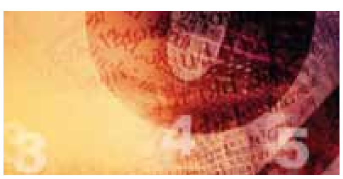
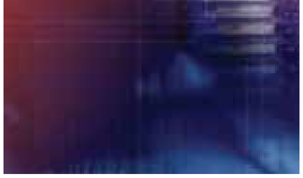
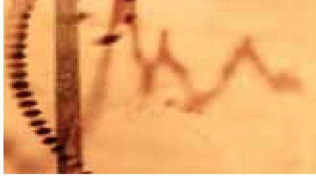
CORNERSTONE RESEARCH

Accounting Class Action Filings and Settlements

Review and Analysis 2004–2009

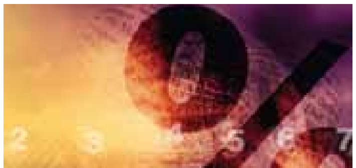


Cornerstone Research specializes in assisting attorneys with the complex business issues encountered in litigation and regulatory proceedings. Our staff and experts possess distinctive skills and experience in using economic, financial, accounting, and marketing research to analyze the issues of a case and develop effective testimony. We provide objective, state-of-the-art analysis that has earned us a reputation for excellence and effectiveness.

We maintain a close relationship with many leading faculty and industry experts throughout the country and, through them, have access to even broader networks of expertise.

Reports such as this one are purposely brief, often summarizing published works or other research by Cornerstone Research consultants and affiliated experts, and do not necessarily represent the views of Cornerstone Research.

Additional information about Cornerstone Research consulting services is available through our Boston, Los Angeles, Menlo Park, New York, San Francisco, and Washington, DC, offices as well as from *www.cornerstone.com*.



INTRODUCTION

Over the past eight years, there have been significant changes in the regulation of corporate accounting practices aimed at improving the quality of financial information available to investors. As a result of the Sarbanes-Oxley Act of 2002 (SOX), CEOs and CFOs now certify financial reports, management and auditors report on the effectiveness of internal controls, and the Public Company Accounting Oversight Board (PCAOB) has responsibility for auditing standards. At the same time, there have been significant changes in the overall economy, with a major run-up fueled, in part, by complex financial instruments, followed by a dramatic downturn in the global economy. These factors have had important consequences for the litigation landscape.

In this report we focus on securities class action filings and settlements for cases that involve alleged violations of Generally Accepted Accounting Principles (GAAP) (accounting cases). Our principal findings include:

- In 2009 about 35 percent of initial class action filings included accounting allegations, a decrease of 10 percent from an average of 45 percent over the preceding five years.
- In 2009 over 60 percent of settled cases included accounting allegations.
- Accounting cases are less likely to be dismissed.
- Accounting cases have been more costly to settle, particularly for companies that faced SEC action.
- Cases in which defendant companies restated their financial statements are less likely to be dismissed, but have not resulted in significantly higher settlements in recent years.
- Cases in which defendant companies announced internal control weaknesses have settled for higher amounts in recent years.

Our sample includes more than 1,100 class action filings and more than 600 class action settlements from 2004 through 2009.[1] Additional aspects of these filings and settlements are discussed in *Securities Class Action Filings—2009: A Year in Review*[2] and *Securities Class Action Settlements: 2009 Review and Analysis,*[3] respectively. Our sample is limited to those cases that involve allegations of fraudulent inflation in the price of the defendant company's common stock.

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

The total number of class action filings declined in 2009. Filings fell 20 percent, from 223 filings in 2008 to 178 in 2009, a 5 percent decline from the annual average of 188 filings from 2004 through 2008 (Figure 1). The number of filings with accounting-related allegations or "accounting filings" fell even more dramatically, from 92 in 2008 to 62 in 2009, a decrease of 33 percent. As a percentage of total filings, accounting filings declined to 35 percent in 2009, the lowest percentage of all years in our sample.

