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ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

Accounting Class Action Filings and Settlements

2011 Review and Analysis

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INTRODUCTION

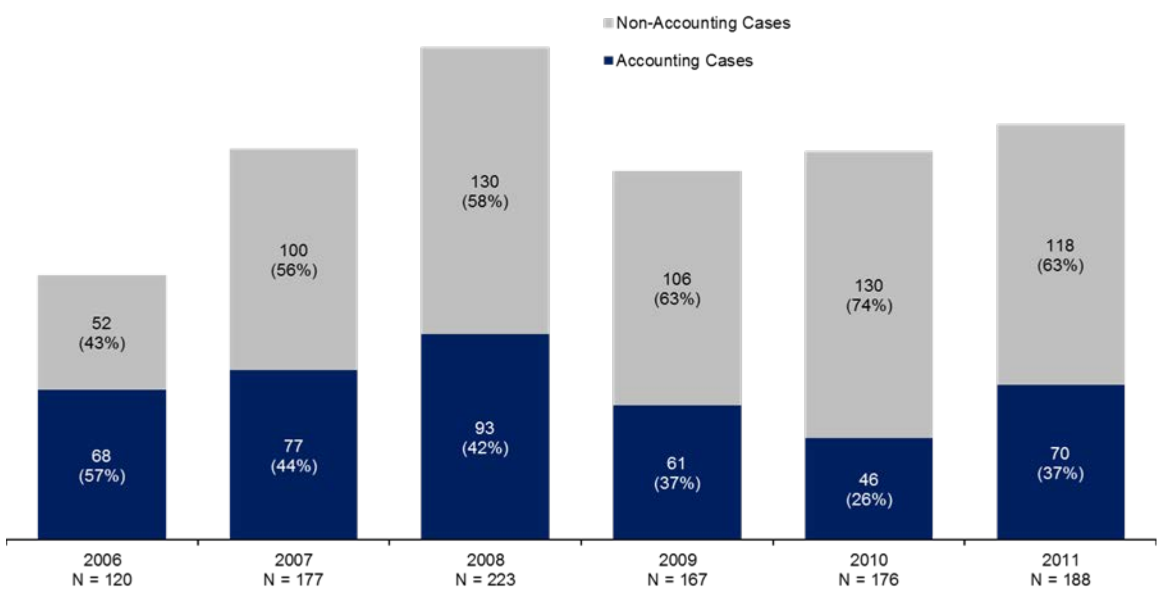
Our study of securities class actions involving accounting allegations through 2011 is conducted on the eve of the tenth anniversary of the passage of the Sarbanes-Oxley Act (SOX). The past year has also seen a waning of initial filings related to the credit crisis. At the same time, 2011 was marked by increased stock market volatility and the expansion of case filings involving companies headquartered in China (Chinese reverse merger cases). These factors have created a dynamic environment for securities class action litigation, particularly for cases involving accounting allegations.

In this report, we highlight the unique characteristics of securities cases involving accounting allegations and introduce a new analysis on the evolution of accounting allegations as cases move through the litigation process.

CASE FILINGS

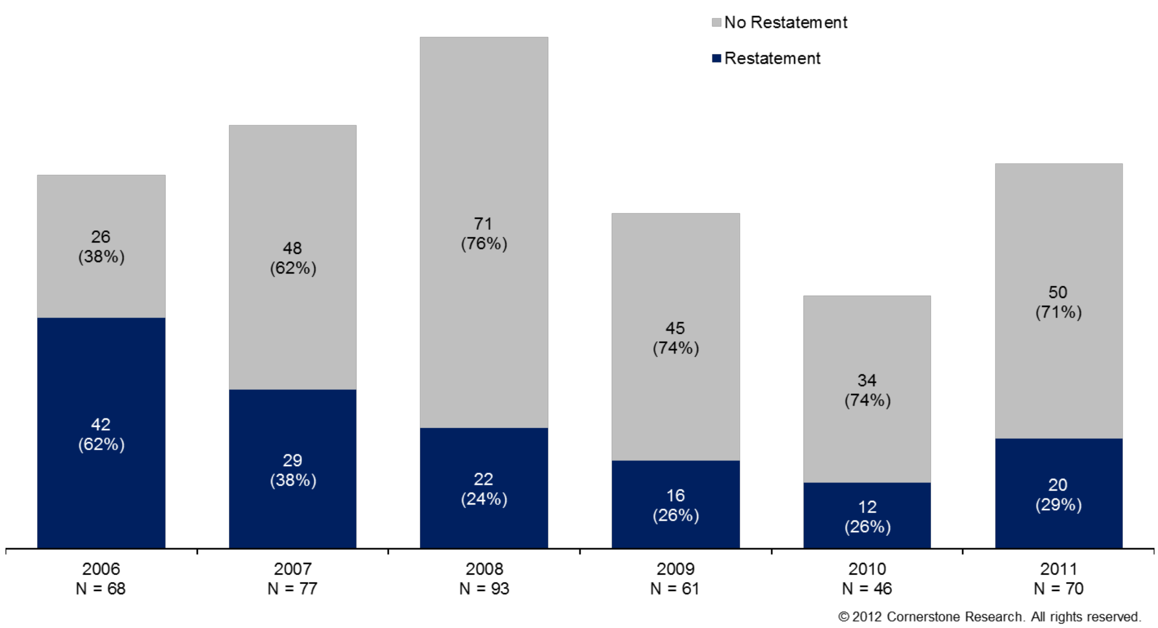
During 2011, the number of securities class action filings that involved accounting allegations (accounting cases) increased in both number and as a proportion of total securities case filings, compared with 2010, which had the lowest number of accounting case filings in recent years (see Figure 1). Not only did the number of accounting case filings increase from 46 in 2010 to 70 in 2011, but the proportion of total case filings represented by accounting cases increased from 26 percent to 37 percent. We attribute this increase in part to an increase in the number of Chinese reverse merger case filings in 2011. As discussed in *Securities Class Action Filings—2011 Year in Review* (*2011 Filings Report*), Chinese reverse merger cases are significantly more likely to involve restatements of financial statements, and as a result, plaintiffs are more likely to allege violations of generally accepted accounting principles (GAAP) in those cases than in other types of securities class actions.

