). In previous research, Rachmat (2019) stated that a manager or company director likes a high income statement to get bonuses from shareholders for their performance by increasing the Trend Index of a company's net income. Hartati et al., (2014) argues that a company board of directors to get a bonus from the owner of the company will try to maximize the increase in overall company profits by tarnsfer pricing. The bonus is given not only based on the amount of profit in each period, but on the performance of the directors in managing the company so that the directors will show their performance towards the company owners to get an appreciation or bonus.

Debt Covenant

Debt Covenant is a contract that is shown to a debtor to limit activities that may damage a loan value and loan recovery (Pambudi, 2017). In a go public company it is impossible to be separated from a debt that can be used as operations and also to expand its business. Based on the Debt covenant hypothesis, it predicts that the manager of a company wants to increase profits and assets to reduce contract renegotiation on debt when the company enters into an agreement regarding its debt. In a high profit situation, creditors may assume that the company can reduce the level of risk of unpaid debt. Company managers are trying to increase profits and avoid credit regulations, one of which is using transfer pricing as an effort to increase profits in the company. Watts et al., (1986) stated that the higher the loan the company desired, the company would try to show good performance so that creditors were sure that the company was able to meet its liabilities. Lasdi (2008) states that the leverage ratio is a proxy for a company's tendency to violate contract agreements. Based on this explanation, it can be concluded that a debt covenant is a contract given by a creditor to a debtor to limit activities that can damage the value of a loan and loan recovery. Company managers attract creditors by trying to increase profits and avoid credit regulations, one of which is by using transfer pricing as an effort to increase company profits. *Leverage ratio as a proxy for a company's tendency to violate contractual agreements and leverage can be an indication of the level of security for creditors in providing loans to the company.*

Tunneling Incentive

Tunneling incentives are concentrated ownership related to control rights and rights to cash flow in certain parties as controlling shareholders (Mispiyanti, 2015). Tunneling incentive is a behavior of the majority shareholder who transfers the company's assets and profits for their own benefit, but costs are borne by minority shareholders (Hartati et al., 2014). Based on the type, tunneling incentives can be divided into two forms. First, the majority shareholder can move resources from the company to himself through inter-company transactions with owners. The transfer of resources can be done in various ways, one of which is through transfer pricing. Second, controlling shareholders can increase their share of the company without transferring assets through issue of shares or other financial transactions that result in losses for non-controlling shareholders (Noviastika et al., 2016).

Audit Quality

Audit quality is all the possibilities that can occur when the auditor audits the client's financial statements and finds violations or errors that have occurred and reports them in the audited financial statements (Damayanti et al., 2016). Quality audit is an audit conducted by a competent and independent auditor. De Angelo (1981), stated that both audit qualities were owned by a public accounting firm (KAP Big 8 at that time) with a good reputation. Financial reports are audited by auditors from The Big Four Public Accounting Firm, namely Deloitte Touche Tohmatsu Limited, PricewaterhouseCorporate - PwC, Ernst and Young - E&Y, and KPMG as well as Public Accounting Firms in Indonesia affiliated with The Big Four, namely KAP Osman Bing Satrio (Deloitte), KAP Tanudiredja, Wibisana, Rintis & Partners (PwC), KAP Purwantono, Suherman & Surja (E&Y), and Siddharta Widjaja & Partners (KPMG), the results obtained are of higher quality in displaying the true value of the company because it has a level of fraud which is lower than the company audited by the Non The Big Four Public Accounting Firm. This does not mean that the Non The Big Public Accounting Firm is bad in terms of its audit quality, but that there is a possibility of misstatement in presenting the true value of the company (Annisa et al., 2012).

Multinationality

A multinational corporation is a company based in one country and has production and marketing activities in one or more foreign countries (Puspopranoto, 2006). It carries out its activities on an international scale that does not look at national borders and is led by a joint strategy from a parent company. Transfer pricing activities of multinational companies relate to transfers of both tangible and intangible goods based on the principle of fair market price provisions.

Foreign Ownership

Article 1 paragraph 8 of Law Number 25 Year 2007 states that Foreign Capital is capital owned by foreign countries, individual foreign citizens, and Indonesian Legal Entities whose capital is partly or wholly owned by foreign parties. Referring to the article above, it can be concluded that foreign share ownership is the proportion of common stocks of a company owned by individuals, legal entities, the government and their parts with foreign status. Foreign ownership can be measured in accordance with the proportion of common stocks owned by foreigners (Anggraini, 2011). The use of control rights to maximize personal welfare by distributing wealth from other parties is often referred to as expropriation. For example, a foreign controlling shareholder may transfer company funds and assets for his own benefit. This is done through the practice of transfer pricing: a foreign controlling shareholder sells the product of the company he controls to his private company at a price below the market.

