

HOW DO TRADING, SERVICE, AND INVESTMENT SECTOR COMPANIES MAKE TRANSFER PRICING DECISIONS?

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Abstract

The purpose of this study was to examine the effect of bonus mechanisms, tunneling incentives, debt covenants, and sales growth on company decisions in transfer pricing practices. Trading, service, and investment companies listed on the Indonesian Stock Exchange (IDX) in 2014-2018 were used as the research population. The sampling technique used a purposive sampling method with specific criteria so that the final sample of the study was 21 sample companies. The research analysis technique used multiple regression analysis techniques using the IBM SPSS 21 application. This study proved that the bonus mechanism and sales growth could not influence the company to choose to practice transfer pricing. Tunneling incentives have a positive and significant effect on the decision to practice transfer pricing. In contrast, debt covenants have a negative and significant impact on the decision to practice transfer pricing. This research concluded that bonus mechanisms and sales growth could not determine transfer pricing practice decisions, while tunneling incentives can influence companies in making decisions on transfer pricing practices. Debt covenant has a negative and significant effect on transfer pricing practice decisions. Future research may use other bonus mechanism measures, such as proxies for compensation. Subsequent studies can select company objects with a larger population, such as non-financial companies on the IDX.

Keywords: Bonus mechanism, tunneling incentive, debt covenant, sales growth.

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INTRODUCTION

Companies use tax planning to make the tax burden smaller. Companies with low tax burdens can maximize profits after tax. Companies can use the practice of determining transfer pricing to minimize their tax burden. Transfer pricing can be carried out in one department to another in a particular company or at two companies with a special relationship, such as a subsidiary company and a holding company. Transfer price is a decision to determine the transfer price for goods,

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services, or intangible assets between a related company such as a holding company and a subsidiary company. Transfer pricing as an accounting research topic has focused on numerous experimental studies for many decades (Hussein, Kraten, Seow, & Tam, 2017).

In taxation, transfer pricing is a significant action or problem because transfer pricing can cause a country's tax revenue to decrease. Even though the tax authorities make regulations, there are still transfer pricing practices in several companies in Indonesia. There have been many cases of transfer pricing, such as the case of PT Adaro Energy. According to a Global Witness report on July 4, 2019, PT Adaro through one of its subsidiaries in Singapore, namely Coaltrade Services International. PT Adaro paid its tax liabilities \$125 million less than the tax payable in Indonesia itself. The company moves large amounts of money through tax havens and has succeeded in reducing its tax bill to be paid in Indonesia by almost \$14 million annually. Because so many transfer pricing cases occurred in Indonesia, the Minister of Finance of the Republic of Indonesia in 2016 issued Regulation No.213/PMK.03/2016 concerning new provisions for transfer pricing documents. The companies in Indonesia have an obligation that must be done to submit an Annual Tax Return Corporate Income Tax. Companies conducting transactions with special parties are required to submit transfer pricing documents.

The research that examines the influence of certain factors on the decision to practice transfer pricing has been studied previously. The analysis of Nazihah & Fuadah's (2019) results showed that the management was practicing transfer pricing because there is a push from the bonus mechanism that the company owner has determined. The company owner sets a high bonus if the manager can achieve the targeted profit. The manager will get a large bonus, so this action motivates managers to practice transfer pricing (Nazihah & Fuadah, 2019). Research by Fitri et al. (2019) companies carries out transfer pricing activities influenced by the bonus mechanism. A study from Hartati et al. (2014) stated that the bonus set based on the profitability formula could influence managers' transfer pricing practices. Sarifah et al. (2019) and Nuradila & Wibowo (2018) conducted research. They showed different results, where the bonus set by the company owner could not encourage managers to carry out transfer pricing activities. Another study indicated that the bonus mechanism does not affect, while intangible assets and inventory intensity ratio significantly affect transfer pricing decisions (Khasanah & Suryarini, 2020).

