COMPARABILITY ANALYSIS OF COMPANIES ENGAGED IN INTRA-GROUP TRANSACTIONS (STUDY CASE: PT PLANT PIPE MANUFACTURING)

Amalia Ghassani
Subiakto Sukarno
Wiwiek M. Daryanto

ABSTRACT

PT Plant Pipe Manufacturing is an Indonesian multinational enterprise (MNE) specializing in producing steel pipes for agricultural purposes. This study focuses on the Company's cross-border business activities with its related parties and their impact on its financial performance. Transfer pricing, a strategy employed by the Company to optimize operations and maximize profits, is examined in light of its audited financial report for 2018 to 2022. Surprisingly, the findings indicate a continuous decline in sales and operating profit during this period, leading to consecutive losses. Notably, a significant portion of the Company's sales can be attributed to its related parties in Japan. According to Indonesian tax regulations, as PT Plant Pipe Manufacturing engages in transfer pricing transactions with its related party, it must adhere to the arm's length principle. To ensure compliance and demonstrate that intra-group transactions do not result in profit shifting or loss conditions, the Company must submit Transfer Pricing Documentation. To assess the profitability of the Company, a comparability analysis using the Transactional Net Margin Method (TNMM) is conducted. The analysis reveals that the Company's profitability ratio, as measured by Return on Total Cost (ROTC), falls below the range observed in comparable independent companies operating in similar industries. To address this disparity, the Author introduces a comparability adjustment by considering the Company's production capacity. By incorporating this adjustment, the ROTC values increase, indicating that PT Plant Pipe Manufacturing's profitability surpasses the industry average under normal conditions. This finding suggests that the Company's financial performance does not hurt Indonesian taxation concerning transfer pricing policies.

Keywords*:* Transfer Pricing, Comparability analysis, TNMM, ROTC, Tax

INTRODUCTION

The global economy is growing worldwide, and as a result, many MNEs are conducting cross-border transactions, particularly intra-group transactions within their business group. (KPMG, 2023). The amount of worldwide commerce that involves the movement of goods and services, finances (such as currency), and non-tangible assets (such as patents) within a multinational corporation's network is growing significantly. (United Nations, 2011). Recorded that global enterprises are responsible for approximately 60% of world trade, transfer pricing has become a critical issue in the international tax realm (Ping & Silberztein, 2007), also stated nowadays it is estimated that between 60% to 70% of global economic and commercial activity occurs within the same Group or affiliated companies. (KPMG, 2022).

The growth of activity within the same Group or affiliated parties is due to group integration and how they maximize profit. For example, in a company or business organization, when a higher division in the production process sells materials to a lower-down division, they use transfer pricing to minimize expenses. This approach is designed to increase their internal revenue. (Baye, Michael, & Prince, 2022).

To maximize profit, they consistently endeavor to minimize costs incurred in their operational activities, including taxation. To reduce tax payments, multinational corporations shift income, transferring profits from entities subjected to high tax rates to those subject to lower rates. Transfer pricing represents a specific method employed to facilitate such income shifting. (Sari, Utama, Fitriany, & Rahayu, 2021)

In accounting, a transfer price is a tool used to determine the value of products a profit center supplies to other responsibility centers, such as a cost center. (Anthony, Hawkins, & Merchant, 2012). Furthermore, transfer pricing refers to a company's policies that establish the price of a transaction, which may involve goods, services, intangible assets, or financial dealings conducted within the Company. (Hendriarto, 2021).

When conducting transfer pricing within the Group, a standard is considered to be followed. The arm's length principle is the international standard to set prices for related party transactions. (Finnerty & Merks, 2007). The arm's length principle is met when a transaction's terms are comparable to those agreed upon between independent companies in similar transactions under similar circumstances. (OECD, 2011). Furthermore, the arm's length principle asserts that transactions involving affiliated entities ought to mirror the genuine economic worth of the respective contributions made by each party involved in said transaction. (Bose, 2020).

Suppose the transaction does not meet the arm's length principle, it is concluded an analysis that intercompany transactions resulting income shifting between jurisdictions, which helps reduce their overall tax burden. (Riedel & Zinn, 2014). Hence many government regulatory bodies strengthen their oversight of transfer pricing compliance by implementing transfer pricing regulations and audits. (Ping & Silberztein, 2007). However, by establishing additional regulations of the conditions of interrelated transactions and imposing taxes with special relationships, it is anticipated that the incidence of tax avoidance through manipulative transfer pricing strategies can be curtailed or mitigated. (Sentanu, Ispriyarso, & Juliani, 2016)

Regarding the issue that enterprises can utilize transfer pricing to manipulate their taxable profits, many fiscal authorities operating at the national level, including the Indonesian Tax Office, are concerned about this. ("Director of General Taxes") (KPMG, 2023). As a result, many governments are introducing and expanding transfer pricing regulations to combat the practice of profit shifting through intercompany transactions. (Riedel & Zinn, 2014). Hence, Indonesia produced a law product that regulated transfer pricing to defend their tax bases through these tactics.