Company Size

Company size basically refers to the grouping of companies consisting of small companies, medium companies, and large companies. Company scale is a measure used to reflect the size of the company through the company's total assets. On the other hand, company size is also measured by total sales and the average level of sales. In this research, total assets are used in measuring the size of the company because the asset value is relatively more stable than total sales. A company can perform well when it can make the right operational decisions, and one such decision is *transfer pricing*. It must be noted that *transfer pricing* is often done by a company that has offices in more than one location or country. Therefore, *transfer pricing* is probably implemented very often by a company with large financial resources (Halim,2019)

Emprical Review and Hypothesis Development

Tax Avoidance and *Transfer Pricing*

It was already stated in Taxation Act No.36/2008 that tax is a mandatory contribution that tax payers must pay without expecting direct return from this payment, and that the outcome of this contribution will be used to finance governmental expenses for the favor of people prosperity. For a company, tax is a cost and therefore the presence of tax is affecting cash flow and profit (Mardiasmo, 2011; Supriyati, 2011). A company is considered good when it has good financial performance. Two indicators are used to measure good financial performance, namely how effective the tax rate is applied by the company and how good the company is in managing taxation issues (Cahyadi et al., 2018). Usually, many companies consider tax as a problem and they do anything toward tax avoidance, which among others is through *transfer pricing*. The companies do *transfer pricing* by shifting its tax duty to a country with lower tax rate. A multinational company often does *transfer pricing* to minimize its global tax duty (Rachmat, 2019). *Transfer pricing* implemented by multinational companies can reduce total tax rate that must be paid by the companies. Indeed, multinational companies convince that their tax duty can be minimized by shifting their income and profit to a country with lower tax rate. If effective tax rate of a company is low, then the possibility of tax avoidance through *transfer pricing* is high. In contrast, if effective tax rate is high, then the company is hesitate for *transfer pricing*. The company does *transfer pricing* as an effort to minimize the level of tax that should be paid. Therefore, it can be said that *transfer pricing* can affect tax level that the company must bear. Regarding to this position, first hypothesis is stated as following:

H_1 : *Tax avoidance* has effect on *transfer pricing.*

Bonus Mechanism and *Transfer Pricing*

Bonus mechanism is a return given by shareholders to manager (board of directors) for managerial contribution in attaining good company performance (Hansen et al., 2005). It was said by Rachmat (2019) that any manager of a company will really like income statement that shows high revenue level because they expect a bonus from shareholders. If manager can successfully improve company performance and raise company's Net Profit Trend Index, then manager will get the bonus. Hartati *et al.* (2014) found that bonus is given by company owner to manager if manager can maximize company profit, and this profit maximization is often achieved by manager through *transfer pricing*. *Agency theory* asserted that *principal* and *agent* have different interests. Manager usually wants appreciation over the performance that the company has achieved. Manager always improves company performance because manager presumes that company owner will give manager a reward or recognition for successful achievement over company goals (Hartati et al., 2014; Lo et al., 2010;). In addition, Faizi (2018) found that bonus can motivate company manager to select the proper accounting procedure to shift profit from the future period to the current period, and this position is in line with *bonus plan hypothesis.* Meanwhile, Lo *et al.* (2010) believed that if company performance is determined based on company's profit statement, then manager will always take efforts to improve total profit of the company. High level of company profit is associated with high possibility that appreciation will be given to the company. Bonus mechanism is closely related with *transfer pricing* because *transfer pricing* is one of several steps done by manager to improve company profit. In regard of these statements, second hypothesis is proposed as following:

H_2 : Bonus mechanism has effect on *transfer pricing.*

Debt Covenant and *Transfer Pricing*

Debt Covenant is a contract shown by creditor (lender) to debtor (borrower) to limit any activity of debtor that may damage loan value and loan *recovery* (Pambudi, 2017). Pertinent to this statement, Watts (1986) found that if loan level of the company is high, then the company will always take efforts to show to creditor that the company can achieve good performance in order to convince creditor that the company can pay the loan. Taylor *et al*. (2015) explained that *leverage ratio* is a proxy of inclination if a company will contravene a contract. *Leverage* shows how much company asset is financed by debt. According to Watts (1986), *debt covenant hypothesis* in *positive accounting theory* has predicted that if debt or loan level of the company is high, then the presentation of this debt or loan in financial statement will not be conservative because manager tends to show that manager has successfully improved profit and asset to reduce contract renegotiation over debt when the company goes into debt covenant. The company shows to the creditor that the company has good performance by improving profit level and asset value of the company as high as possible, and this is usually done through *transfer pricing*. Good company performance makes the creditor believing that its credit fund is secured. Therefore, company manager must always make decision to improve profit level and asset value because creditor usually likes a company with strong asset to cover its debts (Pambudi, 2017). In accordance with these statements, third hypothesis is written as following:

H_3 : *Debt covenant* has effect on *transfer pricing.*

Tunneling Incentive and *Transfer Pricing*

Tunneling incentive represents a concentrated ownership held by certain entity over the right of control and the right of cash flow in the company, which makes the entity acting as a controlling shareholder (Mispiyanti, 2015). *Tunneling incentive* is a behavior done by majority shareholders when they transfer profit and company asset for their own benefit but the cost of this transfer is charged to minority shareholders (Hartati *et al.,* 2014). Furthermore, Mispiyanti (2015) also said that majority shareholders do monitoring and controlling over company management and this action affects company performance. These shareholders engineer company performance for their own benefit and prefer of doing *tunneling* than distributing financial resource as dividend. In other words, the controlling shareholders do *tunneling* by creating concentrated ownership over the right of control and the right of cash flow in the company (Mispiyanti, 2015). Meanwhile, Ming *et al.* (2005) declared that the controlling shareholders would shift the surplus of financial resources for their interest rather than distribute it as dividend. It is not surprising because they definitely will use the right of control to improve their prosperity with other richess (Claessens, Djankov, Fan, & Lang, 2005). The controlling shareholders would not pay dividend to non-controlling shareholders but rather than transfer the profit to other company controlled by them and do transactions of sale and purchase only with entities related (affiliated) to them. This process is called *transfer pricing*. When the controlling shareholders have high incentive toward expropriation, then they tend to do transaction only with entities related to them. By the statements above, fourth hypothesis is elaborated as following:

H_4 : *Tunneling incentive* has effect on *transfer pricing.*

Audit Quality and *Transfer Pricing*

Audit quality is any possibility that might occur when auditor conducted audit on client's financial statement and found mistake or error and then made report about it in audited financial statement (Damayanti *et al.,* 2016). The process of an audit is affected by four factors, namely professionalism, accountability, integrity and transparency. These factors represent the measurer of audit quality. Of all these factors, transparency is the most important factor in determining audit quality. Transparency helps the shareholders to ensure that they will get accurate disclosure about the company. Company management needs transparency to ascertain that the company has the expected quality of audit. At least, transparency may convince shareholders that they receive accurate information about the company. For auditor itself, any audit process always needs transparency in order to produce accurate disclosure. High level of transparency to shareholders regarding tax issue is strongly recommended by public authority (Sartori, 2011). Tax aggresiveness behavior to avoid tax report is seemingly too frequent. One example of tax aggresiveness behavior is that the company does tax avoidance using *transfer pricing* to minimize its tax duty. Transparency is needed to convince shareholders that they receive information about tax in good quality and therefore, auditor should audit company's financial statement in such a way to maintain the reliability of information. With respect to these statements, fifth hypothesis is proposed as following:

H_5 : Audit quality has effect on *transfer pricing.*

Multinationality and *Transfer Pricing*

A company may have several branches or subsidiaries in various countries. Multinational company tends to minimize its operational expenses by reducing its tax duty. One reason why certain country is selected as a place to establish branch office is that the country has soft tax regulation, which therefore multinational company can do *transfer pricing* to produce lower tax duty (Omar & Zolkaflil, 2015). Different tax rate policy in different countries also motivate the management to conduct *transfer pricing*. When the company has several subsidiaries and high level of product diversification, then the company tends to decide to conduct *transfer pricing* (Lanis & Richardson, 2013). Regarding to these statements, sixth hypothesis is stated as following:

H_6 : Multinationality has effect on *transfer pricing*

Foreign Ownership and *Transfer Pricing*

Many companies, including Indonesian companies, have concentrated ownership structure. However, concentrated ownership may cause conflict of interest involving controlling shareholders, management, and non-controlling shareholders. Usually, non-controlling shareholders rely on controlling shareholders (even trust them) to supervise management. While implementing supervisory function over management, therefore, controlling shareholders have better position over the others in the company and also have better access to information. *Transfer pricing* decision, as the consequence, will always be under acknowledgment of controlling shareholders. When the company has large number of foreigners who hold controlling shares, then they will use their influence to require the company to implement *transfer pricing* in order to optimize company profit (Kiswanto *et al.* 2014). Based on these explanations, seventh hypothesis is elaborated as following:

H7 : Foreign ownership has effect on *transfer pricing*

Company Size and *Transfer Pricing*

Company size is known from asset, resource, and turnover that a company has obtained. Large company mostly operates in a complex business environment and therefore manager takes caution in presenting financial statement to keep the company from suffering loss. A company can perform well when it can make the right operational decisions, and one such decision is *transfer pricing*. It must be noted that *transfer pricing* is often done by a company that has offices in more than one location or country. Therefore, *transfer pricing* is probably implemented very often by a company with large financial resources (Lanis & Richardson, 2013; Schandlbauer, 2017; Halim, 2019).

H8 : Company size has effect on *transfer pricing*

Research and Methodology

Method of this research involves descriptive statistic test, classical assumption test and hypothesis test. Regression test is used for testing the hypotheses. Data type is secondary data, which take form as financial statements of manufacturing companies that list at Indonesia Stock Exchange on period of 2016-2018. Therefore, research population is manufacturing companies that list at Indonesia Stock Exchange on period of 2016-2018 but the collected data are on period of 2015-2019. Sampling technique is *purposive sampling* with criteria. Three criteria are used, respectively: the companies did not suffer commercial and fiscal losses during research period; the companies have presented financial statements in complete manner and these statements have been audited not later than December 31; and the companies must have receivable transaction with their affiliate company or with privilege entity. After applying these criteria, there were 275 samples obtained.

Operational Definition and Variable Measurement

Dependent variable of this research is *transfer pricing* whereas its independent variable includes tax avoidance, bonus mechanism, *debt covenant, tunneling incentive*, audit quality, multinationality, foreign ownership, and company size. *Transfer pricing* is a policy made by a company to set a price of a transaction made between the company and its privilege entities. ***Transfer pricing*** is measured by *Related Party Transaction* (RPT). Presumably, a company tends to do *transfer pricing* when it makes transaction with affiliate company because both sides can take considerable benefit from *transfer pricing* (Baihaqi *et al.,* 2019: Melmusi, 2016; Refgia *et al.*, 2017). The formula of RPT is total receivable of privilege entities divided by total receivable of the company. *Current Effective Tax Ratio* (CETR) is used to measure tax duty. When tax duty is already known, it will help researcher in detecting whether the company does tax avoidance or not (Faizi, 2018; Mispiyanti, 2015; Yuniasih *et al.,* 2012). The formula of CETR is tax liability divided by post-tax net profit. **Bonus mechanism** is a reward given by company owner to manager for manager achievement on company performance and net profit. Bonus mechanism is measured by Net Profit Trend Index (Faizi, 2018; Cristea, 2016; Hartati *et al.,* 2015) and the formula of this Index is net profit of current year divided by net profit of previous year. ***Debt covenant*** is a contract given by creditor as lender to debtor as borrower to minimize any activity that can damage loan value and hamper loan recovery. *Debt covenant* is measured by *leverage ratio* or Debt-Equity Ratio (*DER*) (Rosa *et al.,* 2017). The formula of this ratio is total liability divided by total asset. ***Tunneling incentive*** is a behavior shown by the owners of concentrated shares over the right of control and the right of cash flow. The owners of concentrated shares is also called as controlling shareholders because they can transfer asset and profit of the company to the other company that they have controlled. Usually, the transaction of sale and purchase made between the company and its affiliate company is set on unreasonable price. *Tunneling incentive* is proxied by two indicators, namely quantitative indicator and qualitative indicator. Quantitative indicator is the holding of 50 percent or more of total shares while qualitative indicator is any condition that support the count of shareholding. In this context, shareholding refers to the ownership of concentrated shares that makes the owner acting as controlling shareholder. Shareholding percentage is determined through a ratio (Faizi, 2018), which the formula of this ratio is concentrated ownership compared to number of share in circulation. **Audit quality** is a degree of performance of auditor when auditor carries out an audit on financial statements of the client, then finds mistakes or errors, and later makes disclosure about it in the audit report. Audit quality, in this context, is closely related with auditor reputation. Audit process in high quality is an audit done by auditor who is competent, independent and recognized as having good reputation (Rosa *et al.,* 2017; Noviastika *et al.,* 2016). In this research, audit quality is used as *dummy variable*. **Multinationality** describes a characteristic when a company has more than one branch. Multinationality is proxied by number of subsidiaries. The formula is number of subsidiary in abroad divided by total subsidiary (Richardson, *et al*., 2013). **Foreign ownership** is proxied by a ratio and the formula of this ratio is percentage of foreign ownership compared to total share in circulation. **Company size** is proxied by asset size and the formula is natural logarithm of total asset (Richardson *et a*l., 2013).

