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Accelerated Vesting of Employee Stock Options in Anticipation of FAS 123-R

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ABSTRACT

In December 2004, the Financial Accounting Standards Board (FASB) mandated the use of a fair value–based measurement attribute to value employee stock options (ESOs) via Financial Accounting Standard (FAS) 123-R. In anticipation of FAS 123-R, between March 2004 and November 2005, several firms accelerate the vesting of ESOs to avoid recognizing existing unvested ESO grants at fair value in future financial statements. We find that the likelihood of accelerated vesting is higher if (1) acceleration has a greater effect on future ESO compensation expense, especially related to underwater options, and (2) firms suffer greater agency problems, proxied by fewer blockholders, lower pension fund ownership, and top five officers holding a greater share of ESOs. We also find a negative stock price reaction around the announcement of the acceleration decision. Furthermore, stock returns are significantly negative before the new vesting dates and positive afterward, suggesting that vesting dates could have been backdated.

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