Transfer pricing research can be influenced by transferring company assets or profits, commonly called tunneling incentives. Yulianti & Rachmawati (2019) showed that transferring company assets/profits could affect transfer pricing practices practiced by companies. According to Sarifah et al. (2019), the increasing actions of transferring profits/assets can encourage companies to practice transfer pricing with related parties. The research results by Saraswati & Sujana (2017) showed that tunneling could determine the transfer price, where if the shareholder has high ownership, it can trigger the practice of transfer pricing. Research by Rosa et al. (2017) and Susanti & Firmansyah (2018) proved that tunneling activities do not have any positive effect but negatively affect when the transfer of company profits is high, the practice of transfer pricing will decline. Meanwhile, Nazihah & Fuadah's (2019) research results showed that companies do transfer pricing, not because of tunneling.

Companies that determine transfer prices can be triggered by a debt covenant (debt contract). Companies' existence of debt agreements starts the research by Rosa et al. (2017) and Nuradila & Wibowo (2018) transfer pricing activities. If the company violates more of the

stipulated debt agreement provisions, this will encourage managers to determine accounting procedures to increase profits. Companies can use transfer pricing activities to increase their profits. (2016) showed differences in results, where the transfer price practice is not triggered by the company's existence of a debt contract.

There is no research on the effect of sales growth on transfer pricing in the previous study, but the variable sales growth has been done with the tax avoidance variable. Silvia's (2017) research proved that companies avoid the tax due to increased sales growth. Purwanti & Sugiyarti (2017) suggested that the increase in sales is getting bigger every year. It will increase the company's sales growth, resulting in enormous profits and tax burdens borne by the company. Companies that have high tax responsibilities will take tax avoidance actions that company profits do not decrease. Oktamawati (2017) provided results that tax avoidance activities are driven by sales growth.

The purpose of this research is to study and test the effect of bonus mechanisms, tunneling incentives, debt covenants, and sales growth on company decisions in determining transfer pricing practices. The originality of this research is located in the object of research that uses trade, service, and industrial companies. The proxy used to measure the tunneling incentive variable is also different from previous studies, where the measurement of tunneling incentive in this study is proxied using managerial ownership. Another originality is the emergence of the sales growth variable as a new variable indicated to influence transfer pricing activities.

The basis of the research theory uses agency theory and positive accounting theory. Agency theory was first proposed by (Jensen & Meckling, 1976), which explains the relationship between the agent (management party) and the principal (shareholder). Agency problems arise when there is a difference in information between the management and the shareholders. Managers try to manage the company's tax costs so that the manager's performance compensation is not reduced due to increased sales growth, impacting rising company profits. When a particular group controls the ownership structure, there is an agency conflict between the shareholder with the most extensive ownership and the shareholder with the lowest ownership. The more information held by the shareholders with the most significant ownership inflicts them to take actions that produce specific benefits. If there is a loss, the loss is borne by the minority shareholder. Agency theory is used as the basis for the tunneling incentive variable and the sales growth variable.

This study uses the bonus plan hypothesis in positive accounting theory as the basis for the bonus mechanism variable. The debt covenant hypothesis is used as the basis for the debt covenant variable. The bonus plan hypothesis explains if managers who set specific bonuses prefer to use accounting procedures to increase company profits, such as transfer pricing practices. Meanwhile, the debt covenant hypothesis explains that the greater the opportunity to breach debt contracts by the company, it encourages management to use the profit-increasing accounting method.

This study uses trade, service, and investment companies as the object of research. The companies in the trade, service and investment sectors were chosen because these companies have considerable potential to carry out transfer pricing practices. For example, in trading companies where transfer pricing practices can occur when the shareholder company sells goods to subsidiary companies at prices above or below fair value. This study takes the period 2014-2018. Within five years, the research results are expected to be better and more representative and can describe the conditions of companies in Indonesia that practice transfer pricing.

The company uses a bonus mechanism to motivate majority shareholders and minority shareholders to work harder to achieve the company's targeted profit. If the company measures the bonus based on net income, the majority shareholder will likely report a high net income to increase the reward for that year. The bonus plan hypothesis suggests that managers tend to choose accounting procedures to boost profits if they take the bonus mechanism policy. Managers can manipulate financial reports so that the company gives a big bonus. Managers can carry out transfer pricing practices that aim to increase the company's net profit. Research by Fitri et al. (2019) and Nazihah & Fuadah (2019) showed that transfer pricing practices could be influenced by the bonus plan policy set by the company.