Indonesia has addressed transfer pricing issues by incorporating the OECD Transfer Pricing Guidelines (from now on referred to as OECD TP Guidelines) into several domestic regulations. The domestic transfer pricing regulation is now embodied in PER-43/Pj/2010 and was amended by PER-32/Pj/2011. At the latest regulation, they produced PMK-213/Pj/2016. Furthermore, to comply with this regulation, every enterprise conducting transfer pricing practice must demonstrate whether their intra-group transaction follows the arm's length principle and is consistent with the ordinary course of business.

Based on standard practices, it is possible that even though the Transfer Pricing Documentation has been prepared, it still be audited by tax audits. (Tambunan, 2022) stated that transfer pricing audits had become a routine part of tax audits in Indonesia because the tax authorities have found that many multinational companies (MNEs) have been operating in Indonesia while continuously reporting losses and not paying taxes. For those MNE which report a financial loss, they decrease the potential tax to the country. According to (Muhammadi, Ahmed, & Habib, 2016), the loss of potential tax is due to the practice of transfer pricing done by the Company.

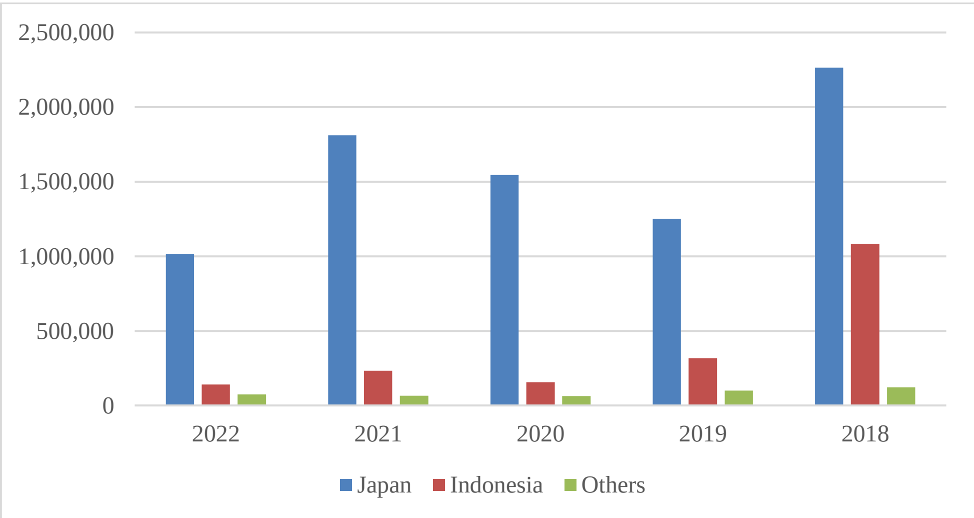
This transfer pricing practice applies to many MNEs established in Indonesia, including PT Plant Pipe Manufacturing (after this referred to the Company). They conduct transactions with entities within their business group, such as sales and purchase transactions, to integrate economically by internalizing costs. For sales transactions, 67.92% is to related parties in Japan; for purchase transactions, it's a small amount recorded in the COGS. Even though it conducted a transaction within the intra Group, the Company suffered a decline and fluctuation in sales during 2018-2022, aligned with its operating profit as depicted in **Table 1** below.

Table 1 – Summary of Profit and Loss of the Company 2018-2022

	2022	2021	2020	2019	2018
Sales	1,228,946	2,109,917	1,761,596	1,666,499	3,467,468
Cost of Goods Sold	1,254,801	1,944,900	2,011,003	1,627,571	2,884,251
Gross Profit	-25,855	165,017	-249,407	38,928	583,217
Gross Profit Margin	-2.10%	7.82%	-14.16%	2.34%	16.82%
Operating Expense	255,433	311,741	308,137	363,657	464,992
Operating Profit (Loss)	-281,288	-146,724	-557,544	-324,729	118,225
COGS to Sales ratio	102.10%	92.18%	114.16%	97.66%	83.18%
Operating Expense to COGS ratio	20.36%	16.03%	15.32%	22.34%	16.12%

Source: Audited Report of PT Plant Pipe Manufacturing (2018-2022)

The presented data reveals that the Company has substantially reduced sales during 2022 compared to the preceding year, accounting for a notable decrease of 41.75%. In addition, when drawing a comparison with the sales figures from 2018, the reduction in sales amounts to 64.56%. Regarding the Operating Profit (Loss) level, the Company last recorded a profit in 2018 but has since experienced consecutive losses from 2019 until now. This trend in declining sales is further emphasized through the tabular and graphical representation of the Company's sales performance from 2018 to 2022, as depicted in **Figure 1**.



Source: Management of the Company (2023)

Figure 1 – Sales Trend of the Company based on Region

Figure 1 above indicates that the Japanese market constitutes the most significant portion of the Company's market share, followed by the domestic market and other countries. Analyzing the sales trend of the Company by Region, it becomes apparent that distinct differences exist among the various geographic areas. Specifically, the graph illustrates that the sales in the Japanese market have matured over time compared to the other regions. Conversely, the sales trend for the domestic market demonstrates a higher degree of volatility, marked by significant declines in revenue.

