Series: Advances in Social Science, Education and Humanities Research

Proceedings of the Tarumanagara International Conference on the Applications of Social Sciences and Humanities (TICASH 2019)

PROCEEDINGS OF THE TARUMANAGARA INTERNATIONAL CONFERENCE ON THE APPLICATIONS OF SOCIAL SCIENCES AND HUMANITIES (TICASH 2019)

Influence of Transfer Pricing, CEO Compensation, and Accounting Irregularities on Tax Aggressiveness

Authors
Estralita Trisnawati, Fenny, Herlina Budiono

Corresponding Author
Estralita Trisnawati

Available Online 20 May 2020.

DOI
https://doi.org/10.2991/assehr.k.200515.028 How to use a DOI?

Keywords
transfer pricing, CEO Compensation, accounting irregularities, tax aggressiveness

Abstract
The purpose of this study is to investigate the influence of transfer pricing, chief executive officers' compensation, accounting irregularities on tax aggressiveness. The sample covers manufacturing companies listed on the Indonesian Stock Exchange (IDX) during 2012 – 2016. By using purposive sampling, selected companies data amounted to 115, thus the total sample used in this study is 575. Based on the sample collected, this research uses partial least square method in hypothesis testing. Contrary to prior research, the results of this study indicate that transfer pricing has influence on tax aggressiveness. Meanwhile, chief executive officers' compensation and accounting irregularities have no influence on tax aggressiveness.

Download article (PDF)

< >

Volume Title
Proceedings of the Tarumanagara International Conference on the Applications of Social Sciences and Humanities (TICASH 2019)

Series
Advances in Social Science, Education and Humanities Research

Publication Date
20 May 2020

ISBN
978-94-6252-970-0

ISSN
2352-5398

DOI
https://doi.org/10.2991/assehr.k.200515.028 How to use a DOI?

Cite this article

ris

enw

bib

```
TY  - CONF
AU  - Estralita Trisnawati
AU  - Fenny
AU  - Herlina Budiono
PY  - 2020
DA  - 2020/05/20
TI  - Influence of Transfer Pricing, CEO Compensation, and Accounting Irregularities on
Tax Aggressiveness
BT  - Proceedings of the Tarumanagara International Conference on the Applications of
Social Sciences and Humanities (TICASH 2019)
PB  - Atlantis Press
SP  - 170
EP  - 174
SN  - 2352-5398
UR  - https://doi.org/10.2991/assehr.k.200515.028
DO  - https://doi.org/10.2991/assehr.k.200515.028
ID  - Trisnawati2020
ER  -
```

Advances in Social Science, Education and Humanities Research, volume 439
Tarumanagara International Conference on the Applications of Social Sciences and Humanities (TICASH 2019)

Influence of Transfer Pricing, CEO Compensation, and Accounting Irregularities on Tax Aggressiveness

Estralita Trisnawati
Faculty of Economics
Tarumanagara University
estralitat@fe.untar.ac.id

Fenny
Faculty of Economics
Tarumanagara University
fennydarwin18@gmail.com

Herlina Budiono
Faculty of Economics
Tarumanagara University
herlinab@fe.untar.ac.id

***Abstract*— The purpose of this study is to investigate the influence of transfer pricing, chief executive officers' compensation, accounting irregularities on tax aggressiveness. The sample covers manufacturing companies listed on the Indonesian Stock Exchange (IDX) during 2012 – 2016. By using purposive sampling, selected companies data amounted to 115, thus the total sample used in this study is 575. Based on the sample collected, this research uses partial least square method in hypothesis testing. Contrary to prior research, the results of this study indicate that transfer pricing has influence on tax aggressiveness. Meanwhile, chief executive officers' compensation and accounting irregularities have no influence on tax aggressiveness.**

Keywords: transfer pricing, CEO Compensation, accounting irregularities, tax aggressiveness