H1: The bonus mechanism has a positive effect on the decision to carry out transfer pricing.

In companies with a concentrated ownership structure, agency conflicts can occur in shareholders with significant ownership and shareholders who have little ownership. Shareholders with significant ownership who have higher information can transfer their assets or profits for their benefit. If there is a loss, the loss will be borne by the minority shareholder. Santosa & Suzan's (2018) research explains that the controlling shareholder will transfer assets to its subsidiary to reduce profit-reducing costs. Suppose the more tunneling, the transfer price practice will also be higher. Research by Saraswati & Sujana (2017) and Noviasatika et al. (2016) showed that companies that frequently transfer assets impact increasing transfer pricing practices.

H2: Tunneling incentive has a positive effect on the decision to do transfer pricing.

A debt covenant is a debt contract between a debtor and creditor, in which the agreement has established limits. The positive accounting theory explains the debt covenant hypothesis. This hypothesis explains that companies that have large debts will get closer to the limitations of debt contracts, where it triggers managers to choose accounting methods that can increase company profits if the opportunity to do so is breaches of contract are getting bigger. Managers can carry out transfer pricing practices to reduce the company's tax burden so that profits increase so that the company can relax these credit limits. Research results by Rosa et al. (2017) and Nuradila & Wibowo (2018) stated that transfer pricing activities could occur because of the influence of company debt agreements.

H3: Debt covenant has a positive effect on the decision to do transfer pricing.

Sales growth is the change in sales of goods or services from year to year, where sales growth is used as a benchmark for companies to increase sales. The higher the sales growth, the higher the company's profit. Higher profits have an impact on tax costs that the company bears. With an increased tax burden, companies will choose ways to minimize their taxes. Companies can practice transfer pricing to reduce taxes by conducting inventory sales transactions with related parties. The company can set prices for goods or services above or below market value with affiliated parties. Previous research has not examined the effect of sales growth on transfer pricing. Still, research on sales growth variables has been conducted on tax avoidance variables such as Fadjarenie & Anisah (2016) and Purwanti & Sugiyarti (2017). High sales growth results have an impact on increasing tax evasion.

H4: Sales growth has a positive effect on the decision to carry out transfer pricing.

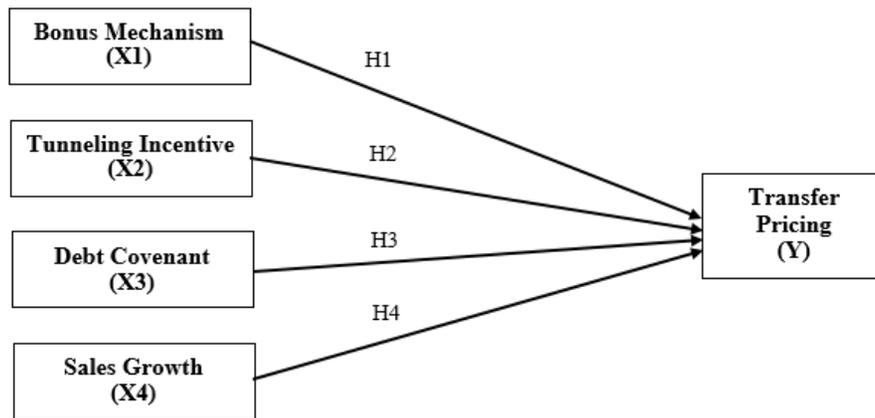


Figure 1. Thinking Framework Model

RESEARCH METHODS

The research design of this study is a hypothesis-testing study with a quantitative approach. This study selects trade, service, and investment companies that have been listed on the IDX from 2014 to 2018. The population consists of 154 companies. The research data is taken in annual reports and financial reports obtained through the official website of the IDX and the official website of related companies. The sampling technique used purposive sampling, which resulted in 76 units of analysis. This study uses multiple regression analysis models with hypothesis testing using a partial significance test (t-test). The following are some of the criteria for the purposive sampling technique:

