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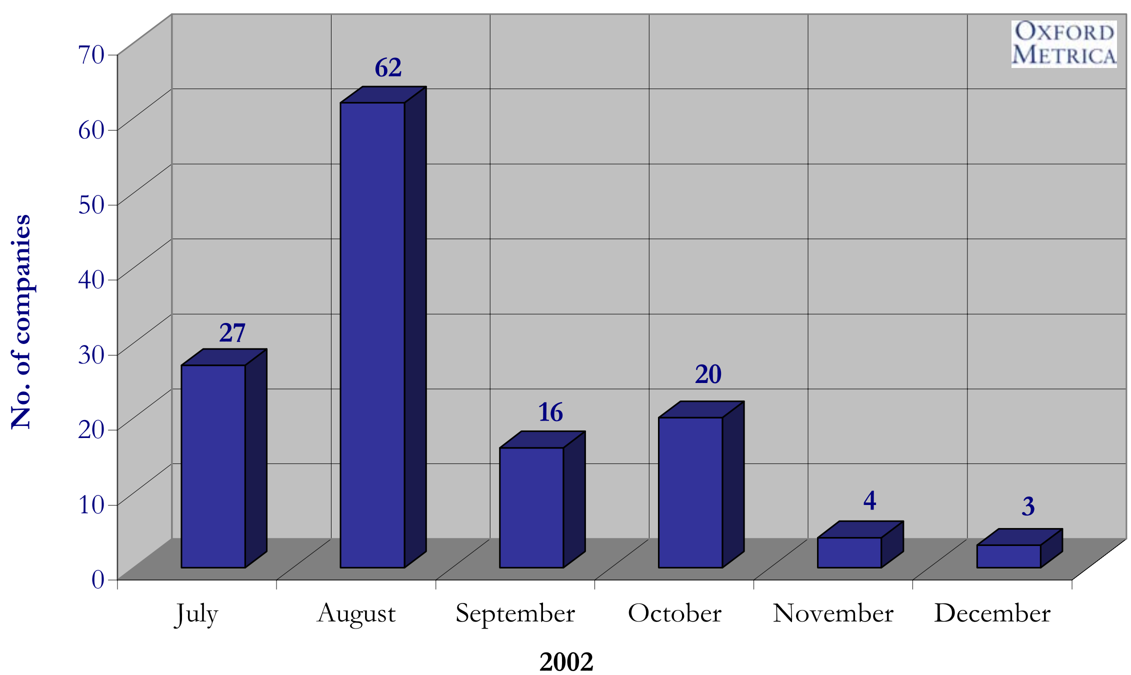
Voluntary expensing on the decline after a mixed market response

Dwindling appetite for voluntary expensing

In the last six months of 2002, 132 US firms announced their intention to expense options voluntarily. Figure 1 shows the monthly pattern in these announcements. It appears that after an initial flurry in July and August, the number of firms joining the ranks of the early announcers has dwindled significantly.

Figure 1: The Decline in Announcements to Expense



Mixed market reaction to the adoption of expensing

Part of the explanation for this reticence may be the mixed signals being emitted by the stock market's reaction to these announcements which is far from neutral. A number of recent studies have indicated that, in aggregate, there has been little reaction. However, this aggregation obscures the considerable variation in market response across companies, as illustrated in Figure 2. The figure presents the risk-adjusted stock price performance of four portfolios consisting of each quartile of the 132 announcers ranked by the magnitude of the response. Clearly, the variation is large and significant.

A quarter of the firms were rewarded with an average improvement in value in excess of 10%, in stark contrast to the larger than 15% negative response to the worst quartile. A small part of this difference may be explained by whether a firm was an early or late adopter.

