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An essay to analyze information asymmetry: originality and ways to reducing the level of information asymmetry

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Abstract

Previous studies suggest the Information asymmetry and management incentive they can make important problem in the efficient allocation of firms' resources in a capital market. The improvement of disclosure quality have crucial role in mitigating these problems. This paper focuses on the relationship between disclosure quality and information asymmetry and ways to reducing the level of information asymmetry.

***Keywords*:** information asymmetry, disclosure quality, ways to reduce information asymmetry

Introduction:

The issue of information asymmetry in accounting literature is very important to research, insofar as accounting is a service activity function provides useful accounting and financial information for the purpose of making economic decisions for different stakeholder. The disclosed information can minimize information asymmetry, so that the market becomes characterized by efficient and effective resource allocation and optimal economy. The information asymmetry in kinds of adverse selection and moral hazard has different adverse outcomes on the firm, such as transaction costs generates by the adverse selection and moral hazard, the low liquidity market and the increasing of capital cost. In this manner, the management has incentive to disseminate more information about the current financial condition and the firms' prospect voluntarily and therefore reduce this asymmetry. In addition, in order to reduce information asymmetry between stockholders and firms' managers and improve capital allocation and protect investors, market regulator has legislated disclosure code. Any decision, regarding the purchase or sale of stocks, needs detailed information of the return and risk. In one side, the investors want to maximize interests of their investment and on the other side, the managers' wants to maximize their firm value and their personnel compensation.

Several researches showed that there are Substituting relationship between information asymmetry and the quality of financial disclosure. This study have found that the increasing of information asymmetry between individuals within the same organization and shareholders whereby the incentive for voluntary disclosure. While other studies have argued a complementary relationship linked earnings quality and

disclosure extent or quality. This studies shows that more information quality level causes managers to have a greater incentive to disclose more and high level quality information (Dye, 1985).

There are several specific mechanisms can be used to incite managers to act in accordance with investors' interests, the first one is the managerial compensation, the second concerned by the direct intervention by shareholders, while the third mechanism is the takeover threat (Houston, 2006). Scott (2003) provides that the asymmetry information as a condition where there are differences in the information held by participants of capital market such as between firms' managers and shareholders. According to results found by Hartono (2008) the information asymmetry is the only information private owned by the investors who received information only (informed investors).

There are two kinds of information asymmetry, namely: adverse selection and moral hazard. the adverse selection it that the managers and other people in the normally know more about the state, facts and prospects of the company than outside investors, and that may influence the shareholders decision, there are not disclosed. While the moral hazard concerns the activities carried out by the managers and not entirely known to the shareholders and lenders. So that firms' managers can take action beyond the knowledge of shareholders in violation of the contract and the actual ethics or norms may not be worth doing.

The moral hazard can occur due to the separation of ownership and control that characterizes several large firms. There are several explanations that can underlie the dissemination of information asymmetry level to the symmetric information, as follows: firstly, the private information publicly disseminated through the official announcement of the issuer firm information. Secondly, investors who have private information will use it and after that they would be willing to sell. This condition means that all firms' investors will get the same information disseminated. This way is slower than if the issuer company distributing information by announcing it as the first explanation. The third explanation provides that investors who receive private information will undertake speculative action. In this away Investors who have private information would have an incentive to transact using it to achieve the full information price. The fourth explanation based on the idea that investors who do not have private information will obtain this private information by observing through the changes as a reflection of the information held by the investors who have private information.

The reminder of this paper proceeds as follows. In Section 2, present the Measurement of Information Asymmetry. Section 3, presents several determinants and conditions to maintain the information asymmetry' level. Section 4, provides Prior literature of Ways to reduce the level of informational asymmetry. Section 5, discusses the relationship between disclosure quality and information asymmetry. We conclude in Section 6.

Measurement of Information Asymmetry:

The problem of measuring the information asymmetry about a firm's value, hence about the payoffs of its securities, has been extensively analyzed in the market microstructure literature. This line of research stems from Bagehot's (1971) observation that adverse selection due to the presence of better-informed traders in a financial market may affect its process of price formation. In this context it is reasonable to believe that market players in closer touch with a firm and its business (e.g., employees, suppliers, analysts, traders) are those who possess better information about that firm and trade on it. Based on this premise, market microstructure attempts to estimate the extent of information asymmetry about a firm from observed market data (quotes, bid-ask spreads, trades, and transaction prices).