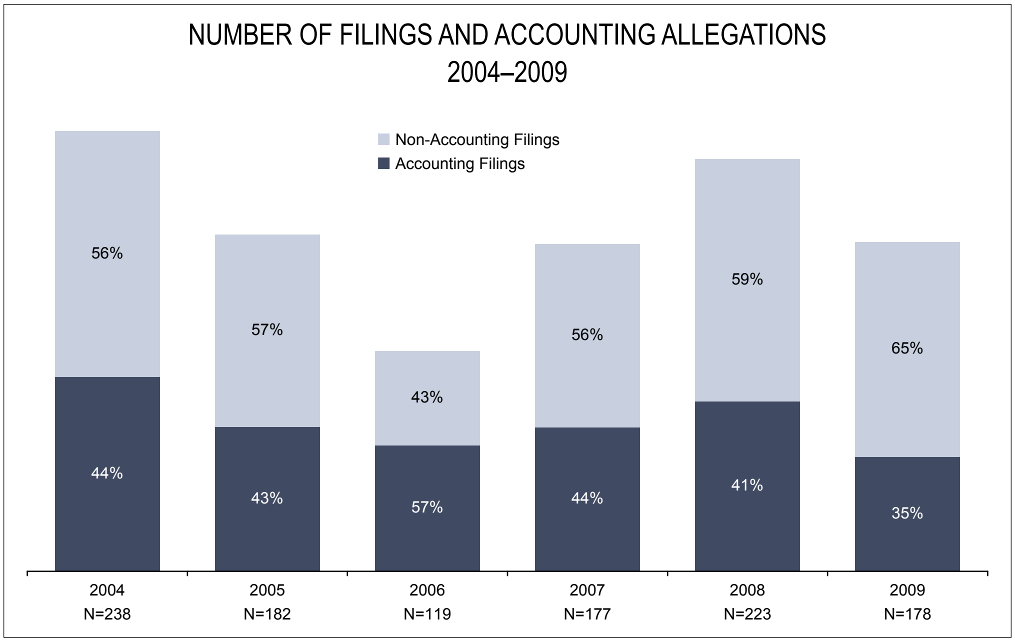
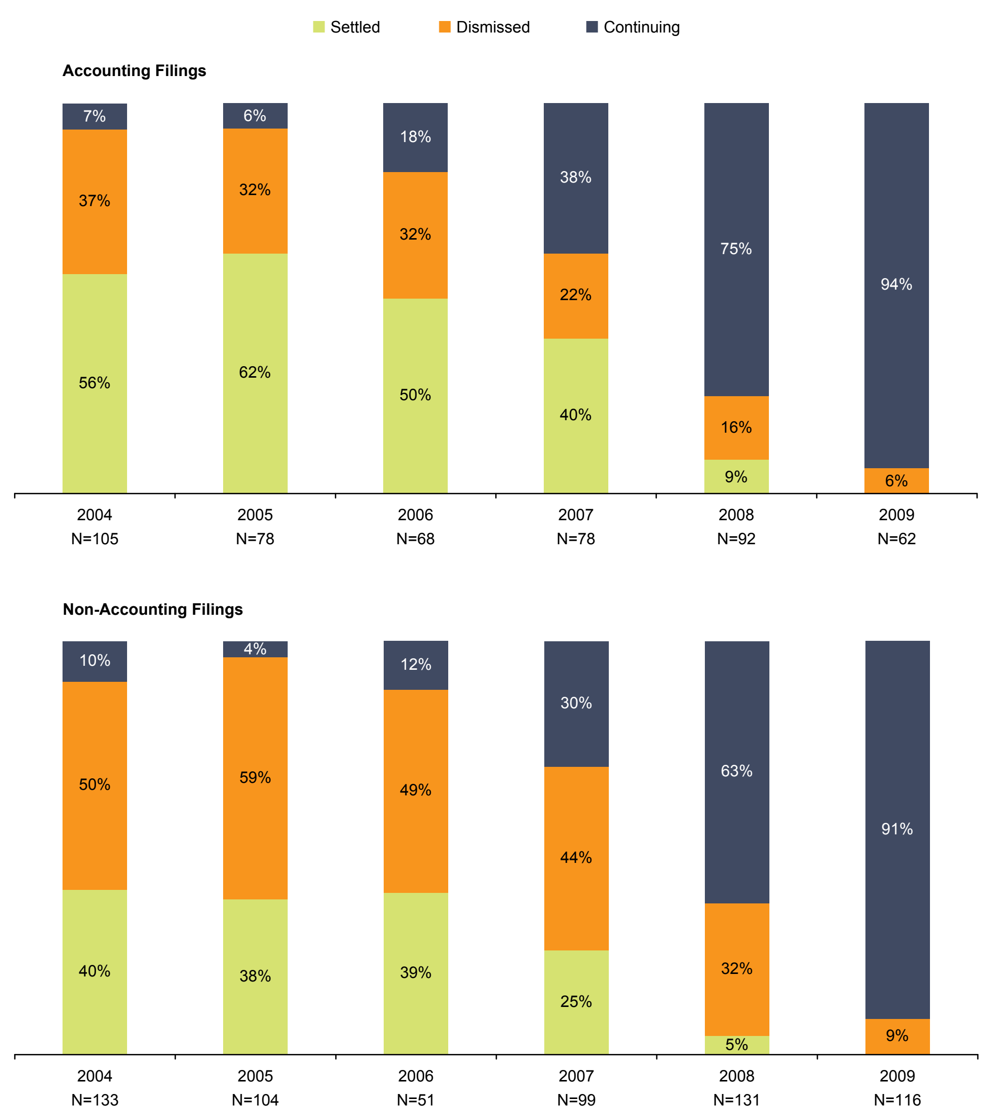


Figure 1

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

Accounting filings are less likely to be dismissed than filings that do not include such allegations. For example, of the class actions filed in 2005, only 32 percent of accounting filings had been dismissed by the end of 2009, compared with 59 percent of filings without accounting-related allegations or "non-accounting filings" (Figure 2). Of all initial filings in our sample, 37 percent of accounting filings had settled by the end of 2009, compared with 23 percent of non-accounting filings. The same pattern holds in each year of our sample. The fact that accounting cases are less likely to be dismissed may be due to the greater complexity of these cases relative to non-accounting cases.

