

Information Asymmetry and Agency Problems in the Financial Market

Haoyang Wang *

College of Letters & Science, University of California, Santa Barbara, Santa Barbara, CA 93106, USA

* Corresponding Author Email: haoyangwang@ucsb.edu

Abstract. This paper discusses that the agency problem stems from the information asymmetry between shareholders and professional managers, this comes from the fact that shareholders cannot have expertise in every aspect. Therefore, in the actual operation of the company, it is necessary to hire professional managers to manage the company. However, at the same time, the two parties with asymmetric information have different ways of income. The professional manager whose income mainly comes from a fixed salary is bound to be more interested in short-term development than like the shareholders. The reason. The main income is profiting sharing and future asset appreciation. As a result, managers will not value long-term development as much as shareholders. As well as this paper will discuss whether it can minimize the agency cost by changing the remuneration method of professional managers to equity incentive value. This paper will also discuss the feasibility and possible problems by having directors directly involved in the management of the company, or creating a regulator to oversee the professional managers.

Keywords: Information Asymmetry, Agency Problems, Equity Incentive.

1. Introduction

Information asymmetry means that when the two interacting parties have different information, the cooperation or decision reached by these two people may be irrational. For example, the seller hides part of the truth from the buyer so that the buyer buys something he might not otherwise want. Information asymmetry has been noticed and explained by scholars as early as the Greek period. The economics of free trade gained more attention after Adam Smith proposed it, and received a lot of research after World War II. Agency problem is a typical form of information asymmetry. In the agency problem, agents may withhold information or take other actions to gain greater personal benefit. This results in agents and principals having different levels of information. An agency problem is when a person needs the help of a professional, he cannot be sure that the professional's interests are aligned with his own, and so there is no guarantee that the professional will be able to serve him wholeheartedly. In the area discussing today, the agency problem occurs between the equity owners of a company and the professional managers hired by the company. The biggest benefit analysis between the two is that the equity owner's main source of profit comes from the dividends that the company receives when it makes a profit, whereas the professional manager's main source of profit comes from the salary and bonuses that the company pays him. Therefore, in many cases, professional managers will choose to maximize their own interests at the expense of the shareholders' interests, and this will lead to agency problems. The agency problem was recognized and discussed by economists at a very early stage. In the 1960s and early 1970s, It has been realized that risk sharing between individuals and groups is a significant enough issue to affect economic and business management. This article was about a difficult point, which is that when people in different roles have different attitudes towards risk, they are bound to conflict [1]. The agency theory can help us to further the discussion on this issue. There are people who play different roles in a business, such as shareholders and professional managers, whose interests are not aligned. So their appetite for risk is different. This creates all sorts of contradictions [1]. Put simply, agency theory sums up the various relationships in life as the principal and the agents who performs the work? Agency theory especially emphasizes the role of contractual relationship [1]. For example, when a family business hires a

professional manager, the owner of the family business may be more interested in the long-term benefits of decades, but the professional manager only works in the business for a few years, and he or she will be particularly interested in the short-term performance of the company in these years. This is a disadvantage for equity owners. How to solve this problem has become the focus of many economists.

2. Agency Problem

Agency costs are the costs borne by the principal of an agent when an agency problem occurs. In business, it refers to the losses suffered by shareholders. Agency costs are widespread in business. For example, a company hires a professional manager in order to increase sales. The professional manager does something that overdraws the company's brand image in order to increase sales during the period of time he is contracted to work. At the end of the contract, because of this resume, the professional manager goes to work for another company. But then the problem arises: the company loses money because of the damage to its brand image. The company suffers because of the damage to its brand image. This is where the shareholders' interests are jeopardized, and this is where the agency costs come in. The forms of agency costs are not limited to this. For example, a professional manager may seek to have a small business acquired by a large corporation in order to become an executive of a larger one. But this is not in the interest of the shareholders, which is what Milton Friedman called: The shareholder is the principal and the professional manager is the agents. When they maximize their own interests, their actions are inconsistent, which is actually the agency cost. In recent decades, the demand for professional managers has increased, so that professional managers have more job opportunities. They can choose to move from one company to another. This makes their interests no longer tied to the long-term development of the company, which increases the likelihood of agency costs [2]. Agency costs exist universally, because his root is the agency problem caused by information asymmetry, as long as the interests of shareholders and professional managers are not the same, then professional managers will have the incentive to do things against the interests of shareholders. According to the agency theory, the key to all agency costs is that the interests of professional managers and shareholders are not the same [3]. As long as the information asymmetry exists, then professional managers have the ability to do things against the interests of shareholders. Even many shareholders, because of the lack of professional knowledge, in the professional manager to do these things cannot see what is wrong with these things. As long as information asymmetry exists, agency costs will always exist.