FIGURE 1: FILINGS AND SHARE OF ACCOUNTING CASES
2006–2011



In 2011, the number of accounting case filings involving financial statement restatements increased, reversing a four-year trend of declines (see Figure 2). In recent years, declines in the number of financial statement restatements by publicly traded firms have been widely attributed to improved corporate governance practices as a result of SOX. The latest study on restatement frequencies by Audit Analytics,[1] however, reported an increase in the number of restatements in 2010, which may be contributing to the increase in 2011 case filings involving restatements.

FIGURE 2: ACCOUNTING CASE FILINGS AND RESTATEMENTS
2006–2011

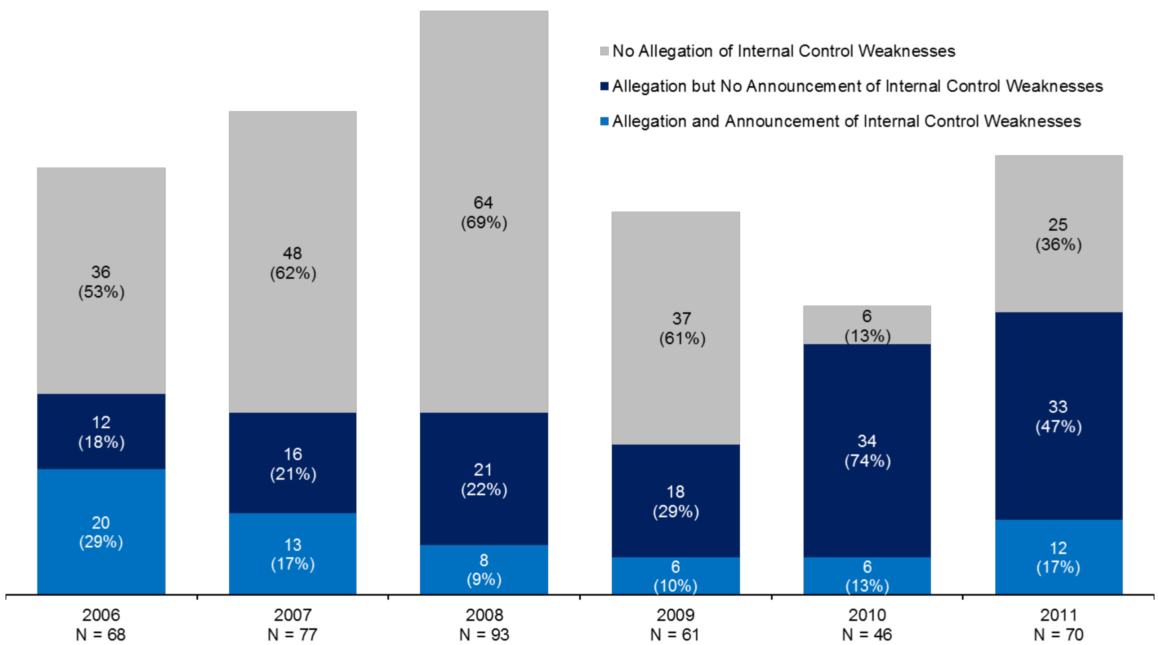


The number of filings involving restatements increased in 2011, reversing a four-year trend of declines.

[1] See Audit Analytics, *2010 Financial Restatements: A Ten Year Comparison*, May 2011.

For the second consecutive year, more than 60 percent of accounting case filings included allegations of internal control weaknesses (see Figure 3). These allegations relate to compliance with the reporting requirements of SOX Section 404. Thus, the increase in these allegations is relevant to the ongoing debate regarding the costs and benefits of SOX. In 2011, only 17 percent of initial filings with these claims were accompanied by company announcements reporting the presence of internal control weaknesses over financial reporting.[2] Accordingly, plaintiffs may believe that including these claims will bolster their position in litigation, regardless of whether material internal control weaknesses were actually present.

FIGURE 3: ACCOUNTING CASE FILINGS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES 2006–2011



More than 60% of accounting case filings included allegations of internal control weaknesses.

[2] Determination of whether an accompanying announcement of internal control weaknesses was made was based on whether the first identified complaint referred to an announcement during or subsequent to the class period that the company had a weakness or weaknesses in internal controls over financial reporting.

CASE STATUS AND PROGRESSION

Figures 4a and 4b present the status of cases categorized by the year in which the case was filed. As shown, accounting cases are typically less likely to be dismissed than non-accounting cases. For example, of the securities class actions filed in 2006, only 38 percent of accounting cases were dismissed by the end of 2011, compared with 46 percent of non-accounting cases. Following from the lower dismissal rate, accounting cases are more likely to settle than non-accounting cases. For example, 56 percent of the accounting cases filed in 2006 were settled by the end of 2011, compared with 50 percent of non-accounting cases. The differences among 2007 and 2008 cases are even more pronounced. In 2007 and 2008, 55 percent and 38 percent of respective accounting cases had settled by the end of 2011, compared with only 36 and 20 percent of respective non-accounting cases. Figures 4a and 4b also show that accounting cases continue to take a longer time to resolve than non-accounting cases. For example, of the class actions filed in 2010, 85 percent of accounting cases were continuing at the end of 2011, compared with only 55 percent of non-accounting cases. Similarly, for cases filed in 2011, 19 percent of non-accounting cases had already been resolved, compared with only 6 percent of accounting cases.

