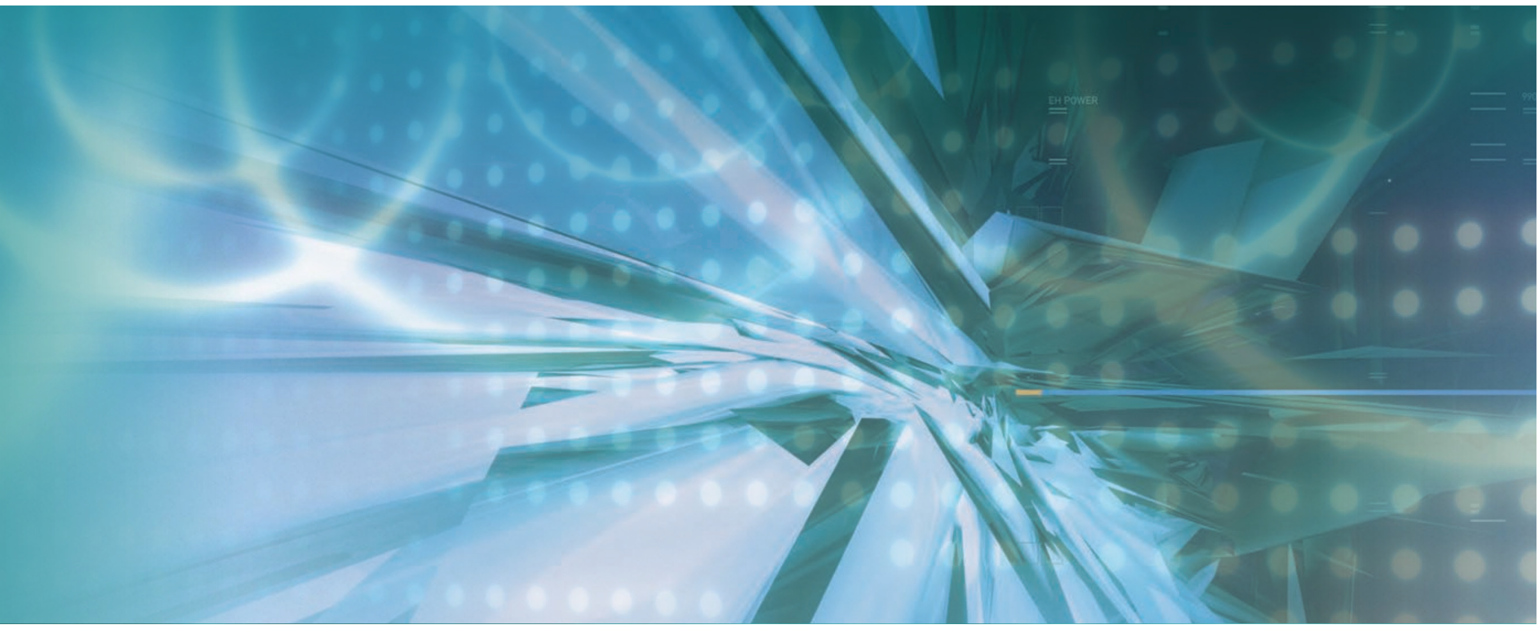
CORNERSTONE RESEARCH

ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

Accounting Class Action Filings and Settlements

2013 Review and Analysis



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HIGHLIGHTS

- While the number of accounting case[1] filings in 2013 remained relatively constant at 47, the market capitalization losses associated with these cases increased compared with 2012. (pages 3 and 4)

- In 2013, accounting case filings were almost evenly distributed over seven industry sectors, but the majority of settlement dollars in accounting cases were in the financial sector. (pages 7 and 8)

- In 2013, the proportion of filings involving allegations of internal control weaknesses was higher than in any of the prior five years. (page 11)

- Although filings were relatively unchanged, the number of accounting case settlements in 2013 increased for the second year in a row, but remained relatively low compared with the ten-year history. (page 5)

- In a reversal of the typical pattern, accounting case settlement amounts were lower than for non-accounting cases in 2013 primarily due to the large proportion of Chinese reverse merger settlements, which tend to be smaller in size. This change is not expected to indicate a long-term trend. (page 6)

- Settlements of accounting cases are generally associated with substantially higher "estimated damages" than those for non-accounting cases; however, this was not true in 2013. (page 13)

- Cases involving accounting irregularities typically settle for higher amounts than cases that do not involve these allegations. (page 14)

FIGURE 1: **SUMMARY STATISTICS**

2013 Filings Summary

	Accounting Cases	Non-Accounting Cases
Number of Filings	47	119
Total Disclosure Dollar Losses	$44.8B	$58.7B

2013 Settlements Summary

	Accounting Cases	Non-Accounting Cases
Number of Settlements	44	23
Median Settlement	$4.2M	$15.3M
Average Settlement	$26.6M	$156.7M
Total Settlement Value	$1,193.5M	$3,580.5M

Note: The majority of the total settlement value for non-accounting cases is represented by one large settlement. Without this case, the total value for non-accounting cases is $1,155.5 million, and the median and average are $14.4 million and $53.6 million, respectively.

SPOTLIGHT: SEC INVESTIGATIONS OF ACCOUNTING-RELATED FRAUD

"Our aim is . . . to create an environment where you think we are everywhere—using collaborative efforts, whistleblowers, and computer technology to expand our reach, focusing on gatekeepers to make them think twice about shirking responsibilities, and ensuring that even the small violations face consequences."

