

The Economic Dilution of Employee Stock Options: Diluted EPS for Valuation and Financial Reporting

John E. Core; Wayne R. Guay; S. P. Kothari

+ Author & Article Information

The Accounting Review (2002) 77 (3): 627-652.

<https://doi.org/10.2308/accr.2002.77.3.627>

Share ▾

Tools ▾

Cite ▾

In this paper, we derive a measure of diluted EPS that incorporates the economic implications of the dilutive effects of employee stock options. We show that the existing FASB treasury-stock method of accounting for the dilutive effects of outstanding options systematically understates the options' dilutive effect, and thus overstates reported EPS. Using firm-wide data on 731 employee stock option plans, our proposed measure suggests that economic dilution from options is, on average, 100 percent greater than dilution in reported diluted EPS using the FASB treasury-stock method.

We examine the implications of our analysis for stock price valuation, the price-earnings relation, and the return-earnings relation. We demonstrate analytically that when firms have options outstanding, empirical applications of equity valuation models that use reported per-share earnings as an input (e.g., Ohlson 1995) yield upwardly biased estimates of the market value of common stock. We predict that when the difference between our measure of economic dilution from options and the FASB treasury-stock method dilution from options is greater, the observed return-earnings and price-earnings coefficients will be smaller, and we provide some (albeit weak) empirical support for this prediction.

This content is only available via PDF. Note: Supplemental materials and Teaching Notes are not available for Early Access articles. Links within the PDF will be activated once the article has been compiled and published in an issue.

American Accounting Association

You do not currently have access to this content.

Sign in

Don't already have an account? [Register](#)

[Skip to Main Content](#)

Member Login

Pay-Per-View Access
\$25.00

AAA Members: Please log in for free access to content. Note, Teaching Notes are a full member benefit and are not available to student members.

 Buy This Article



[View Metrics](#)

Citing Articles Via

Web Of Science (39)

Google Scholar

CrossRef (76)

Email Alerts

Article Activity Alert

Publish Ahead of Print Alert

New Issue Alert

Information for Authors

Authorship Policy

Plagiarism Policy

Data Integrity Policy

Citing Corrected Articles Policy

Minimizing Overlapping Decision Rights Policy

Prior Publication Policy