FIGURE 4A: STATUS OF ACCOUNTING CASES
2006–2011

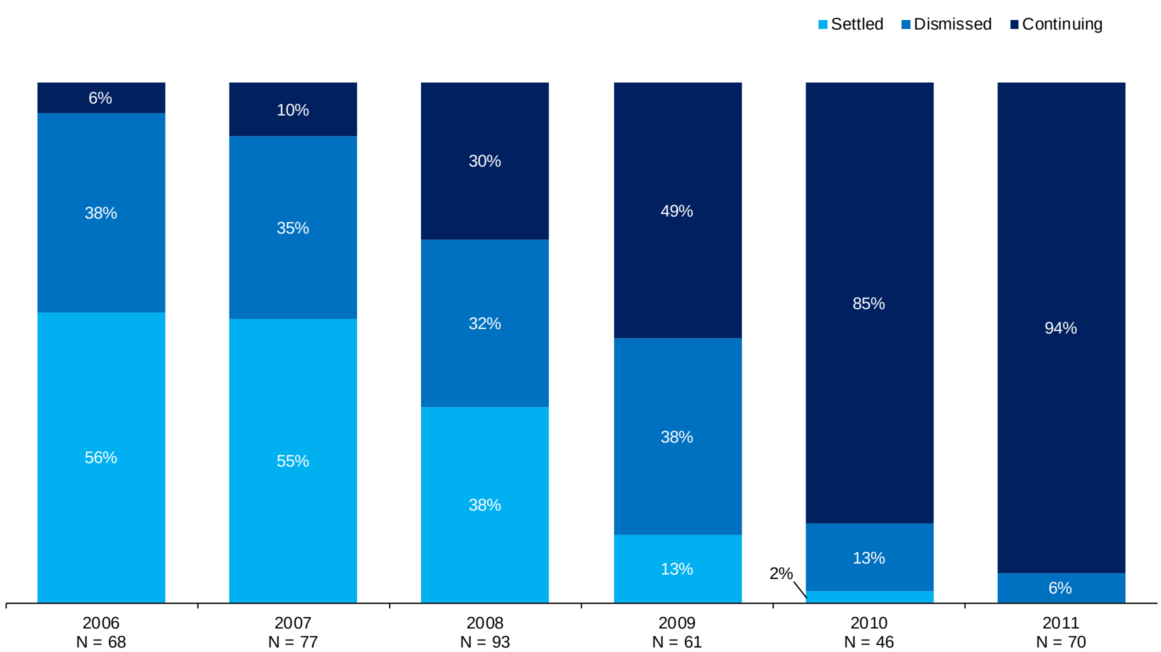
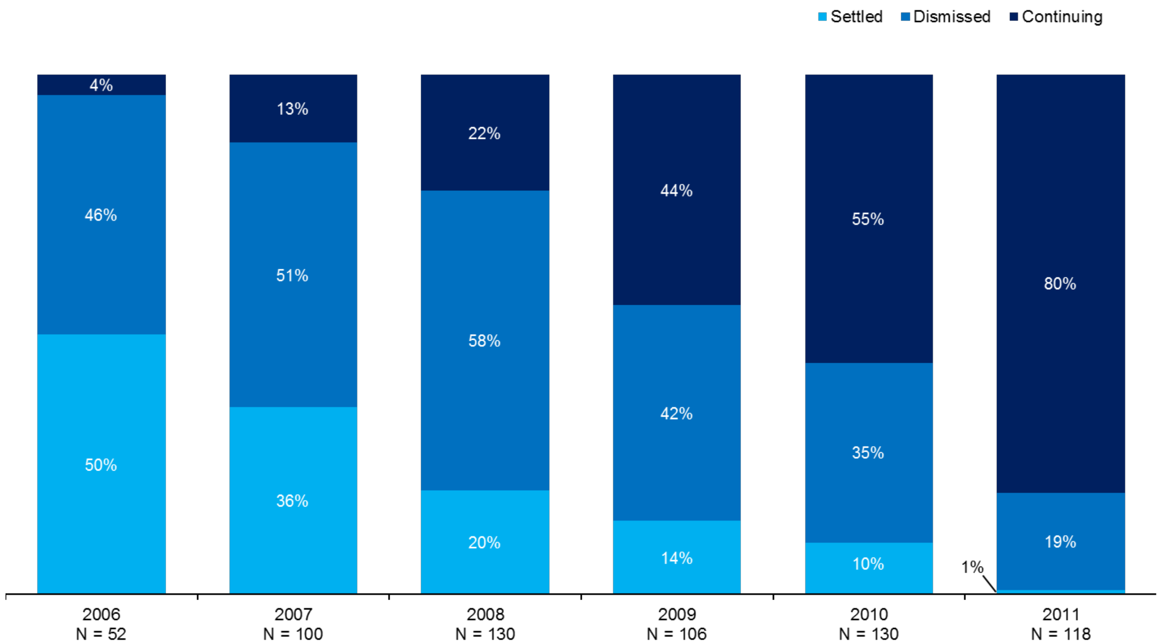


FIGURE 4B: STATUS OF NON-ACCOUNTING CASES 2006–2011



Accounting cases are typically less likely to be dismissed than non-accounting cases.

For cases that have reached disposition, Figures 5a and 5b present the stage at which the case is resolved for accounting cases and non-accounting cases, respectively. As shown, 27 percent of non-accounting cases were voluntarily dismissed prior to a ruling on motion to dismiss, compared with only 8 percent of accounting cases. For those cases that reached a ruling on motion to dismiss, a higher percentage of accounting cases settled prior to a ruling on summary judgment, compared with non-accounting cases. A relatively low percentage of both accounting and non-accounting cases reached a ruling on summary judgment.