—SEC Chair Mary Jo White at the Securities Enforcement Forum, 10/9/2013

The SEC has made it well known that it has aggressively renewed its focus on identifying accounting-related fraud. In July 2013, the SEC's Division of Enforcement unveiled the creation of a new Financial Reporting and Audit Task Force (Task Force). The objective of the Task Force is to more proactively identify misstatements in financial statements and disclosures. The Task Force is reported to have already generated several "significant investigations," with more expected to follow.[2]

Working with the Division of Economic and Risk Analysis (DERA, previously known as RiskFin), the Task Force initiatives rely at least partly on analytical models, such as the widely discussed Accounting Quality Model (AQM), commonly referred to as "RoboCop." The AQM is intended to be a predictive scoring model to flag "earnings management," or anomalous discretionary accounting choices made by companies compared with their peers. Building on existing academic research that provides "indicators" of earnings management, the AQM incorporates in its model consideration of "inducers" (i.e., incentives to commit fraud).[3]

DERA is also developing text analytic tools that analyze patterns in companies' financial statement footnotes and the management discussion and analysis (MD&A) section of their SEC filings to identify those that might indicate fraud. These recent developments are in addition to the SEC's efforts to facilitate whistleblower tips. The SEC reported that it received over 550 tips in 2013 related to allegations involving corporate disclosure and financials.

The SEC's recent efforts have garnered much attention, and are generally expected to increase SEC enforcement actions involving accounting issues. These efforts could also have significant potential consequences for private securities litigation involving accounting issues. Increased SEC enforcement activity may affect not only the volume of private securities litigation filed, but also the amount for which these cases settle. This is because securities class actions accompanied by SEC actions are associated with higher settlement amounts.[4]

With the dwindling of other targeted litigation, such as credit crisis and Chinese reverse merger cases, it is conceivable that the SEC's current focus could provide an opportunity for plaintiff counsel to make accounting-related cases a future wave in securities class action litigation.

"I think financial-statement fraud, accounting fraud has always been important to the SEC. . . . It's certainly an area that I'm interested in and you're going to see more targeted resources in that area going forward."

Mary Jo White, in *Forbes*, "How SEC's New RoboCop Profiles Companies for Accounting Fraud," 8/9/2013

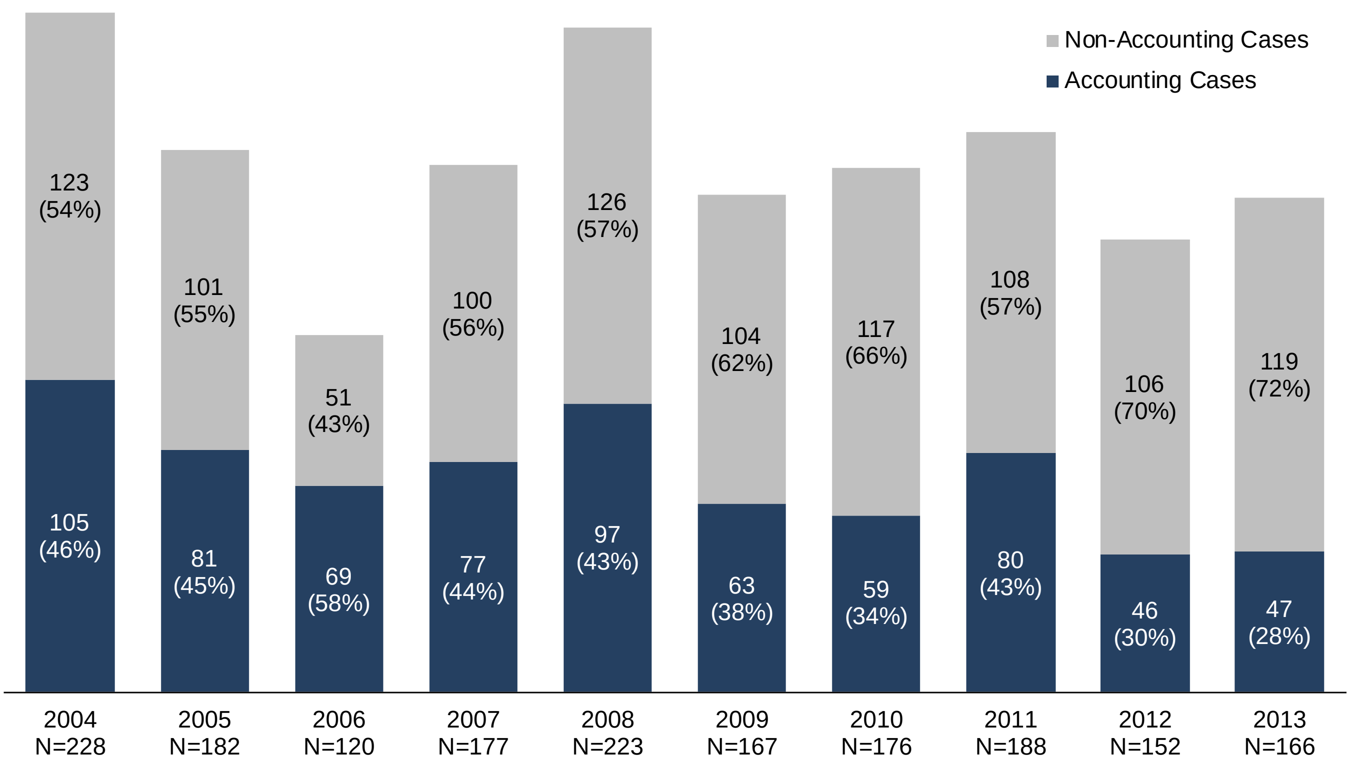
FILINGS AND SETTLEMENT ACTIVITY

FILINGS AND SHARE OF ACCOUNTING CASES

- In 2013, there were 47 accounting case filings, compared with 46 in the prior year.
- The low number of accounting case filings and absence of a year-over-year change is consistent with trends in overall securities class action filing activity.[5] The past two years have been marked by an absence of any new types of securities class actions, such as those that involve Chinese reverse mergers (CRMs).
- Only two filings in 2013 were CRM cases, compared with a peak of 31 in 2011, which represented 39 percent of all accounting cases for that year.