PT Plant Pipe Manufacturing must demonstrate its compliance with tax regulations and transfer pricing guidelines set by the Indonesian Tax Office. The Company must show that it has not engaged in any tax planning strategies that take advantage of differences in tax rules across international jurisdictions. One example of an inappropriate approach to transfer pricing mentioned in the passage is when a company employs a false transfer pricing strategy, artificially shifting its profits to a related party outside the country. To ensure compliance, PT Plant Pipe Manufacturing must adhere to the arm's length principle in determining its transfer prices. This principle states that prices charged in transactions between related parties should be comparable to those charged between unrelated parties.

To provide evidence of their compliance, PT Plant Pipe Manufacturing must submit Transfer Pricing Documentation to the Directorate General of Taxes. This documentation should demonstrate that the Company's transfer pricing transactions within the intra-group do not result in losses or profit shifting to other companies.

The Author intends to understand better the Company's financial condition and position compared to other companies. This evaluation is necessary to assess whether PT Plant Pipe Manufacturing's transfer pricing transactions align with the arm's length principle. Furthermore, based on this evaluation, the Author aims to develop transfer pricing strategies for future applications.

LITERATURE REVIEW

Transfer Pricing Guidelines

Transfer Pricing regulations are intended to regulate the pricing of transactions between associated entities, ensuring that such transactions are conducted on an arm's length basis, reflecting the same market conditions as those observed among unrelated entities. The recent evolution of international tax laws has highlighted the need for accurately documented Transfer Pricing outcomes that align with the value generated by the transaction. (Baker McKenzie, 2019). OECD issued a transfer pricing documentation guideline that can be applied internationally to ease the tax administration. (PwC, 2014)

The current international tax system relies on separate accounting, requiring multinational corporations to use transfer pricing to determine each affiliate's income for related party transactions. Although the arm's length principle should guide transfer pricing, various prices can exist for the same transaction, mainly when comparable transactions are not between unrelated parties. Tax authorities face difficulties verifying adherence to the arm's length principle, allowing MNCs to undervalue or overvalue exports and imports between high-tax and low-tax jurisdictions to lower their global tax burden. (Mooij & Liu, 2018)

An observable trend in transfer pricing regulations is linked to the publication and implementation of the Base Erosion and Profit Shifting (BEPS) Actions 8, 9, and 10 plan and the OECD TP Guidelines by the OECD/G20. These guidelines target the erosion of the taxable base and the shifting of profits to regions with low or no tax rates. Implementing these standards has contributed to increased regulatory scrutiny of transfer pricing practices by global tax authorities. (Patel, 2015).

The OECD TP Guidelines outline the following three objectives of transfer pricing documentation: (i) to furnish tax authorities with informative material that can aid them in performing a comprehensive audit of the transfer pricing methods used by taxable entities within their jurisdiction. However, it may be imperative to complement the furnished documentation with further information as the audit advances, (ii) to equip tax authorities with the requisite knowledge to conduct a well-informed evaluation of the potential risks associated with transfer pricing, (iii) to supply tax authorities with valuable information that facilitates a meticulous examination of the transfer pricing procedures employed by taxable entities within their purview. However, augmenting the provided documentation with supplementary data may be imperative during the audit's progression. (OECD, 2022)

Indonesia Transfer Pricing Requirements

The governing regulations for transfer pricing documentation in Indonesia are outlined in Regulation No. 213/PMK.03/2016 (PMK-213) issued by the Indonesian Ministry of Finance. According to PMK-213, taxpayers exceeding the threshold must prepare and maintain transfer pricing documentation that demonstrates the arm's length nature of their related party transactions.

To avoid penalties and tax liabilities, Indonesian taxpayers must ensure compliance with transfer pricing regulations, including preparing proper documentation to demonstrate the arm's length nature of related party transactions. These regulations apply to corporations in Indonesia with subsidiaries abroad, and non-compliance can lead to significant financial consequences.

Transfer Pricing Method

OECD defines a different term as comparability, which means comparison to an uncontrolled transaction is not subject to manipulation or influence. Controlled and uncontrolled transactions can be considered comparable when differences do not significantly impact the factor under analysis, such as price or margin, or when appropriate adjustments can be made to eliminate the significant impact of such variations. (OECD, 2022).

Transfer pricing methods are utilized to ascertain fair pricing for transactions between related entities, which may have significant tax and financial reporting implications. Companies can select from various transfer pricing methods to determine the appropriate transfer pricing, including the Comparable Uncontrolled Price (CUP), Cost Plus, Resale Price, Profit Split, and Transactional Net Margin Methods (TNMM).

The choice of transfer pricing method depends on the availability of comparable transactions, the nature of goods or services involved, and industry conditions. Companies must document their transfer pricing decisions meticulously to comply with tax regulations and prevent disputes with tax authorities.