I. INTRODUCTION

It is widely-accepted that taxation is an integral part in Indonesia and contribute a major part to improve the economy and development of this nation, particulary in infrastructure improvement (Trans Java Highway, Trans Sumatera Highway, Probolinggo Port, Komodo Labuan Bajo Airport, Trans Sulawesi Train) and government health programme (BPJS). Tax revenue from this sector can be seen from the realization of this country's revenue and expenditure budget (APBN). According to data from the Ministry of Finance, the realization of APBN from 2012 until the end of 2016 has not reached the target. As of December 31, 2016, the realization only contributed about 87.06% of the revised budget (APBN-P) in 2016. Total revenue which had included tax amnesty programme in 2016 only contributed to 107 trillion. If a part of tax amnesty was not included, then its achievement reached a mere Rp 1,448,1 trillion, or equal to 81,07% from total revised budget in 2016.

This indicates the realization of its budget in Indonesia has not been optimized yet and might be caused by issues like tax avoidance or tax aggressiveness, namely Base Erosion and Profit Shifting (BEPS). These practices are not only conducted in Indonesia, but they have as well occurred in some other countries for these past few years. This problem has been widely- concerned and eventually gained the attention of the international tax authorities. The Organization for Economic Cooperation and Development (OECD) sought to address this issue by arranging a forum, called, the Global Forum on Transparency and the Exchange of Information for Tax Purposes.

One way which was used by the Global Forum to address such practices was with the formation Automatic Exchange of Information (AEoI). Indonesia as a member of the Group of Twenty (G20) and Global Forum has committed to participate in this exchange of information and issued Perppu No. 1 of 2017 and Regulation of the Minister of Finance No. 70 / PMK.03 / 2017 regarding access to financial information for tax purposes

Taxation may be a burden for most companies, thus they may always try to minimalize their tax expense by planning tax avoidance or tax aggressiveness activities. This is not to exclude multinational companies, for example Google, Apple, Amazon, and Starbucks are all trying to minimize their tax burden

Various researches on tax aggressiveness have been done by previous researchers, however it appears that there were contradictory results. For instance, research conducted by Frank et al. [1] and indicate that there is a positive and significant influence between the aggressiveness of financial statements and tax aggressiveness. While research conducted by Halioui et al. [2] showed a significant influence between the compensation of the chief directors and tax aggressiveness, whereas the same study which was conducted by Chee et al. [3] showed different results. Furthermore, Kusuma and Wijaya [4] stated that there is a positive and significant influence between transfer pricing and tax avoidance. Other research conducted by Hashim et al. [5] showed no significant effect between accounting irregularities and tax aggressiveness.

This study discusses the effect of transfer pricing, stock ownership by chief executive officer, and accounting irregularities towards tax aggressiveness, as these issues are considered to be important and contentious to be discussed. Looking at the recent phenomenon, this research will discuss about tax aggressiveness since numerous researches on tax avoidance have been done in Indonesia. The objective of this study is for the government, especially the Directorate General of Taxes (DGT) to be more aware with companies that may conduct aggressive tax planning on their businesses.

II. TRANSFER PRICING

De Simone [6] provides a more detailed analysis of companies performing transfer pricing based on the OECD standard "arm-length". It was stated that the difficulty of identifying a comparable non-arm-length price has caused the OECD to set up an acceptable transfer pricing guideline He also emphasized that the adoption of international accounting standards (IFRS) increases the flexibility for firms to set transfer rates. Implementation of IFRS has increased the aggressiveness of the company to transfer its income to reduce the tax paid. Furthermore, Robinson [6] found that firms which make their tax departments as profit centers report lower ETRs than firms that make their tax department as a cost center.

In fulfilling the company's business strategy, many companies are making trade- offs strategy between tax burdens and other expenses. There are still various companies setting their transfer pricing based on the company's policy and do not use the "arm- length" principle, which leads the company to set a lower transfer price to related parties, resulting in lower sales value which on the other hand will lower income taxes, thus triggering the occurrence of tax aggressiveness.

Political cost hypothesis suggests that well-performing firms will attract more attention from public and government, leading to higher political costs, one of which is tax- related burden. Given this hypothesis, the company is motivated to reduce tax expense by adopting transfer pricing practices which may reduce the overall corporate tax burden [4].