These efforts have caught the attention of other areas of finance, for they may help researchers identify such an intrinsically elusive concept as a firm's information environment. This has been especially the case in corporate finance. Notably, microstructure measures have been found significantly sensitive to numerous important corporate events. Prior microstructure work suggests a number of measures of adverse selection.

Most of these measures rely upon the notion that the intensity of asymmetric information about the value of an asset is an important determinant of that asset's liquidity. Yet, the concept of liquidity (the ability to trade promptly and with little or no price impact) is also intrinsically elusive and multifaceted (see Hasbrouck 2005). In addition, many of these measures are estimated with high-frequency trade and quote data, whose sparseness limits both their time series and cross-sectional use in corporate finance. Lastly, concordance across these measures is often modest (e.g., Clarke & Shastri 2001; and Hasbrouck 2005).

The determinants and conditions to maintain the information asymmetry' level:

Using information power on the capital market can be strongly punished, but there are a lot of factors which increase information asymmetry or other just maintain the same level, affecting the level of development of the market. For example, Martha Stewart, CEO of Martha Stewart Living Omnimedia Co., has been charged with obstructing an investigation into insider trading. She has not been charged with illegal insider trading, but she did sell 3.928 shares of stock in the biopharmaceutical company In Clone Systems, earning 228.000 dollars, the day before the FDA (Regulation Fair Disclosure) rejected approval of its anti-cancer drug Exbitux and its stock fell. The issue of whether and how information differences across investors affects prices and the cost of capital cannot be addressed in conventional models of asset pricing, such as the Capital Asset Pricing Model, because these models generally assume investors have homogeneous beliefs. Hidden management practices increase informational asymmetry.
Alchian & Demsetz (1972), Williamson (1985) searched for solution for vertical integration and different strategies not just for financial field, but also for other areas which can affect public health. There a lot of companies which do not use their websites to communicate relevant information to the external users of financial information. A recent study that has a sample with 30 traded companies revealed that a lot of companies use their website in inappropriate way, especially to communicate information considering corporate governance (Yabing et al., 2010).

Ways to reduce the level of informational asymmetry:

More researchers, like Francis et al. (2005), Leuz and Verrecchia (2000), revealed that disclosure quality lowers information asymmetry, share price volatility or stock liquidity. Lang and Lundholm (1993) document a positive relationship between the need for financing and voluntary disclosure. Diamond and Verrecchia say that voluntary disclosure by a firm reduces information asymmetry and lowers its cost of capital, because greater transparency enhances stock market liquidity and reduces transactions costs for a firm's stock. Voluntary disclosure may complement a firm's governance attributes in reducing stock market asymmetry.
Implying a complex informational-decisional system, corporate governance can distribute information on internal and external level, contributing to the reduction of informational asymmetry. In the case that information asymmetry exists, it's imposed a control system, which implied agency costs (Boisselier, 1999) like monitoring and stimulation, ordering costs and residual costs. Independent auditor must verify if management implemented procedural requirements. The companies can also use individual attributes for monitoring the informational asymmetry in order to reduce capital market asymmetry. Instruments offered in principal-agent theory are considered proper to reduce informational asymmetry between them (Wiedenhofer and Krahnke, 2007).
For the lemon problems, Akerlof 1970 pointed out that many free-market institutions can be seen as ways of solving or reducing lemon problems. One solution Akerlof 1970 noted is warranties, because these give the buyer assurance that the car (i.e.) is not a lemon, and the buyer is therefore willing to pay more for the car with a warranty. Also, the sellers who are willing to offer the warranty are those who are confident that they are not selling a lemon. Akerlof 1970 went beyond cars and showed that the same kind

of issue arise in credit markets and health insurance markets, and also capital market. In banking, authorizing banking institutions reduce information asymmetry that exists between shareholders and managers of funded bank, on the one hand, and potential depositors and investors on the other hand, which cannot distinguish in the start between a potentially viable entity and one doomed to failure (Moinescu, 2013).

