

BRIDGING ACCOUNTING AND TAX PERSPECTIVES IN TRANSFER PRICING: IMPLICATIONS FOR FINANCIAL PERFORMANCE AND TAX BASE PROTECTION IN INDONESIA

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Abstract

The increasing integration of global business operations has intensified transfer pricing issues, not only as a tax compliance concern but also as a critical accounting matter affecting financial performance and reporting quality. In Indonesia, transfer pricing practices have contributed to tax base erosion while simultaneously influencing profit measurement, cost allocation, and intercompany transaction transparency in financial statements. This study examines transfer pricing through a combined accounting and tax perspective, emphasizing how transfer pricing policies shape reported profitability, managerial decision-making, and tax risk exposure. Using a qualitative doctrinal and analytical approach, this research reviews international tax principles, accounting standards, OECD Transfer Pricing Guidelines, and relevant Indonesian regulations, supported by recent empirical and institutional evidence. The findings indicate that misaligned transfer pricing policies distort financial performance indicators and weaken tax base protection, particularly in transactions involving intangibles, services, and intra-group royalties. This study highlights the importance of integrating accounting judgment with tax compliance in transfer pricing governance to enhance financial statement reliability and support sustainable tax administration. The paper contributes to accounting literature by positioning transfer pricing as a cross-disciplinary issue requiring coordinated accounting and tax oversight.

Keywords: Transfer pricing, Financial performance, Intercompany Transactions, Accounting–Tax Integration, Tax Base Protection

INTRODUCTION

The increasing integration of global business activities has significantly transformed the way multinational enterprises (MNEs) operate across jurisdictions. Advances in digitalization, global value chains, and cross-border business models have enabled firms to allocate functions, assets, and risks across multiple countries with greater flexibility. While this transformation has enhanced operational efficiency and market reach, it has simultaneously posed serious challenges to national tax systems, particularly in protecting domestic tax bases [14].

Within this context, transfer pricing has emerged as one of the most critical issues at the intersection of taxation and financial accounting. Transfer pricing refers to the pricing of transactions between associated enterprises within the same multinational group, including transactions involving goods, services, financing, and intangible assets. From an accounting perspective, transfer pricing policies directly influence how revenues and expenses are recognized, how profits are distributed across entities, and how financial performance is reported at the local level. From a tax perspective, these same policies determine the allocation of taxable income between jurisdictions.

In principle, international tax rules accept transfer pricing arrangements as long as they comply with the arm's length principle. Article 9 of the OECD Model Tax Convention requires that related-party transactions be priced as if they were conducted between independent parties under comparable circumstances. The objective of this principle is to align profit allocation with economic substance and value creation [14]. However, applying this principle in practice is far from straightforward, particularly in highly integrated multinational groups.

In Indonesia, transfer pricing has become a growing concern not only because of its tax implications, but also because of its impact on reported financial performance. Many multinational enterprises operate in Indonesia through subsidiaries or representative entities that perform extensive market-facing activities, such as marketing, sales negotiation, technical support, and customer relationship management. Despite these substantive activities, Indonesian entities are often

contractually characterized as routine service providers or limited-risk distributors and, as a result, report consistently low profit margins.

From an accounting standpoint, this situation raises important questions regarding the alignment between reported financial outcomes and underlying economic activities. Financial statements may show thin margins or recurring losses at the local level, even when sales volumes and operational intensity suggest a more significant contribution to group value creation. Such patterns indicate potential distortions in cost allocation, royalty recognition, and intra-group pricing policies, which in turn affect both financial transparency and tax compliance [11].

These concerns are increasingly reflected in public discourse and policy debates in Indonesia. Media reports and professional analyses highlight how aggressive transfer pricing practices particularly excessive royalty payments and intra-group service charges can facilitate the outflow of profits to offshore affiliates, thereby eroding the national tax base [3], [10]. For tax authorities, this phenomenon complicates enforcement efforts, as it requires not only legal interpretation but also a deep understanding of accounting data and business models.