At 28 percent of all cases filed, the proportion of accounting cases was at a ten-year low.

FIGURE 2: **FILINGS AND SHARE OF ACCOUNTING CASES**
2004–2013



Note: Percentages may not add to 100 due to rounding.

FILINGS AND MARKET CAPITALIZATION LOSSES

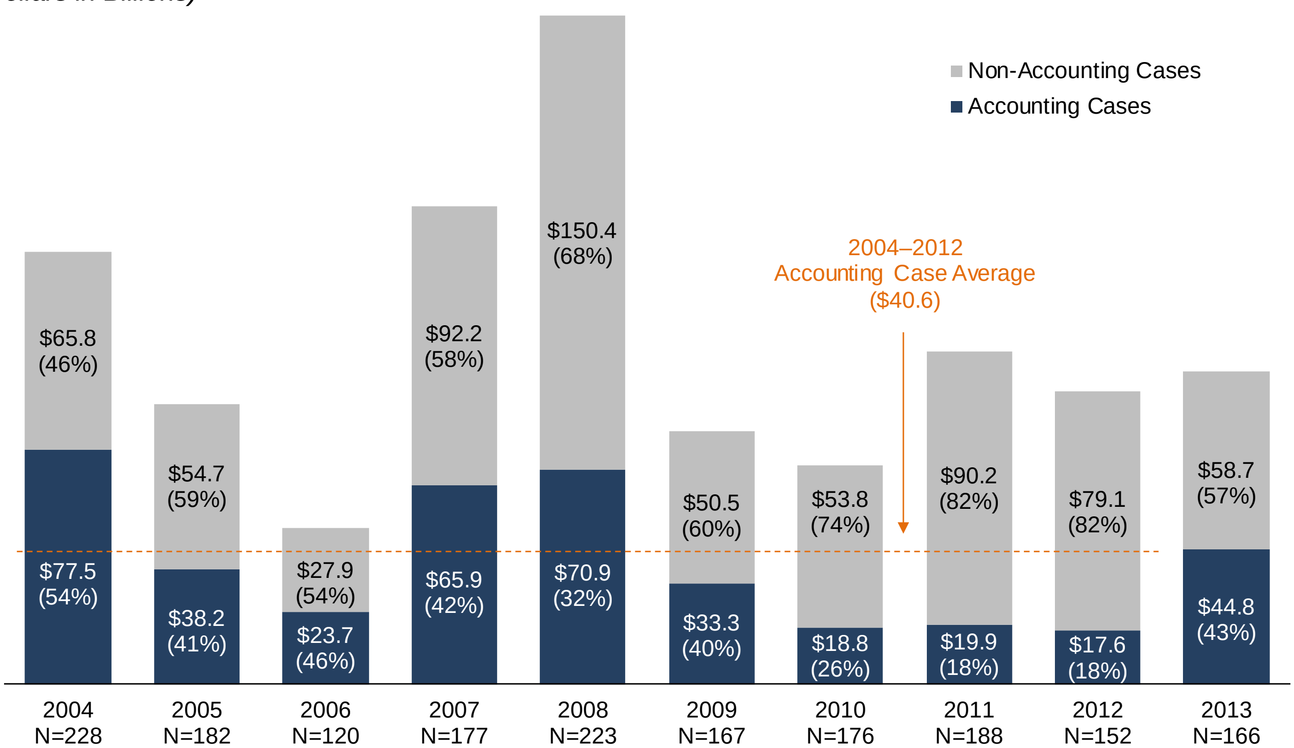
Disclosure Dollar Loss (DDL) Index™

This index measures the aggregate DDL for all filings over a period of time. DDL is the dollar value change in the defendant firm's market capitalization between the trading day immediately preceding the end of the class period and the trading day immediately following the end of the class period. DDL should not be considered an indicator of liability or measure of potential damages.

In 2013, the DDL Index for accounting cases reached the highest level since 2008.

- The DDL Index increased 155 percent from 2012 to 2013 for accounting cases, in contrast to the 26 percent decrease for non-accounting cases.
- Over the last 10 years, the DDL Index for accounting cases has fluctuated significantly. At $44.8 billion, the DDL Index for accounting cases in 2013 was higher than the historical average of $40.6 billion.
- The proportion of the total DDL Index in 2013 represented by accounting cases was also relatively high compared with prior years.
- The 10-year history shows that market capitalization losses are determined in part by the nature of the cases involved. For example, the relatively large number of accounting case filings in 2011 did not translate to a high level of DDL, since a fairly large percentage of the filings in that year involved CRM cases, which tend to involve smaller issuers.

