

Option Acceleration in Response to SFAS No. 123(R)

Steven Balsam; Austin L. Reitenga; Jennifer Yin

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As of February 28, 2006, 958 publicly held companies accelerated the vesting of some or all of their employee stock options in advance of adopting SFAS No. 123(R). In doing so, these companies, on average, avoided \$11.3 (8.4) million in pretax (after tax) expense, which represented 42 percent of prior year income. Investors, in general, react positively to acceleration announcements as we find an average cumulative abnormal return of about one-half of 1 percent for the three-day window (-1,1) surrounding the announcement, with the reaction positively associated with the expense reduction that resulted from the acceleration, the declaration by the firm that the options accelerated are out of the money, return on assets, and firm size. Additionally, we find that the decision to accelerate is positively associated with our estimate of the future expense related to unvested options; that is, the expense avoided because of the acceleration. In contrast, the intrinsic value of unvested options; that is, the expense that would have to be recognized at the time of acceleration, firm profitability, and firm size (i.e., political visibility) are negatively associated with the decision to accelerate. We interpret these results to indicate that managers consider the costs, as well as the benefits, in deciding whether to accelerate. Overall we conclude that while accelerated vesting may be motivated by expense avoidance, it appears to be beneficial to equity investors as evidenced by the positive abnormal returns associated with the announcement of the acceleration and the fact that abnormal returns are positively associated with the expense avoided via acceleration.

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