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Foreign ownership and auditor choice

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A B S T R A C T

We take advantage of the unique institutional background of the B-share stock market in China to explore the impact of foreign investors on auditor choice. Our results show that the percentage of B-share firms audited by Big 4 auditors has decreased with both economic and statistical significance since the segmented B-share market was opened to domestic investors in 2001. We find that the negative effect of opening the B-share market on demand for high audit quality is more pronounced for firms with greater decreases in foreign ownership and for firms with strong incentives to be opaque, such as those in a weak institutional environment, firms with more "other receivables," firms with more related-party transactions, and firms with political connections. Additional analysis shows that our results are not driven by the concurrent decline in capital-raising activities in the B-share market.

1. Introduction

With an increasingly integrated global economy, many capital markets have been liberalized, and foreign capital has become an increasingly important source of financing (Bekaert et al., 2002). However, access to foreign capital can be difficult and costly because of information and agency cost

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problems, especially for firms in emerging markets with a weak legal environment and weak corporate governance. It is often argued that foreign investors are at an informational disadvantage relative to domestic investors because they incur higher information acquisition and processing costs (e.g., Kang and Stulz, 1997). Foreign investors are more likely to value high-quality financial reporting than their local peers and have a stronger demand for high-quality auditors to provide assurance of financial reporting quality and to serve a governance role in monitoring and limiting the consumption of private benefits by controlling shareholders. Prior studies suggest that hiring high-quality external independent auditors can serve as an effective bonding mechanism to improve earnings quality and transparency and hence reduce information asymmetry and mitigate the agency problem (e.g., Fan and Wong, 2005). In this study, we examine the role of foreign investors in auditor choices using a natural experiment from China. We also examine how other institutional factors affect the association between foreign ownership and audit choices across the regime shift.

Before 2001, the Chinese stock market was segmented, with A-shares restricted to domestic residents and B-shares limited to foreign investors. Since March 2001, however, domestic residents have been permitted to trade B-shares with foreign currency. Opening the originally segmented B-share market to domestic investors triggered a dramatic change in the B-share market's investor composition. Using a difference-in-differences approach, we first document that the percentage of B-share firms audited by high-quality (Big 4) auditors has decreased significantly since the segmented market was liberated. Specifically, B-share audits by the Big 4 dropped from 78.5% in the pre-event period (1992–2000) to 49.5% in the post-event period (2001–2006). This result is consistent with our conjecture that foreign investors suffer more serious information problems and hence have stronger demand for high-quality auditors. Opening the B-share market to domestic investors has reduced the overall demand for high-quality auditors. From the perspective of controlling shareholders, this drop in demand implies that the benefits of hiring high-quality auditors have decreased since the B-share market was opened to domestic investors.

To further investigate whether the change of foreign ownership is indeed behind the change of auditor choices in the post-event period, we examine the degree of foreign ownership decline and the likelihood of switching to low-quality (non-Big 4) auditors. We find that firms experiencing greater declines in foreign ownership are more likely to switch to non-Big 4 auditors, supporting our conjecture that foreign ownership affects firm auditor choice.

Finally, we examine whether firms that have strong incentives to be opaque are more likely to switch to low-quality auditors after the opening of the B-share market to domestic investors. With the decline of benefits in hiring high-quality auditors, the costs to these firms of doing so are more likely to exceed the benefits. We find firms that enjoy more opaqueness gains, such as those in weak institutional environments, firms actively engaged in tunneling and propping activities, or more politically connected firms, are more likely to switch to non-Big 4 auditors after 2001. We conduct a series of robustness checks for our empirical results. We find that our evidence is unlikely to be entirely driven by alternative explanations such as the decline of capital-raising activities.

This study contributes to several streams of literature. First, it extends the literature on the determinants of audit choice (e.g., Fan and Wong, 2005; Choi and Wong, 2007; Wang et al., 2008; Guedhami et al., 2009). Our results show that, in addition to the legal environment and ownership structure, foreign investors can play an important role in auditor choice in emerging markets. In a related paper, Guedhami et al. (2009) investigate the association between foreign ownership and auditor choice in privatized firms. The authors find that the likelihood that privatized firms choose a Big 4 auditor decreases (increases) with the level of state (foreign) ownership. The authors, however, point out that their analysis documents only associations rather than causality because post-privatization ownership structure may be driven by unobservable firm and country characteristics that are also potential determinants of auditor choice (i.e., the endogeneity issue). In addition, the authors acknowledge that foreign investors might rationally choose to invest in those firms that hire high-quality auditors (i.e., the reverse causality issue). The advantage of our setting is that the change of foreign ownership around the regulation is triggered by an exogenous event rather than changes in firm characteristics