THE EMPLOYEE STOCK OWNERSHIP PROGRAM PHENOMENA: EVIDENCE FROM INDONESIA

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ABSTRACT

The objective of this study is to explain the employee stock ownership program phenomenon in public companies in Indonesia. The ownership of companies in Indonesia is concentrated by a single controlling shareholder. Sometimes, the board of directors and board of commissioners of a company or his/her family are the controlling shareholders. This study is interested in describing the employment stock option program phenomenon. This study collects data from the Indonesian Stock Exchange database of companies conducting employee stock ownership programs. There were 45 companies conducting this tye of program between 1999 and 2011. In 2011, the number of public companies listed on the Indonesian Stock Exchange was 451. This implies that about 9.97 percent of public companies conduct such a program. Why is it then, that more companies do not use this program? Almost 33.56% of public company directors in Indonesia are the family of the controlling shareholder. Therefore, he/she feels that this program will not have any impact on the manager because the manager has the same interest as the controlling shareholder. Thus, the program is not attractive in Indonesia as a way to reduce the agency problem between shareholders and manager. It is only relevant for public companies with dispersed ownership.

JEL: M41; G32

KEYWORDS: Employee Stock Ownership Program, Corporate Ownership, Concentrated, Dispersed

INTRODUCTION

Management practices used throughout the world can affect a company's practices in Indonesia. These practices generally occur in developed countries and include the employee ownership program. It is better known as Employee Stock Ownership Program (ESOP). This program is introduced by the management of human resources in the form of corporate ownership by employees. One objective of this program is to align the interests between agents (managers) and principles (owners). The alignment can reduce agency problems between owners and managers.

Engaging in this type of program is decided in a general meeting of shareholders, or the extraordinary meeting of shareholders, as in PT Garuda Indonesia Tbk. Based on a decision of the Extraordinary Meeting of Shareholders (EGM) of PT Garuda Indonesia Tbk, on November 15, 2010 as amended by Decision Circular Shareholders on January 26, 2011, the shareholders approved the ownership program by the management and employees (Management and Employee Stock Allocation/MESA). It was done by allotment of shares to the special buyer, which consists of stock bonus and stock discount. It also provides the option right to management and employees (Management and Employee Stock Option Plan/MESOP). Based on the approval of the shareholders, the directors set the number of shares for the MESA program at almost 5% of the total issuance of new shares and for the stock option program MESOP as much as 0.97% of the total issued and paid up shares after the public offering.

In Indonesia, accounting for these programs is set in the Statement of Financial Accounting Standards No. 53. The statement was effective from October 1, 1998. Stock options are offered as a reward to the employee. It is measured and recognized at the fair value of the instruments. The fair value of the instruments can be determined by the service of the employee as a fair value, after deducting from the amount to be paid at the time of the equity instruments given (IAI, 2007).

According to Machfoedz (1999), a stock option is the right to buy shares at a special price. It is usually given to executives for their dedication to the company over a certain period. The employee stock option program is a program directed to provide an opportunity for employees to own stock in the company through stock options. Implementation of the ESOP in Indonesia is not yet optimal. Few public companies currently use this program. The question is why the program is not getting more response from the public companies in Indonesia. The program has some good objectives as follows: 1.) This program can provide rewards to all employees and directors, for their contribution to company performance. 2.) This program can help align the interests, between employees (directors) and owners (principals). 3.) This program can also increase employee motivation and commitment to the company because they are also the owner of the company. Therefore, the program is expected to increase productivity and performance. 4.) This program can be used to retain and motivate key employees and to enhance firm value.

Why then, has the program been used so little, by Indonesian Public companies? Is it concentrated ownership which reduces the take up? The objective is to answer these questions. The remainder of the paper is organized as follows. Section 2 discusses the relevant literature. Section 3 is research method. Section 4 provides analysis based data. Section 5 concludes the paper.

LITERATURE REVIEW

According to El-Tahch and Ricaurte (2011), employee stock option programs are the basis for developing a key employee in the present and future. Companies need to establish a work plan and a good blue print before establishing a basis. Philosophy and benchmarking is a blueprint and a plan to develop a company by an employee ownership program. It is critical to explain plans are intended to be achieved by the company as well as retaining key employees, paying a basic salary at a specific rate or an annual bonus on a certain level, and paying a basic salary or phantom stock.

Another important part prior the ESOP program implementation is a comparative study. This analysis uses market or industry survey data relating to other companies. How do they pay basic salary and annual bonus payments? We compare it with current pay practices in companies that will implement the ESOP. The study will provide an overview of the current picture of employee compensation and what is needed to respond to gaps between the company's compensation plan and the relevant benchmark.

