

Explanation and implications of information asymmetry

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Information Asymmetry Internal Memo Explanation and Implications of Information Asymmetry Explanation of information asymmetry Information asymmetry refers to a situation in which there is imperfect knowledge. It normally occurs when one party has different information to the other (Arora et al. 2011). It is a big problem in financial markets like lending and borrowing or selling and buying shares in the capital market. The borrower tends to have much better information about their financial status than the lender, and the lender is difficulty in knowing if the borrower will ultimately default. This lack of perfect information often leads to moral hazards, adverse selection and market failure (Eckermann, 2006).

Implications of information asymmetry for company executives

To the company executives, information asymmetry leads to moral hazard (Wankhade and Dabade, 2010). Since they have more information about the company than other stakeholders, they tend to take undue risks since the costs they incur often borne by parties that take the risk. For instance, they are more likely to the company's resources in a bid to generate more revenues and get performance contingent compensation even if the investment is highly risky (Arora et al. 2011).

Implications of information asymmetry for investors

To the current investors, information asymmetry makes them incur losses on their investments. They have much less information regarding the performance of their investments and face difficulty in knowing when to sell and when to hold onto their shares (Wankhade and Dabade, 2010).

Implications of information asymmetry for prospective investors

Finally, information symmetry provides harmful situations to potential

investors as brokers often take advantage of their lack of information. It results in adverse selection top them; they may be more inclined by brokers to invest in poor performing stocks thus suffering financial losses or even losing their entire investment (Eckermann, 2006). They end up selecting bad investments.

Work cited

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Wankhade, L, & Dabade, B. (2010). Quality Uncertainty and Perception: Information Asymmetry and Management of Quality Uncertainty and Quality Perception. Berlin: Physica-Verlag.