STATUS OF FILINGS AND ACCOUNTING ALLEGATIONS AS OF DECEMBER 31, 2009
2004–2009



Percents may not sum to 100 due to rounding.

Figure 2

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

The higher average settlement rate for accounting cases also results in accounting cases constituting the majority of settlements in each year. Although accounting cases composed only 43 percent of all cases filed, they accounted for 63 percent of cases settled from 2004 through 2009, which was in line with historical averages for the years in our sample (Figure 3).

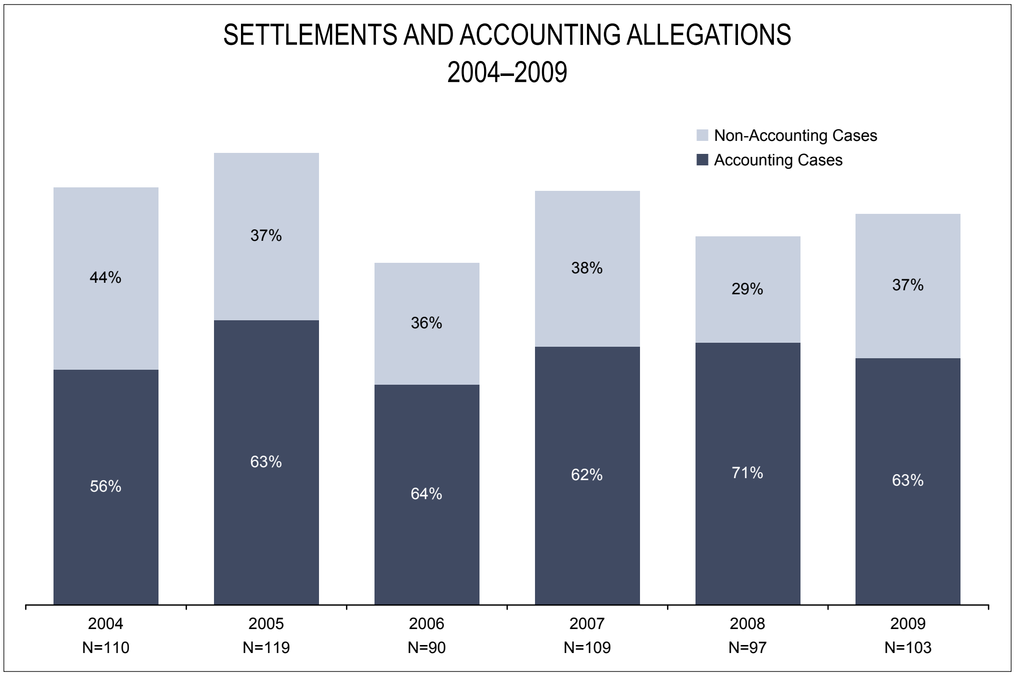


Figure 3

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

In addition to being more likely to settle, accounting cases are associated with higher average settlement outcomes. While accounting cases totaled 63 percent of all cases settled from 2004 through 2009, they accounted for more than 90 percent of total settlement dollars. For example, in 2006, accounting cases accounted for 64 percent of all cases settled, but these cases represented 97 percent of total dollar settlement outcomes (Figure 4). The same general pattern holds over all six years in our study, although it is most pronounced in 2006 and 2007.