FIGURE 5A: PORTION OF RESOLVED CASES ADVANCING TO DIFFERENT LITIGATION STAGES, ACCOUNTING CASES 2006–2011

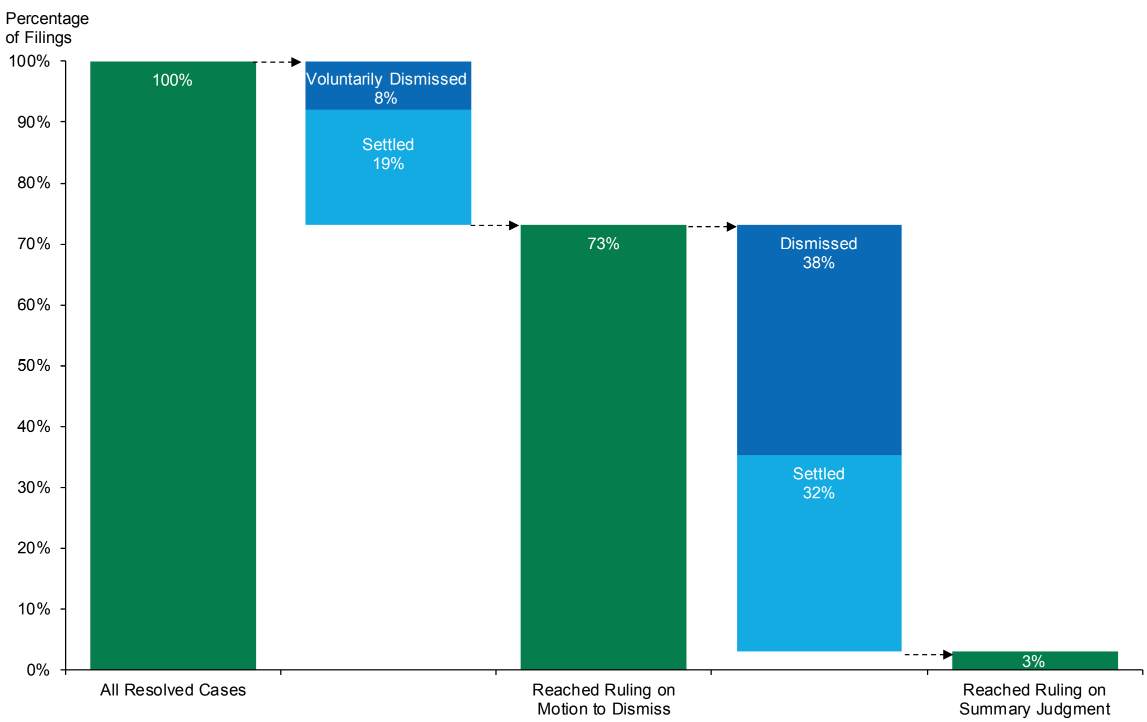
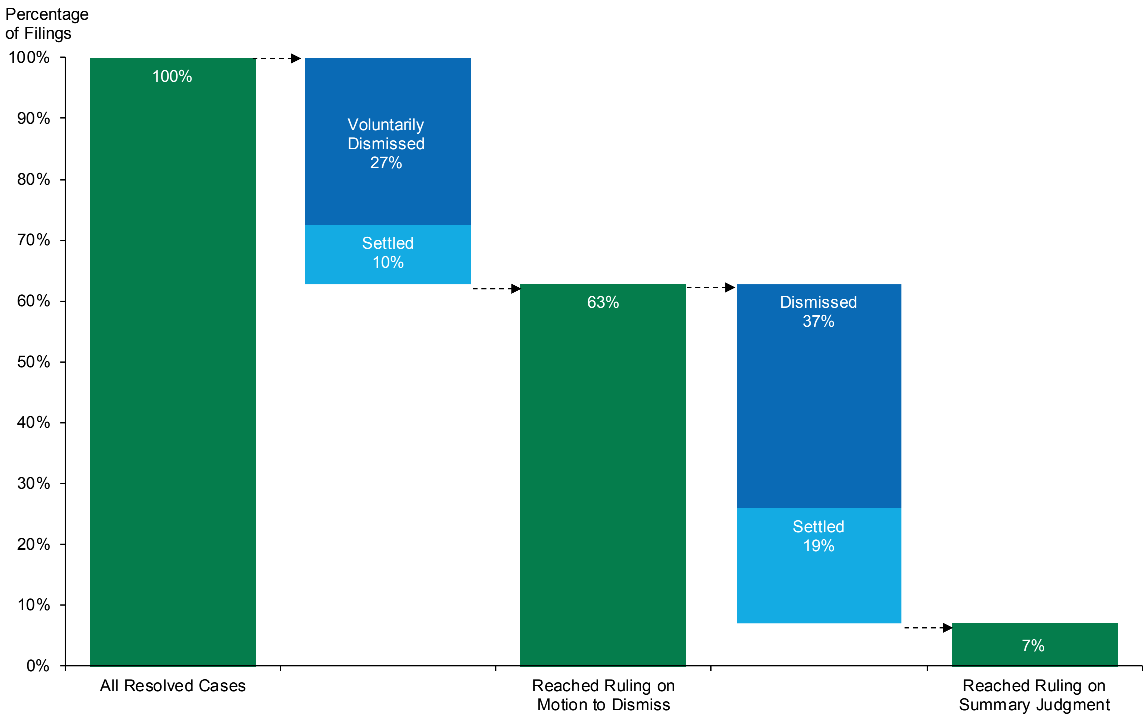


FIGURE 5B: PORTION OF RESOLVED CASES ADVANCING TO DIFFERENT LITIGATION STAGES, NON-ACCOUNTING CASES 2006–2011



As cases advance through the litigation process, we anticipate that accounting allegations will evolve. In this year's study, we examine changes between initial and amended complaints.

In addition to 188 new class actions (as shown in Figure 1), plaintiffs also filed amendments to 164 cases during 2011. Of these cases, 163 were initially filed between 2006 and 2011, the time period covered by our analysis.

The initial complaints in 66 of the 163 cases contained accounting allegations (approximately 40 percent). The majority of these cases were amended only once. In cases that were amended two or more times, we compared the most recent amendment with its corresponding initial filing. Accounting allegations were more likely to be added in amended complaints than dropped, though we observed both additions and deletions in our sample.

Amendments to complaints frequently resulted in changes to class periods. In 44 of the 77 cases we examined (representing 57 percent of the total), class periods in amended complaints differed from those in their corresponding initial complaints.[3] As expected, class periods in cases with short filing lags—defined as the number of days separating the end of the class period from the date that the initial complaint was filed—were more likely to be extended in amended complaints. As shown in Figure 6, the median filing lag for the 44 cases with changes in class periods was 16 days, less than the 24-day median for the 33 cases with no changes in class periods.

FIGURE 6: CHANGES IN CLASS PERIODS
2006–2011

	No Change in Class Period	Any Change in Class Period	Class End Date Moved Forward
Number of Cases	33	44	27
Median Filing Lag	24	16	13
Cases with New Accounting Allegations	11	24	15
Percent of Cases with New Accounting Allegations	33%	55%	56%

Where information regarding class period start and/or end dates was incomplete or missing, the case was included in the group having no change in class period. To avoid counting minor changes in class dates—which may reflect corrections made by plaintiffs to, for example, account for disclosures made after market close—we do not consider changes in class start or end dates of three days or fewer to be changes in the class period. “Any Change in Class Period” includes amended complaints that moved the class start and/or end dates either forward or backward. “Class End Date Moved Forward” includes only amended complaints that moved class end dates forward. Filing lag is the time between the class end date (in an initial filing) and the date on which the complaint was filed.

