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The Pricing of Mismeasured EPS

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Abstract

GAAP measurement of convertible instrument dilution reports a lower bound of diluted EPS relative to an economic assessment of dilution. The extent to which prices reflect information not readily provided under GAAP depends on the magnitude of information processing costs and benefits This study, first, examines whether common stock prices reflect an economic assessment, rather than accounting measurement, of dilution related to convertible instruments. Second, the study examines whether this association varies across levels of costs and benefits of information processing. On average, I find evidence suggesting that investors assess the effects of dilution based on economic predictions of conversion rather than GAAP EPS alone. However, I fail to find an association between economic dilution and stock prices for observations with high information processing costs and low benefits, consistent with it not being cost-beneficial for investors to process the information necessary to impound the accounting mismeasurement into prices. To corroborate this inference, I document positive returns around convertible instrument settlement for firms with high information processing costs and low benefits, consistent with the mispricing reversing over time. Overall, results suggest information processing to unwind EPS mismeasurement is not always cost-beneficial.

Keywords: diluted EPS, convertible debt, convertible preferred stock, information costs, if-converted method, dilution

JEL Classification: G10, G14, M41

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