Table 1. Identification of Sample Selection

No.	Criteria	Total
1.	Trade companies, services, and investments that already registered in Indonesia Stock Exchange (IDX) in 2014-2018	154
2.	Companies that disclose related party receivables in a row in 2014-2018	(17)
3.	Companies with positive profit value in 2014-2018	(51)
4.	Companies published the annual report in 2014-2018	(3)
5.	Companies that disclose the managerial ownership stock data in 2014-2018	(37)
6.	Companies that have consolidated financial reports	(25)
Total of sample companies		21
Total of analysis unit (5 years x 21 companies)		105
Total of data excluded from the study		29
Final Total of Analysis Unit in 2014-2018		76

Source: Processed secondary data, 2020

The dependent variable of this research is transfer pricing, while the independent variable is bonus mechanism, tunneling incentive, debt covenant, and sales growth. The operational definition can be seen in Table 2 below:

Table 2. Operational Definition of Variables

No.	Variable	Definition	Measurement
1.	Transfer Pricing	Determination of the transfer price of goods, services, or intangible assets with related parties	$\frac{\text{Transfer price}}{\text{Related party receivables}}$ (Refgia, 2017)
2.	Bonus Mechanism	Give bonuses to the managers for their achievement of obtaining the targeted profit	$\frac{\text{ITRENDLB Net profit year t}}{\text{Net profit year t-1}}$ (Nuradila & Wibowo, 2018)
3.	Tunneling Incentive	Transfer of assets/profits by the majority shareholder for their own business	$\frac{\text{Managerial ownership Number of management shares}}{\text{Total shares of the company}}$ (Pujiati & Arfan, 2013)
4.	Debt Covenant	Debt contracts aimed at creditors to limit the activities that could break the debt value	$\frac{\text{DER Total of debt}}{\text{Total of equity}}$ (Nuradila & Wibowo, 2018)
5.	Sales Growth	Changes in sales or services from year to year	$\frac{\text{Sales growth Sales in year t – sales in year t-1}}{\text{sales in year t-1}}$ (Purwanti & Sugiyarti, 2017)

Source: Processed secondary data, 2020

RESULTS AND DISCUSSION

Results

The research data were processed by descriptive statistical analysis, which was used to see the smallest, largest, mean, and standard deviation of each research variable. In addition, the data is also processed by multiple regression analysis using the classic assumption test first. The results of the descriptive statistics of all research variables are presented in Table 3.

The data in Table 3 shows that the mean of the bonus mechanism variable is 1.1011479, which means that the bonus mechanism for the sample companies is on average at 110.1%, which indicates that the profit conditions of the sample companies have only increased by 10.1% from the previous year. The mean value of tunneling incentive is 0.1644121, which means that the

sample companies have an average managerial ownership percentage of 16%. The mean debt covenant value of 0.9826300 means that the sample companies have an average value of 98.2%, calculated using the DER debt ratio. Sales growth has a mean value of 0.4080516, meaning that the sample companies experienced an increase in sales growth of 40%. The transfer pricing variable has a mean value of 0.3090277, which means that 30.9% of receivable transactions are categorized as transfer pricing transactions with related parties. The standard deviation value of the bonus mechanism variable, tunneling incentive, debt covenant, sales growth, and transfer pricing shows that the value is smaller than the mean value. This value means that the data distribution of all variables is not much different and tends to be homogeneous.

Table 3. Descriptive Statistic

	N	Min	Max	Mean	Standard deviation
Bonus Mechanism	76	0,21281	2,01732	1,1011479	0,28158024
<i>Tunneling Incentive</i>	76	0,00000	0,76079	0,1644121	0,15717841
<i>Debt Covenant</i>	76	0,37116	1,95600	0,9826300	0,42496285
<i>Sales Growth</i>	76	0,06745	3,04795	0,4080516	0,36533369
<i>Transfer Pricing</i>	76	0,00000	0,97728	0,3090277	0,29143976

Source: Processed secondary data, 2020

This study conducted a classic assumption test with the aim that the estimator was free from bias. The normality test was carried out by looking at the Kolmogorov-Smirnov One-Sample table with a significance value of $0.343 > 0.05$, so the research data were normally distributed. The multicollinearity test shows that all research variables have a VIF value < 10 and a tolerance value > 0.10 . So, the research data does not have multicollinearity symptoms. The heteroscedasticity test used a scatterplot diagram and white test. The scatterplot diagram shows the research data spread and does not shows a particular pattern. It can be concluded that the data does not experience heteroscedasticity.