Figure 6 also shows that in 27 of the 44 cases with changes to the class period, plaintiffs extended the class end dates (i.e., the class end dates were moved forward). We investigated the reasons for these extensions by reviewing the amended complaints for additional announcements or events subsequent to the initial class end date. Further analysis shows that in those 27 cases, 16 had announcements or events that were accounting-related. Examples of these announcements include investigations of accounting irregularities by regulators, auditor resignations, or announcements of restatements of financial statements.

Furthermore, we found that 11 of the 16 cases that extended class periods to include accounting-related announcements also added new accounting allegations. These accounting-related announcements may explain, at least in part, why we see that plaintiffs are more likely to add new allegations to cases whose class periods were extended than to those that did not change (56 percent versus 33 percent).

Extensions of class periods often include accounting-related events.

[3] The 77 cases we examined include 66 cases with accounting allegations in initial filings and 11 cases where plaintiffs introduced accounting allegations in an amended filing.

Of the 66 initial filings that included accounting allegations, 62 included allegations that the company violated GAAP, as shown in Figure 7. Plaintiffs added allegations related to GAAP, internal controls, and/or auditing in amended complaints in which these allegations had not previously existed. As shown in Figure 7, 13 cases that had no GAAP allegations in their initial filings had GAAP allegations added in their amended filings; similarly, 15 cases added internal control allegations, and 11 added allegations related to auditing.[4] In addition, further analysis shows that 29 of the 62 cases that included GAAP allegations in their initial complaints had new GAAP allegations added in their amended filings. For example, amended complaints included additional allegations regarding improper revenue recognition, failure to write down goodwill in a timely fashion, and insufficient disclosures regarding risks and uncertainties.

Accounting allegations were much less likely to be dismissed or dropped. Only four amended complaints dropped all allegations related to GAAP; similarly, only four amendments dropped internal control allegations, and only three dropped auditing allegations.

FIGURE 7: EVOLUTION OF ACCOUNTING ALLEGATIONS 2006–2011

	GAAP	Internal Controls	Auditing
Initial Filings	62	37	8
Accounting Allegations Added	13	15	11
Accounting Allegations Dropped	(4)	(4)	(3)
Most Recently Amended Filings	71	48	16

We define "GAAP" as a group that includes allegations of failures to present financial information in accordance with U.S. generally accepted accounting principles and present the number of complaints that include at least one allegation from this group. Similarly, we define "Internal Controls" as a group that includes allegations of weaknesses in internal control over financial reporting and define "Auditing" as a group that includes allegations that the independent financial statement auditor failed to perform its audit in accordance with professional standards. We counted the cases as adding to these categories only when no other allegation of this type was previously made (e.g., an allegation of improper revenue recognition was added in an amended complaint, but there were no GAAP allegations in the initial complaint).

[4] A total of 24 amended complaints added accounting allegations. Since plaintiffs added more than one type of allegation in some of the amended complaints, there were a total of 39 accounting allegations added, as shown in Figure 7.

Not surprisingly, amended complaints that added auditing allegations also added auditors as defendants. However, the accounting-related defendants that were most frequently added through amended complaints were not auditors, but rather members of audit committees: the number of accounting cases that named audit committee members increased from five (fewer than one in 10 initial complaints) to 21 (more than one in four amended complaints), as shown in Figure 8 below.

FIGURE 8: EVOLUTION OF ACCOUNTING DEFENDANTS 2006–2011

	Company Accounting Personnel	Audit Committee	Auditor
Initial Filings	69	5	8
Defendants Added	3	16	11
Defendants Dropped	(1)	0	(3)
Most Recently Amended Filings	71	21	16

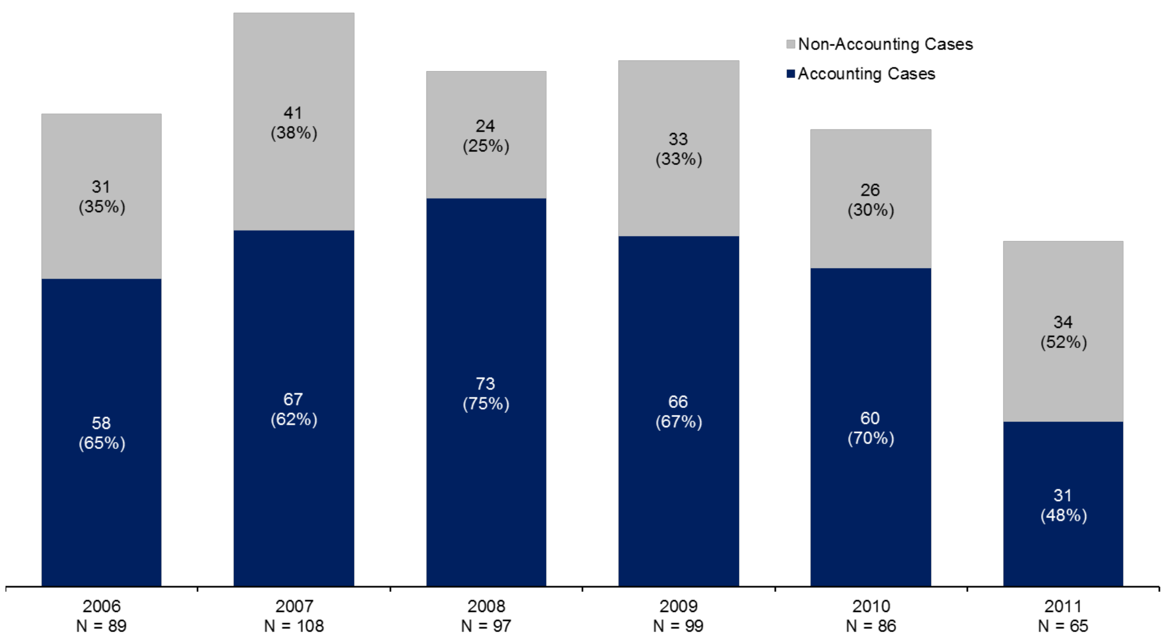
We define "Company Accounting Personnel" as a group of defendants that includes CFOs, CAOs, Controllers, and other employees with accounting roles (e.g., a Director of Finance) and present the number of complaints that include at least one defendant from this group. Similarly, we define "Audit Committee" as a group of defendants that includes members of audit committees and define "Auditor" as a group of defendants that includes independent financial statement auditors. We counted the cases as adding to these categories only when no defendants in the category were previously named (e.g., a member of the Audit Committee was named in an amended complaint but not in the initial complaint).