Research conducted by Richardson et al. [7], Hamid et al. [8], and Kusuma and Wijaya [4] on transfer pricing with the minimization of tax payments indicate a positive influence between the practice of transfer prices by multinational companies against aggressive corporate taxes.

Based on the description of theory described above and prior researches which have been done before, we propose a tentative conclusion that transfer pricing may affect the practice of tax aggressiveness undertaken by companies. This is supported by agency theory in which management will make a decision that increases the value of one company by using transfer pricing strategy to reduce tax expense. It may be only effective with companies in which their managers are judged based on overall performance in each division at the firm, so that managers of each division will collaborate to increase company's profit, which will simultaneously increase the value of the company. Moreover, based on the political cost hypothesis, managers will seek to reduce their tax burden by implementing transfer pricing strategy to other divisions within the company. Accordingly, we state our first hypothesis as follows:

H1**:** There isinfluence of transfer pricing on tax aggressiveness

III. CEO COMPENSATION

Jensen and Meckling [9] point out that providing incentives in the form of shares to management may alleviate agency conflict between managers and shareholders. Such compensation may be effective to align the goals between managers and shareholders. Basically, managers will only use cash surplus of the company for their personal benefits and not to maximize the value of the company. Managers will also prefer to take lower risk investments or projects. However, ownership in the form of shares for the management will motivate managers to take on more risky projects, which will give positive net present value for the company, since risky investments usually increase the value of the company [10]. Such risky projects typically have impact on more risky tax planning, thereby increasing the tax aggressiveness of the management.

Various studies show different results as to whether the compensation to managers will be related to tax aggressiveness. Chee et al. [3] found that CEO compensation gave two different effects. The results show that lower CEO compensation aligns the interests of managers with shareholders, hence minimizing tax payments. On the contrary, higher incentives to manager show negative influence between the CEO's incentives and tax avoidance, as this might be explained by higher-incentive firms are usually profitable companies, thus will thwart the CEO to conduct tax-minimizing practices.

In addition, research done by Armstrong et al. (2015 in [2] stated that if benefits of tax aggressiveness are higher than the expected costs, there is a positive influence between giving incentives to CEOs and tax aggressiveness.

Furthermore, another root causing conflict between managers and shareholders is moral hazard. It is undeniable that managers have more valuable information regarding the company, which will increase the likelihood of managers rising the value of he company by trying to boost its stock price. If management does that, then it is probable they will also conduct tax aggressiveness practice which might reduce corporate tax expense, following which will ultimately increase the value of the company. Therefore, we conclude the next hypothesis as follows:

H2: There is influence of CEO compensation on tax aggressiveness

IV. ACCOUNTING IRREGULARITIES

Agency conflict may result in difference of interests between shareholders and management [9]. Managers will always manage to report the highest profit to get incentives or bonuses given by the company. Accounting irregularities might be one of several ways in which management used to manipulate earnings as to report higher profit on financial statements. This may solve the conflicts between managers and shareholders, because if management seeks to report higher after-tax profit, then they will as well try to lower corporate tax expense, which results in aggressive tax planning performed by managers.

Few researches have been done on the effect of financial reporting on tax aggressiveness. Frank et al. [1] found a positive influence between companies that report aggressive financial statements and tax aggressiveness. Conversely, study by Lennox et al. [11] showed different results, whereas companies that apply these practices are less likely to commit fraud in their accounting report. On the other hand, Hashim et al. [5] found no significant influence between accounting irregularities and tax aggressiveness within firms in Malaysia.

Naturally, companies which are concerned with their stakeholders, report fair financial statements, and establish accounting principles in accordance with accounting standards. Companies reporting their financial statements in conformity with these accounting standards are less likely to pay less taxes. While in contrast, companies which engage in earnings manipulation activities or disclose unusual accounts in their financial statements, have higher probability in attempting to reduce their taxes by conducting aggressive tax planning. Nonetheless, this is also followed by the existence of information asymmetry between managers and shareholders, which in this case, the third hypothesis is:

H3: There is influence of accounting irregularities on tax aggressiveness..