FIGURE 3: **DISCLOSURE DOLLAR LOSS INDEX™**
2004–2013
(Dollars in Billions)

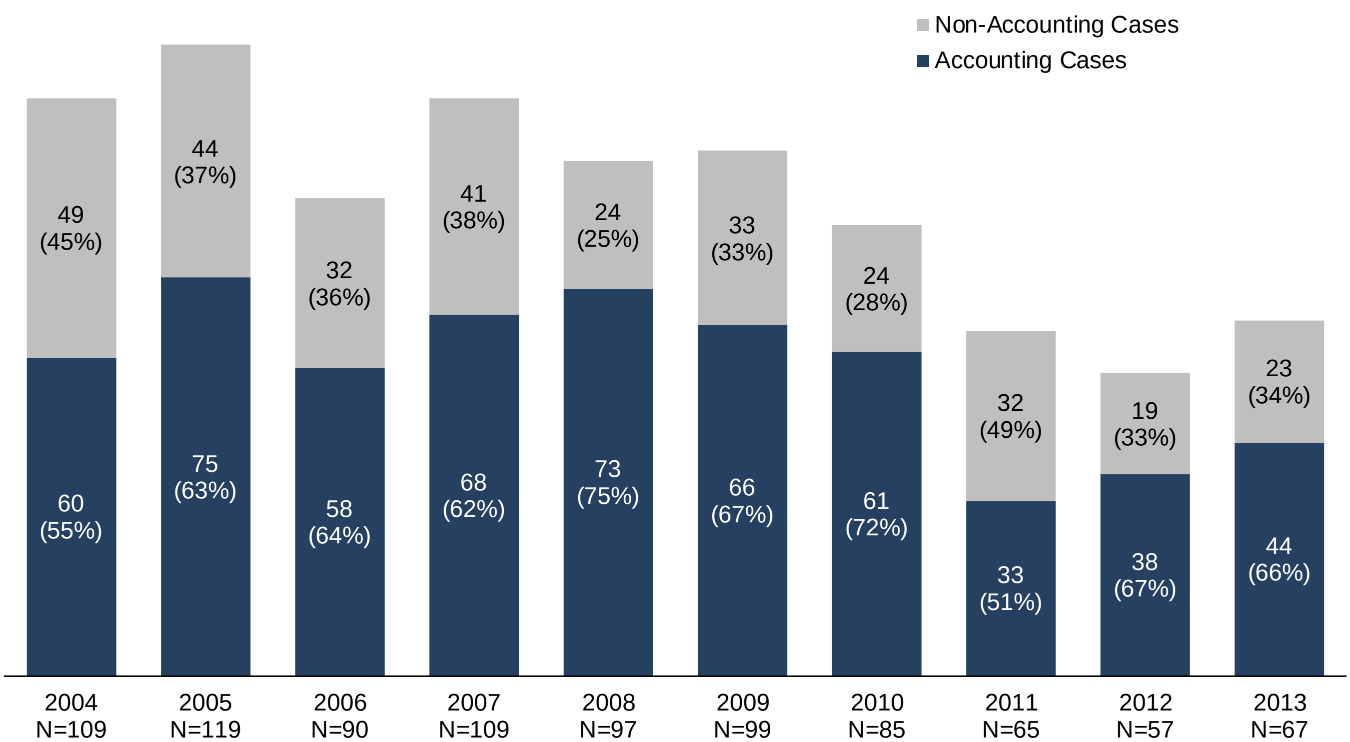


SETTLEMENTS AND SHARE OF ACCOUNTING CASES

- Despite recent year-over-year increases, the number of accounting case settlements has remained relatively low over the last few years. For example, in 2011–2013 the number of accounting settlements ranged from 33 to 44 per year compared with 58 to 75 per year in 2004–2010.
- Recent trends in the number of accounting case settlements are generally consistent with trends in overall securities class action settlements.[6]
- Over the last 10 years, accounting case settlements as a percentage of the total number of cases settled have ranged from 51 percent to 75 percent.
- In 2013, 14 of the 44 settled accounting cases were CRM cases, representing the highest number of CRM settlements to date.
- Given that CRM case filings peaked in 2011 and the fact that, overall, cases generally take about three years to settle, additional CRM case settlements are expected in 2014.

For the second year in a row, the number of settlements of cases involving accounting issues increased.

FIGURE 4: **SETTLEMENTS AND SHARE OF ACCOUNTING CASES 2004–2013**



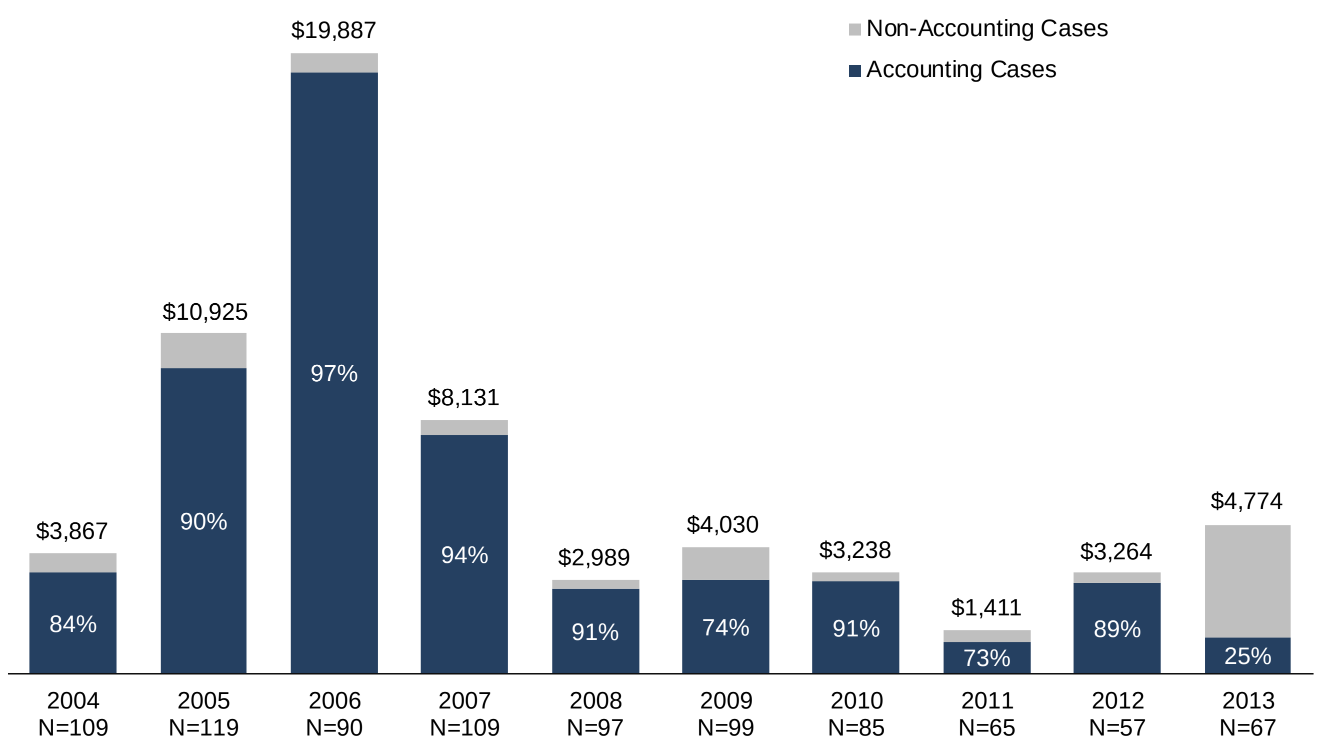
SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES

- Historically, accounting cases have represented the vast majority of the total value of cases settled.
- In contrast to prior years, in which accounting cases have represented as much as 97 percent of the total value of case settlements, accounting cases represented only 25 percent of the total value of cases settled in 2013.
  - This unusual result was due to the presence of one non-accounting case that comprised more than 50 percent of the total value of cases settled. Accordingly, this change is not expected to indicate a future trend.
  - Excluding the settlement mentioned above, accounting cases represented just over 50 percent of the value of cases settled in 2013.

For the first time since passage of the PSLRA, the total value of accounting case settlements was lower than non-accounting cases.

FIGURE 5: **SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES 2004–2013**

(Dollars in Millions)



Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

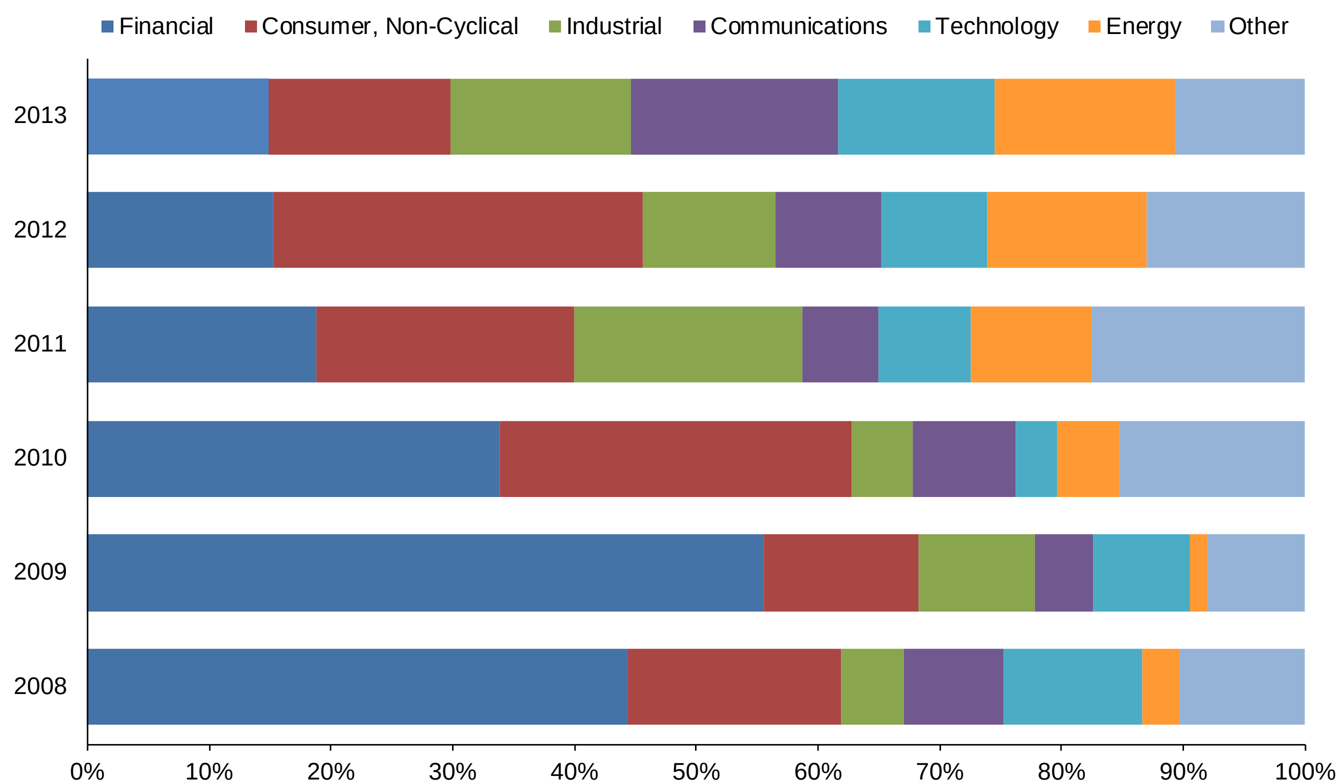
INDUSTRY SECTORS

ACCOUNTING CASE FILINGS AND INDUSTRY SECTORS

- In 2013, securities class action filings of accounting cases were more evenly distributed across industry sectors compared with prior years.
- Recent years have seen fewer accounting case filings against companies in the financial sector while, at the same time, filings against companies in the energy, technology, industrial, and communications sectors have increased.