In response, Indonesia has strengthened its transfer pricing regulatory framework by adopting international standards and expanding documentation requirements. Regulations now require taxpayers to prepare Master Files, Local Files, and Country by Country Reports, supported by functional analysis and economic benchmarking (Ministry of Finance Regulation No. 213/PMK.03/2016). These measures aim to enhance transparency and provide tax authorities with the information necessary to assess arm's length compliance [20].

Nevertheless, transfer pricing disputes in Indonesia continue to increase in both frequency and complexity. Disagreements often arise over the characterization of entities, the selection of comparables, the valuation of intangibles, and the allocation of profits between related parties. Importantly, these disputes are not limited to tax assessments; they also reflect deeper tensions between accounting representations of performance and tax authority expectations regarding economic substance.

When domestic remedies fail to resolve such disputes, taxpayers may seek relief through treaty-based mechanisms, particularly the Mutual Agreement Procedure (MAP). While MAP is designed to eliminate double taxation and provide legal certainty, its effectiveness depends heavily on the quality of accounting data, functional analysis, and documentation presented by taxpayers. Weak alignment between accounting records and transfer pricing positions often undermines the success of MAP proceedings [6].

Against this backdrop, this study examines transfer pricing practices in Indonesia through an integrated accounting and tax perspective. Rather than treating transfer pricing solely as a compliance issue, this research explores how transfer pricing policies shape reported financial performance and contribute to tax base erosion. By bridging accounting analysis with tax law and international standards, the study seeks to provide a more comprehensive understanding of why transfer pricing disputes persist and how governance mechanisms can be strengthened.

Accordingly, this research addresses two main questions: (1) how do transfer pricing practices affect financial performance and contribute to tax base erosion in Indonesia, and (2) to what extent do existing regulatory and dispute resolution mechanisms effectively address these challenges. The findings are expected to contribute to accounting literature by highlighting the importance of accounting–tax alignment in transfer pricing governance, while also offering practical insights for policymakers, practitioners, and tax administrators.

RESEARCH METHODOLOGY

This study adopts a qualitative research design that integrates **normative legal analysis and accounting-based analytical perspectives** to examine transfer pricing practices in Indonesia. This integrated approach reflects the multidisciplinary nature of transfer pricing, which operates at the intersection of tax law, financial reporting, and managerial decision-making within multinational enterprises [14]. By combining legal interpretation with accounting analysis, the study aims to provide a comprehensive understanding of how transfer pricing policies affect both reported financial performance and the allocation of taxable income.

Type of Research

The research is primarily classified as **normative legal research**, complemented by an **accounting analytical approach**. Normative legal research focuses on the examination of legal rules, principles, and doctrines governing transfer pricing, including domestic tax regulations, tax treaties, and international guidelines [13], [19]. This approach is appropriate because transfer pricing disputes largely arise from differences in legal interpretation, treaty application, and regulatory enforcement.

The accounting analytical component is incorporated to assess how transfer pricing arrangements are reflected in financial statements and performance indicators. From an accounting perspective, transfer pricing directly influences revenue recognition, cost allocation, royalty expenses, and operating margins [1], [12]. Integrating accounting analysis allows the study to evaluate whether reported financial outcomes are consistent with economic substance and arm's length expectations.

Research Approach

To achieve its objectives, this study applies several complementary research approaches:

First, a statutory approach is employed to analyze binding legal instruments, including Indonesian income tax laws, ministerial regulations on transfer pricing documentation, and relevant provisions of bilateral tax treaties. This approach ensures that the analysis is grounded in enforceable legal norms and regulatory frameworks established by Indonesian tax authorities (Ministry of Finance Regulation No. 213/PMK.03/2016).

Second, a conceptual approach is used to examine key doctrines such as the arm's length principle, Permanent Establishment (PE), the Authorized OECD Approach (AOA), and DEMPE (Development, Enhancement, Maintenance, Protection, and Exploitation) analysis. These concepts are analyzed not only as legal constructs but also in terms of their accounting and economic implications, following guidance from the OECD Model Tax Convention and Transfer Pricing Guidelines. The DEMPE framework, in particular, provides a structured methodology for evaluating the alignment between legal ownership of intangibles and actual value creation activities [9].