Table 4. Hypothesis Test Results

No.	Hypothesis	B	Significance Value	Conclusion
1.	H1: The bonus mechanism has a positive effect on the decision to carry out transfer pricing.	-0,196	0,072	rejected
2.	H2: Tunneling incentive has a positive effect on the decision to do transfer pricing.	0,448	0,024	accepted
3.	H3: Debt covenant has a positive effect on the decision to do transfer pricing.	-0,363	0,000	rejected
4.	H4: Sales growth has a positive effect on the decision to carry out transfer pricing	0,016	0,847	rejected

Source: Data processed, 2020

The white test shows that the results do not show heteroscedasticity symptoms seen from the value of c^2 count $<c^2$ table (21.432 <96.217 with a confidence degree of 0.05). The autocorrelation test uses the run test by looking at the Asymp. Sig (2-tailed) value $0.817 > 0.05$ so that the research data does not have autocorrelation symptoms. The partial determination coefficient test (r^2) was carried out and showed that the debt covenant variable had a greater r^2 value than the other independent variables, which meant that the debt covenant had a dominant influence on transfer pricing. The results of hypothesis testing are presented in Table 4.

Discussion

The Effect of Bonus Mechanism on Transfer Pricing

The first hypothesis of the study is rejected. It means that the bonus mechanism using ITRENDLB (net profit trend index) as a proxy cannot influence its decision to conduct transfer pricing practices. The results show that trading, service, and investment companies prefer not to increase profits excessively. This result is evidenced by the increase in the mean value of the bonus mechanism each year by only 10.1%. Companies are not motivated to get high bonuses by practicing transfer pricing.

The bonus mechanism cannot influence the transfer pricing practices because the company prefers not to increase profits to an extreme. This practice is because the company wants to maintain the company's good name in the eyes of the whole community and even the government. Company financial reports are prepared and presented following actual circumstances to minimize decision-making that can be detrimental. Companies in the trade, service, and investment sectors tend to be inconsistent in increasing their annual profits. It is reflected in the mean value of 1,1011 or 110.1%, which means that the increase in the company's average annual profit is not too extreme and tends to be stable, namely 10.1% of the previous year's profit. According to Saraswati & Sujana (2017), bonus plans do not affect transfer prices because they have excellent supervision and have an audit committee experienced in their fields. Fraud committed by managers can be detected.

The bonus plan hypothesis suggests that management prefers to use accounting procedures to increase earnings is not supported by this result. The results of this study support previous research, research by Sarifah et al. (2019) showed that the results of the bonus mechanism do not affect transfer pricing. Sundari & Susanti's (2016) study supports this research which stated that the determination of the transfer price is not due to the bonus plan policy. The company reduces companies' net income in the high tax rate area to low tax rate companies to minimize their tax liability. The study results contradict the research of Hartati et al. (2014), which showed that the bonus plan policy drives the practice of determining transfer prices.

The Effect of Tunneling Incentive on Transfer Pricing

Managerial ownership is used as a proxy to measure the tunneling incentive variable in this study. The second hypothesis of this study is accepted. The results show that tunneling incentives measured using the proxy of managerial ownership of trading, service, and investment companies can influence companies to decide to carry out transfer pricing practices. Managers who have higher information in the company can make decisions to perform tunneling for their interests.

Management is directly related to the company's operations compared to shareholders to do whatever they want regardless of the rights of the stockholders.