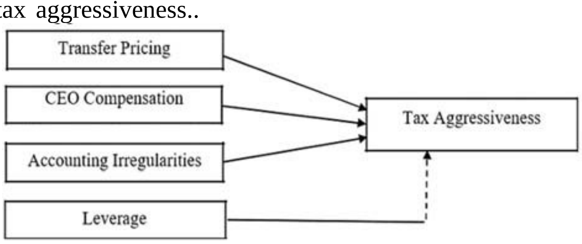

Figure 1.
Conceptual Framework

V. RESEARCH METHOD

This study is focused on all manufacturing companies listed on the Indonesia Stock Exchange for the year 2012 to 2016, data computed in this study obtained from www.idx.ac.id. Sample selection procedures were done by purposive sampling with the following criteria: (a) Manufacturing companies listed on IDX, which are not owned by government and (b) Manufacturing companies which financial statements end on 31 December from the year 2012 to 2016. This study uses 115 companies which comply to the criteria. In addition, this research employed three independent variables with one control variable. Table 1 shows the measurements of each variables used in this study

Table 1.
Measurement of Variables

Variables	Definition	Indicator	Scale
Independent Variables			
Transfer Pricing (TP) (Kusuma & Wijaya, 2017)	Intercompany transfer pricing is related to the transfer of intellectual property, tangible goods, services, and loans or other financing transactions.	Measurement is done by: 1 for firm having related party transactions, and otherwise 0	Nominal
CEO Compensation (Chee *et al.*, 2017)	Incentives to CEO in the form of shares to align the same interest between management and shareholders.	Measurement is done by: 1 for firm in which shares are owned by their CEO, and otherwise 0	Nominal
Accounting Irregularities (AI) (Hashim *et al.*, 2016)	The probability of earnings manipulation is greater with unusual increases in receivables, deteriorating gross margins, decreasing asset quality, slowing sales growth, and increasing accruals.	$DSRI=\frac{NR_t/Sales_t}{NR_{t-1}/Sales_{t-1}}$ where NR is net receivables $GMI=\frac{Sales_{t-1}-COGS_{t-1}/Sales_{t-1}}{Sales_t-COGS_t/Sales_t}$ $AQI=\frac{[1-(CA_t+PPE_t+Securities_t)]/TAs_t}{[1-(CA_{t-1}+PPE_{t-1}+Securities_{t-1})]/TAs_{t-1}}$ where *TAs* is total assets $SGI=\frac{Sales_t}{Sales_{t-1}}$ $DEPI=\frac{Depre_{t-1}/(PPE_{t-1}+Depre_{t-1})}{Depre_t/(PPE_t+Depre_t)}$ $SGAI=\frac{SGAE_t/Sales_t}{SGAE_{t-1}/Sales_{t-1}}$ where SGAE is selling and administration expenses $LVGI=\frac{(CL_t+TLTD_t)/TAs_t}{(CL_{t-1}+TLTD_{t-1})/TAs_{t-1}}$ $TATA=\frac{IFCO_t-CFFO_t}{TAs_t}$ $AI=-4.840+(DSRI+GMI+AQI+SGI+DEPI+SGAI+LVGI+TATA)$	Ratio
Control Variable			
Leverage (Lev)	Total debt divided by total assets	$Leverage=\frac{Total\ Liabilities}{Total\ Assets}$	Ratio
Dependent Variable			
Tax Aggressiveness (*DTAX*) (Frank *et al.*, 2009)	Total book-tax differences less temporary-book tax differences	$PERMDIFF_{it}=\alpha_0+\alpha_1 INTANG_{it}+\alpha_2 MI_{it}+\alpha_3 CSTE_{it}+\alpha_4 \Delta NOL_{it}+\varepsilon_{it}$	Ratio

VI. EMPIRICAL RESULTS

Table 2 illustrates the minimum, maximum, mean, and standard deviations of all variables used in this study.