The stock option program has several benefits as follows.

1. Stock option programs for employees can be used effectively, to reduce agency problems between owners (principals) and managers (agents). The program is expected to increase company performance. According to Iqbal and Hamid (2000), employee stock ownership increases the sense of satisfaction, commitment, and control of the company. An ESOP can also improve employee motivation and productivity for the company (Shulman, 2002).

2. The stock option program for employees is an effective way to reduce agency costs (Brenner, Sundarm, and Yermack, 2000). The costs can be mitigated through the alignment of interests between managers and principals. According to Chance, Kumar, and Todd (2000), this program can be used by public companies, to plan incentives and compensation for employees. McColgan (2001) suggests the structure of executive compensation contracts can be an incentive to increase firm value. It also influences the alignment of interests between owners and managers.

3. According to Senders (1999), ownership of shares by the employee will increase the performance of company and firm value. Iqbal (2000) finds that there is a positive association between operating performance of ESOP companies and the price market of stock of this company.

4. According to Carberry (1996), stock ownership by employees represents voting rights by the employees. Therefore, stock ownership can determine the percentage of their control of the company.

5. Cash flow advantages, an employee can contribute to a plan in the form of cash. The ESOP is required to invest primarily in ownership by employees. This cash flow advantage for companies is clear. Through an ESOP, employees receive a deduction equal to a fair market value of shares (Shulman, 2002).

6. An ESOP can be used to absorb funds from the public. Core and Guay (2000) suggest that when the problem of financial and capital needs arrises, these companies will implement share-based compensation.

According to Bapepam (2002), Indonesian parties implementing the concept of stock ownership by employees, can be divided into two groups. The first group is public companies who have begun implementing a stock ownership program. The program is conducted through a special allocation program for employee or employee stock allocation, bonus shares or a bonus share plan, or provision of stock option or a stock option plan. Employee stock ownership plans, through program savings, or purchasing stock, are not yet a common activity in Indonesia. The second group is subsidiaries of multinational companies (foreign companies). Multinational companies compensate their employees in part through the ESOP program. It is also applied to employees of its subsidiaries in Indonesia, which are eligible to participate in this program.

According to Bapepam (2002), there are two main rules governing the implementation of ESOP in Indonesia as follows. 1. Bapepam. IX.A.7 suggests that employee get priority allotment for up to 10% of total public offerings. 2. Bapepam. IX.D.4 regulates that issuers can increase equity, without giving shareholders pre-emptive rights. Within a period of three years, additional capital can be more than 5% paid up. Based on the regulation, many issuers use this rule to increase the shares up to 5% of the total paid-up capital in the framework of the ESOP program.

This rule also regulates the disclosure required to increase equity without public offering, is limited only as follows. 1.) Analysis and discussion by management about financial conditions. 2.) Pro forma company. 3.) Effect of increasing equity to shareholders after adding equity and, 4.) The reason for the addition of equity without the order is the best option.

The company must also follow regulations governing the exercise price of the shares issued in adding equity without preemptive rights. The exercise price must be at least the market price of the stock in the regular market. It is the average closing price, during the period of 25 consecutive days before the announcement of a general meeting of shareholders, scheduled for adding equity.

The development of the implementation of ESOP in Indonesia is as follows (Bapepam, 2002). Prior to 1998, the ESOP is done by Indonesian companies. At the beginning, the ESOP is the allocation of shares when the company goes public. It is only a stock allocation scheme. In this offering, an employee obtains subsidies or loans guaranteed by the company. Since 1998, before a public offering, an employee is given warrants to purchase shares, at a future predetermined period and price.

Previous researchers observed positive effects of the employee stock ownership plan on operating performance, as documented by Park and Song (1995) and Blasi, Kruse, and Conte (1992). According to

Klien (1997), there are several theoretical perspectives relating to the ownership of companies by employees on employee behavior and corporate performance. Employee stock ownership will increase the employee commitment and performance of the company. According to Jensen and Meckling (1976), financial incentives, such as employee stock ownership, will align the interests of the employee and interests of shareholders.

Positive benefits obtained by employee-owners, is often cited as a primary motive to establish an ESOP. It suggests that an employee will be more motivated and act as owners through ESOP participation. The program also minimizes agency costs and aligns behavior with the goals of the firm. They will perform in their own best interest because they are not thinking as employees but as shareholders. Alignment of interest between agent and principle is of great benefit. This is a result of ESOP implementation. Therefore an ESOP has a significant impact on improving company performance.