Arm's Length Principle

The arm's length principle is generally based on comparing the conditions of transactions conducted with affiliated parties with transactions between independent comparison companies, provided that the economic characteristics of the situations being compared must be pretty comparable. This comparability is achieved when there are no differences (if any) between the situations being compared that could materially affect the conditions being evaluated (e.g., prices or margins) or sufficiently accurate adjustments can be made to eliminate the effect of such differences. (Loots, 2006)

Material differences must be considered between the transactions or companies being compared to achieve comparability between the companies tested and the comparison companies in the transfer pricing analysis. It is necessary to compare factors from transactions or companies that will affect the condition of fairness and business practices to establish comparability. Then, appropriate adjustments are made to create conditions in accordance with the arm's length principle. Important factors include the characteristics of the goods or services delivered, the functions performed by the parties (taking into account the assets used and the risks faced), contractual terms, economic conditions, and business strategies adopted by the parties. (Feinschreiber, 2004)

Transactions that are compared between the companies tested, and the comparison companies must also be seen in the view that these transactions are carried out to maximize company profits. Therefore, the selected comparison companies usually have a good portfolio of financial performance. (Wittendroff, 2010)

Comparability Adjustment

To be able to achieve comparability, several factors must be considered to find a comparison company, including functional differences, asset differences, risk differences, geographic location, market size, distributor or retail market, tax authorities, labor costs, cost of capital in markets, overall economic development, level of competition, and accounting practices. However, all these things cannot always be met in the framework of a transfer pricing analysis to meet arm's length; therefore, adjustments for material differences between the parties being tested and comparison companies must be made to achieve comparability. (Jindal, 2015)

The obligation to prove a comparability adjustment is not regulated further by domestic regulators (DGT) or foreign regulations (OECD TP Guidelines and UNTPM). However, in the case of tax disputes related to comparability adjustments, proof becomes crucial for companies or tax authorities. In addition to this, in carrying out comparability adjustments. Evidence of non-comparability between the tested party and the comparison company must be proportional. This eliminates subjectivity in making comparability adjustments in transfer pricing analysis (Navarro, 2017).

RESEARCH METHOD

This study employs a qualitative and quantitative research approach, effectively using primary and secondary data provided by PT Plant Pipe Manufacturing. The acquired data will be utilized to analyze the requisite formulas required to accomplish the study's objectives. Based on the analysis outcomes, the Author will provide recommendations concerning business-related concerns and formulate a project plan for the Author's topic. Finally, the researcher will present a comprehensive report detailing the research findings and offering suggestions.

The method used for analysis is TNMM, a Transfer Pricing method that is carried out by comparing the percentage of operating net income to costs, sales, assets, or other bases for transactions between parties that have Special Relations with the percentage of operating net income earned on comparable transactions with other parties that do not have a Special Relationship or the percentage of operating net income made on comparable transactions carried out by parties that do not have other Special Relationships. (Republic of Indonesia, 2011).

The Author will apply the above method by comparing the percentage of operating net income cost/sales (profitability ratio) and comparing the ratio to other companies with similar business activities. According to (Daryanto, Wijaya, & Renatauli, Financial Performance Analysis of PT. Ace Hardware Indonesia, Tbk. Before and After The Launch Of Ruparupa.Com, 2020), using a measurement ratio to determine the Company's value is essential in assessing financial performance. The most commonly used profitability ratio for manufacturers and service providers is Return on Total Cost (ROTC). (Levery, 2006). The comparable companies will be collected through a transfer pricing database using several criteria that OECD has modeled.

RESULTS AND DISCUSSION

Company profile

PT Plant Pipe Manufacturing was established in 2003 and operates in the pipe manufacturing industry for agriculture and horticulture needs. Located in the Industrial Estate in Pasuruan and involves various essential elements in its business activities. The Company is a subsidiary of a Business Group with Head Quarter located in Japan and has 30 related party companies. The Company is a foreign investment company, and its significant shareholders are Japanese.

The Company produces agricultural and horticultural support materials like plant stakes and tunnel pipes, made of steel and coated with polyethylene resin/HDPE. Despite being made entirely of steel, they are lightweight. The technology used by the Company is specifically designed for field use, with UV and corrosion resistance making them durable for years. These stakes are also ideal for urban farming due to their simplicity, as they can be customized to fit customer needs, whether as a pergola or simply a plant stake.

Financial performance

Table 2 – Vertical and Horizontal Analysis of Actual and Budget 2022

	Actual 2022	Horizontal	Vertikal	Budget 2022	Vertical
Sales	1,228,946	-52.05%	100%	2,563,200	100%
Cost of Goods Sold	1,254,801	-42.07%	102%	2,166,071	84.51%
Gross Profit	**(25,855)**	**-106.51%**	**-2.10%**	**397,129**	**15.49%**
Operating Expenses	255,433	-32.83%	21%	380,302	14.84%
Operating Income/Loss (EBIT)	**(281,288)**	**-1,771.72%**	**-22.89%**	**16,826**	**0.66%**
Total Cost	1,510,234	-40.69%	123%	2,546,374	99.34%

Source: Internal Management of the Company (2023)

According to **Table 2**, the Company's sales in 2022 are significantly far below the budgeted expectations amounting to -52.05%, aligned with the operating income (loss) level amounting to 1,771.72%, but the total cost only decreased by -40.69%%. As a result, the Company achieved a lower profit margin than anticipated.