Table 2.
Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
TP	575	0	1	.72	.449
CEO	575	0	1	.23	.420
AI	575	-41.4164	1945.3549	7.695745	86.5828579
LEV	575	.0372	5.0561	.560033	.5066855
DTAX	575	-.5414	.3679	.000174	.0391535
Valid N (listwise)	575				

Source: Data processed by SPSS 20

Table 2 shows minimum and maximum values of 0 and 1 respectively for both transfer pricing and CEO's shares variables due to the use of nominal ratio for both variables. On average, the value of accounting irregularities is 7.695745 with minimum and maximum values of -41.4164 and 1945.3549 respectively, and a standard deviation of 86.5828579. Meanwhile, the minimum, maximum, mean, and standard deviation values for leverage is 0.0372, 5.0561, 0.560033, and 0.5066855, respectively. The average amount of tax aggressiveness measured by DTAX is 0.000174, with its minimum and maximum amounted for -0.5414 and 0.3679, respectively.

Table 3.
Hypothesis Testing

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STDEV|)	P-Values
TP → DTAX	-0.075	-0.072	0.035	2.107	*0.035
AI → DTAX	0.003	0.004	0.017	0.175	0.861
CEO → DTAX	0.003	0.002	0.028	0.112	0.911
LEV → DTAX	0.100	0.101	0.208	0.480	0.631

Note: significant at 5% level

Table 3 shows that the statistic value of transfer pricing is 2.107 and significant at 5%. This result indicates that H_1 is supported since there is influence of transfer pricing on tax aggressiveness. Moreover, table 3 indicates that there is no influence of CEO compensation on tax aggressiveness, which is shown by its statistics value of 0.112 and p-values of 0.911. Thus, H_2 is not supported in this study. This result is in accordance with studies by Mahulae et al. [12] and Kalbuana et al. [13] in which data from automotive and banking companies listed on IDX were used respectively. A few rationales behind this might be able to explain the result. First, we found that there are only 125 out of 575 samples in which companies give their shares to chief executive officers. Second, this study uses data collected from manufacturing companies listed in IDX, thus, we assume there might be different cultures considering that incentives given to directors in this country may be in the form of bonus, allowance, promotion, and etc. Table 3 also shows that statistics value of 0.175 for accounting irregularities. Therefore, H_3 is not supported

Based on the results of the research discussed earlier, it was found that accounting irregularities variables have no influence on tax aggressiveness. The result of this study supports the research conducted by Hashim et al. [5]. Prior research, Hashim et al. [4] suggested that there might be a complexity in the study of accounting irregularities with tax aggressiveness. Various motivations with different empirical evidence lie behind these two activities.

In addition, Hashim [5] assumed that companies might not do both practices at once, as it is difficult for companies to report higher income to investors as well as lower taxable income to tax authorities, because such practice will result in massive book-tax differences, which will ultimately become a concern for the government [1] & [11]. In addition, Abdullah et al., and Ariff & Hashim [5] in Hashim et al. [5] suggested that a good governance system might mitigate the practice of accounting irregularities and tax aggressiveness. Furthermore, the table also indicates that there is no significant relationship between leverage as a variable control and tax aggressiveness.

VII. CONCLUSION

This study aims to obtain empirical evidence on the influence of transfer pricing, chief executive officers' compensation, and accounting irregularities on tax aggressiveness in manufacturing companies listed on Indonesia Stock Exchange (IDX) from the year 2012 to 2016. Tax aggressiveness in this study is measured by discretionary permanent differences (DTAX). This research uses manufacturing companies listed on Indonesia Stock Exchange (IDX) as the population. This is due to the fact that manufacturing companies have the most data compared to another industries to present the overall companies in Indonesia.

Based on empirical data results, we conclude that there is influence of transfer pricing on tax aggressiveness. The results indicate that companies which have more and higher transactions of transfer pricing are likely to abide tax regulations and less aggressive in minimizing their taxes. Nevertheless, we find no influence of chief executive officers' compensation and accounting irregularities on tax aggressiveness.