Wah (1999) finds that total shareholder returns for ESOP firms, exceeded those of non ESOP firms by 6.9% and that average annual return on assets for ESOP was 2.7% higher than for industry peers without an ESOP. Wah (1999) uses 382 U.S. public firms that adopted ESOP over the period 1971-1995. Kruse and Blasi (2002) uses 343 matched pairs of ESOP and non ESOP held firms closely. Kruse and Blasi (2002) also compare performance differences from three years prior, to three years after introduction of the ESOP. Kruse and Blasi (2002) find differences in favor of ESOP of 2.4% in sales, 2.3% in employment, 2.3% in sales per employee, and 4.4% in employee productivity. Lee (2003) uses Taiwanese electronics manufacturers and finds similar productivity gains of 4-5% associated with the introduction of ESOP.

Pugh, Oswald and Jahera Jr. (2000), found that company performance, increased significantly for return against equity, return on assets and net profit margin, in the short term. Iqbal and Hamid (2000), examine the longitudinal relationship, between stock price changes and the operating performance of ESOP firms. They find a positive relationship between stock price changes and performance. They also find this relationship is significant on several quarters, after the changes in stock prices occurred.

Ducy, Iqbal, and Akhigbe (1997), examine the ESOP three year pre- and post-implementation economic performance, of publicly traded firms using operating cash flow (OCF), rather than accounting returns. Ducy, Iqbal, and Akhigbe (1997) determine that adjusted industry performance ESOP, deteriorated on all three measures: OCF to market value of assets, OCF to sales, and OCF per employee. According to Kruse, Freeman, Blasi, Buchele, and Scharf, (2003), the role of human resources policies and the motivation of ESOP employee-owners, are how employee ownership works successfully. It requires three analyses: incentives of ownership, availability of participative mechanisms and the corporate culture.

However, the executives can take advantage of the opportunities available, to increase earnings. They hope that the stock market price will increase (Baker, Collins, and Reitenga, 2002). This occurs because earnings information shows the company's performance. The information can also be used to predict the future performance of companies.

Managed earnings are known as earnings management. Some researchers in Indonesia such as the Asyik (2007) and Astika (2008) study the correlation between earnings management and ESOP. Asyik (2007) finds that company managers have the ability to manage earnings, around the option grant date. The effect is stronger when executives release earnings before the option grant date during the period prior to ESOP. For the period after ESOP, the effect is stronger relating to managing stock price volatility. This occurs because the volatility in determining fair value of options based on management policy.

Astika (2008) finds employee stock options granted, positively effect earnings management before the grant date. The results indicate that the more the option grant, the more likely they will be able to manage earnings downward. Managers hope to lower the option exercise price. Astika (2008) also finds the number of exercised employee stock options, positively influenced earnings management before the exercised date. It indicates the more the exercised option, the more likely the manager, can manage earnings upward, before the exercised date, to take advantage of a higher stock price.

DATA

The samples in this study are from public companies that have implemented an ESOP. The companies are listed on the Indonesian Stock Exchange, in the period 1999-2011. Sampling was done by purposive sampling. Forty-vive ESOP companies were available. The number of companies conducting ESOP is limited. There are 451 companies listed on the Indonesian Stock Exchange. This implies only 9.97% of public companies conduct an ESOP. Based on the facts, why do fewer companies utilize the ESOP program? The program has some advantages for both the company and shareholders. Is it caused by limiting rules in Indonesia, regulating the ESOP program? Or whether the concentrated ownership of the public companies, is causing the ESOP program to be less popular in Indonesia? These conditions will be discussed in the data analysis.

RESULTS

Based on the samples, the study analyzes the structure of corporate ownership. This study uses the ultimate ownership structure, to trace corporate ownership. To trace ultimate ownership, this study collects data from the Indonesian Business Data Center. It is caused by concentrated corporate ownership (Sanjaya, 2011). This study analyzes corporate ownership only for the manufacturing industry because data on the ultimate ownership of non-manufacturing companies is very difficult to find. Based on 45 companies conducting the ESOP program, the study identifies four companies included in the manufacturing industry, including PT Davomas Abadi Tbk in 2002, PT Dynaplast Tbk in 2003, Tbk PT Indofood Sukses Makmur Tbk in 2004, and PT Multistrada Arah Sarana Tbk in 2007. The following figures show the ownership structure, for each company as follows. Figure 1 shows the ownership structure of PT Davomas Abadi Tbk in 2002.