Table 3 - Financial Analysis of Actual 2021 vs 2022

	Actual 2022	Horizontal	Vertikal	Actual 2021	Vertical
Sales	1,228,946	-41.75%	100%	2,109,917	100%
Cost of Goods Sold	1,254,801	-35.48%	102%	1,944,900	92%
Gross Profit	**(25,855)**	**-115.67%**	**-2.10%**	**165,017**	8%
Operating Expenses	255,433	-16.25%	21%	304,994	14%
Operating Income (EBIT)	**(281,288)**	**-100.95%**	**-22.89%**	**(139,977)**	-7%
Total Cost	1,510,234	-32.88%	123%	2,249,894	107%

Source: Internal Management of the Company (2023)

Table 3 shows a decrease of 41,75% in 2022 total sales compared to the previous year; this also aligned with the operating income (loss) level, which decreased by 100.95%.

Preparation of Transfer Pricing Documentation

The Company's approach to developing transfer pricing documentation is lawful and involves adherence to the technical provisions outlined in the local regulation, PMK-213. In compliance with this, the Company must prepare the documentation within four months following the conclusion of the tax year, taking into account the availability of data utilized in the arm's length analysis. Due to the routine and specific nature of the documentation, the Company must commence its preparation early in the year, coinciding with the commencement of financial audits and the filing of the Corporate Income Tax Return. This practice also aligns with the ex-ante principle, whereby taxpayers must apply arm's length analysis before engaging in transactions. The preparation process can be conducted internally by the finance or tax department or with the assistance of tax consultants, thereby enabling the Company to meet the Transfer Pricing Documentation deadline.

Based on PMK-213, Taxpayers could document non-financial events/occurrences/facts affecting the formulation of the price of profit level. In this section, considering the Company's consecutive financial losses, it becomes necessary to document their underlying reasons, including explaining why the maximum capacity was not attained. Additionally, a comprehensive calculation must be undertaken to establish the extent of the gap between the complete analysis results, demonstrating that any variance between the budgeted and actual figures is attributable to rational commercial circumstances rather than decisions made regarding transfer pricing. This analysis should also encompass the disparity between the ratio range and the precise ratio exhibited by the Company.

It is recommended that the Company diligently records all relevant evidence about transactions with related parties, encompassing contracts, invoices, payment receipts, bank statements, and documentation substantiating the completion of work or receipt of goods. Furthermore, it is crucial to document the rationale behind the benefits received by the Company for these related party transactions. This meticulous documentation is paramount as the tax authorities frequently scrutinize the validity of such transactions in the context of taxation.

Comparability analysis

The OECD Guidelines provide several steps for completing a comparability analysis, considered good practice but optional. (OECD, 2022). This process is adapted to domestic regulation by completing pricing or profit tests at the gross profit or net operating income level. Based on DGT Regulation Number 32/Pj/2011, after conducting a comparability study, the transfer pricing approach is used to test the implementation of the arm's length principle.

Several analytical steps must be taken to ensure the Company's business activities comply with the arm's length principle.

Functions, assets, and risks (FAR) analysis
Based on the Company's function, assets, and risk being examined. The analyzed Company primarily engages in manufacturing activities and assumes associated risks. Therefore, it can be classified as a manufacturing company that does not conduct research and development or possesses intangible assets.

Product and/or services characteristics
Variances in the distinct qualities of products or services typically contribute, to some extent, to variations in their market value. The type of products sold to the customer is agricultural and horticultural supporting materials such as plant stakes and tunnel pipe made of steel and coated by polyethylene resin/HDPE.

Selecting the most appropriate transfer pricing method
Several criteria were applied to determine the method chosen for the benchmarking analysis. The result that this analysis will use a transactional profit method called TNMM. TNMM determines whether the amount charged in a controlled transaction is fair and customary price by referring to an objective measurement of the net profit of a comparable independent entity, known as profit level indicator, which consists of financial ratios.

After method selection

- Multi years data: the data spanning multiple years is used to guarantee that unusual factors do not influence the outcomes for the year being analyzed.
- Profit Level Indicator: the OECD Guidelines suggest that the denominator must be sufficiently independent of controlled transactions, or there will be no objective starting point.
- Interquartile range: fair price based on Transfer Pricing methods can be determined by the arm's length range, which ranges between the first and third quartiles. (Republic of Indonesia, 2010). Any point within the range nevertheless satisfies the arm's length principle. (OECD, 2022).

The Return on Total cost (after this, referred to as ROTC) ratio is considered.

$$ROTC = \frac{Operating\ Profit\ (loss)}{(COGS + Operaing\ Expense)}$$

Table 4 - ROTC of PT Plant Pipe Manufacturing 2022

Account	Formula	Amount
Revenues	A	1.228.946
Sales		1.244.118
Scrap sales		15.172
Cost of goods sold	B	1.254.801
Gross profit	C = A – B	-10.683
Operating expense	D	
Sales expense		128.384
General and administrative expense		127.049
Total cost	E = B + D	1.510.234
Operating profit	F = A – E	-266.116
ROTC	**G = F / E**	**-17,62%**

Source: Management of the Company (2023)

Benchmarking analysis
The third-party database is used to identify a set of independent Asia-Pacific companies that are reasonably comparable in terms of functions, assets, and risks. The search process includes checking companies on a database, eliminating non-conforming companies, and selecting potential comparable companies.

