CHAPTER I

INTRODUCTION

1.1 Background

Globalization that is happening now brings development to the world economy. A good economic development turns out to bring companies to keep abreast of the existing economic flows and make them able to compete in their business. This led to the management of each company trying to do everything to confront the competition. The company's strategic planning is very influential for the continuity of the company. Companies that are not able to compete slowly will begin to be displaced from the business world because they are unable to maintain the performance of their company.

By continuing to improve the efficiency and effectiveness of the company in achieving an increase in profits, companies will be able to continue to expand its business. One of them with inter-company transactions that occur both inside and outside the country transaction. Not only that transactions can also occur within a company or between division, which includes the sale of goods and services, licensing rights and other intangible assets. Transactions that occur within a company as this will complicate the pricing to be transferred. Pricing on transactions between division commonly known as *transfer pricing* (Mangoting, 2000; Marfuah & Azizah, 2014).

Transfer pricing is a company policy in determining the transfer price of a transaction, whether goods, services, intangible assets, or financial transactions carried out by the company. There are two groups of transactions in transfer pricing, namely *intra-company* and *inter-company* transfer pricing. *Intra-company* transfer pricing is the transfer pricing between divisions in one company. Whereas *inter-company* transfer pricing is transfer pricing between two companies that have special relationships. Transfer pricing is often also referred to as intracompany pricing, *intercorporate pricing*, *interdivisional* or *internal pricing*, which are calculated prices for the purpose of management control over the transfer of goods and services between members (company group). Transfer pricing is usually set for *intermediate products* which are goods and services supplied by the seller's division to the buyer's division. The transaction itself can be done in one country (*domestic transfer pricing*), as well as with different countries (*international transfer pricing*) (Zain, 2007).

The Taxation Law refers to the term transfer pricing with transactions between parties that have special relationships. This is as regulated in article 18 paragraph (4) of Law No. 36 of 2008 concerning Income Tax. Based on Law Number 36 of 2008 regulated in Article 18 paragraph (4), namely: a special relationship between taxpayers can occur due to ownership or control of the share capital of an entity by another body as much as 25% (twenty five percent) or more, or between some bodies which are 25% (twenty five percent) or more of their shares owned by a body.

Law No. 36 of 2008 concerning Income Tax also has rules that deal with transfer pricing issues, namely Article 18. Transfer pricing rules usually cover several things, namely: understanding special relationships, authority to determine the ratio of debt and capital, and authority to make corrections in things happen that are not arm's length transactions. Further rules and details about transfer pricing are contained in the Regulation of the Director General of Taxation Number 32 of 2011 concerning the application of *arm's length principle* in transactions between taxpayers and those with special relationships. In this rule, the definition of *arm's length principle* is defined as the principle which stipulates that if the conditions of a transaction between parties having a special relationship are equal or equal to the conditions in the transaction between parties that do not have a special relationship that becomes a comparison, price or profit for transactions carried out by parties that have a special relationship must be the same as or are in a price range or profit in a transaction made between parties that have no special relationship.

Initially, transfer pricing is known in management accounting as a price policy that is applied to the delivery of goods or services between departments within a company with the aim of measuring the performance of each division or department (Indah Dewi Nurhayati 2013: 32). In addition, the pursuit of profits, cash flow, marketing objectives, is a series of reasons that make companies need to develop processes to allocate overhead costs and design strategies to estimate the transfer prices for goods and services produced (Prem Sikka and Hugh Willmott, 2010: 342).

But lately, transfer pricing has been recognized as a strategic tool that can facilitate companies to achieve competitive advantage (Siddique and Ahmed, 2015). So that transfer pricing is a very important issue in accounting and taxation. Because often companies do transfer pricing schemes that are not in accordance with applicable law so that transfer pricing is often misused by companies as a form of tax avoidance. Sometimes companies want to get high profits but feel heavy when paying high corporate taxes. From this phenomenon, the company decided to transfer pricing which is one of the company's strategies to reduce their tax burden.

According to the Indonesian Directorate General of Taxes, there is no doubt that transfer pricing is very influential on state tax revenues. According to the calculation of the Director General of Taxes, the country has the potential to lose 1,300 Trillion Rupiah due to transfer pricing practices. It was even more confirmed by internal information from the Director General of Taxes that the loss was mostly due to payments of Interest, Royalties and Intragroup Service so that the Director General of Taxes believed that by stopping payments the country would no longer need to add debt.

Many of the issues of transfer price transactions in Indonesia occur in plantation, mining and manufacturing companies. Such as the case of PT Asian Agri, PT Adaro Energy, and PT Toyota Motor Manufacturing Indonesia. PT Adaro Energy Tbk is one of the transfer price cases that is detrimental to Indonesia because the company is selling with an affiliated company in Singapore namely Coaltrade Service International Pte Ltd. This case arose as a public report to the Department of Energy and Mineral Resources.

From the report, PT. Adaro Energy Tbk allegedly sold coal below the international standard price with an average of US $ 26.3 per ton during 2005 until 2006. Then by Coaltrade, the coal was sold again to the market according to market prices. This is intended to avoid paying royalties and taxes that should be paid to the state treasury. In Coaltrade's financial report documents, Coaltrade's profits were higher than Adaro's.