Based on the tracing in the chain of ownership, this study finds the controlling shareholder in PT Davomas is Hassoks Enterprise Ltd with a 23.17% ownership stake. Hassoks is a foreign company, for which we were unable to trace control. Hassoks' control rights to PT Davomas are 23.17% and cash flow rights are 23.17%. This result indicates that there is no agency problem between controlling shareholder and non-controlling shareholders in PT Davomas. Therefore, the number of control rights and cash flow rights are the same, or cash flow rights leverage is zero. Cash flow rights leverage can be used as a proxy for determining the agency problems. Cash flow rights leverage is control rights minus cash flow rights. PT Davomas is controlled by foreign institution.

The compositions of the board of directors and commissioners of PT Davomas on December 31, 2002 are as follows:

Board of Directors	Board of Commissioners
President Director: Johanes Herkiamto	President Commissioner: Hermawan Felani
Director: Theodorus Hopmans	Independent Commissioner: Anthonius A. Unawekla
Director: Berliana Sukarmadidjaja	Commissioner: Elfisno

Board of directors and commissioners are professional people. During the tracing of the chain of ownership in PT Davomas, this study is unable to find, the names of families associated with directors and commissioners.

Figure 1: Ownership Structure of PT Davomas Abadi Tbk in 2002

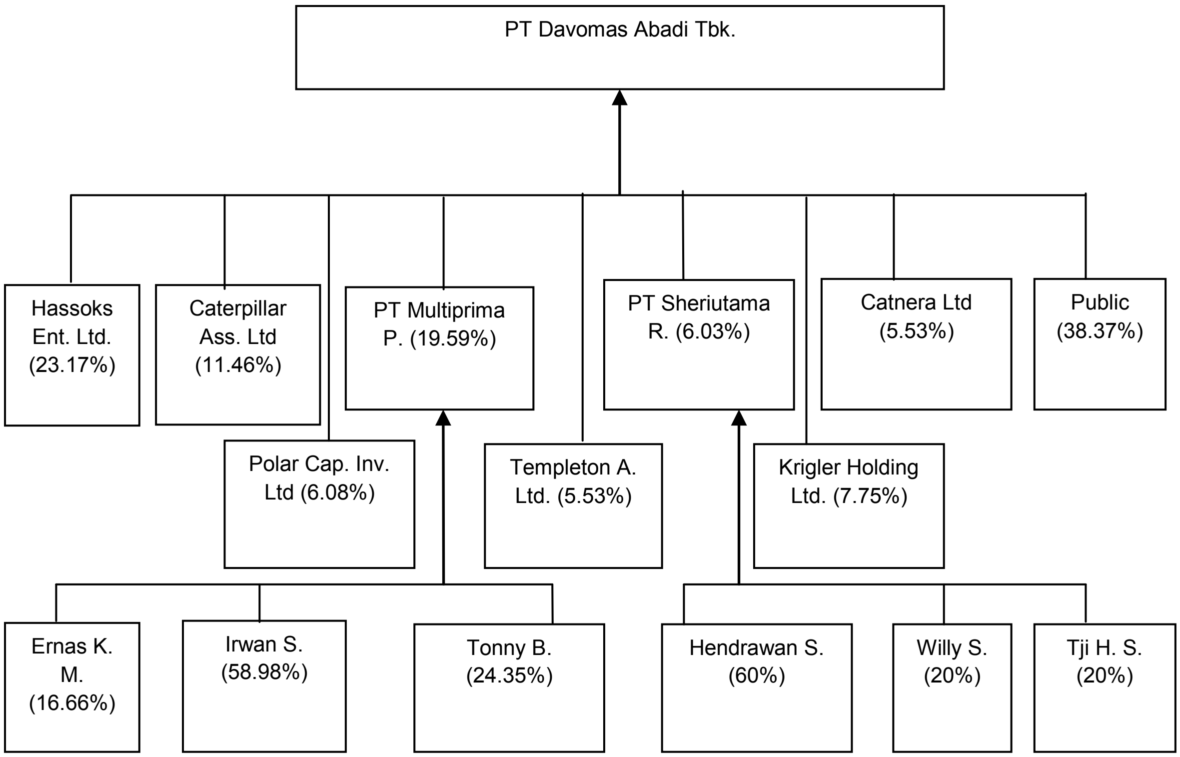

Figure 1 shows the ownership structure of PT Davomas Abadi Tbk. There are direct and indirect ownership on the structure. Hassoks is a controlling shareholder of PT Davomas Abadi Tbk. The control rights of Hassoks in PT Davomas Abadi Tbk are 23.17%. Cash flow rights of Hassoks in PT Davomas Abadi Tbk are 23.17%.