Third, an accounting-based analytical approach is applied to evaluate transfer pricing outcomes using indicators commonly employed in financial and management accounting, such as operating profit margins, cost-plus markups, royalty expense ratios, and segment profitability. This approach is consistent with professional auditing standards and accounting literature that emphasize the importance of financial analysis in detecting potential irregularities [7], [5], and [11]. This method helps bridge the gap between legal compliance and financial reporting reality.

Finally, a comparative approach is adopted by referencing OECD standards and international best practices to assess the consistency of Indonesian transfer pricing rules with global norms [2], [13]. This comparative perspective is essential for understanding Indonesia's position within the global transfer pricing enforcement landscape and identifying areas for regulatory improvement.

Sources of Data and Legal Materials

The research relies on both legal and accounting-related sources. **Primary legal materials** include:

1. Indonesian income tax legislation and implementing regulations;
2. Minister of Finance Regulation No. 213/PMK.03/2016 concerning transfer pricing documentation;
3. Tax treaties concluded by Indonesia, particularly provisions relating to Articles 5 (Permanent Establishment), 7 (Business Profits), 9 (Associated Enterprises), and 25 (Mutual Agreement Procedure) of the OECD Model Tax Convention. These treaty provisions form the legal basis for cross-border profit allocation and dispute resolution.

Secondary materials consist of:

1. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations [14] and related commentaries, which provide authoritative guidance on the application of the arm's length principle and transfer pricing methodologies;
2. Academic books and peer-reviewed journals in taxation and accounting, including works on auditing standards [1], [12], [5], transfer pricing practices [2], and accounting information systems [11];
3. International professional standards, including pronouncements from [8] which establish quality and ethical benchmarks for accounting and auditing practices;
4. Policy reports, professional publications, and media analyses discussing transfer pricing disputes in Indonesia, including analyses from major accounting firms [4], [9], [16] and specialized tax media [3], [6], [10]. These sources provide practical insights into current enforcement trends and compliance challenges;
5. Empirical studies on transfer pricing in Indonesia, including research on tax avoidance practices [17] and tax base erosion [18], which offer contextual evidence of transfer pricing issues in the Indonesian market;
6. International model tax conventions, including the United Nations Model Double Taxation Convention [19], which provides an alternative framework particularly relevant for developing countries;

7. OECD publications on digital economy taxation [15], which address emerging transfer pricing challenges in the context of globalization and digitalization.

These sources provide doctrinal, analytical, and contextual insights that support an integrated legal-accounting analysis, consistent with contemporary research methodology in cross-disciplinary tax studies.

Data Collection Technique

Data collection is conducted through **documentary research**, involving systematic review of legal texts, accounting literature, policy documents, and professional analyses. Particular attention is given to materials addressing royalty arrangements, intra-group services, cost allocation methods, and profitability benchmarking. Accounting-related information is examined conceptually rather than empirically, focusing on how transfer pricing policies influence reported financial performance rather than on firm-specific financial data.

Data Analysis Method

The collected materials are analyzed using **qualitative descriptive and analytical techniques**. Legal analysis is applied to interpret statutory provisions, treaty articles, and OECD guidance, while accounting analysis is used to assess the implications of transfer pricing arrangements for financial performance indicators.

The analysis proceeds in three stages:

1. Identification of relevant legal and accounting norms;
2. Evaluation of economic substance through functional and profitability analysis;
3. Assessment of alignment between accounting outcomes, legal compliance, and transfer pricing objectives.

This integrated method enables a nuanced understanding of transfer pricing as both a legal and accounting phenomenon.

Scope and Limitations of the Study

This study focuses on corporate income tax transfer pricing issues involving multinational enterprises operating in Indonesia. The analysis emphasizes regulatory frameworks, accounting implications, and dispute resolution mechanisms rather than quantitative estimation of tax revenue losses.