Data Analysis Technique

Research variables are analyzed through several stages, which starts with descriptive test, continues to classical assumption test and ends at hypothesis test. Descriptive analysis will test each variable to determine the values of minimum, maximum, mean and standard deviation. Classical assumption test involves testing on normality, multicollinearity, heteroscedasticity and autocorrelation. Hypothesis test consists of F test, determination coefficient test, and t test.

Data analysis model is shown as following:

$$Y \quad = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + b_5X_5 + b_6X_6 + b_7X_7 +$$

Where:

Y= Variable of Transfer Pricing
a= Constanta
b1, b2, b3 = Regression Coefficient
X_1= Variable of Tax Avoidance

X_2= Variable of Bonus Mechanism
X_3= Variable of Debt Covenant
X_4= Variable of Tunneling Incentive
X_5= Variable of Audit Quality
X_6= Variable of Multinationality
X_7= Variable of Foreign Ownership
X_8= Variable of Company Size
e = Standard Error (error rate) 5%

There are 7 (seven) assumption test for this research results.

i. *Normality Test*
ii. *Multicollinearity Test*
iii. *Heteroscedasticity Test*
iv. *Hypothesis Test*
v. *Simultaneous Hypothesis Test (F)*
vi. *Partial Hypothesis Test (Test-t)*
vii. *Coefficient of Determination*

Result and Discussion

Descriptive Statistic Test

Results of descriptive statistic test are shown by the values of minimum, maximum, mean and standard deviation of research sample. Results of the test are presented in the following table.

Table 1: Results of Descriptive Statistic Test

	N	Minimum	Maximum	Mean	Std. Deviation
Tax Avoidance	275	.0624	.3934	.25579	.0534
Bonus Mechanism	275	.2976	2.3255	1.0858	.3753
Debt Covenant	275	.0707	.8340	.3948	.1784
Tunneling Incentive	275	.3289	.9841	.6496	.1533
Audit Quality	275	.0000	1.000	.4200	.4950
Multinationality	275	249	.0000	.6154	.1379
Foreign Ownership	275	249	.3289	.9841	.6574
Company Size	275	249	5.3899	13.3067	10.0787
Transfer Pricing	275	.0001	.9684	.2618	.3049
Valid N (*listwise*)	275				

Relating to *transfer pricing*, standard deviation value is higher than mean value. This result signifies that data variation of this variable is relatively high or that the data are heterogenous. Meanwhile, mean value of tax avoidance, bonus mechanism, *debt covenant, tunneling incentive,* multinationality, foreign ownership and company size, is generally higher than its standard deviation value. Based on this result, it can be said that data variation of these variables is relatively low or that the data tend to be homogenous. Audit quality has mean value of 0.42 that closes to 0. This result is obtained because most companies in the sample use Public Accountant Office of Non-Big Four.

Classical Assumption Test

Normality test was done using *Kolmogorov-Smirnov* statistical analysis. The effect of tax avoidance, bonus mechanism, *debt covenant, tunneling incentive,* audit quality, multinationality, foreign ownership and company size on *transfer pricing* was tested. The result showed that this effect has *Kolmogorov-Smirnov*'s Z-value of 1.214 and the value of its *Asymp. Sig. (2-tailed)* is 0.105. This result signifies that the residual of sample data has normal distribution. Multicollinearity test was also conducted and the results showed that tolerance value is > 0.10 and VIF value is $\leq$ 10. These results indicate that there is no multicollinearity symptom.

Table 2: Results of Multicollinearity Test

Model	***Collinearity Statistics***	
	Tolerance	VIF
Tax Avoidance	.956	1.046
Bonus Mechanism	.975	1.025
Debt Covenant	.997	1.003
Tunneling Incentive	.970	1.030
Audit Quality	.950	1.053
Multinationality	.882	1.133
Foreign Ownership	.972	1.029
Company Size	.900	1.111

Heteroscedasticity had been examined using Glejser Heteroscedasticity Test. Results of the test showed that significance value of each independent variable is higher than or equal to 0.05. Regarding to this result, it is said that there is no heteroscedasticity problem.