Table 5 – Database and Manual Screening

Phase	Criteria
Phase 1: checking companies on the database	Legal status Only companies with "Active" status are considered.
	Ownership data To exclude companies where twenty-five percent or more of the shares are owned by another company, the BvD Independence Indicators criterion is selected, and companies with BvD Independence Indicators A+, A, and A- are considered.
	Business description data Only companies with overview information are considered.
	Geographic area Only companies in the "Far East and Central Asia" regions were selected to limit comparable companies in the Asia Pacific.
	Industry code The relevant code incorporating potentially comparable entities has been identified to ascertain prospective companies within the Asia-Pacific region that bear similarities to the tested party.
	Financial data availability All companies with financial data available in 2021, 2020, and 2019 are considered.
Phase 2: eliminating and selecting potential comparable companies	Companies with different functions Potential comparison companies may be in the same industry but perform different functions are eliminated.
	Companies that own intangible assets Eliminate companies that own intangible assets.
	Companies with different products Potential comparison companies which produce different products are eliminated.

Source: Author and Orbis TP Catalyst (2023)

Selected comparable companies
Based above criteria gathered, several candidate companies became a population. At the manual review stage, some companies were rejected, and five comparable companies were selected, comparable to PT Plant Pipe Manufacturing as a tested party. ROTC analysis results are as follows.

Table 6 – ROTC of Comparable Companies

Name of Company	ROTC
Jindal Pipes Limited	3.34%
JNB Steel Industries Private Limited	7.30%
JTL Industries Limited	7.51%
Krishna Iron Strips and Tubes Private Limited	2.44%
Maa Kudargarhi Steels Private Limited	3.13%
Maxim Tubes Company Private Limited	4.53%
The Company	**-17.62%**
Maximum (Q4)	7.51%
Upper quartile (Q3)	5.92%
Median (Q2)	3.34%
Lower quartile (Q1)	3.01%
Minimum (Q0)	2.44%

Source: Author and Orbis TP Catalyst (2023)

Based on the benchmarking analysis conducted on seven comparable independent companies, applying the arm's length principle of related party transactions identified an interquartile range between 3.01% to 5.92% with a median of 3.34%. Based on the benchmarking analysis, the Company shows that the adjusted ROTC ratio of PT Plant Pipe Manufacturing falls below the interquartile range of comparable independent companies.

Comparability adjustment

Adjustments were necessary to account for fixed costs that revenue could not cover in 2022, given the decline in production quantity compared to normal conditions. This indicates that the Company did not operate at full capacity yet still had to bear high fixed costs. The table below illustrates the adjustments made by the Company to account for special conditions such as non-optimal production capacity due to a decrease in export and domestic sales, as well as receiving fewer projects from the government, compared to normal conditions in previous fiscal years (2014-2018).

Table 7 – Calculation of Production Capacity

Description	Formula	Volume (Unit)	Production capacity (%)
Installed capacity (available)	A	2.040.000	100,00%
Normal capacity (2014-2018)	B	1.620.830	79,45%
Capacity used in 2022	C	406.200	19,91%
Unused capacity in 2022	D = B - C	1.214.630	59,54%

Source: Management of the Company (2023)

The table indicates that in 2022, PT Plant Pipe Manufacturing had an idle capacity of 59.54%. Idle capacity refers to the portion of a company's production capacity that is not utilized or used for productive use. This high idle capacity suggests the Company is not operating at its normal production level. As a result, it faces challenges in fully utilizing its resources and generating sufficient revenue to cover its fixed costs associated with production. Fixed costs are expenses that do not vary with the level of production or sales, such as rent, salaries, and utilities.

To address this issue and provide a more accurate representation of the Company's financial condition, PT Plant Pipe Manufacturing has adjusted its fixed costs. These adjustments involve considering the unused capacity and its impact on the Company's ability to cover fixed costs. By making these adjustments, the Company aims to enhance comparability and present a more realistic depiction of its financial situation. The table above highlights the Company's idle capacity and its impact on its ability to absorb fixed costs. It also emphasizes the Company's efforts to adjust fixed costs to accurately reflect its financial condition, thereby improving comparability and providing a clearer understanding of its situation.

Table 8 – Calculation of Adjustments to Fixed Costs

Fixed costs related to production capacity	Total actual	Percentage of unused capacity	Adjustment amount for unused capacity
	A	B	C = A x B
Fixed costs as a component of COGS	511,803	59.54%	304,731
Fixed costs as a component of selling expenses	32,511	59.54%	19,357
Fixed costs as a component of general and administrative expenses	99,141	59.54%	59,030
Total	**643,455**	**59.54%**	**383,118**

Source: Management of the Company (2023)

The adjustments made to PT Plant Pipe Manufacturing's fixed costs due to its unused capacity. It specifies the specific amounts adjusted for different categories of expenses:

- Cost of Goods Sold: An adjustment of USD 304,731 has been made to account for the unused capacity. This adjustment reflects the portion of the cost of goods sold that the Company's sales revenue cannot cover due to lower production and sales volumes compared to normal conditions in previous years.