No single industry sector accounted for a significant portion of accounting case filings in 2013.

FIGURE 6: **ACCOUNTING CASE FILINGS BY INDUSTRY SECTOR**
2008–2013

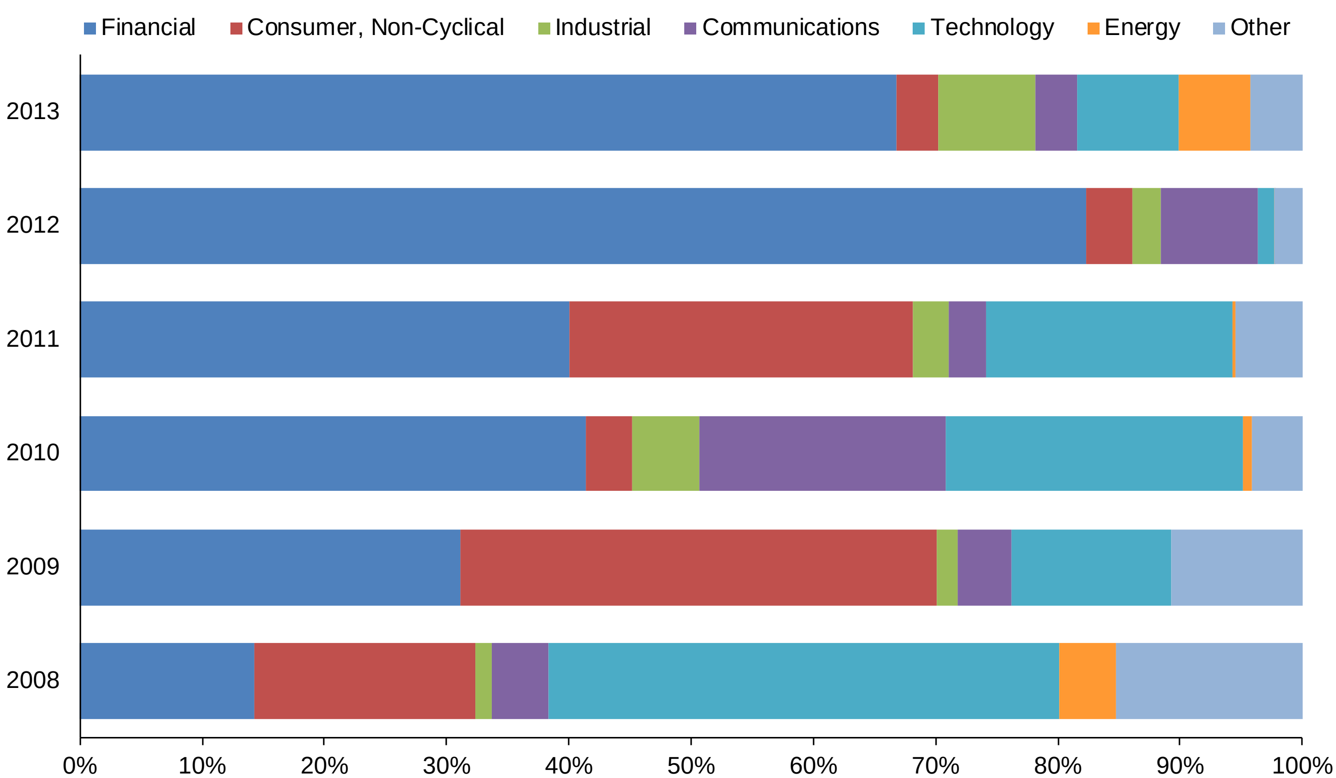


ACCOUNTING CASE SETTLEMENT DOLLARS AND INDUSTRY SECTORS

- The prevalence of accounting allegations is correlated with industry type.
  - For example, financial institution cases settled in recent years have tended to include accounting allegations.
  - In contrast, pharmaceutical cases (included within the consumer non-cyclical sector) comprised a large portion of non-accounting case settlements in 2013, and they represented a small portion of total settlement dollars in accounting cases.
- The distribution of settlement dollars by industry sector in 2013 is very different from that of five years ago, when cases in the technology sector comprised the largest portion of accounting case settlement dollars, and financial sector cases represented a relatively small amount.

Reflecting the resolution of a number of credit crisis cases, total settlement dollars recently have been dominated by cases in the financial sector.