Table 3: Results of Heteroscedasticity Test

Model	**T**	**Sig.**
(*Constant*)	1.088	.278
Tax Avoidance	-.942	.347
Bonus Mechanism	1.665	.097
Debt Covenant	-1.617	.107
Tunneling Incentive	-1.574	.117
Audit Quality	.251	.802
Multinationality	1.671	.298
Foreign Ownership	1.321	.686
Company Size	1.201	.638

Autocorrelation test was conducted on research variables. It was found that Durbin Watson value is 2.031 with DL value of 1.77052 and DU value of 1.83062. In regard of these results, it can be said that DU<D<4-DU = 1.83062 < 2.031 < 2.16938, which signifies that there is no autocorrelation.

F Test (Simultaneous)

Below are the results of F test that is applied simultaneously on research variables:

Tabel 4: F Test (Simultaneous)

ANOVA[a]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	23.943	5	4.769	6.642	0.000
	Residual	193.138	269	.718		
	Total	216.981	274			
a. Dependent variable: transfer pricing						
b. Predictor: (Constant), tax avoidance, bonus mechanism, debt covenant, tunneling incentive, audit quality, multinationality, foreign ownership, company size						

Pertinent to the contents of the table above, significance value of F test is 0.000, which is smaller than 0.05. By virtue of this result, it can be said that one of independent variables has significant effect on dependent variable. Therefore, research model is considered fit.

Multiple Linear Regression Analysis

Below is the table of the results of multiple linear regression analysis

Tabel 5: Results of Multiple Linear Regression Analysis

Model	***Unstandardized Coefficients***		**t**	**Sign**
	b	Std. Error		
(*Constant*)	-1.343	.350	-3.840	.000
Tax Avoidance (X1)	-1.001	.506	-1.976	.049
Bonus Mechanism (X2)	-.110	.324	-.338	.736
Debt Covenant (X3)	1.158	.226	5.120	.000
Tunneling Incentive (X4)	-.279	.507	-.550	.583
Audit Quality (X5)	.801	.349	2.297	.022
Multinationality (X6)	-.603	.298	-2.021	.045
Foreign Ownership (X7)	1.671	.686	2.437	.016
Company Size (X8)	1.321	.638	2.071	.040
Note: Dependent Variable: Transfer Pricing				

Multiple linear regression was applied on independent variables. Regression equation is made based on data in above table. Each independent variable is included into this equation excepts two variables, respectively X2 and X4. The equation is written as following:

$Y = -1.343 - 1.001X_1 + 1.158\, X_3 + 0.801\, X_5 - 0.603\, X_6 + 1.671\, X_7 + 1.321\, X_8 + e$

The above equation leads to the following results:

- *Constant (a) = 1.343. This position signifies that although independent variables in the equation, which comprise of tax avoidance (X_1), debt covenant (X_3), audit quality (X_5), multinationality (X_6), foreign ownership (X_7), and company size (X_8), have different significance value, but transfer pricing (Y) still remains to be 1.343.*
- *Coefficient value for X_1 (b_1) is -1.001 and the value is negative. This position denotes that an increase by 1 in tax avoidance will lead to a decrease by 1.001 in transfer pricing.*
- *Coefficient value for X_3 (b_3) is 1.158 and the value is positive. This position determines that if debt covenant increases by 1, then transfer pricing increases by 1.158.*
- *Coefficient value for X_5 (b_5) is 0.801 and the value is positive. This position indicates that the increase of audit quality by 1 is followed by the increase of transfer pricing by 0.801.*
- *Coefficient value for X_6 (b_6) is -0.603 and the value is negative. This signifies that an increase by 1 in multinationality will lead to a decrease by 0.603 in transfer pricing.*
- *Coefficient value for X_7 (b_7) is 1.671 and the value is positive. This position denotes that any increase in foreign ownership by 1 will lead transfer pricing to increase by 1.671.*
- *Coefficient value for X_8 (b_8) is 1.321 and the value is positive. This position determines that the increase of company size by 1 leads to the increase of transfer pricing by 1.321.*

Coefficient of Determination

Determination coefficient test is conducted with the help of SPSS Program. Result of the test is presented in the following.

Table 6: Results of Determination Coefficient Test

Model	***R***	***R Square***	***Adjusted R Square***	***Std. Error of the Estimate***
1	*.331*	*.110*	*0,093*	*.84734*

Note: Dependent Variable is kept.