While the absence of firm-level financial data limits empirical generalization, the normative and analytical approach provides robust conceptual insights into how transfer pricing affects financial reporting and tax governance. This limitation is consistent with the study's objective to evaluate regulatory coherence and practical effectiveness rather than fiscal magnitude.

Ethical Considerations

The research relies exclusively on publicly available legal documents, academic publications, and professional analyses. No confidential taxpayer data or proprietary financial information is used. All sources are properly cited in accordance with APA 7 standards to ensure academic integrity and transparency.

RESULTS AND DISCUSSION

Results

This study identifies several key findings regarding transfer pricing practices in Indonesia from an integrated accounting and tax perspective.

First, the findings indicate that transfer pricing practices systematically affect reported financial performance at the subsidiary level. Many multinational enterprises operating in Indonesia consistently report **low operating margins or cost-plus returns**, despite performing substantial market-facing and revenue-generating activities. This pattern suggests a structural misalignment between reported profitability and actual economic contributions.

Second, the analysis finds recurring **accounting indicators associated with transfer pricing risk**, including persistently low profit margins, high royalty expense ratios, and significant intra-group service charges. These indicators appear consistently over time and across entities with similar functional profiles, indicating that accounting data can serve as **early warning signals of potential profit shifting**.

Third, the findings reveal that **royalty payments** constitute one of the most significant channels through which profits are shifted out of Indonesia. In many cases, Indonesian entities perform substantial activities related to the development, enhancement, maintenance, protection, and

exploitation (DEMPE) of intangibles, yet receive only routine compensation. This suggests a misalignment between economic substance and profit allocation.

Fourth, the study finds that transfer pricing disputes in Indonesia are increasing in both frequency and complexity, particularly in cases involving royalties, intra-group services, and entity characterization. The effectiveness of dispute resolution mechanisms, including the Mutual Agreement Procedure (MAP), is strongly influenced by the **consistency between accounting records, functional analysis, and transfer pricing documentation**.

Overall, the findings demonstrate that weak integration between accounting information and tax compliance frameworks contributes to distorted financial reporting, increased disputes, and erosion of the Indonesian tax base.

Discussion

1. Transfer Pricing Practices and Financial Performance in Indonesia

The findings confirm that transfer pricing in Indonesia should be understood as a **structural governance issue**, rather than merely a technical pricing matter. The persistent reporting of low margins by Indonesian subsidiaries, despite significant operational activities, is consistent with prior research documenting profit allocation distortions in developing economies [2], [17].

Compared to earlier studies focusing primarily on tax avoidance, this research extends the literature by emphasizing the **accounting implications** of transfer pricing. The findings show that transfer pricing policies shape how financial performance is constructed and reported, thereby affecting managerial decision-making and stakeholder assessment [18].

2. Arm's Length Principle and Practical Challenges

The results highlight persistent challenges in applying the arm's length principle in Indonesia, particularly due to the limited availability of reliable local comparables. This finding aligns with the OECD Transfer Pricing Guidelines, which acknowledge that comparability analysis remains a central source of dispute in transfer pricing enforcement [14].

Prior professional studies note that profit-based methods such as the Transactional Net Margin Method (TNMM) are highly sensitive to accounting assumptions and cost allocation practices [4]. This study confirms these observations in the Indonesian context and further demonstrates that such sensitivities directly affect reported profitability and dispute outcomes.

3. Royalty Payments, DEMPE Analysis, and Accounting Implications

The prominence of royalty-related findings supports international literature identifying intangibles as a major driver of base erosion and profit shifting [13], [9]. This study corroborates prior research by showing that excessive royalty charges often reflect a misalignment between legal ownership and economic substance.

However, this research adds an accounting perspective by demonstrating that excessive royalties not only reduce taxable income but also **distort operating income and performance ratios** in financial statements. This finding is consistent with accounting literature emphasizing the risks of misrepresenting value creation through aggressive cost allocation [12].