Members of audit committees were the accounting-related defendants most frequently added in amended complaints.

CASE SETTLEMENTS

For each of the five years preceding 2011, there were more than 85 settlements per year, and in each year, more than 60 percent of those cases involved accounting issues. A sharp decline in the number of settlements occurred in 2011,[5] however, and in contrast to the prior five years, less than half of settlements reached in 2011 were accounting cases.

FIGURE 9: SETTLEMENTS AND SHARE OF ACCOUNTING CASES 2006–2011

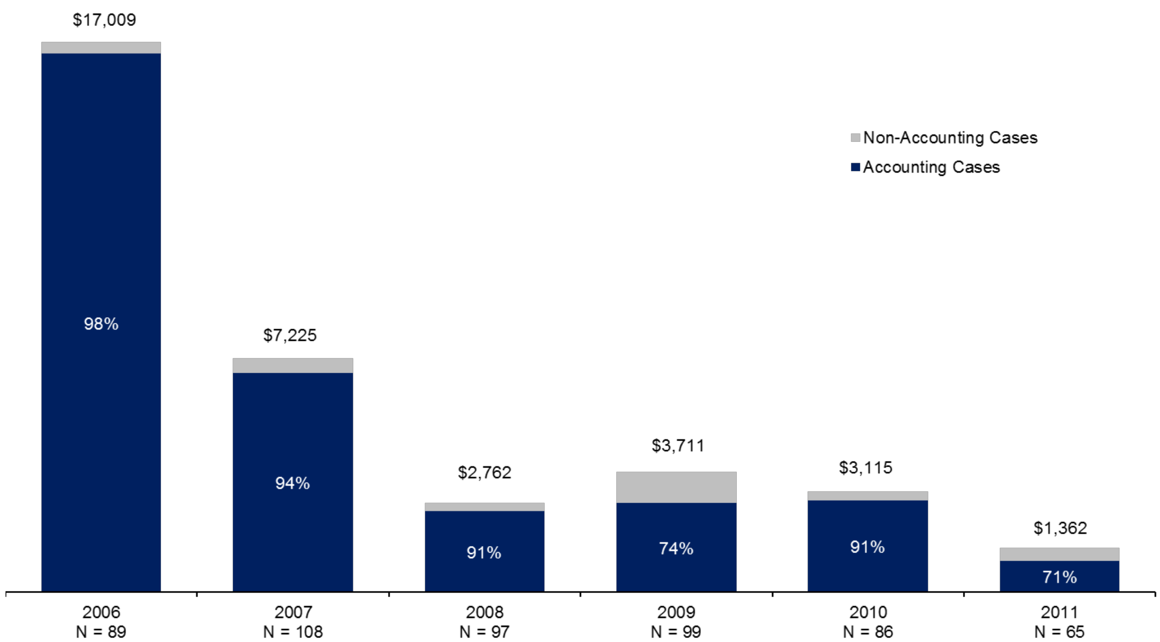


[5] See Cornerstone Research, *Securities Class Action Settlements—2011 Review and Analysis* (*2011 Settlements Report*), for further discussion.

Despite the fact that accounting cases represented less than half of the number of cases settled in 2011, as shown in Figure 10, these cases represented more than 70 percent of the total settlement value in 2011. Moreover, within the prior five-year period, accounting cases have represented as much as 98 percent of the total value of settlements reached and typically have involved substantially higher settlement amounts, compared with non-accounting cases.

FIGURE 10: SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES 2006–2011

Dollars in Millions

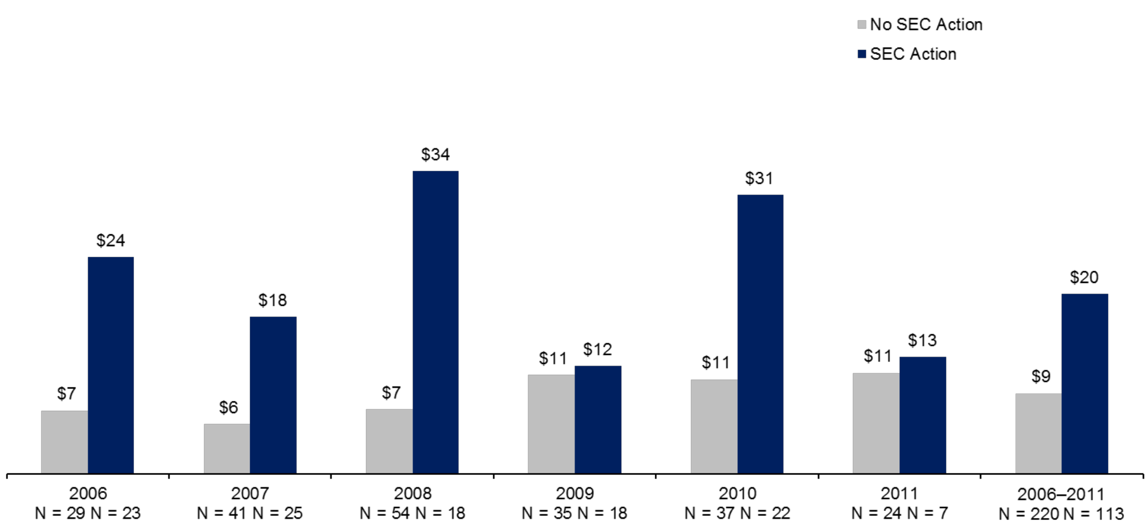


Accounting cases represented more than 70% of 2011 total settlement values.