Determination coefficient test was conducted and it was found that the value of *Adjusted R Square* is 0.093 or 9.3%. This finding signifies that the degree of the effect of independent variables, which include tax avoidance, bonus mechanism, *debt covenant*, *tunneling incentive*, audit quality, multinationality, foreign ownership and company size on dependent variable, which is *transfer pricing*, is 9.3% while the remaining 90.7% is explained by other variables beyond this research.

Discussion

Effect of Tax Avoidance on *Transfer Pricing*

Manufacturing companies are quite familiar with *tax avoidance*. Tax duty of these companies is usually high. As large-scale taxpayers, the companies perceive tax as a burden. Therefore, tax avoidance is selected as a way to escape from this burden, and one door toward this escape is *transfer pricing*. Tax duty is measured by *Current Effective Tax Ratio* (CETR). If this ratio is low, then manufacturing companies tend to do tax avoidance. The companies must keep their tax payment as low as possible to minimize its distraction on another fund allocation. Tax avoidance is a strategy that must be integrated with the strategy of other company. When a company has several branches or subsidiaries, then it is highly possible that this company will consider to do tax avoidance through *transfer pricing*. So far, *transfer pricing* is truly effective in helping the company to achieve company goals, especially concerning with improving profit level and fulfilling shareholder expectation. *Agency theory* upholds this position by saying that for fulfilling shareholder expectation, the management should maximize any activity that can minimize company burden. *Transfer pricing* is selected because it takes benefit from different tax regulation applied at different country, and *transfer pricing* is proved to be successful in improving company profit (Pil et al., 2020). This finding is consistent with the finding given by Faizi (2018), which said that tax avoidance has effect on *transfer pricing* decision.

Effect of Bonus Mechanism on *Transfer Pricing*

Result of research showed that bonus mechanism did not affect *transfer pricing*. Bonus promised by company owner to be given to management is even not important consideration. The decision toward *transfer pricing* is related more with whether the company has branch or subsidiary, or not at all. Indeed, *transfer pricing* decision is not merely based on bonus incentive. *Principal* always has supervisory mechanism (*monitoring cost)* to be applied on management. This mechanism is a part of *agency cost* spent by *principal* to minimize agency problem or conflict of interest when principal examines the performance of management in managing the company. It contrasts with *bonus plan hypothesis* in *positive accounting theory*, which says that accounting policy made by manager is always based on managerial expectation for bonus. Moreover, this position is in line with previous findings given by Faizi (2018), Rosa *et al.* (2017), Cristea (2016), and Mispiyanti (2015), which generally showed that bonus mechanism does not have effect on *transfer pricing* decision.

Effect of *Debt Covenant* on *Transfer Pricing*

Result of research has shown that *debt covenant* has positive effect on *transfer pricing* decision. If *debt covenant ratio* of a company is high, then the possibility that the company implements *transfer pricing* to convince creditor to give loan is also high. When company resource is mostly coming from loan, then the company is facing the fact that it must pay several costs, such as repayment cost, administrative cost, and interest rate cost. Besides this, the company is required to pay operational cost if the company decides to implement *transfer pricing* with its branch or subsidiary in the country that has lower financial charges (worker cost, raw material cost, and tax duty). This position is in conformity with *debt covenant hypothesis* in *positive accounting theory*, which says that when the company seemingly has intention to violate accounting principle regarding debt agreement, then company manager tends to use certain accounting procedure that can improve company profit. This procedure usually involves the reduction of contract renegotiation over debt when the company initiates debt agreement. This position is also in tune with the finding given by Rosa *et al.* (2017), which indicated that *debt covenant* has effect on *transfer pricing* decision.

Effect of *Tunneling Incentive* on *Transfer Pricing*

Result of research indicated that *tunneling incentive* did not have positive effect on *transfer pricing* decision. The level of *tunneling incentive* in a company never affects *transfer pricing* decision made by the company. Controlling shareholders does not use the right of control toward expropriation to increase their own benefit. In other words, they do not incline toward *transfer pricing*. This position is consistent with *agency theory*, which determines that *principal* gives authority to *agent* to manage the work and to make the best decision for the benefit of *principal*. The statement agrees with *political cost hypothesis* in *positive accounting theory*, which explains that accounting policy selected by company manager is always affected by political condition in the company. This position corresponds with the findings given by Saifudin *et al.* (2018) and Rosa *et al.* (2017), which generally says that *tunneling incentive* does not affect *transfer pricing* decision.