- Selling Expenses: An adjustment of USD 19,357 has been made for selling expenses. This adjustment considers the impact of unused capacity on the Company's ability to generate sufficient sales revenue to cover these expenses.

- General and Administrative Expenses: An adjustment of USD 59,030 has been made for general and administrative expenses. This adjustment reflects the fixed costs associated with administrative functions that the Company's income cannot fully cover due to the underutilized production and sales volumes.

These adjustments are made to provide a more accurate assessment of the Company's financial performance, considering the effects of idle capacity. By making these adjustments, PT Plant Pipe Manufacturing aims to calculate its ROTC for 2022 based on a more realistic depiction of its situation, as calculated in the table below.

Table 9 – Adjusted ROTC of PT Plant Pipe Manufacturing 2022

Account	Actual	Adjustment	After adjustment
Revenues	1,244,118	-	1,244,118
Sales	1,228,946	-	1,228,946
Scrap sales	15,172	-	15,172
Cost of goods sold	1,254,801	304,731	950,070
Gross profit	-10,683	-	294,048
Total expense			
Sales expense	128,384	19,357	128,384
General and administrative expense	127,049	59,030	68,020
Operating profit (loss)	-266,116	-	97,645
Total cost	1,510,234	-	1,146,473
ROTC	**-17.62%**	**-**	**8.52%**

Source: Management of the Company and analyzed by the Author (2023)

Adjustments for production capacity have been made for these comparison companies to increase comparability with the Company. The adjusted ROTC obtained by the Company of 8.52% is above the arm's length range obtained from the selected comparison companies. Therefore, it can be seen that the profitability level under normal conditions is higher than the average of similar industries; consequently, it does not negatively affect Indonesian taxation from the perspective of the transfer pricing policy.

CONCLUSION

Based on the financial performance analysis, PT Plant Pipe Manufacturing, like many other multinational enterprises (MNEs) in Indonesia, engages in transactions with entities within its business group, experiencing a decline in sales and operating profit from 2018 to 2022. Sales to related parties in Japan constitute a significant portion, while the domestic market demonstrates volatility and declines in revenue.

To comply with tax regulations, PT Plant Pipe Manufacturing must adhere to the arm's length principle and submit Transfer Pricing Documentation, ensuring that intra-group transactions do not result in profit shifting or loss conditions. Through benchmarking analysis conducted on seven comparable independent companies, utilizing the arm's length principle for related party transactions, it was found that the interquartile range for the comparable companies' ROTC ratio ranged from 3.01% to 5.92%, with a median of 3.34%. However, the Company's ROTC ratio fell below this range, indicating a need to investigate the reasons for the loss.

With the information gathered, the Company could make a comparability adjustment to improve comparability. In this study, the adjustment was made by adjusting the production capacity; the Company's ROTC values were brought above the interquartile range, demonstrating that its profitability level under normal conditions surpasses the industry average. Therefore, it does not pose any negative implications for Indonesian taxation concerning transfer pricing policies.

RECOMMENDATION

Based on the previous analysis, the Company should apply the recommendation: (i) Domestic regulation requires documentation; the Company could regularly prepare transfer pricing documentation at the start of each year. The Company could begin in early preparation to guarantee the timely availability of the documentation before the deadline for submitting the Corporate Income Tax Return or no later than four months after the financial year ends; (ii) Suppose the Company cannot reach the arm's length principle range. In that case, the Company should prepare an explanation and supporting file related to the loss condition and explain it in the transfer pricing documentation. Also, adjustments can be made to improve comparability analysis; (iii) Considering the transfer pricing analysis and determining the arm's length ratio, the Company has several strategies to ensure its profits align with the arm's length range. In 2022, the ROTC fell below the range and needed to increase the profitability ratio by increasing the revenue and optimizing the production and operating expense cost.

LIMITATION

This final project will focus on a comparability analysis of the Company related to its intra-group transaction to determine whether the transaction aligns with the domestic transfer pricing regulation. During finishing this study, there were several limitations attributable to the constraints of time and the unavailability of data, which are listed as follows: (i) Comparability analysis for PT Plant Pipe Manufacturing; (ii) The analysis will be based on financial data from 2018-2022; (iii) Comparability analysis was limited to the related party transaction in 2022; (iv) Compare the financial performance of similar companies using a database called TP Catalyst; and (v) It is limited to recommending a transfer pricing strategy to achieve the arm's length principle.

REFERENCES

Anthony, Hawkins, & Merchant. (2012). *Accounting: Text and Cases, 13th Edition.* New York: McGraw Gill.

Baker McKenzie. (2019). *Transfer Pricing Documentation: A Key Focus*. Retrieved from https://www.bakermckenzie.com/en/insight/publications/2019/02/transfer-pricing-documentation-a-key-focus

Baye, Michael, & Prince, J. (2022). *Managerial Economics and Business Strategy 10th Edition.* New York: McGraw Gill.

