

EXECUTIVE SUMMARIES

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Stock Market Overvaluation as a Threat to Corporations and the Society

8 **H**ardly any CEO agrees that their company share is overvalued. However, the overvaluation of company stock is at least as common and as harmful as undervaluation. In this short paper, I deal with the potential problems caused by the overvaluation to the company and to the society, the reasons for overvaluation and some solutions that help to avoid it.

The misvaluation of companies leads to the misallocation of resources between companies. The overvalued companies have better access to both equity and debt capital, whereas undervalued companies have difficulties to raise capital. As an end result, the overvalued companies may undertake investments, which are not as profitable as the stock market expects. In addition, they may use these overvalued shares as currency for acquisitions. The overvaluation may also lead to misallocation of resources within the company, when company management attempts to fulfil overoptimistic expectations of the stock market on company growth and future profitability. At worst, management finds out from the stock market or financial analysts where to invest and where to divest. Management may achieve growth through acquisitions (by using overvalued stocks), but profitability may be more difficult to reach. The recent trend in financial statements is to show good profitability either by extending accounting principles or using *pro forma* statements, but profitability can not be artificially inflated indefinitely. The corrective price changes may be large causing private investors to lose their trust for the stock market.

The overvaluation could even be more common than undervaluation, since several stakeholders have clear incentives to increase stock prices whereas no-one really has interest to lower stock price although it is overvalued. Company management benefits from the stock price increase through stock option plans and direct ownership of shares. In addition, the ability to undertake acquisitions with overvalued stock allows them to lead larger companies. In larger companies they are better paid, they gain more respect and have more power. Financial analysts have interest to give "Buy" recommen-



dations to maintain good relations to company management, to promote the brokerage function of their employer and to facilitate the employer's investment banking activities.

Due to the problems caused by the overvaluation, it should be of great importance to develop measures to avoid and detect overvaluation. For the time being, they are rare. Some proposals are presented in the paper on financial disclosure, compensation and corporate governance. In the future, further research, norms and appropriate practices are needed to improve the accuracy of stock market valuation. ■