FIGURE 7: **ACCOUNTING CASE SETTLEMENT DOLLARS BY INDUSTRY SECTOR 2008–2013**



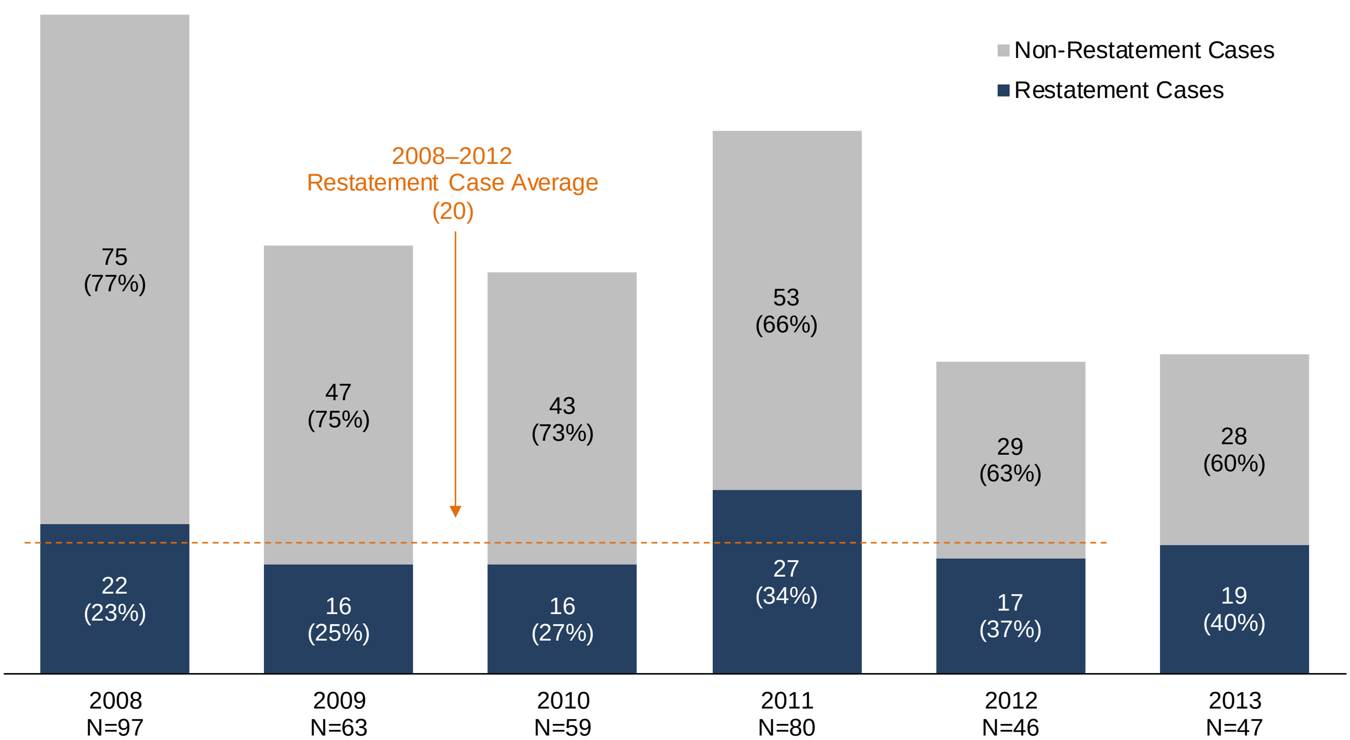
ACCOUNTING RESTATEMENTS

ACCOUNTING CASE FILINGS AND RESTATEMENTS

- At 40 percent of all accounting cases, the proportion of filings involving restatements in 2013 is higher than any of the prior five years.
- This is consistent with data showing that the number of restatements by accelerated filers (i.e., large companies that are heavily targeted in securities class actions) has increased in recent years.[7]
- The 2013 increase in new filings involving restatements also suggests a possible change from observations over the last several years that restatements of financial statements had become less severe in nature (e.g., smaller downward restatements and shorter periods covered).[8]

Recent increases in the number of restatements by large firms have led to a rise in the proportion of accounting case filings involving restatements.

FIGURE 8: **ACCOUNTING CASE FILINGS AND RESTATEMENTS 2008–2013**



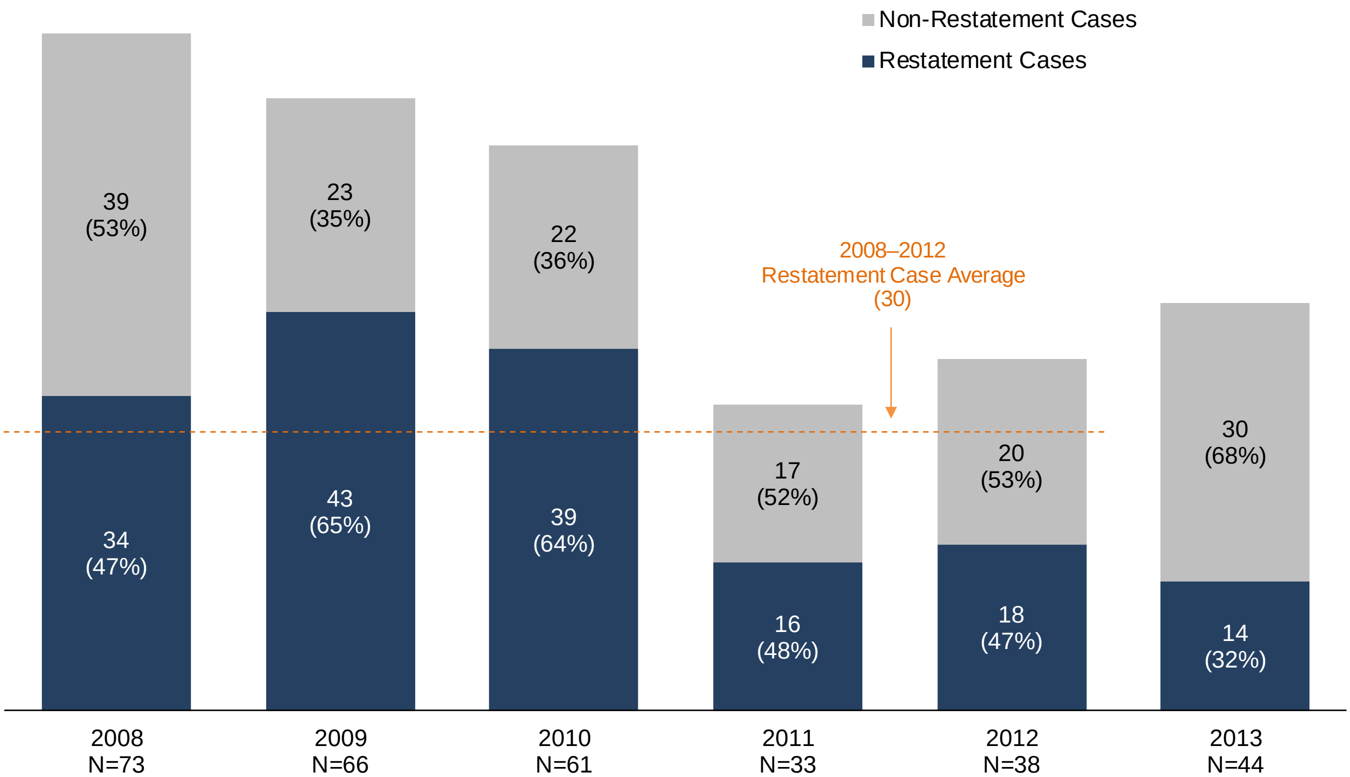
ACCOUNTING CASE SETTLEMENTS AND RESTATEMENTS