Figure 2: The Stock Market Reaction to the Announcements

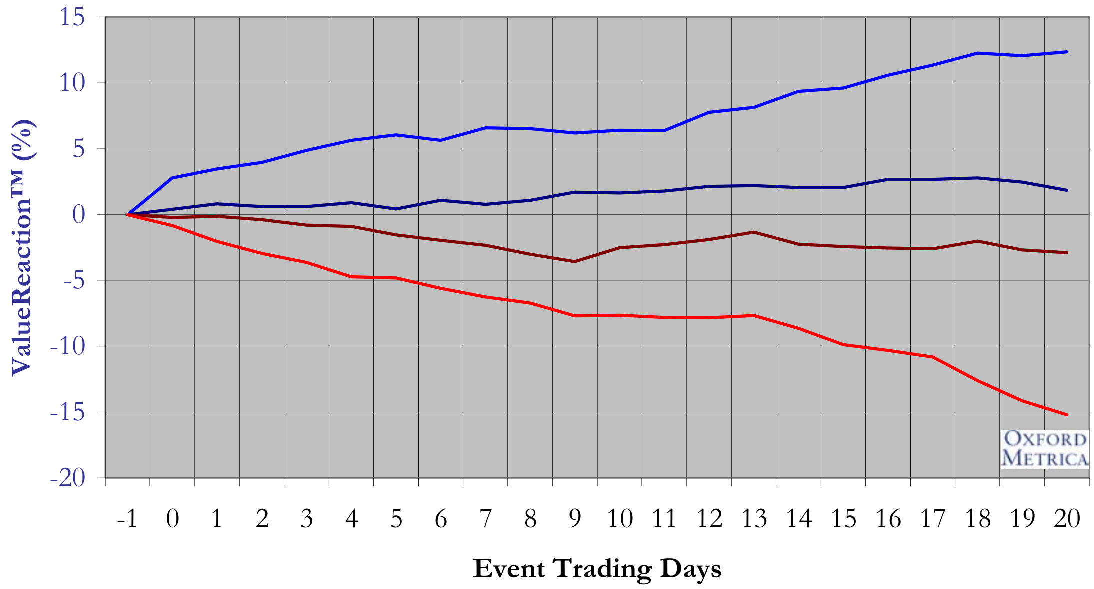
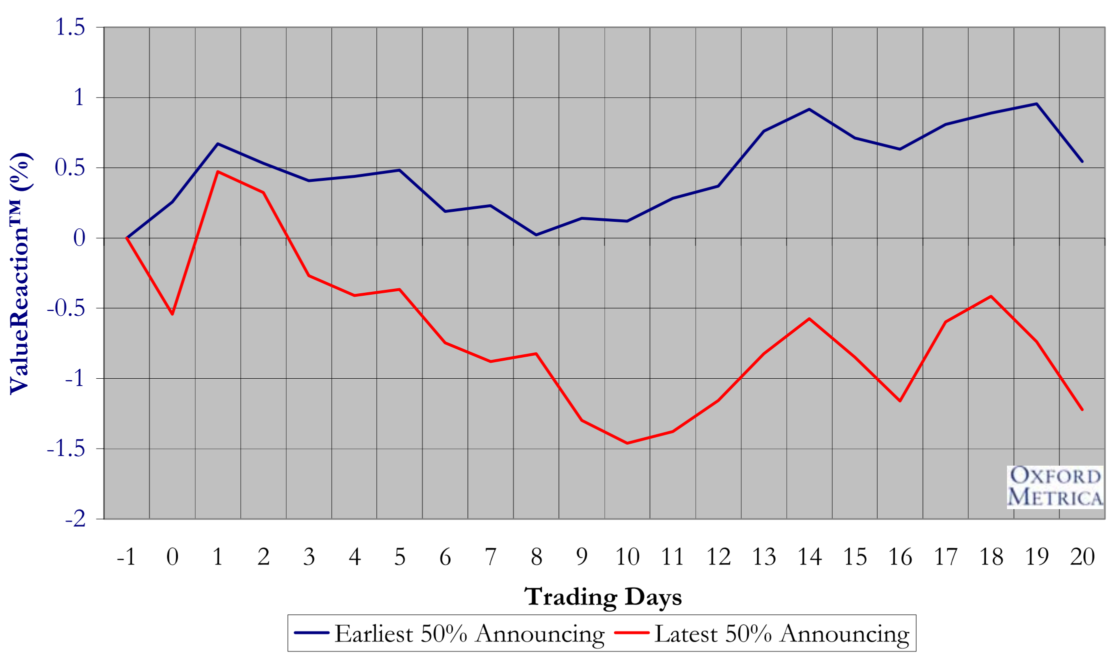