Figure 2 shows the ownership structure of PT Dynaplast Tbk in 2003. Based on the chain of ownership in PT Dynaplast Tbk, the controlling shareholder in this company is the Bank of Bermuda Ltd. Hong Kong. The percentage of shares, owned by Bank of Bermuda in PT Dynaplast is 39.80%. Bank of Bermuda is a foreign company we could not trace who controls the bank. Bank of Bermuda has control rights as well as cash flow rights in PT Dynaplast (39.80%). This suggests, that agency problems between controlling shareholders and non-controlling shareholders are low or absent. It indicates the value of cash flow rights leverage is zero. PT Dynaplast is also controlled by a foreign institution.

The compositions of the board of directors and commissioners of PT Dynaplast on December 31, 2003 are as follows:

Board of Directors
President Director: Tirtadjaja Hambali
Director: Gunawan Tjokro
Director: Mulyadi Kosasih

Board of Commissioners
President Commissioner: Soebekti Hambali
Commissioner: Robert Wiryono
Commissioner: Santoso Symkoputro
Commissioner: Sri Hartini Urip S.

The President Director and Commissioner of PT Dynaplast is the second controlling shareholder. They are the largest controlling shareholder, after the Bank of Bermuda. Their control rights and cash flow rights are 26.58%. The number is still lower than the control rights and cash flow rights of Bank of Bermuda. The objective of ESOP in this company is to motivate corporate executives, to work better for the company. Performance improvement will increase the value of the firm. It will also improve the welfare of both owners and managers. Agency problems in PT Dynaplast are low. It encourages alignment between the controlling shareholder and non-controlling shareholders, such as Bank of Bermuda and Hambali's family and other non-controlling shareholders.