There are ways to reduce agency costs, such as establishing an effective regulatory system and hiring people with the same expertise to supervise professional managers. This will reduce the information inconsistency between professional managers and shareholders. Shareholders can use the supervisor to gain access to more detailed front-line information about the company that may be actively or passively hidden by the manager. The regulator can also use its expertise to prevent shareholders from being deceived or cheated by professional managers. But in existing economic theory, the costs of the regulatory system, such as the regulator's salary, are also considered as part of agency costs. Cost of guarantees is the cost that an agent incurs in order to establish trust with his principal. Collateral costs are the costs that agents incur to establish trust with their principals, such as those associated with obtaining insurance, posting performance bonds, and other forms of financial assurance. Binding costs may include contractually limiting the agent's decision-making power or increasing the transparency of the agent's decisions. Theoretically, the agent will bear these costs only if their marginal benefit is equal to or greater than the agent's marginal cost. Guarantee costs may reduce the steps that the principal needs to take to monitor the agent. Thus, the agent's acceptance of these costs may lead to a higher utility outcome for both parties. In practice, bonding costs are almost impossible to measure. Based on the existence of agency costs, the Friedman Doctrine suggests that the best decision makers are the shareholders because only the shareholders really care about the long-term growth of the firm, rather than considering the short-term performance in the few short

years specified in the contract. For a long time, economists have been studying the characteristics of decisions made by professional managers when they are not shareholders in the company [4].

There are other ways to minimize the agency problem, such as giving equity incentives to professional managers, so that their main source of income is not the fixed salary stipulated in the contract, but rather the stock with the potential for future appreciation. In this way, the manager may be able to think about the long-term development of the company, rather than focusing on the short-term figures that look better on paper. Any concern about diminishing shareholder rights does not stand up to scrutiny [5]. Based on the research of agency theory. Shareholder participation in modern companies is too low, not too high [5]. The Friedman Doctrine has also been partially challenged, with theories suggesting that during stock market mania, there are many speculative investors who become shareholders in a company. They don't care what the company will do decades from now, only what it will do in a few years or even a few months. They look for a short-term earnings report that will surprise the market, a short-term surge in the stock price, and the ability to sell the stock for a return on their investment. Shareholders may be more concerned with short-term performance. For example, when Boeing started to financialize in the 21st century, shareholders started to remove the engineer culture of Boeing in order to have a better share price in the stock market. As a result, Boeing's investment in technology has been reduced and quality control has been loosened. In recent years, Boeing has experienced major safety problems with some of its airplanes, resulting in major accidents that have cost Boeing money in the long run.

3. Solutions to Agency Problem

There are two main ideas to solve the agency problem, one is to align the interests of professional managers and shareholders. The most common measure of this method is changing the fixed salary system of professional managers to equity incentive system. That is, in addition to a small portion of the fixed salary, the professional manager of the vast majority of the income will come from the achievement of certain goals after the equity incentives. In this way, most of the professional manager's income will come from dividends and asset appreciation due to the increase in share price. When a professional manager's source of income is the same as that of a shareholder, he will naturally think in terms of shareholders. When the professional manager receives a fixed salary. Then. He will pay special attention to the company's short-term data performance, because his contract with the company only signed to this period of time, his next time he needs to look for new jobs in the company ah, these new jobs need to look at his last period of the company's data performance, so he needs to sacrifice the long-term interests of the company for a better short-term performance, to pave the way for their own future development, which is also what mentioned above. When a professional manager receives equity incentives, the vast majority of his income will come from the stock dividends and stock appreciation. Stock dividends and stock appreciation is the asset value added, in fact, professional managers become an important shareholder, then he. Out of the maintenance of their own interests, they will pay more attention to whether these decisions can benefit the company in the long term, bring cash flow in the long term, and bring the stock price increase to increase his assets. So, equity incentive policy is a good solution to the agency problem. For example, 79 percent of the firms in which corporate officers and directors own fewer than 1 percent of the firms' shares operate in multiple lines of business [6]. In contrast, only 39 percent of the firms in which officers and directors own more than 25 percent of the firm's shares operate in multiple segments [6]. These findings are robust to alternative measures of diversification and include other well-known determinants of the level of diversification [6]. It also documents a significant negative correlation between levels of diversification such as equity block holders outside [6]. Thus, the findings provide support for the idea that increasing equity ownership [6]. Managers' pursuit of value decreases, decreasing diversification. And increased ownership by outside shareholders reduces managers' pursuit of diversification and their ability to pursue these strategies [6].