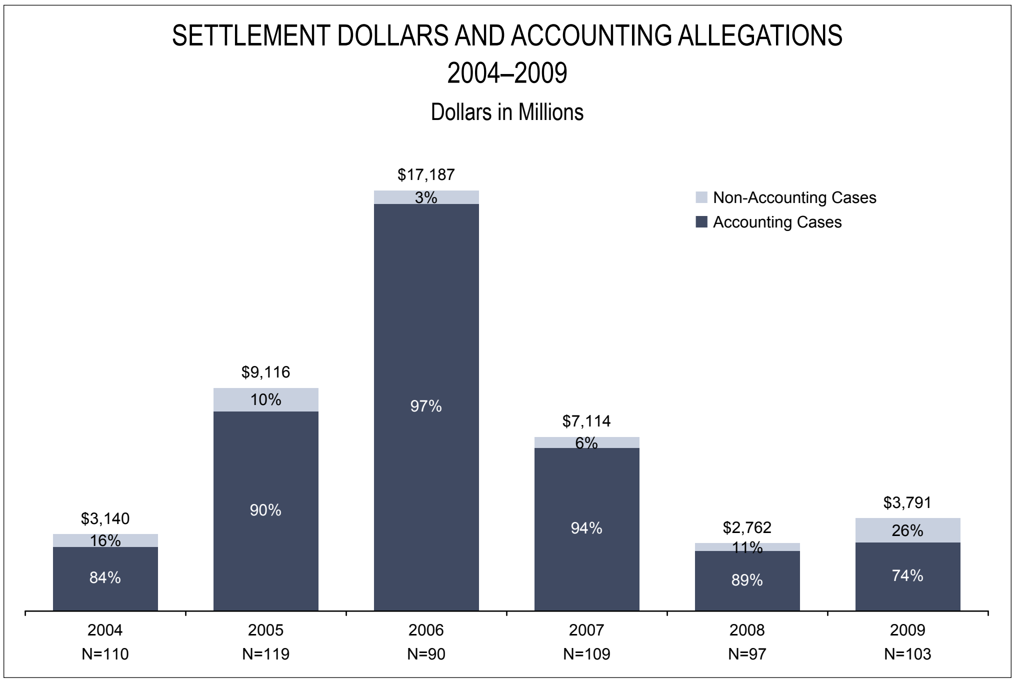


Figure 4

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

A relatively small number of cases with unusually large settlements contributed to the differences in average settlement outcomes between accounting and non-accounting cases. In our sample, all non-accounting cases settled for $200 million or less. In contrast, more than 5 percent of accounting cases settled for amounts in excess of $300 million (mega-settlements). Accounting cases also resulted in higher median settlement outcomes: $9 million versus $6 million for accounting and non-accounting cases, respectively (Figure 5).

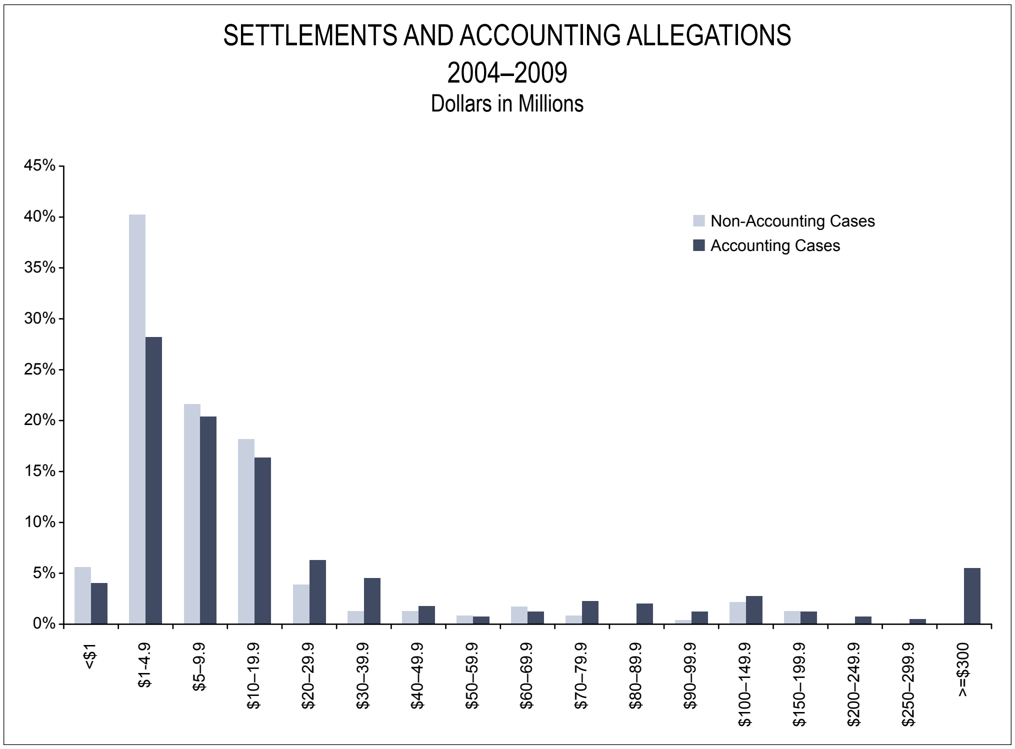


Figure 5

FILINGS AND SETTLEMENTS WITH ACCOUNTING ALLEGATIONS

The five largest settlements, which together accounted for almost half of the total settlement dollars from 2004 through 2009, were all accounting cases (Figure 6). In fact, 19 of the 20 largest settlements in this time period were accounting cases. Three of the five largest settlements occurred in 2006 and together represented 64 percent of total settlement dollars in that year.