Bose, A. (2020). Managing transfer pricing risks: Fund managers are facing new challenges as tax authorities seek to establish increasingly stringent transfer pricing compliance requirements. *The Business Times*.

Daryanto, W. M., Wijaya, J., & Renatauli, R. (2020). Financial Performance Analysis of PT. Ace Hardware Indonesia, Tbk. Before and After The Launch Of Ruparupa.Com. *International Journal of Business, Economics and Law*.

Feinschreiber. (2004). *Transfer Pricing Methods: An Application Guide.* John Wiley & Sons.

Finnerty, C. J., & Merks, P. (2007). Fundamental of International Tax Planning. *International Bureau of Fiscal Documentatio*.

Hendriarto, P. (2021). Relevance between Transfer Pricing and Taxpayer Compliance and Marketing Accounting Management Efficiency. *Linguistics and Culture Review*, 2066-2077.

Jindal. (2015). *Transfer Pricing in Relation to International Transaction.* Delhi: Young Global Publication.

KPMG. (2022). *Cyprus: The Importance of Transfer Pricing Rules*. Retrieved from https://kpmg.com/cy/en/home/insights/2022/09/cyprus-the-importance-of-transfer-pricing-rules.html

KPMG. (2023). *Global Transfer Pricing Services*. Retrieved from https://home.kpmg/id/en/home/services/tax/global-transfer-pricing-services.html.

Levery, M. (2006). *Transfer Pricing Rules and Compliance Handbook.* Chicago: CCH.

Loots. (2006). A Comparability Adjustment Transfer Pricing Model. *North-West University*.

Mooij, R. D., & Liu, L. (2018). *At A Cost: the Real Effects of Transfer Pricing Regulations.* International Monetary Fund.

Muhammadi, Ahmed, & Habib. (2016). Multinational Transfer Pricing of Intangible Assets: Indonesian Tax Auditors's Perspective. *Asian Review of Accounting*.

Navarro. (2017). Transactional Adjustment in Transfer Pricing. *International Bureau of Fiscal Documentation*.

OECD. (2011). Transfer Pricing Legislation - A Suggested Approach. *Centre for Tax Policy and Administration*.

OECD. (2022). *Transfer Pricing Guidelines.*

Patel, Z. (2015). Retrieved from Base Erosion and Profit Shifting (BEPS) Actions: https://www.deloitte.com/global/en/services/tax/analysis/beps-actions.html

Ping, L., & Silberztein, C. (2007). *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?* Retrieved from https://www.oecd.org/tax/transfer-pricing/39265412.pdf

PwC. (2014). *International Transfer Pricing: Transfer Pricing at Your Fingertips.* Retrieved from https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf

PwC. (2017). *Tax Flash: Transfer Pricing Documentation.*

Republic of Indonesia. (2010). *PER-43/Pj/2010 concerning Application of Arm's Length Principle in Transaction between Taxpayer and the Party Having Special Relationship.*

Republic of Indonesia. (2011). *DGT Regulation Number 32/Pj/2011 regarding Application of Arm's Length Principle in Transaction between Taxpayer and the Party Having Special Relations.*

Republic of Indonesia. (2016). *Minister of Finance Regulation Number 213/PMK.03/2016 concerning Types of Documents and/or Additional Information that must be Retained by Taxpayers that Conduct Transactions with Related Parties, and Procedures for Their Management.*

Riedel, N., & Zinn, T. (2014). The Increasing Importance of Transfer Pricing Regulations: A Worldwide Overview. *Intertax*.

Sari, D., Utama, S., Fitriany, & Rahayu, N. (2021). Transfer pricing practices and specific anti-avoidance rules in Asian developing countries. *International Journal of Emerging Markets*.

Sentanu, A. I., Ispriyarso, B., & Juliani, H. (2016). Analisis Yuridis Terhadap Transfer Pricing Sebagai Upaya Tax Avoidance (Penghindaran Pajak). *Diponegoro Law Review*.

Tambunan, M. (2022). Transfer Pricing Settlement in Indonesia: A Note for Tax Authority, Tax Court, and Taxpayers based on the Tax Court Decisions. *Bisnis & Birokasi: Jurnal Ilmu Administrasi*.

United Nations. (2011). *An Introduction to Transfer Pricing*. Retrieved from https://www.un.org/esa/ffd/wp-content/uploads/2011/06/20110607_TP_Chapter1_Introduction.pdf.

Wittendroff, J. (2010). *Transfer Pricing and the Arm's Length Principle in International Tax Law.* Kluwer Law International.

Amalia Ghassani
Sekolah Bisnis dan Manajemen, Institut Teknologi Bandung
Email: amalia_ghassani@sbm-itb.ac.id

Subiakto Sukarno
Sekolah Bisnis dan Manajemen, Institut Teknologi Bandung
Email: subiakto@sbm-itb.ac.id

Wiwiek M. Daryanto
Sekolah Tinggi Manajemen IPMI
Email: wiwiek.daryanto@ipmi.ac.id