This study subjects to limitations and constraints which may influence the outcomes of this study. This research uses only manufacturing companies which are listed on Indonesian Stock Exchange, although this may be adequate to present an overview of the practices of taxation in Indonesia, the results may differ from other Southeast Asian countries. Besides, our study also finds that giving shares as compensation to CEO is still unpopular in most companies in Indonesia. Further studies should be done by increasing more population, for example using sample from another industries, such as banking, automotive, food and beverages, non- financial industries, and etc. More researches regarding these variables should also be done in another developing countries to gain more evidence. Besides, all variables in this study only contribute 1 % of variations to tax aggressiveness. Therefore, future research should consider other variables such as corporate governance, institutional ownership, family ownership, political connections, or CEO bonus as another independent variables, mediating variables should be taken into account as well if appropriate.

REFERENCES

[1] Frank, M.M., Lynch, L.J., & Rego,S.O. 2009. Tax Reporting Aggressiveness and Its Relation to Aggressive Financial Reporting. *The Accounting Review* 84(2): 467-496.

[2] Halioui, K., Neifar, S., & Abdelaziz, F.B. 2016. Corporate Governance, *CEO* Compensation, and Tax Aggressiveness: Evidence from American firms listed on NASDAQ 100. Review of Accounting and Finance 15(4): 445-462.

[3] Chee, S., Choi, W., & Shin, J.E. (2017). The Non- Linear Relationship Between CEO Compensation Incentives And Corporate Tax Avoidance. *The Journal of Applied Business Research* 33(3): 440- 450.

[4] Kusuma, H. & Wijaya, B. 2017. Drivers of Intensity of Transfer Pricing: An Indonesian Evidence. Proceedings of the Second American Academic Research Conference on Global Business, Economics, Finance and Social Sciences (AAR17 NewYork Conference).

[5] Hashim, H.A., Ariff, A.M., & Amrah,M.R. 2016. Accounting Irregularities and Tax Aggressiveness. *International Journal of Economics, Management and Accounting* 24(1): 1-14.

[6] Klassen, K.J., Lisowsky, P., & Mescall, D. 2017. Transfer Pricing: Strategies, Practices, and Tax Minimization. *Contemporary Accounting Research* 34(1): 455-493.

[7] Richardson, G., Taylor, G., & Lanis, R. 2013. Determinants of Transfer Pricing Aggressiveness: Empirical Evidence from Australian Firms. *Journal of Contemporary Accounting & Economics* 9: 136-150.

[8] Hamid, A.A., Arshad, R., Pauzi, N.F.M. 2016. The Prediction of Transfer Pricing Manipulation among Public Listed Companies in Malaysia. *Malaysian Accounting Review* 15(1): 341-361.

[9] Jensen, M.C. & Meckling, W.H. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3(4): 305-360.

[10] Rego, S.O. & Wilson, R. 2012. Equity Risk Incentives and Corporate Tax Aggressiveness.*Journal of Accounting Research* 50(3): 775-810.

[11] Lennox, C., Lisowsky, P., & Pittman, J. 2013. Tax Aggressiveness and Accounting Fraud.*Journal of Accounting Research* 51(4): 739- 778.

[12] Mahulae, E., Pratomo, D., & Nurbaiti, A. 2016. Pengaruh Kepemilikan Institusional, Kepemilikan Manajerial, dan Komite Audit Terhadap Tax Avoidance. *E-Proceing of Management* 3(2): 1626.

[13] Kalbuana, N., Purwanti, T., & Agustin, N.H. 2017. Pengaruh Kepemilikan Manajerial, Beban Pajak Tangguhan, dan Tingkat Pajak Efektif Terhadap Penghindaran Pajak di Indonesia. *Magistra, 100*.

[14] Shackelford, D.A., Slemrod, J., & Sallee, J.M. 2011. Financial Reporting, Tax, and Real Decisions: Toward a Unifying Framework. International Tax Public Finance 18(4): 461-494.

[15] Dyreng, S.D. 2009. The Cost of Private Debt Covenant Violation. Doctoral Dissertation.University of North Carolina