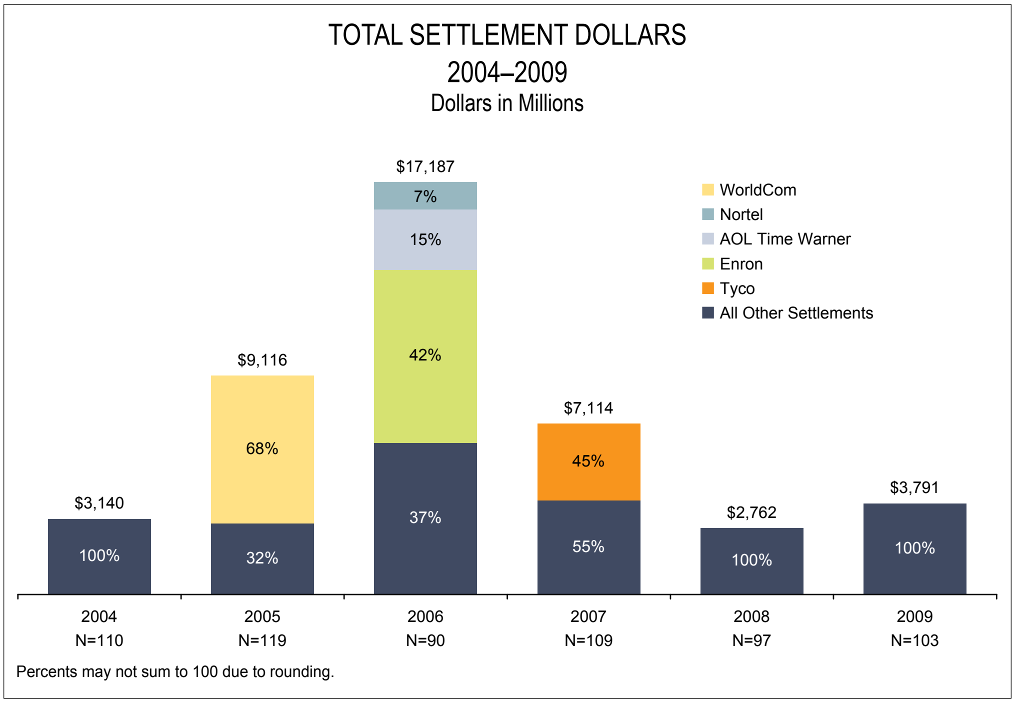


Figure 6

CHARACTERISTICS OF ACCOUNTING CASES

To understand better the nature of accounting cases, we examined the accounting allegations associated with settled cases (Figures 7 and 8). Below we discuss various characteristics of accounting cases associated with higher settlement outcomes.

ACCOUNTING SETTLEMENTS BOX SCORE
2004–2009

	2004	2005	2006	2007	2008	2009	All Years
Accounting Settlements	**52**	**65**	**52**	**67**	**68**	**52**	**356**
General Characteristics							
SEC Action	38.5%	23.1%	44.2%	38.8%	26.5%	38.5%	34.3%
Restatement	51.9%	60.0%	55.8%	61.2%	57.4%	61.5%	58.1%
Write-down	21.2%	21.5%	26.9%	16.4%	19.1%	26.9%	21.6%
Allegations							
Internal Control Weaknesses	26.9%	40.0%	38.5%	58.2%	55.9%	65.4%	48.0%
With Announcement of Internal Control Weaknesses	1.9%	10.8%	25.0%	44.8%	14.7%	51.9%	24.7%
Without Announcement of Internal Control Weaknesses	25.0%	29.2%	13.5%	13.4%	41.2%	13.5%	23.3%
Revenue Recognition[1]	32.7%	35.4%	46.2%	29.9%	11.8%	19.2%	28.7%
Expense Recognition[2]	23.1%	20.0%	15.4%	25.4%	27.9%	32.7%	24.2%
Revenue and Expense Recognition	34.6%	32.3%	25.0%	37.3%	50.0%	40.4%	37.1%
Overstated Loans	5.8%	7.7%	13.5%	11.9%	10.3%	13.5%	10.4%
Overstated Goodwill	7.7%	16.9%	13.5%	19.4%	8.8%	17.3%	14.0%
Overstated Inventory	23.1%	23.1%	13.5%	19.4%	19.1%	17.3%	19.4%
Overstated Receivables	48.1%	52.3%	34.6%	58.2%	36.8%	32.7%	44.4%
Understated Liabilities	9.6%	13.8%	36.5%	34.3%	48.5%	26.9%	28.9%

1 Excludes cases where there was an allegation related to expense recognition.
2 Excludes cases where there was an allegation related to revenue recognition.

Figure 7

CHARACTERISTICS OF ACCOUNTING CASES

ACCOUNTING SETTLEMENTS BOX SCORE
2004–2009
Dollars in Millions

	Median	Mean	Minimum	Maximum	# of Cases
Accounting Settlements	**$9.00**	**$106.60**	**$0.23**	**$7,230.50**	**356**
General Characteristics					
SEC Action	$18.80	$262.70	$0.75	$7,230.50	122
Restatement	$10.00	$148.88	$0.44	$7,230.50	207
Write-down	$6.00	$53.96	$0.28	$1,142.78	77
Allegations					
Internal Control Weaknesses	$10.00	$117.06	$0.44	$6,156.10	171
With Announcement of Internal Control Weaknesses	$12.38	$113.75	$0.69	$3,200.00	88
Without Announcement of Internal Control Weaknesses	$9.00	$120.57	$0.44	$6,156.10	83
Revenue Recognition[1]	$6.63	$117.98	$0.44	$7,230.50	102
Expense Recognition[2]	$12.63	$98.84	$0.23	$3,200.00	86
Revenue and Expense Recognition	$11.35	$123.73	$0.55	$6,156.10	132
Overstated Loans	$24.00	$290.51	$0.23	$7,230.50	37
Overstated Goodwill	$10.53	$314.27	$1.20	$6,156.10	50
Overstated Inventory	$7.55	$39.50	$0.55	$1,142.78	69
Overstated Receivables	$9.00	$119.56	$0.23	$6,156.10	158
Understated Liabilities	$10.50	$122.01	$0.28	$7,230.50	103

1 Excludes cases where there was an allegation related to expense recognition.
2 Excludes cases where there was an allegation related to revenue recognition.