The financial report raised suspicion, how could Adaro own mine but have a small profit. This is thought to be the practice of transfer pricing at PT Adaro with the resale method. PT Adaro sells its products to related parties, namely affiliates in Singapore. As a result of this transfer pricing practice, it is estimated that Indonesia will lose at least Rp 10 trillion (Oktavia et al, 2012).

Many of the factors underlying the use of transfer pricing policies for the purpose of corporate tax planning. Jarallah, et al., (2011) states that many theoretical approaches have attempted to address the issue of transfer pricing from three different perspectives, namely economic, mathematical programming, and behavior. These factors can come from the external and internal environment of business, such as *exchange rate* and *foreign ownership*.

The exchange rate can affect the company's decision to transfer pricing. The exchange rate is very closely linked to international trade because the multinational company's cash flow denominated in several currencies in which the value of each currency relative to the dollar will differ due to the time difference (*fluctuation*). These different exchange rates will later affect the practice of transfer pricing to multinational companies. The exchange rate is different is what will affect the transfer pricing practices of multinational companies. As a result, multinational companies may try to reduce the risk of the exchange rate of foreign currency by transferring funds into strength currency through transfer pricing to maximize overall corporate profits (Marfuah & Azizah, 2014).

Stock ownership by foreigners is the ownership of shares held by foreign parties from both individual and institutional. At the time of control exerted by the controlling shareholders of foreign getting bigger, the controlling shareholder of foreigners will seek to allocate the company's resources for personal gain in a range of important decisions, including the effect of pricing policies as well as the amount of the transfer pricing transaction (Sari, 2012: 162). Because of this, transfer pricing can occur as the effect a little more of foreign ownership. The studies were conducted on Rahadian (2015) and Refgia (2017) showed that foreign ownership has a significant positive effect on transfer pricing practices. This is due to the higher control rights held by the controlling shareholder, making it possible for the controlling shareholders to order management to conduct transactions to related parties that are expropriation. At the time of the controlling shareholder-owned by a foreign company, the foreign controlling shareholder can sell the products of its controlled to private firms with cheaper prices and harm non-controlling shareholders (Kiswanto & Purwaningsih, 2014).

Based on the description above, researcher was motivated to carry out this research because in the development of the use of transfer pricing schemes there was motivation that affected management to carry out transfer pricing schemes in order to increase profits in the current period, and this was mentioned in positive accounting theory where there were two hypotheses that became opportunistic behavior of managers in increasing profits in the current period, namely exchange rate and foreign ownership.

This research uses a sample of manufacturing companies listed on the Indonesia Stock Exchange in 2014-2017. That is because it is in accordance with the phenomenon that occurs about transfer pricing carried out by manufacturing companies. Thus, the focus of this paper is to obtain empirical evidence regarding the impact of exchange rate and foreign ownership on the transfer pricing decision in the context of this research using secondary data from the Indonesian Stock Exchange for the 2014-2017 period.

1.2 Problem Definition

Based on this background, the problem can be formulated as follows:

1. How does the foreign ownership affect on the company's transfer pricing decision?
2. How does the exchange rate affect on the company's transfer pricing decision

1.3 Research Objectives

This research aims to obtain empirical evidence about:

1. The effect of foreign ownership on the company's transfer pricing decision.
2. The effect of exchange rate on the company's transfer pricing decision.

1.4 Research Benefits

This research is expected to provide benefits in the form of:

1. Government

   Provide an overview of how the exchange rate and foreign ownership affect the company took the decision on transfer pricing and the research results can contribute to the government for establishing transfer pricing regulation.

2. Investor

   For investors, this research can provide an overview of companies that conduct transfer pricing, especially manufacturing industries, so that it becomes an evaluation and input in considering decisions related to investing in a company.

3. Educational Institutions

   This research adds to a reference in the library so that it can be used for research in the future.

1.5 The Scope of Research

In order for the results of this research to be focused on the problem and so that the avoidance of the unwanted interpretations of the results of the research, this research focuses on:

1. Manufacturing companies listed on the Indonesia Stock Exchange (IDX) in the period 2014 to 2017.
2. The dependent variable is transfer pricing carried out by a manufacturing company that has a special relationship only measured by the existence of a sales transaction. Because the transaction has fairly material value.
3. This research only discusses foreign ownership variables and exchange rates. In measuring foreign ownership, the writer uses a ratio scale of the number of foreign ownership divided by the total of outstanding shares. While in measuring the variable of exchange, the scale ratio used is gain/loss on foreign exchange divided by profit/loss before tax.

1.6 Writing Systematic

The discussion in this research is described in five chapters with a systematic discussion to make it easier for readers in understanding this research. Writing systematic gives an overview of each chapter as follows:

Chapter I, Introduction discusses the general description that becomes the basis of this research. It consists of background, problem definition, research objectives, research benefits, and writing systematic.

Chapter II, Literature Review discusses the theory that has the relationship with the research problem. This is useful as a rationale for solving problems. Moreover, this chapter also looks at previous research, theoretical framework, and the hypothesis that will be tested in this research.

Chapter III, Research Method provides an overview of the plan for conducting the research. This chapter includes the research design, population and sample, variables and measures, data collection method, and data analysis method.

Chapter IV, Results and Discussion discusses the description of the research object and analysis as well as discussion of the research results regarding the effect of foreign ownership and exchange rate on company's transfer pricing decision.

The last chapter, Chapter V Conclusions contains conclusion about research result. It also contains suggestion for the next research.