The capital cost can be influenced by the quality of the accounting standards, the efficiency of the capital market, the importance and relevance of the capital market in companies' financing CES Working Papers 262 and corporate governance. There is a relationship between accounting information and effective administration, and this relationship can be positive and negative. Positive when managers don't have nothing to hide, and negative when they search to hide a lot of data, in this way increasing the level of asymmetry and hiding the true value of the company in the eyes of outside investors.

By adopting IFRS, an improvent of the quality of financial reporting of companies was espected, that have the effect of reducing information asymmetry and risk and, therefore, a decrease in the cost of capital (Munteanu et al., 2011). Financial disclosure obligations imposed by IFRS in order to improve the quality of financial statements presented by companies located where local standards are low disclosure requirements, and this can be translated by reducing information asymmetry, allowing investors to better monitor their investment performance (Munteanu et al., 2011), in addition to increasing the transparency of financial information. SEC Chairman Arthur Levitt said that it is known that high quality accounting standards reduce the cost of capital.

IASB Chairman Sir David Tweedie said that IFRS will reduce the capital cost and will open new opportunities for diversification and improved investment results. In Great Britain, Latridis (2010) examined the problem studied by Barth et al. (2008), the effect of IFRS adoption upon the quality of financial information. He concluded that the Standards strengthened the quality of data through decrease of revenues practices of management and improving the relevance of financial information in investment decisions.

For Beaver (1981), Healy and Palepu (2001) and Scott (2009) in ordet to encourage the participation on the capital market, the use of IFRS can be a convenient choice, especially for emerging countries where capital markets do not function on a proper level. For these systems to fulfill their positive role in evaluation and financing, traded companies must communicate sufficient information necessary for decisional process of users. To verify and control managers, shareholders use financial control which has the mission to verify and express the opinion about the true and fair value of the company, about the financial position and performance, showing the real intrinsic value of the firm. Financial audit can verify the managerial performance of entrepreneurs, observing the way their actions contributed to the company's benefits or losses. This way of control can sometimes make managers reveal more relevant information, useful for investors, reducing information asymmetry. In the last 20 years a lot of financial and audit scandals, meant to present the companies in a good light when they was just a lemon, discussed the ethical issues in relation to the functioning of the capitalist economy.

The CES Working Papers 263 response if the audit is a good method to reduce informational asymmetry depends on the professional ethic engaged in financial control. Recent researches revealed that the transparency of financial statements significantly influence investors decisions (Hodge et al., 2004; Bushman et al., 2004). Using the eXtensible Business Reporting Language to communicate financial information through electronic ways may contribute to assure transparency and to reduce informational asymmetry. Financial statements available on the internet raise the efficiency of corporate governance through transparency and dissemination, facilitating the communication between managers and investors.

The relationship between disclosure quality and information asymmetry:

Accounting Information must be relevant to evaluate of past, present and future event. In addition, the information provided in the financial statements must be reliable and do not have any errors that may cause consumer confuse and make an erroneous decisions. Therefore recognition, measurement and disclosure of accounting information can be effective in market view and financial condition. Financial statements should be on underlying assumptions and estimate accounting items according to issue of uncertainty that have important effects on the company's financial picture.

Because of relevant information decrease information asymmetry between company management and outside investors, market participants always are looking for high quality financial information. There are numerous studies in the accounting literature that demonstrate achievement of higher disclosure quality, reducing information asymmetry.

According to the findings of Francis and Wang (2008) extensive disclosure policy is a mechanism that reduces information asymmetry between managers and outside investors. Glosten and Milgrom (1982) present the relation between corporate disclosure and information asymmetry in terms of the model. Their model shows that corporate disclosure information asymmetry level increases to decreases in disclosure. Walker (1995) findings show that the information asymmetry and market liquidity increases proportionally to the decrease and increase in disclosure, respectively.

Lang and Lundholm (1993) present evidence which indicates that informative disclosure policies result to more follower analysts, more accurate earnings forecasts by analysts and less dispersion among analysts' forecast. These results indicate that informative disclosure policy reduces information asymmetry. Point of importance is the recognition of items in the financial statements is affected by accountant estimates. Accounting disclosure should look to the future visions of opportunities and risks that face the company. Disclosure may be critical to the company's financial position when there is uncertainty and risk around company.