Figure 8

CHARACTERISTICS OF ACCOUNTING CASES

The SEC brought actions against defendants, as evidenced by the filing of a litigation release or administrative proceeding, in approximately one-third of the accounting settlements in our sample. In contrast, as reported in *Securities Class Action Settlements: 2009 Review and Analysis,* SEC actions occurred in approximately 25 percent of all post–Reform Act settlements (settlements from 1996 through 2009). This difference suggests that the SEC is more likely to investigate and bring actions in accounting cases. Moreover, of the accounting cases settled from 2004 through 2009, those that involved SEC actions were associated with significantly higher settlements (Figure 9). SEC actions, which are more common for accounting than non-accounting cases, provide at least a partial explanation for the earlier observation that accounting cases result in higher settlement outcomes (Figure 5).

Accounting cases with and without SEC involvement had median settlements of $19 million and $7 million, respectively. This difference was particularly marked (and steadily increased) from 2005 to 2008, but narrowed significantly in 2009. At this stage, it is not possible to determine if the reduced difference in 2009 represents a fundamental change in settlement outcomes going forward.

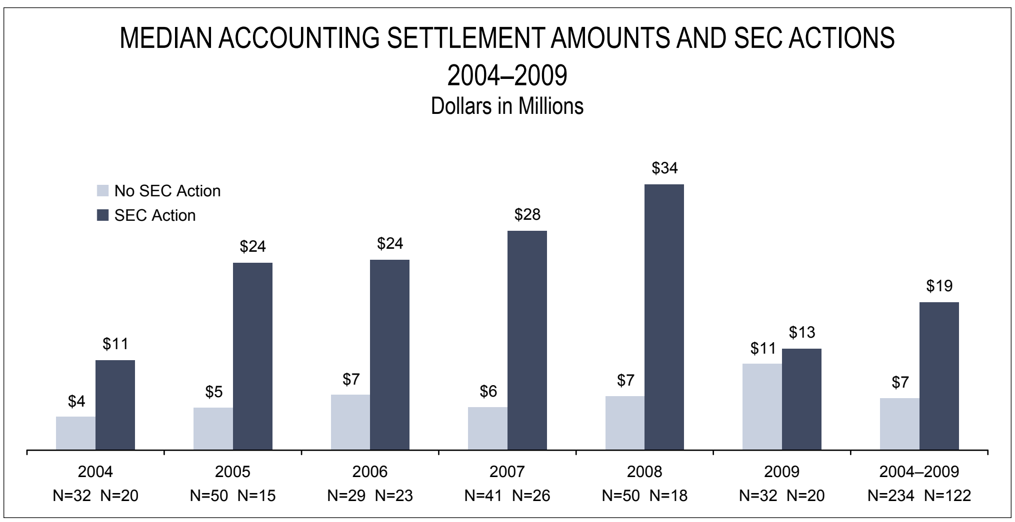


Figure 9

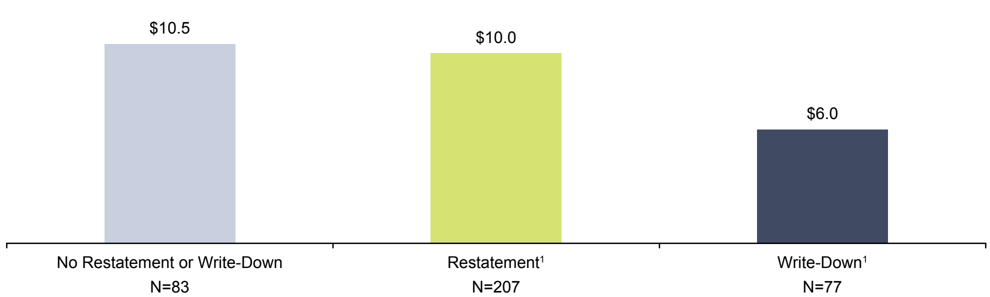
CHARACTERISTICS OF ACCOUNTING CASES

We also examined the impact of two different types of accounting events: restatements and write-downs of assets. Under GAAP,[4] a company should restate its financial statements to correct errors, whereas a company may write down an asset to reflect a change in the company's current estimate of the fair market value of the asset.

Cases in which the defendant restated its financial statements do not appear to have translated into higher settlement amounts in recent years. The median settlement for accounting cases referencing restatements[5] was $10.0 million versus $10.5 million for cases referencing neither restatements nor write-downs, a difference that is more likely to reflect random variation in the data than a genuine difference in settlement outcomes (Figure 10).[6]

Median settlements for accounting cases involving asset write-downs were significantly lower than restatement-related accounting cases: $6 million versus $10 million, respectively. Cases including asset write-downs also resulted in significantly lower settlements than cases that referenced neither restatements nor write-downs. One possible explanation is that allegations in cases with write-downs, including allegations that the write-downs should have been taken sooner, may be more difficult to prove than allegations in other cases and thus may result in lower settlement amounts.

