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Ownership concentration, foreign shareholding, audit quality, and stock price synchronicity: Evidence from China ☆

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ABSTRACT

This paper investigates the effects of largest-shareholder ownership concentration, foreign ownership, and audit quality on the amount of firm-specific information incorporated into share prices, as measured by stock price synchronicity, of Chinese-listed firms over the 1996–2003 period. We show that synchronicity is a concave function of ownership by the largest shareholder with its maximum at an approximate 50% level. Further, we find that synchronicity is higher when the largest shareholder is government related. We also find that foreign ownership and auditor quality are inversely associated with synchronicity. Finally, we show that the amount of earnings information reflected in stock returns is lower for firms with high synchronicity.

1. Introduction

Roll (1988) finds that a large proportion of stock return variation is not explained by changes in market wide factors or by announcements of value-relevant public information,[1] which he takes as an indication of the amount and rate of private information capitalization into stock prices via informed trading. Built upon this foundation, a growing body of finance literature provides evidence that is consistent with this information-based interpretation of stock price synchronicity or firm-specific return variation. For example, Morck, Yeung, and Yu (2000) examine worldwide synchronicity at the country level, and find that stock price movements are more synchronous in emerging markets with greater impediments to informed trading than in developed markets with fewer impediments. Morck et al. report that China

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[1] Roll (1988) shows that the market model R^2 for his US sample is only about 20% when daily returns are used.

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has the second highest synchronicity among 40 sample countries. They argue that poor investor protection in emerging markets such as China discourages informed trading, which, in turn, leads to high synchronicity. Similarly, Jin and Myers (2006) show that synchronicity decreases with a country's accounting transparency. Recent studies by Fernandes and Ferreira (2008, 2009) and Kim and Shi (2009) also find synchronicity to be higher in emerging markets than in developed markets.

Higher stock price synchronicity or lower firm-specific return variation in emerging markets stems from two primary sources. First, while many emerging markets have disclosure regulations of similar quality to those in developed markets, these regulations are often not fully enforced (Ball, 2001; Chan and Hameed, 2006). Second, corporate ownership structure in emerging markets is well characterized by concentrated ownership by founding family members or government, divergence between cash-flow rights and voting rights, and firm affiliations with large business groups via cross shareholdings. This ownership structure is conducive to managerial entrenchment, and provides entrenched controlling owners with incentives and opportunities to extract private control benefits at the expenses of outside investors (Johnson, La Porta, Lopez-De-Silanes, and Shleifer, 2000; Bertland, Mehta, and Mullainathan, 2002). In this environment, the controlling owners have incentives to withhold (or selectively disclose) value-relevant, private information to outside investors to conceal the valuation implication of their self-serving behaviors (Fan and Wong, 2005; Kim and Yi, 2006). As a result, the cost of acquiring private information is likely to be higher, and the profitability of informed trading is lower, in emerging markets as compared to developed markets. This may discourage informed trading and limit the incorporation of firm-specific information into stock prices, leading to more synchronous (or less informative) stock prices.

While the overall evidence in previous studies suggests that China has a relatively high synchronicity because of poor investor protection, it is unclear whether there are discernible differences in synchronicity across firms in China.[2] Unlike the cross-country focus in several prior studies (e.g., Morck, Yeung, and Yu, 2000; Li, Morck, yang, and Yeung, 2004; Jin and Myers, 2006; Fernandes and Ferreira, 2009), our analysis focuses on firm-level investor protection mechanisms within a single country—China. We study the link between synchronicity and corporate governance characteristics unique to China that are deemed to influence the flow of firm-specific information to the market. This linkage comes about through the effects of corporate governance on managerial constraints and incentives, which are likely to influence the information environment and stock prices (Gompers, Ishii, and Metrick, 2003; Bushman, Piotroski, and Smith, 2004; Cremers and Nair, 2005).

We first consider two important aspects of ownership structure in China: ownership concentration of the largest shareholder, and whether the largest shareholder is government related. In transitional economies like China's, most listed firms are partially privatized, and thus, corporate ownership is highly concentrated in the hands of a single investor associated with the central or local government or government-controlled institutions such as state-owned enterprises. For example, about 43% of the outstanding shares for our sample firms are owned by the largest shareholder, of whom 66% are government related. These unique institutional features allow us to evaluate the impact of ownership structure on the information environment of the Chinese market.

We also examine whether the presence of shares issued to foreign investors is associated with synchronicity. Foreign investors, who are typically sophisticated institutional investors, may have superior capabilities, resources, and skills to collect and process value-relevant, firm-specific information (Kim and Yi, 2009). In China, there are two types of share-issuing firms: firms that issue shares exclusively to domestic investors and those that simultaneously issue shares to both domestic and foreign investors. Further, shares issued to foreign investors are traded on two separate markets with different institutional infrastructures such as disclosure regulations and investor protection: (1) the Shanghai or Shenzhen domestic exchange that is considered an emerging market; and (2) the Hong Kong stock exchange that is a well-developed market. These institutional features provide a unique opportunity to examine the impact of foreign ownership on the flow of firm-specific information to outside investors, and to investigate whether this impact differs systematically with the institutional infrastructure of the market on which foreign shares are traded.

Finally, we investigate a hitherto unexplored question of how the quality of external auditors is associated with the extent to which firm-specific information is capitalized into stock prices in an accurate and timely manner. Auditing plays an important role in alleviating information asymmetries between corporate insiders and outside investors, and improves the quality of information contained in financial statements (Dopuch and Simunic, 1982; Becker, DeFond, Jiambalvo, and Subramanyam, 1998; Kim, Chung, and Firth, 2003). Firms with high-quality auditors are therefore expected to provide more credible, firm-specific information and better investor protection, and thus, greater firm-specific information capitalization or lower synchronicity, compared to other firms. The extant literature, however, has failed to consider whether auditor quality is associated with synchronicity, though auditors are instrumental in the production of reliable, firm-specific information. We aim to fill this void by examining the issue in an environment where investor protection is relatively poor and Big 4 audits are relatively uncommon.[3]

[2] Previous governance research suggests that there is considerable disparity in corporate governance quality and characteristics, including ownership structures across firms, in emerging markets (e.g., Klapper and Love, 2004; Allen, Qian, and Qian, 2005). These differences are likely to affect voluntary disclosures and corporate transparency, which in turn could affect the information environment.

[3] In developed markets such as the NYSE and Amex, most listed firms engage Big 4 auditors. In the domestic Chinese markets, however, the Big 4 audit only a small proportion of listed firms. In our sample of Chinese-listed firms, the Big 4 market share is about 7.3%, while in the US it is well over 90% (Choi, Kim, Liu, and Simunic, 2008). See DeFond,