Company's financial reporting and disclosure is essential due to information asymmetry and the agency problem among companies and their stockholders. Accounting disclosure led to greater market liquidity and reduced the company’s cost of capital (Healy and Palepu, 2001; Diamond and Verrecchia, 1993). Some research are believed information asymmetry associated with earnings quality and earnings quality is considered as a measure of information asymmetry (Verrecchia, 1990). As a result, the quality of corporate disclosure and earnings quality have a negative or substitute relation.

This means that firms with low earnings quality, reveal more information with more quality. However, this argument ignores this fact that disclosing are based on low quality information (earning quality). Thus we can say that under rational expectations, there is little validity for this type of disclosure (Francis et al,2008). Easler and O'Hara (2004) showed that if the amount of secret information is more than data reported, due to information asymmetry, estimation risk of investors increase and they are asking more return. In this context, Lang and Lundholm (1997) found firm with a weak correlation between the returns of companies and Interest rates, have higher disclosure. (The substantive relation) However, some studies result that there is complementary relationship between disclosure quality and earnings quality. It means, if the quality of financial reporting or earnings quality increases, managers are more motivated to disclose more information.

Jung and Kwon. (1988) consider Information quality as the probability manager has confidential information and study disclosure or non-disclosure of information about the decisions. The more risk of confidential information, the more likely to follow it. The reason can be expressed in this way is not disclosing information by manager are considered as bad news by market and thus the value of the company are reduced. Companies to reduce information asymmetry and cost of capital, are motivated to do the highest level of disclosure. In this circumstances, the cost of information disclosure include risk sharing, agency costs and ownership costs (Diamond and Verrecchia, 1991; Hayes and Lundholm 1996). This cost eliminates advantage due to lower cost of capital and thereby cause to the lack of full disclosure of information by companies.

Botosan and Plumlee (2002) found that high-quality financial reporting reduces the cost of capital. In this scope, Ghosh and Doocheol (2010) investigated the relation between financing by debt and earnings quality. Using accruals quality criteria for measuring the quality of earning, study show there are nonlinear relation between debt financing and earnings quality. Important part of the literature on disclosure examine the quality of voluntary disclosure in response to information asymmetry existence. The endogenous voluntary disclosure investigated by Gietzmann and Trombetta (2003). They found that firms communicate information about their condition voluntarily by disclosing high quality information and selection of accounting policies. As a result of voluntary disclosure for venture firms, accounting policies affects the cost of capital. models without considering the relationship between disclosure quality and earnings quality, consider high-quality voluntary disclosure in response to the quality of financial information. In relevant study there are two basic approaches for measuring disclosure quality have evolved within the academic literature.

The first involves direct disclosure scoring by the researcher based on a self-developed disclosure index. Examples constitute Wiseman (1982) and Botosan (1997). The second involves the use of external ratings of disclosure such as those published in TSE. This study is based on the second approach, although each method has its own advantages and disadvantages. Subjective judgment by researcher's disclosure index could be named as a disadvantage of the first approach. As such, the index may not fully reflect the views of relevant user groups such as investors, creditors or financial analysts; On the other hand its advantage is due to its Applicability to a broad cross section of firms and not being restricted to those firms covered by the external agency (Artiach and Clarkson 2010).

According to literature and the importance of disclosure in business realm, the problem this research seeks to embark is whether disclosure quality whether internal information cause to disclose more. Thus the followings is the research hypothesis: Main hypothesis: There is a significant relationship between earnings quality and the quality of disclosure.

Conclusion

With regard to the issue of importance of information asymmetry in the capital market and its role in investor confidence, this study examines the conflict between disclosure quality and earnings quality as measures of information asymmetry in financial environment. The results of testing the first hypothesis show that there is a significant relation between disclosure quality and earnings quality criteria. In the other words, the increase in information asymmetry has led the company to eliminate any possible unpleasant consequences, they have incentive to increase the quality of reliable disclosure in timely basis. Findings of provided models verify the substitution relationship between the quality level of disclosure and information asymmetry criteria.

This relation is unlike the findings of Francis et al. (2008). Increasing the level of disclosure quality respond to information asymmetry by company, is considered as evidence for increased estimates of the risks, impose higher cost of capital. This evidence is consistent with the results of Botosan end Plumlee (2002), Zhang (2001).

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