MEDIAN ACCOUNTING SETTLEMENT AMOUNTS AND ACCOUNTING EVENTS
2004–2009
Dollars in Millions



1 There are 11 cases in which both restatement and write-down occurred.

Figure 10

CHARACTERISTICS OF ACCOUNTING CASES

Not only are restatements not associated with higher settlement outcomes, but the frequency of filings with restatements has been steadily declining since 2006. The total number of accounting filings that referenced restatements declined 53 percent from 2004 through 2009, from 34 in 2004 to 16 new filings in 2009 (Figure 11). In 2005 and 2006 the majority of accounting filings referenced restatements, whereas in 2008 and 2009 only one-fourth of accounting filings did so. It is possible that improvements in corporate governance and internal controls resulting from SOX requirements, which companies began implementing in 2004,[7] have led to a decrease in restatements and restatement-related class actions.

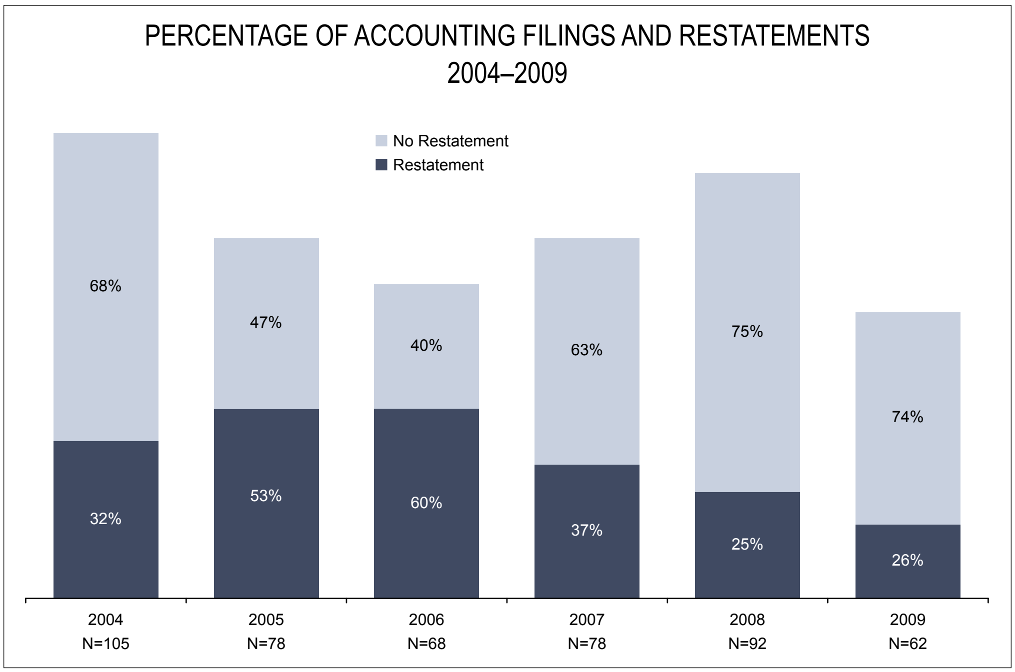


Figure 11

CHARACTERISTICS OF ACCOUNTING CASES

Accounting cases with restatements, compared with accounting cases without restatements, are more likely to settle. On average, 58 percent of accounting settlements included restatements compared with 39 percent of accounting cases filed. Moreover, the number of accounting settlements with restatements as a proportion of all accounting settlements increased over this time period, from 52 percent in 2004 to 62 percent in 2009 (Figure 7). In each year of our sample, with the exception of 2004, accounting cases with restatements were more likely to settle and less likely to be dismissed. For example, of new cases filed in 2005, 71 percent of those with restatements had settled by 2009 (Figure 12). In contrast, only 51 percent of cases without restatements had reached settlement, with 41 percent having been dismissed.

Figure 12

CHARACTERISTICS OF ACCOUNTING CASES

We also examined the relation between internal control weaknesses (alleged by plaintiffs or announced by the defendant) and settlement outcomes. Of accounting settlements that included allegations of internal control weaknesses, about half included announcements of internal control weaknesses by defendants. Complaints that included mention of a company's announcement of internal control weaknesses always included allegations of internal control weaknesses. Cases with both allegations and announcements of internal control weaknesses had a median settlement amount of $12.4 million (Figure 13), significantly higher than cases with allegations but no announcements ($9.0 million) and cases with no mention of internal controls at all ($8.0 million).