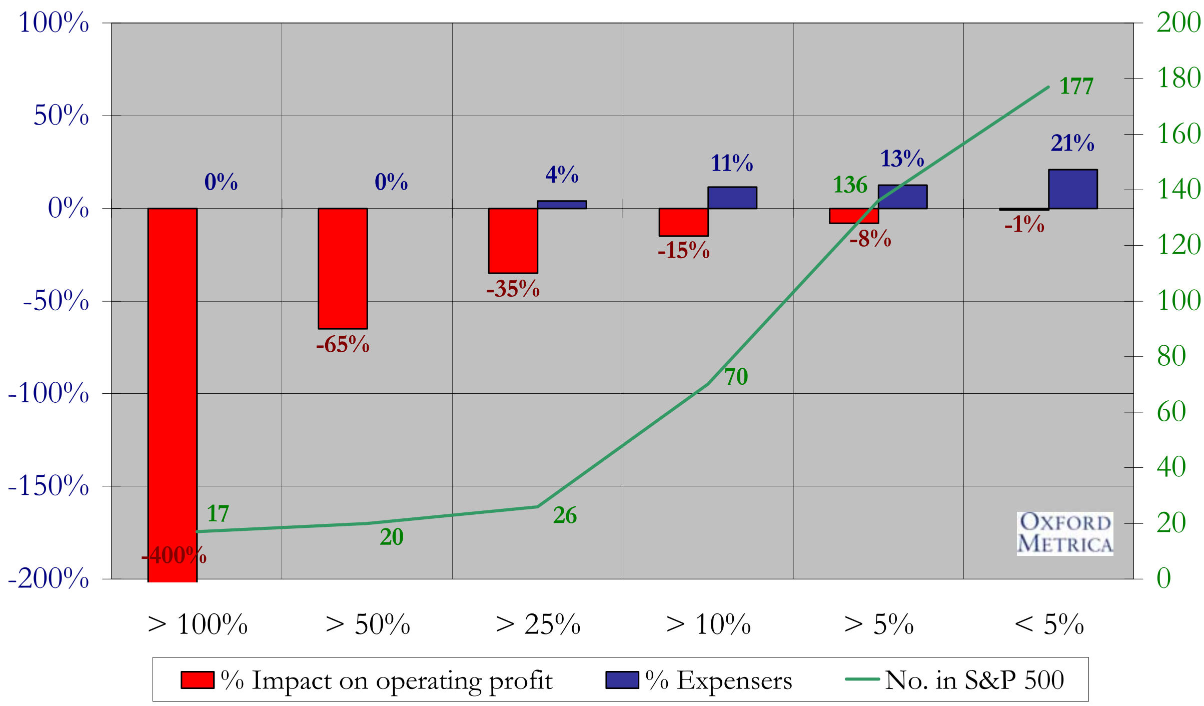
Figure 3 shows the difference in the average stock market reaction to firms that announced early their intention to expense *versus* those that announced later. The market does appear to view slightly more favourably the 'early expensers' but the difference in value reaction is only part of the story.

Figure 3: The Changing Stock Market Reaction



In order to understand the market response, it is important to consider the likely impact of the eventual expensing on reported profit. Shown in Figure 4 is the impact on operating profit of expensing options across the constituents of the S&P500 Index in the US[1]. The red bars show the percentage impact, categorised as by the x-axis. The green line shows the number of firms in the S&P500 within each category. Thus, seventeen firms show an impact on operating profit of more than 100%; in fact, a median average loss of -400%. At the other extreme, 177 firms show an impact of less than 5%; a median average of -1%. The blue bars indicate the percentage of each category that has opted to expense. Thus, 21% of the firms that are impacted less than 1% have chosen to expense. No firms that are impacted more than 50% have chosen to expense.

Figure 4: The Selection Bias of Firms Opting to Expense Options



In summary, the management of firms announcing their intention to don voluntarily the horsehair coat of adopting expensing, may have been perceived as self-serving by an increasingly sceptical market.

[1] 446 firms are included for analysis. For the remaining 54 firms in the S&P500, the data was reported as 'Not Meaningful'. *Source of data*: Bear Stearns & Co.

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