

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

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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.

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