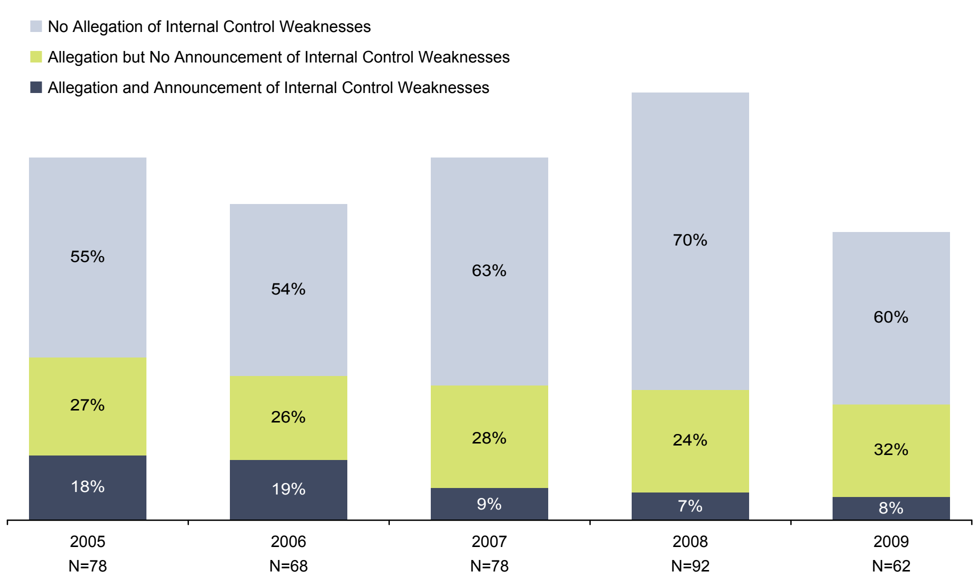
MEDIAN ACCOUNTING SETTLEMENT AMOUNTS AND
INTERNAL CONTROL WEAKNESSES
2004–2009

Figure 13

CHARACTERISTICS OF ACCOUNTING CASES

These settlement outcomes may have led, in part, to the persistence of cases with allegations of internal control weaknesses. Filings alleging internal control weaknesses as a percentage of all accounting filings increased from 31 percent in 2008 to 40 percent in 2009. Overall, however, the number of filings with alleged weakness in internal controls has decreased, dropping from 35 filings in 2005 to 25 filings in 2009. This decrease is consistent with the decrease in the number of filings referencing company announcements of internal control weaknesses. The latter has declined in recent years, from 18 percent of accounting filings in 2005 to 8 percent in 2009 (Figure 14),[8] perhaps as a result of SOX. It is possible that improvements in corporate governance and internal controls as a result of SOX, whose requirements companies began to implement in 2004, have led to a decrease in announcements of, and allegations claiming, internal control weaknesses.

PERCENTAGE OF ACCOUNTING FILINGS AND INTERNAL CONTROL WEAKNESSES
2005–2009



Percents may not sum to 100 due to rounding.

Figure 14

CONCLUSION

Although the challenging economic environment that continued through 2009 resulted in a year-over-year decline in the number of initial filings, the number of 2009 filings remained within historical averages. Accounting-related allegations remain a common feature of both new filings and settlements. Accounting class actions tend to be more complex than non-accounting cases and are more likely to result in settlement rather than dismissal. Accounting cases also result in higher settlement outcomes, especially cases in which a company faces an SEC action. Cases filed in recent years and in conjunction with the 2008 stock market decline and resulting turmoil in the financial markets have yet to reach conclusion, and may affect settlement patterns in the future.

ENDNOTES

1 Settlements are identified by RiskMetrics Group's Securities Class Action Services (SCAS). Settlement year is the year in which the hearing to approve the settlement was held. Consistent with *Securities Class Action Settlements: 2009 Review and Analysis,* cases involving multiple settlements are reflected in the year of the most recent partial settlement, provided certain conditions are met. These conditions are described in further detail in *Securities Class Action Settlements: 2009 Review and Analysis*.

2 Cornerstone Research, *Securities Class Action Filings—2009: A Year in Review*.

3 Cornerstone Research, *Securities Class Action Settlements: 2009 Review and Analysis*.

4 Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*—a replacement of APB Opinion No. 20 and FASB Statement No. 3.

5 Most recent complaint prior to settlement refers to an announcement during or subsequent to the class period that the defendant company will restate, may restate, or has unreliable financial statements. No distinction is made between restatements that occurred during or after the class period. Restatements made prior to the beginning of the class period are not included.

6 Mega-settlements often involve cases referencing restatements. For example, eight out of the top ten largest settlements during 2004 through 2009 included a restatement. The mean (as opposed to the median as used above) settlement for accounting cases referencing restatements was $149 million versus $35 million for cases referencing neither a restatement nor a write-down.

7 Under the provisions of Section 404 of the Sarbanes-Oxley Act, public companies and their independent auditors are each required to report on the effectiveness of a company's internal controls. For accelerated filers (companies with a public float in excess of $75 million) this requirement became effective for fiscal years ending on or after November 15, 2004

8 Since companies first began implementing SOX in 2004, we have included data starting from 2005 for purposes of year-over-year comparability.

Boston
617.927.3000

Los Angeles
213.553.2500

Menlo Park
650.853.1660

New York
212.605.5000

San Francisco
415.229.8100

Washington
202.912.8900

www.cornerstone.com