The results of this study support the agency theory used as a basis, in which in a concentrated ownership structure, agency conflict appears in shareholders with significant ownership and shareholders with low ownership. The high level of information held by large shareholders can transfer wealth in the form of assets, profits, etc., for the benefit of individuals without considering the rights of minority shareholders. The increase in profit is carried out by the majority shareholder using transfer pricing for their interests. If there is a loss, the loss is borne by the minority shareholder. Transfer pricing is carried out to reduce costs that result in reduced profits. The transfer of assets/profits can be done by selling the inventory or assets of the parent company to the subsidiary at a price above fair value. Research by Sarifah et al. (2019) and Saraswati & Sujana (2017) support this research which shows that the higher results of asset transfers impact increasing the practice of determining transfer prices. Another study of the effects of inventory in transfer pricing indicated that inventory levels are an essential part of accounting, offshored supply chains, and transfer pricing (Stefano, et al., 2021). Research by Rosa et al. (2017) contradicts the research results wherein their research proves that the practice of transfer pricing is not influenced by the transfer of company assets/ profits.

The Effect of Debt Covenants on Transfer Pricing

The third hypothesis of the study is rejected, where the hypothesis test results show the debt covenant variable has a negative effect on the practice of determining transfer prices. The result of the research means that the greater the debt covenant, the smaller the company's interest in transfer pricing practices. The DER ratio used as a proxy for the debt covenant variable has a negative effect on the practice of determining the company's transfer price.

If the violation of the debt agreement gets closer to the company, the company is less interested in using accounting methods to make high profits. The company will be more careful not to violate the agreement so that companies tend to be less interested in profit-increasing accounting procedures such as transfer pricing practices. The mean value of the debt covenant variable is 0,9826300, which is classified as low. It means that the company has a capital structure with a low debt ratio. The company tends to be less interested in using accounting methods to increase profits, such as transfer pricing. The debt covenant hypothesis explains that if a company is getting closer to violating accounting principles for debt contracts, the higher the possibility of management using profit-increasing accounting procedures. Managers can choose a method by determining the transfer price to reduce the tax burden so that company profits increase so that the company can relax its credit limit.

Research that supports this research is Sari & Mubarak's (2018) research, which shows that higher debt contracts impact decreasing decision-making in practicing transfer pricing. Fitriani (2019) has the same results as this study, which proves that debt covenants negatively affect transfer prices. The greater or, the smaller the debt covenant value, the more it can encourage managers to practice transfer pricing. However, the study results contradict Sundari & Susanti (2016), which shows that the bigger or smaller the debt contract cannot affect the company in determining the transfer price.

The Effect of Sales Growth on Transfer Pricing

The fourth hypothesis of the study is rejected. The study results prove that the sales growth of trading, service and investment companies cannot trigger companies to implement transfer pricing practices. Companies with high sales growth will also have high profits, resulting in a high tax burden. Hypothesis test results prove that the company determining the transfer price is not influenced by increased sales growth. Companies with high sales growth will increase the tax that must be paid. Companies are not interested in implementing transfer pricing practices by charging low prices for goods or services to reduce their taxes. However, the company will still pay the tax burden according to its dependents because the increase in sales growth will increase its income to bear the tax burden. Sales growth has a mean value of 0.4080516, which is classified as low, which means that the sample companies have low sales growth on average, and some companies even experience a decline in sales. With low sales growth, companies are less interested in increasing profits with transfer pricing practices.

This study does not support the agency theory, which states that managers are selfish and tend to avoid the risk of paying corporate taxes. This study indicates that the company does not prevent the risk of paying tax burdens due to increased sales growth. Research that examines the effect of sales growth on transfer pricing has never been done. Still, research on the impact of sales growth variables has been conducted on the tax avoidance variable. Research by Widiayani et al. (2019) supports this result, showing that increased sales growth does not encourage companies to avoid tax. Increased sales growth does not always impact increasing profits, so it does not significantly affect tax avoidance. Research by Titisari & Mahanani (2017) also proves that sales growth cannot encourage companies to avoid tax.

CONCLUSION

The bonus mechanism and sales growth cannot influence the company to choose the transfer pricing decision. Tunneling incentives can influence companies to decide to practice transfer pricing, while debt covenants negatively affect decisions to carry out transfer pricing practices. Future research may use other bonus mechanism measures, such as proxies for compensation. Subsequent analysis can select company objects with a larger population, such as non-financial companies on the IDX.

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