Effect of Audit Quality on *Transfer Pricing*

Result of research has revealed that audit quality has positive effect on *transfer pricing* decision. If the auditor who audits company's financial statements has high or good reputation, then the user of audit information will believe that this information is in good quality. When the information of audit can be dependable, then the user will perceive that the company will not implement aggressive tax policy. Besides audit information, company's tax position is also determined by transaction made by company with other company. Therefore, a company still has courage to do *transfer pricing* or to have closed transaction with affiliate company because the user of audit information often relies only on auditor reputation as the measurer of audit quality. The user always associates good reputation of auditor with less inclination toward *transfer pricing*. Audit report is always put as enclosure in general description of the company and this report states any entity that has relation or affiliation with the company (referring to Standard Statement of Financial Accounting No.7/2015). When a company initiates transaction with affiliate company and sets the transaction on price that is considered by independent auditor as unreasonable, the company can always show any report or explanations regarding the price. The determination of transaction price should obey the Decree of Directorate General for Tax Affair No.PER-32/PJ/2011 concerning The Implementation of Fairness and Usuality Principles in Business and Transaction Between Taxpayers and Privilege Entity. This result is in conformity with the finding given by Rosa *et al.,* (2017), which says that audit quality has effect on *transfer pricing* decision.

Effect of Multinationality on *Transfer Pricing*

Company management decides to shift company resources to the branch or subsidiary in other country to get the bigger profit. The companies that have subsidiary in other country always make decision toward *transfer pricing*. Main goal of *transfer pricing* is usually costing efficiency. Different policies across countries can lead to different decisions among the manufacturing companies in Indonesia. This position accords with the finding conveyed by Lanis & Richardson (2013).

Effect of Foreign Ownership on *Transfer Pricing*

Shareholding (share ownership) in Indonesian manufacturing companies is often dominated by foreign ownership. This domination makes foreigners have great influence on various company decisions, including decisions regarding price setting and transaction level. Foreign ownership in Indonesian manufacturing companies has reached over 20% and this proportion makes some foreigners to always be involved in the making of *transfer pricing* decision. Therefore, these foreigners are usually trusted by non-controlling shareholders to occupy high position in the company. Besides shareholding proportion, respectable position is given to these foreigners because they are considered capable to supervise individuals who operate the company, having better access to information, and capable to give policy direction that suits to the external condition. This position is in line with the findings put on by Kristianto et al. (2017), Chen et al. (2018), and Refgia et al. (2016).

Effect of Company Size on *Transfer Pricing*

Total asset owned by a company represents the maturity level of the company. If the size of the company is large, then the company is always associated with big cash flow, good operational, better public perception on company product, and strong profitability. Investors may then demand something that compels the management to improve internal development, to increase operational efficiency and to optimize the profit. One strategy to make this happen is by *transfer pricing* decision (Richardson et al., 2013; Pil et al., 2020).

Conclusions

The objective of this research is to provide proof regarding the effect of tax avoidance, bonus mechanism, *debt covenant, tunneling incentive,* audit quality, multinationality, foreign ownership and company size on *transfer pricing* at manufacturing companies that list at Indonesia Stock Exchange on period of 2016-2018. Several findings were obtained from this research. There is a proof that tax avoidance, *debt covenant,* audit quality, multinationality, foreign ownership and company size have effect on *transfer pricing* decision. Meanwhile, bonus mechanism and *tunneling incentive* do not have significant effect on *transfer pricing* decision. A lot of factors involve in transfer pricing decision. One from inside company and the others from outside company. Transfer pricing is a tool to achieve certain goals. The purpose of transfer pricing can be categorized as internal goal (evaluation of performance between managers) and external goals (reduction of tax revenue globally, reduction of tariffs). The manufacturing companies when decide about transfer pricing must be careful because there are two perceptive about transfer pricing. One perceptive from business that transfer pricing is something useful because a company can save money related tax but the other perceptive from government side, transfer pricing has believed to be able to have reduced or even disappearing potential for a country's tax revenue.The companies are allowed to make *transfer pricing* decision only if the companies are capable to give explanation and to submit report regarding transaction price in *transfer pricing*. In addition to these requirements, the companies that conduct *transfer pricing* must obey the Decree of Directorate General for Tax Affair No.PER-32/PJ/2011 concerning *The Implementation of Fairness and Usuality Principles in Business and Transaction Between Taxpayers and Privilege Entity*.

It is suggested that next research should try investigate other sector and put external factors such as, currency rate and tax rate as the variables' implication of this research is that result of research will provide inputs for academicians in developing the latest *transfer pricing* concept in accounting field and also may give the companies something to be considered before making business strategy.

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