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Family control and idiosyncratic volatility: Evidence from listed firms in Hong Kong

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ABSTRACT

Family control of listed firms in Hong Kong is substantively different and materially higher than in the US which could offer different insights into the effects of family ownership on corporate transparency. Using a sample of listed Hong Kong firms and idiosyncratic volatility as a proxy for firm-specific stock price informativeness, we find that family firms exhibit higher idiosyncratic volatility of stock prices than similar non-family firms. Further, the relation between family ownership and idiosyncratic volatility is weaker for firms with higher leverage but stronger in periods before equity issues. Additionally, we find that family firms disclose more information, particularly related to operations, than nonfamily firms in annual reports. These results are consistent with the argument that family firms disclose more information than their nonfamily peers to reassure skeptical outside investors that they are not expropriating their investment.

1. Introduction

In this paper, we use a sample of Hong Kong-listed firms to show that the idiosyncratic return volatility in family firms is higher than for comparable non-family firms. Further, we show that this difference is higher in periods before additional equity issues and lower for more leveraged firms. Prior studies have established idiosyncratic volatility of stock prices as a proxy for firm-specific stock price informativeness.[1] Consistent with this literature, we use idiosyncratic volatility as the measure of stock price informativeness. We are motivated to examine stock price informativeness in family controlled Hong Kong-listed firms because family ownership is the dominant form of organization in Hong Kong. Further, stock price informativeness is one dimension in which corporate transparency manifests itself. Corporate transparency has become a matter of global importance to regulators, investors and other stock market participants such as financial analysts and auditors.

We interpret our finding of higher idiosyncratic volatility in family firms compared to their non-family peers to mean that family-controlled firms make more firm-specific price-relevant information available to investors than non-family-controlled firms.[2] We find that family firms that issue additional equity exhibit a stronger increase in idiosyncratic volatility compared to the additional equity issues by non-family firms. We interpret this finding as suggesting that family-controlled firms

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[1] Idiosyncratic return volatility is an outcome variable that could depend on a number of factors, including the disclosure of firm-specific information by the managers of the firm and the collection of private firm-specific information by analysts and informed investors that gets used in trading. Prior literature identifies several of these factors and suggests that after controlling for these factors, the residual idiosyncratic volatility is primarily determined by the information disclosure by managers and private information collection by analysts and investors.

[2] In particular, we do not interpret our finding as suggesting that the family firms are interested in the volatility of their stock returns but rather, that they improve transparency, which in turn results in higher idiosyncratic volatility.

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make more informative disclosures to the external shareholders, especially when seeking additional financing, to reassure them that their funds will not be expropriated by the controlling family. We also find that family firms which are more leveraged exhibit a smaller increase in idiosyncratic volatility than non-family firms. This is consistent with the idea that family firms that borrow money from institutions or from the family itself to finance their growth and expansion have less need to disclose more information to external shareholders compared to family firms that have either sought or expect to seek capital from the equity market.

Higher stock informativeness can be driven by either mandated or voluntary financial disclosures, or by voluntary disclosures of non-financial information on firm-specific operations. We also explore whether family firms contribute to stock price informativeness by making more voluntary financial or nonfinancial disclosures in annual reports which are the primary source of investor communication in Hong Kong firms. Based on the checklist of voluntary disclosure established by Gul and Leung (2004), we hand-collected disclosure information from annual reports for 2003 for all Hong Kong firms with financial data available in the *Global Vantage* database, which includes family firms and non-family firms. Our analysis shows that the total disclosure score for family firms is significantly higher than for non-family firms, validating the results we obtained from our tests of idiosyncratic volatility. Further, we find that the additional disclosures by family firms were mostly non-financial operating information items. This finding further supports our findings on the incremental *firm-specific* disclosures undertaken by family firms.

Our study contributes to a better understanding of the effect of family-controlled organizational structure on corporate transparency. We find that family firms disclose more price-relevant information than non-family firms. Prior studies show that there is a lower agency cost attributable to the separation of ownership from management, but these studies also speculated that the family insiders might exploit the information asymmetry between them and the non-controlling shareholders to expropriate minority shareholder interests for private benefits. Our findings provide some insight into this issue by showing that family firms actively try to reduce the information asymmetry by disclosing more information.

The rest of this paper is organized as follows. The next section reviews the background and the relevant literature. The third section describes our measures and develops our hypotheses. The fourth section provides a description of our data, the models we use to test our hypotheses, our results and interpretations. Concluding remarks are given in the fifth and final section.

2. Background and literature

Regulators and other capital market participants have been concerned for a long time about the incentives that managers face in reporting (Levitt, 1998; Leung and Horowitz, 2010). Corporate failures such as those of Enron and Worldcom, as well as the more recent financial crisis have renewed researchers' interest in the determinants and consequences of the wrong corporate reporting incentives. A significant part of this literature has focused on the effect of ownership structure on corporate disclosures (Ali et al., 2007; Hutton, 2007; Anderson and Reeb, 2003; Chen et al., 2008).

Family ownership could affect both the production and reporting incentives in myriad ways. Previous studies have addressed the differences between family-controlled and other firms in terms of two different agency relationships: the separation of ownership and control referred to as the Type 1 agency relationship, and the differences in the incentives of family investors and external investors referred to as the Type 2 agency relationship.

Family investors are closely involved with their family business either as entrepreneurs or as managers in the firm. This reduces the separation between ownership and control and, therefore, family firms have lower Type 1 agency conflicts. Specifically, family investors know more about the operations and markets of their firms and are therefore better able monitor managerial actions directly (Demsetz and Lehn, 1985) without recourse to formal reports. This direct monitoring of the managerial actions reduces moral hazard and improves risk sharing between the investors and managers. The reduced recourse to formal reports in assessing managerial performance, in conjunction with the ability of family investors to better detect manipulations in those reports (Anderson and Reeb, 2003), deters managers from manipulating financial and other formal disclosures (e.g., 8K disclosures in the US). In this way, the reduced Type 1 agency problem provides managers incentives for higher quality reporting.

Type 2 agency conflict affects the reporting incentives in several ways. In contrast to firms with diffuse or significant external institutional ownership, external investors in family firms have limited ability to directly influence the operational and reporting choices in the family-controlled firms. The managers in family firms are beholden to the controlling shareholders and do not have an incentive to be accountable to non-controlling investors unless this is in the interest of the controlling shareholders as well. Therefore, in firms where insider family shareholders and managers seek to protect their private control benefits, the controlling insiders might proactively discourage openness and make the firm less transparent and prefer private debt over equity funding. Therefore, we expect the Type II agency conflicts in primarily debt-financed family firms to be more severe than in other family firms, which makes the managers less willing to be open. On the other hand, in family firms that frequently seek outside capital, the controlling shareholders have incentives to encourage disclosures so that the current and potential external investors can be reassured of the safety of their invested capital (Srinidhi et al., 2010). In these firms, the Type 2 agency problem is overcome by the need to attract capital and results in positive reporting incentives for managers. Based on this logic, family firms that seek outside equity capital are likely to provide more firm-specific information to investors and highly leveraged family firms are likely to be less transparent.