4. Transfer Pricing Disputes and the Mutual Agreement Procedure

The increasing number of transfer pricing disputes in Indonesia mirrors trends observed in other jurisdictions with heightened enforcement intensity [2]. While treaty-based mechanisms such as the Mutual Agreement Procedure (MAP) are designed to mitigate double taxation, prior studies highlight their dependence on documentation quality [19].

This study contributes to the discussion by demonstrating that **accounting consistency** plays a decisive role in MAP effectiveness. Inconsistencies between financial reporting and transfer pricing positions weaken a taxpayer's credibility and reduce the likelihood of successful dispute resolution [6].

5. Integrating Accounting and Tax Perspectives

The discussion underscores the necessity of integrating accounting and tax perspectives in transfer pricing governance. Prior accounting research emphasizes that accounting systems actively shape performance interpretation and organizational behavior [1], [11].

Building on this literature, the present study demonstrates that accounting data should be treated as a **core evidentiary foundation** in transfer pricing assessment. Alignment between legal characterization, functional analysis, accounting recognition, and economic benchmarking is essential to enhance transparency, reduce disputes, and support sustainable tax administration.

CONCLUSION AND RECOMMENDATIONS

Conclusion

This study demonstrates that transfer pricing in Indonesia is not merely a tax compliance issue, but a multidimensional challenge that directly affects financial reporting quality, corporate performance measurement, and the sustainability of the national tax base. By integrating accounting and tax perspectives, the analysis reveals that many transfer pricing disputes stem from misalignment between reported financial outcomes and the underlying economic substance of business activities.

From an accounting viewpoint, persistently low margins, excessive royalty expenses, and disproportionate service fees often signal inconsistencies between functional reality and reported profitability. These financial indicators should not be viewed solely as outcomes of intercompany pricing policies, but as early warning signs of potential profit shifting. When accounting data are examined alongside functional analysis and DEMPE considerations, they provide a more comprehensive basis for evaluating whether intercompany transactions truly reflect arm's length conditions.

From a tax perspective, the findings reaffirm that legal form alone is insufficient to determine profit allocation. The application of Articles 5, 7, and 9 of tax treaties must be grounded in economic reality, supported by coherent accounting evidence. Without such integration, enforcement efforts risk becoming reactive and dispute-driven, increasing uncertainty for both taxpayers and tax authorities.

This study contributes to the accounting literature by highlighting the strategic role of financial information in transfer pricing governance. It emphasizes that accounting systems are not neutral record-keeping tools, but active instruments that shape how value creation, risk allocation, and profitability are interpreted in tax examinations. Strengthening the alignment between accounting practices and transfer pricing policies enhances transparency, reduces dispute potential, and supports fair taxation.

In practical terms, the study suggests that policymakers, tax authorities, and corporate managers should adopt a more integrated approach to transfer pricing oversight. Improving documentation quality, ensuring consistency between accounting outcomes and functional analysis, and promoting effective use of dispute resolution mechanisms such as the Mutual Agreement Procedure are critical steps toward balancing tax base protection with investment certainty. Ultimately, bridging accounting and tax perspectives in transfer pricing is essential not only for safeguarding public revenue, but also for fostering a credible, transparent, and sustainable business environment in Indonesia.

Recommendations

This study recommends that policymakers and tax authorities in Indonesia strengthen transfer pricing oversight by adopting an approach grounded in economic substance, integrating tax law analysis with accounting data, particularly profitability indicators and cost structures. Multinational enterprises are encouraged to ensure alignment between transfer pricing policies, functional analysis, and reported accounting outcomes to enhance transparency and reduce dispute risks. Accountants and tax practitioners should view transfer pricing as a cross-disciplinary issue affecting financial reporting quality and performance measurement, rather than solely a tax compliance matter. In addition, the effective use of dispute resolution mechanisms, such as the Mutual Agreement Procedure (MAP), should be supported by consistent and coherent accounting documentation. Future research is encouraged to adopt empirical and cross-country comparative approaches to strengthen evidence on the impact of accounting–tax integration in transfer pricing governance.

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