From 2006 to 2011, approximately 34 percent of all accounting cases involved accompanying SEC actions. This compares with approximately 10 percent for non-accounting cases. As shown in Figure 11, accounting cases involving accompanying SEC actions have settled for higher amounts than accounting cases not involving SEC actions.

FIGURE 11: MEDIAN ACCOUNTING CASE SETTLEMENT AMOUNTS AND SEC ACTIONS 2006–2011

Dollars in Millions

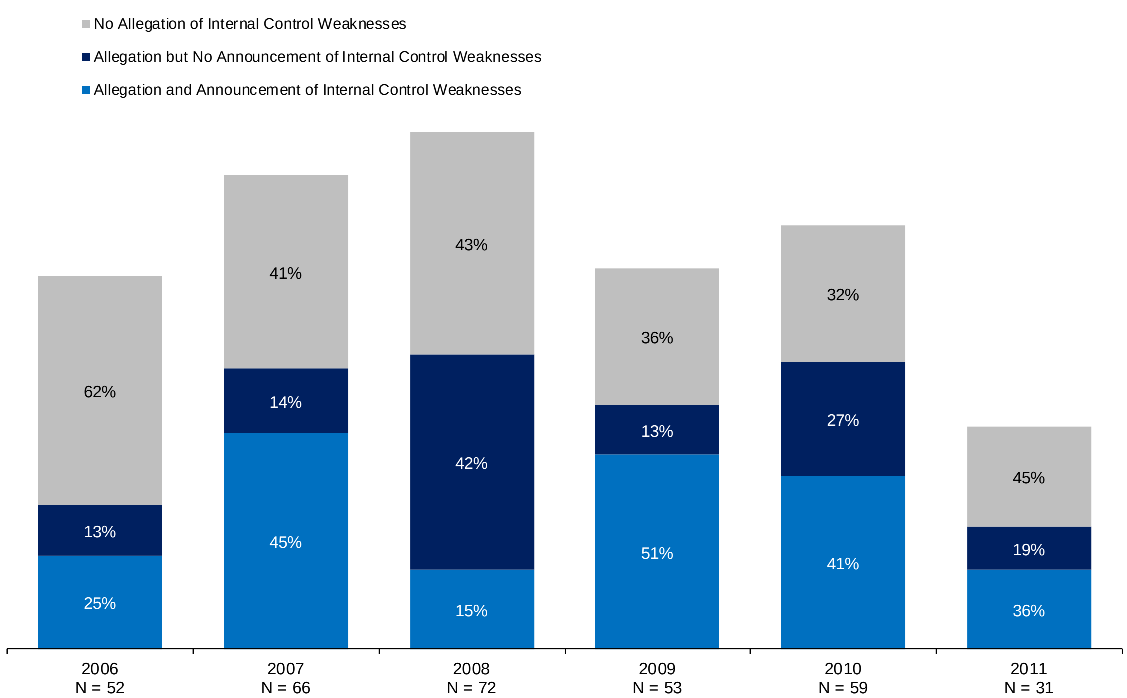


We have investigated the frequency and effect on settlements of different types of accounting allegations, specifically, allegations of internal control weaknesses, the presence of financial statement restatements, and allegations of write-downs. Since a measure of investor losses is the most important factor in determining settlement amounts, in our analysis, we compare not only settlement values but also settlements as a percentage of "estimated damages" for cases with and without these factors.[6]

6 For purposes of our research, we use a measure of investor losses referred to as "estimated damages," which is based on a modified version of a calculation method historically used by plaintiffs in securities class actions. We make no attempt to link these simplified calculations of shareholder losses to the allegations included in the associated court pleadings. Accordingly, we do not intend for "estimated damages" to be indicative of actual economic damages borne by shareholders.

As shown in Figure 12, in each of the five years subsequent to 2006, the majority of accounting cases settled have included allegations of internal control weaknesses. In 2011, 65 percent of settled cases with these allegations were accompanied by statements in the complaint that the company had announced the presence of internal control weaknesses.

FIGURE 12: ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES 2006–2011

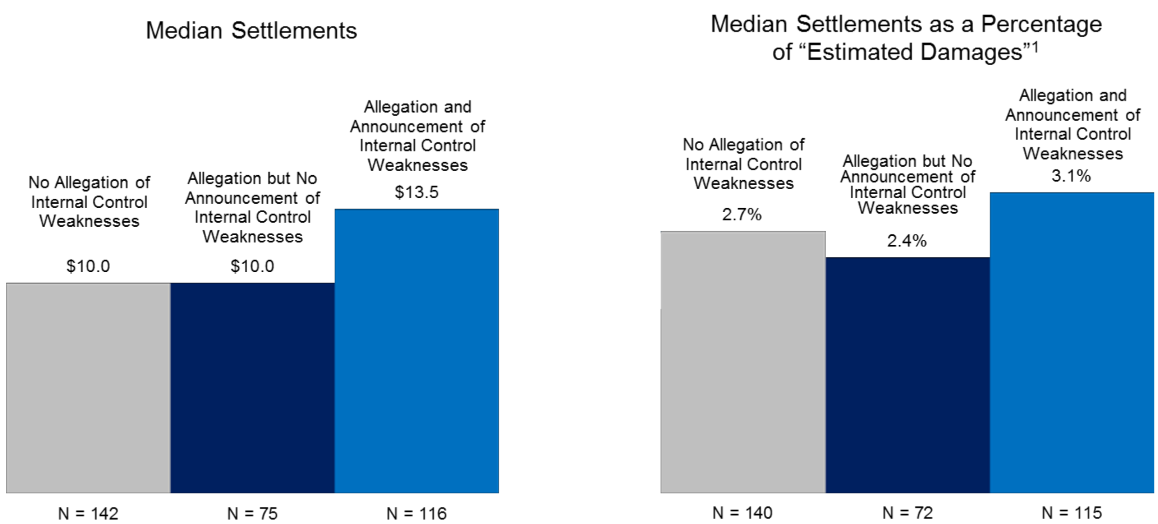


The majority of accounting cases settled include allegations of internal control weaknesses.