Figure 2: Ownership Structure of PT Dynaplast Tbk in 2003

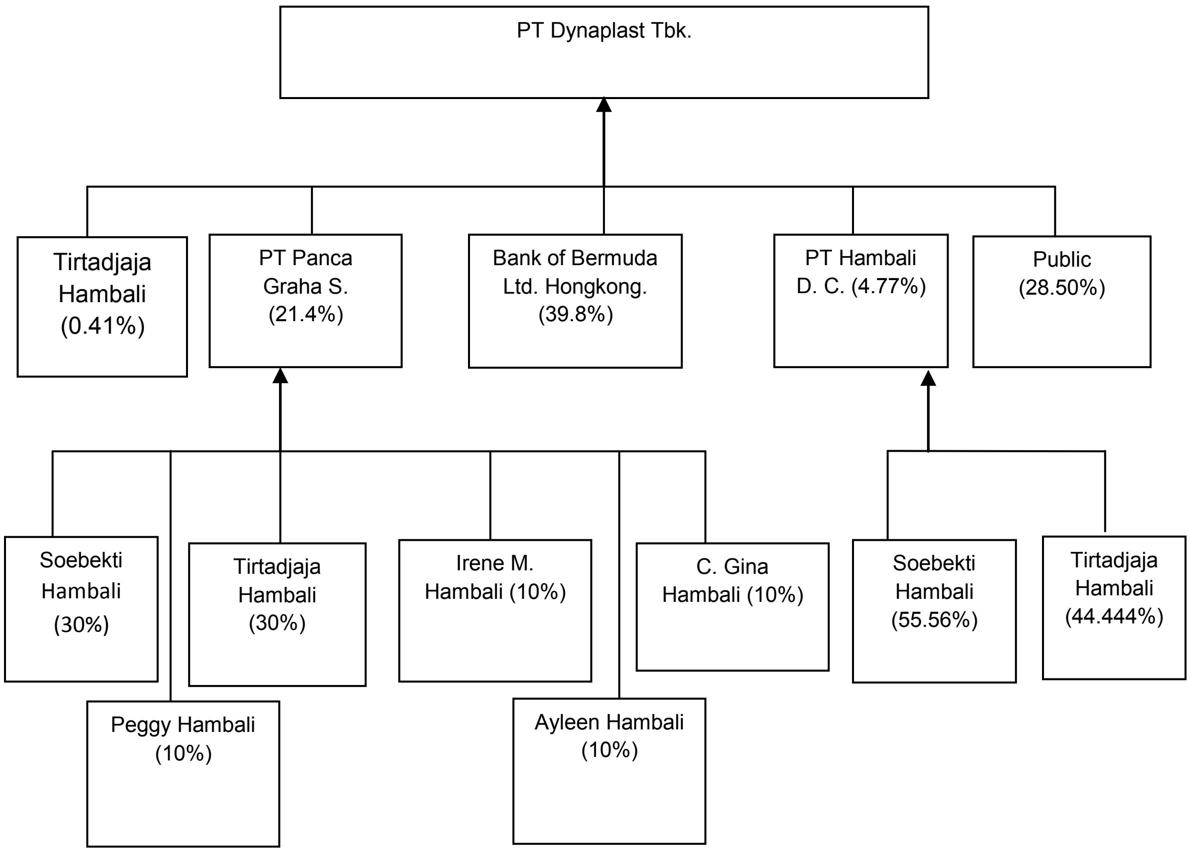

Figure 2 shows the ownership structure of PT Dynaplast Tbk. There are direct and indirect ownership on the structure. Bank of Bermuda is the first controlling shareholder of PT Dynaplast Tbk. The control rights of Bank of Bermuda in PT Dynaplast Tbk are 39.80%. Cash flow rights of Bank of Bermuda in PT Dynaplast Tbk are 39.80%.The second controlling shareholder of PT Dynaplast Tbk is Hambali's family. They have the control and cash flow right is the same (26.58 %).

Figure 3 shows the ownership structure of PT Indofood Sukses Makmur in 2004. Based the chain of ownership in PT Indofood Tbk, we find the controlling shareholder is First Pacific Company Ltd. The percentage of shareholding by First Pacific Company Ltd. in PT Indofood is 46.53%. First Pacific Company Ltd. is a foreign company and we were not able to trace who controls the company. Control rights of First Ltd. in PT Indofood are 46.53%. Cash flow rights of First Ltd. are 46.53%. These results show that there is no agency problem between the controlling shareholder and non-controlling shareholders in PT Indofood. This occurs because the control rights and cash flow rights are equal, or cash flow rights leverage is zero. PT Indofood is controlled by a foreign company.

Figure 4 shows the ownership structure of PT Multistrada Arah Sarana Tbk in the year 2007. Figure3 4 shows PVP XIII Pte Ltd. is the controlling shareholder. In PT Multistrada, agency problems are low and almost nonexistent. The control rights of PVP XIII Pte Ltd. are equal to its cash flow rights. We could not trace who owns PVP XIII Pte Ltd. PVP XIII Pte Ltd. is a foreign company. Thus, PT Multistrada is controlled by a foreign company.

Based on these four manufacturing companies, ESOP in Indonesia is only conducted by companies owned by foreigners. ESOP is conducted in companies which have the low agency conflict between the controlling shareholder and non-controlling shareholders. It is shown, by the value of cash flow right leverage equal to zero. The leverage can be used as a proxy for agency conflicts between controlling shareholder and non-controlling shareholders on concentrated ownership.