Another solution is to break the information asymmetry between professional managers and shareholders, for example, by hiring professional regulators to monitor professional managers. When the professional manager does something against the interests of the shareholders, the regulator will report it to the shareholders and use his or her expertise to explain to the shareholders why these things are done. On the surface there is no problem, but behind the scenes it is against the interests of the shareholders. There are two main problems with this approach is. One is that the salaries of the regulators themselves can become a major cost, and the other is that it is difficult to ensure that the regulators are not corrupt. On average, the SG&A costs to total assets ratio is 27 percent, compared to the research and development (R&D) to total assets ratio of 3 percent [7]. Regulators collude with professional managers, because professional managers can use their power to give regulators benefits beyond their salary. When regulators collude with professional managers, shareholders suffer even deeper deception. Because shareholders are often not professionals in the field, once two professionals work together to cheat shareholders. The shareholders can hardly find out in a short time. The statistically significant relationship is founded between corporate performance and insider ownership, external board representation, debt financing, and corporate control activities [8]. It finds a positive correlation between more insider ownership and performance, while it finds a negative correlation between more outsiders on the board, more debt financing, and greater corporate control activities and performance [8]. Other relationships remained unchanged except that in the extended OLS regression, the relationship between insider ownership and firm performance disappeared [9]. It finds that the effect is not significant in insider ownership, corporate debt, and corporate control activities in the joint equation estimation [9]. Without considering the composition of the board, where the influence of outsiders remains, the results are consistent with the best use of each control mechanism [9]. It is not clear why the persistent negative impact on corporate performance occurs with more outsiders on the board [9]. One possible reason is that the presence of outsiders on the board is politically motivated, and these political outsiders are more concerned with issues such as the environment than with the company's revenue and development [9]. However, it can be argued that the agency problem cannot really be solved as long as agency relationships as well as information asymmetries remain. Agency costs will still be.

An important part of the cost of running a business. This is why some economists believe that making the shareholders directly responsible for the operation of the company would be the most effective model, because only the major shareholders would really consider the future development of the company as the most important thing, instead of sacrificing the long-term development to create a short-term good data, in this view, the family-owned business is likely to be very competitive. This is because the descendants of the family will be motivated by. Equity inheritance as well as a sense of mission would never sacrifice the company's interests. But this is a very ideal situation, because it has to admit that is many shareholders are really not very professional. Even if he is a very capable person, he cannot possibly know all the specialties needed to run a large company, so he still needs advisors, and these advisors may still have agency problems. Equity incentives for professional managers can also be a huge burden on shareholders. In the 1990s, it was noted that the growth rate of executive compensation lagged behind that of CEO compensation [10]. Economists published many papers on how to solve the agency problem of listed companies by reforming executive compensation schemes [10].

4. Conclusion

In conclusion, agency costs exist because of agency problems caused by information asymmetry. Because of the information asymmetry between shareholders and professional managers, shareholders may not have specialized knowledge in every aspect. Therefore, they may not always be able to participate in the direct management of the company. Therefore, professional managers will have a lot of information that shareholders cannot grasp, including the company's real operating conditions and future development potential. Because the professional manager's income comes from

a fixed salary, while the shareholders' income comes from profit dividends and the future. The capital appreciation brought about by the increase in share price, the starting point of the interests of both sides are different, resulting in different goals for both sides. Professional managers tend to focus more on the short term, which creates agency costs. It can use a method such as changing the compensation of professional managers to equity incentive system and the establishment of regulators to reduce agency costs. Letting stock owners directly involved in the management of the company can also reduce the information asymmetry, but in the current operation of the enterprise, the agency cost is difficult to avoid completely. The agency problem is hard to solve because there is a basic conflict of interest between shareholders and management. Although methods like corporate governance practices and equity incentives are used to reduce the problem, they cannot completely eliminate the agency costs. It's important to understand that these solutions can only reduce the problem to some extent, and that complete resolution of the agency problem is unlikely. Thus, it's essential to keep trying to improve corporate governance and align shareholder and management interests to decrease agency costs and enhance the company's long-term success.

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