Figure 13 shows median settlement amounts and median settlements as a percentage of "estimated damages" for various categories related to the presence of internal control weaknesses. Overall, for cases settled during 2006 to 2011, median settlements tended to be higher both in dollar amounts and as a percentage of "estimated damages" for cases involving internal control weakness allegations with accompanying company announcements.

FIGURE 13: MEDIAN ACCOUNTING CASE SETTLEMENTS AND INTERNAL CONTROL WEAKNESSES
2006–2011

Dollars in Millions



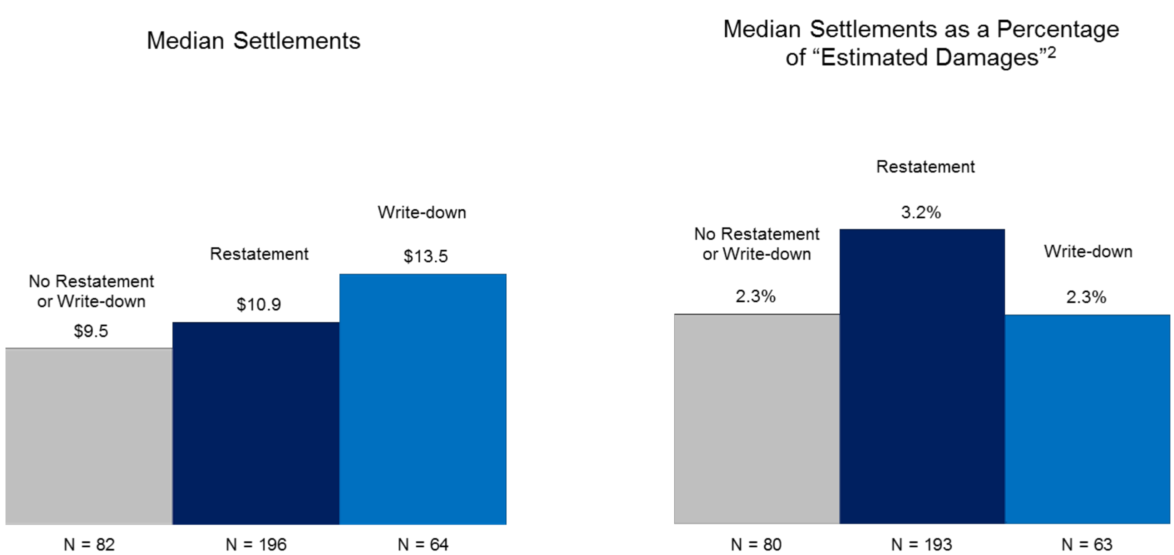
1. Six cases were excluded from "Median Settlements as a Percentage of 'Estimated Damages'" due to unavailable damages data.

When internal control allegations are made without any corresponding company announcement, settlements are not higher either in value or as a percentage of "estimated damages," compared with accounting cases with no internal control allegations. In other words, allegations of internal control weaknesses do not appear to be associated with increases in settlements amounts, unless accompanied by a company announcement noting the presence of internal control weaknesses.

Two major areas of accounting allegations are financial statement restatements and write-downs of assets in financial statements. Financial statement restatements may support plaintiff allegations that a misstatement occurred; however, they do not speak to intent. Write-downs are typically considered as changes in estimates and are accounted for prospectively rather than requiring a financial statement restatement.

As shown in Figure 14, based on the median settlement amount, cases involving write-downs settle for higher values than cases not involving write-downs (even when compared with cases involving restatements). Cases involving financial statement restatements, however, settle for a significantly higher percentage of "estimated damages" compared with cases involving write-downs. This suggests that the higher settlement values (and corresponding lower settlements as a percentage of "estimated damages") associated with cases involving write-downs are due in part to the higher investor losses involved with these cases.

FIGURE 14: MEDIAN ACCOUNTING CASE SETTLEMENTS AND ACCOUNTING EVENTS[1]
2006–2011
Dollars in Millions



1. There are nine cases in which both restatement and write-down occured.
2. Six cases were excluded from "Median Settlements as a Percentage of 'Estimated Damages'" due to unavailable damages data.

CONCLUDING REMARKS

The share of securities class action filings involving accounting allegations increased in 2011, compared with 2010, which had the lowest share of accounting cases since we began collecting data. The number of accounting case filings involving financial statement restatements also increased, reversing a four-year trend of declines in those filings. As we approach the tenth anniversary of the passage of SOX, it is interesting to observe the increase in allegations related to SOX 404 reporting requirements. For the second consecutive year, the majority of accounting cases included allegations of internal control weaknesses, often without a corresponding announcement of such weaknesses by the company.

Based on a new analysis of amended class action filings, we found that accounting allegations were often added beyond those included in the initial complaint. Amended filings also resulted in extensions of the class period, often to include accounting-related announcements. Plaintiffs also brought allegations against new accounting-related defendants as cases progressed through the litigation process, most often adding members of an audit committee.

Accounting cases continue to take longer to resolve and are less likely to result in dismissal than settlement, which may be attributable to the tendency for these cases to involve higher investor losses and/or to be more complex than non-accounting cases. Of the cases that were initially filed during 2006 through 2011, only 8 percent of accounting cases were voluntarily dismissed by the end of last year, compared with 27 percent of non-accounting cases. As in past years, accounting cases also result in higher settlement outcomes, particularly for cases in which companies face SEC actions. Although the number and size of settlements were lower in 2011 than in any other year in our sample, accounting cases continued to represent a disproportionately higher share of total settlement values.

RESEARCH SAMPLE

This report utilizes the databases described in the *2011 Filings Report* and the *2011 Settlements Report*. We focus on cases filed or settled since 2006; thus, our samples consist of subsets of the full databases described in these reports. In addition, in cooperation with the Stanford Law School Securities Class Action Clearinghouse, we identified 164 matters in which amended complaints were filed during 2011. We excluded one amendment as it related to a case that was filed prior to January 1, 2006, the beginning of our sample period. For each of the remaining 163 cases, we reviewed the most recent amended complaint (available as of the date of publication) and compared it with its corresponding initial filing.

Please reference Cornerstone Research in any reprint of the charts and tables included in this study and include a link to the report:

www.cornerstone.com/accounting-class-action-filings-and-settlements

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