Figure 3: Ownership Structure of PT Indofood Sukses Makmur Tbk. in 2004

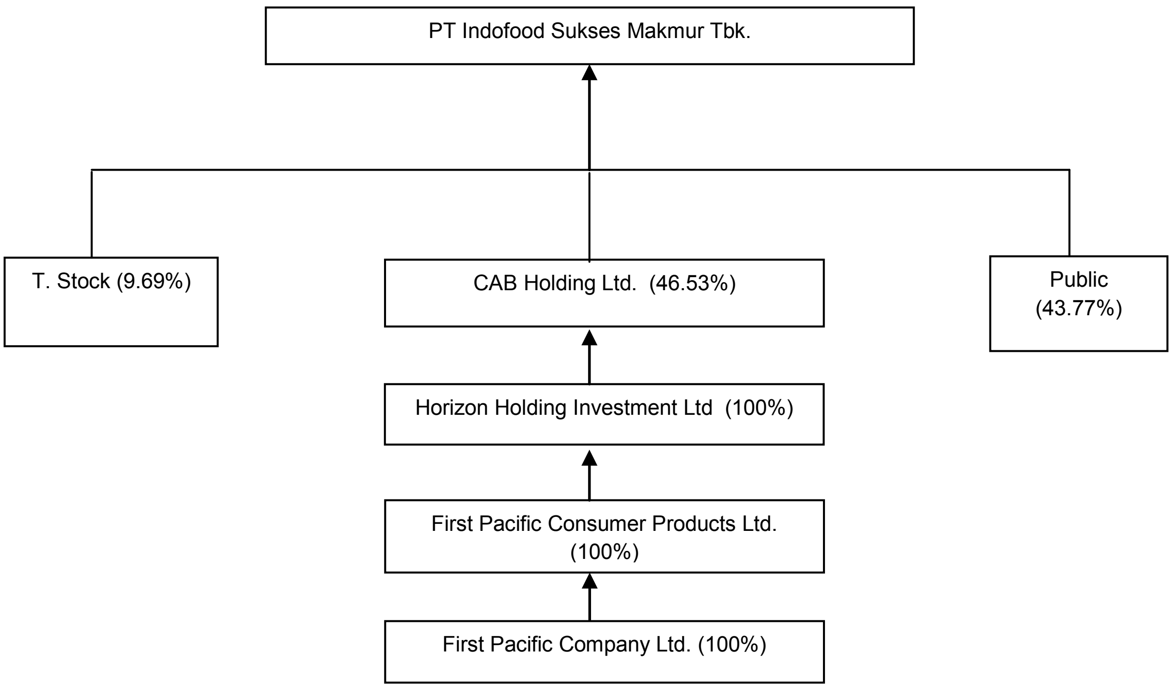

Figure 3 shows the ownership structure of PT Indofood Sukses Makmur Tbk. There are direct and indirect ownership on the structure. First Pacific Company Ltd. is a controlling shareholder of PT Indofood Sukses Makmur Tbk. The control rights of First Pacific Company Ltd. in PT Indofood Sukses Makmur Tbk are 46.53%. Cash flow rights of First Pacific Company Ltd. in PT Indofood Sukses Makmur Tbk are 46.33%.

The next discussion is why the ESOP programs are less popular in Indonesia? Though, this program has several benefits, such as reducing the agency problem between principals and agents. Another objective of ESOP is to align the interests, between managers and owners. The alignment will improve the employee performance. It can also increase the value of the firm. It will give a positive impact on the welfare of both the employee and the employer. Why is this program not popular in Indonesia?

Sanjaya (2011) shows that public companies which are not owned by ultimate or direct ownership (immediate) is 3.79% of all manufacturing companies, listed on the Indonesian Stock Exchange during 2001-2007. There are 96.21% of manufacturing companies, which are owned by ultimate ownership. Companies which have dispersed ownership are cut off at less than 10% of control rights and include 0.49%. Based on the 10% cut off, 99.51% of manufacturing companies have concentrated ownership. The results confirm that only 0.49% of manufacturing companies are dispersed.

Sanjaya (2011) also suggests the family is the greatest controlling shareholder at 68.49% . This finding is consistent with La Porta, Lopez-de-Silanes and Shleifer (1999), Claessens, Djankov and Lang (2000), Faccio and Lang (2002), and Siregar (2006). The Indonesian government only controls 2.58% at a 10%.

cut off rate. The results differ little from Siregar (2006). Other controlling shareholders control 28.93% at a 10% cut off. Other controlling shareholders include foreign investors, cooperatives and employees.

Figure 4: Ownership Structure of PT Multistrada Arah Sarana Tbk. in 2007

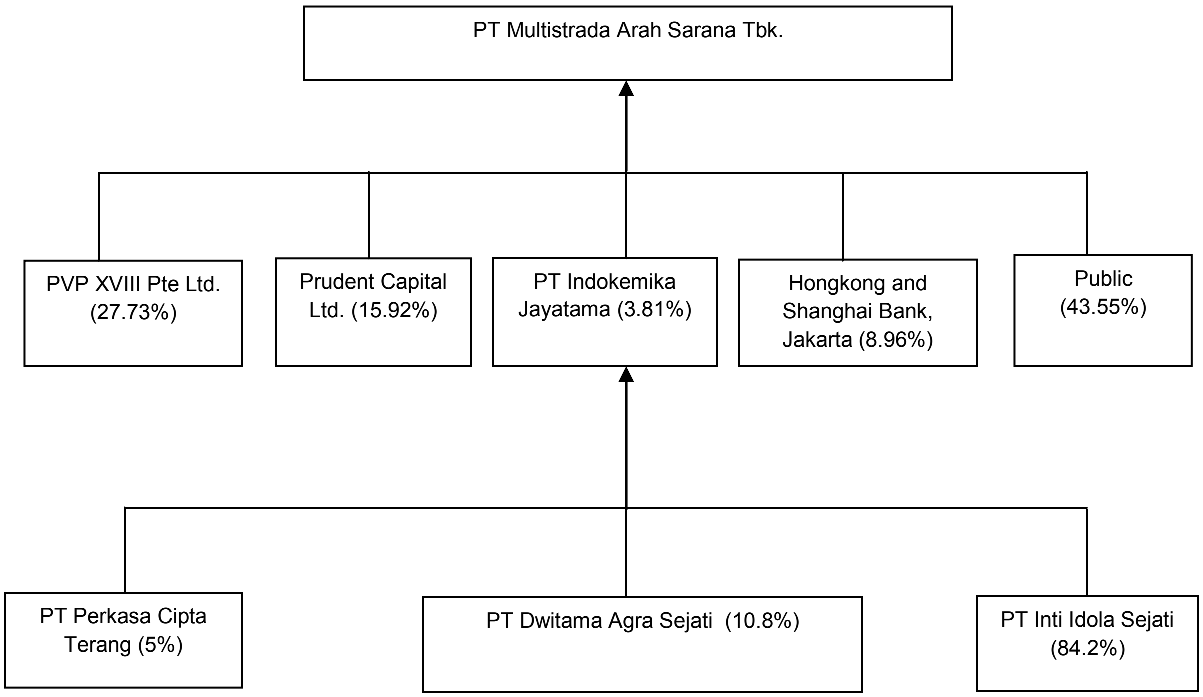

Figure 4 shows the ownership structure of PT Multistrada Arah Sarana Tbk. There are direct and indirect ownership on the structure. PVP XIII Pte Ltd. is a controlling shareholder of PT Multistrada Arah Sarana Tbk. The control rights of PVP XIII Pte Ltd. in PT Multistrada Arah Sarana Tbk are 27.73%. Cash flow rights of PVP XIII Pte Ltd. in PT Multistrada Arah Sarana Tbk are 27.73%.

Siregar (2006) shows 437 of 1302 observations on a categorical variable rate 1 for management. This result indicates that 33.56% of controlling shareholders are also the directors of public companies. This means that directors of public companies are the controlling shareholders, or the family member of a controlling shareholder. Involvement in the board of directors is another way to improve the control mechanisms other than through ownership pyramids or cross-ownership.

In this circumstance, the ESOP program is not important because without this program, directors have aligned their interests with shareholder interests. Directors may not make decisions that will harm their family members. The phenomenon of agency problems in Indonesia is different from the phenomenon of agency problems in the U.S. or the U.K. Agency problems occurred in Indonesia, between controlling shareholder and non-controlling shareholders. ESOP programs become less relevant when applied in this context. ESOP programs are more effectively implemented in dispersed ownership, where managers are the company controllers. Agency problems that occur are usually between management companies and owners.

An ESOP program becomes very relevant and appropriate when implemented in the context of dispersed ownership. The objective of the program is to reduce agency problems and to improve the performance of each employee. Meanwhile, for companies with concentrated ownership, the ESOP program is a less effective means to reduce agency problems. This is due to agency problems which occurred between controlling and non-controlling shareholders. How does the ESOP program align the interests between controlling shareholder and non-controlling shareholders? It can not be done easily. However, this program can be done within the context of concentrated ownership. This program can be implemented in companies which do not have agency problems, between controlling shareholder and non-controlling shareholders. The ESOP program is a strategy to make managers more serious and committed to their jobs. It is a way which is mutually beneficial for all parties existing in the company.

CONCLUSION

The objective of this study is to explain the phenomena of the employee stock ownership program in public companies in Indonesia. This study describes the employment stock option program phenomenon. Sampling was done by purposive sampling. Forty-five companies conducted ESOP programs between 1999 and 2011. In 2011, the number of public companies listed on the Indonesian Stock Exchange was 451. This implies 9.97% of all firms used an ESOP.

This study concludes the ESOP program is less attractive for implementation in Indonesia. It is caused by company directors who are controlling shareholder or family member of a controlling shareholder. Second, ownership of companies in Indonesia is concentrated in certain groups such as family. Family is the most dominant controller of public companies. Third, agency problems in Indonesia occur between controlling and non-controlling shareholders. These conditions make the ESOP program less popular in Indonesia. Thus, the program is not attractive in Indonesia as a way to reduce agency problems between shareholders and managers. It is only relevant for public companies with dispersed ownership.

The ESOP program is effectively implemented in situations with dispersed ownership. Agency problems occur in dispersed ownership between managers (agent) and owners (principles). To reduce this problem, the ESOP program can be implemented. This program aligns interests between managers and owners. In the context of concentrated ownership alignment occurs between managers and owners. It occurs because the manager is a family member of the owners. In this situation, the managers will not make decisions to benefit themselves and harm the owner. If it is done, the manager also harms their families.

Limitations of this study are, firstly this study only describes the phenomena existing in Indonesia. Secondly, this study is limited to the context of Indonesia. Thirdly, private ownership in some companies abroad cannot be traced. Subsequent studies might consider aspects of ownership when conducting research on ESOP. Previous studies can be developed by considering the agency problems occurring in Indonesia. Future studies can also compare the ESOP phenomenon in some East Asian countries.

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BIOGRAPHY

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