- The number and proportion of case settlements involving restatements were lower than any of the prior five years, and more broadly, the number of such cases has been relatively low in the last three years.

- Since cases often take about three years from filing to settlement, the recent increase in filings involving restatements has not yet translated to an increase in the number of settlements involving restatements.

The proportion of accounting case settlements involving restatements dropped to 32 percent in 2013.

FIGURE 9: **ACCOUNTING CASE SETTLEMENTS AND RESTATEMENTS**
2008–2013



INTERNAL CONTROL ALLEGATIONS

ACCOUNTING CASE FILINGS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES

- In 2013, the proportion of filings involving allegations of internal control weaknesses was higher than in any of the prior five years.

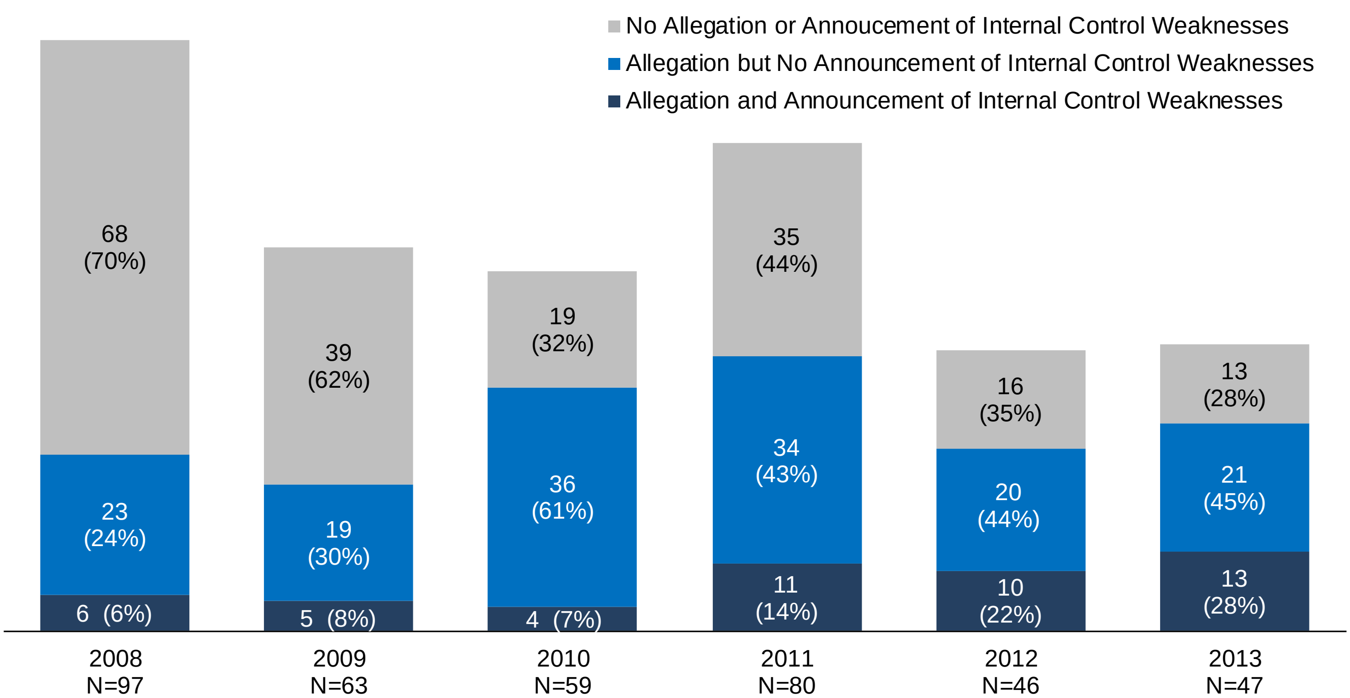
- The proportion of cases involving company announcements of internal control weaknesses has also grown substantially over the past three years—reaching 28 percent of all accounting cases in 2013, compared with only 6 to 8 percent in 2008–2010.

- In 2013, plaintiffs alleged internal control weaknesses when there were no accompanying announcements in 45 percent of all accounting cases.

- Most cases that include allegations of internal control weaknesses also allege Generally Accepted Accounting Principles (GAAP) misstatements. For example, in 2013, more than 90 percent of cases that included internal control weakness allegations also involved accompanying GAAP allegations.

Over 70 percent of accounting cases filed in 2013 involved allegations of internal control weaknesses.

FIGURE 10: **ACCOUNTING CASE FILINGS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES**
2008–2013



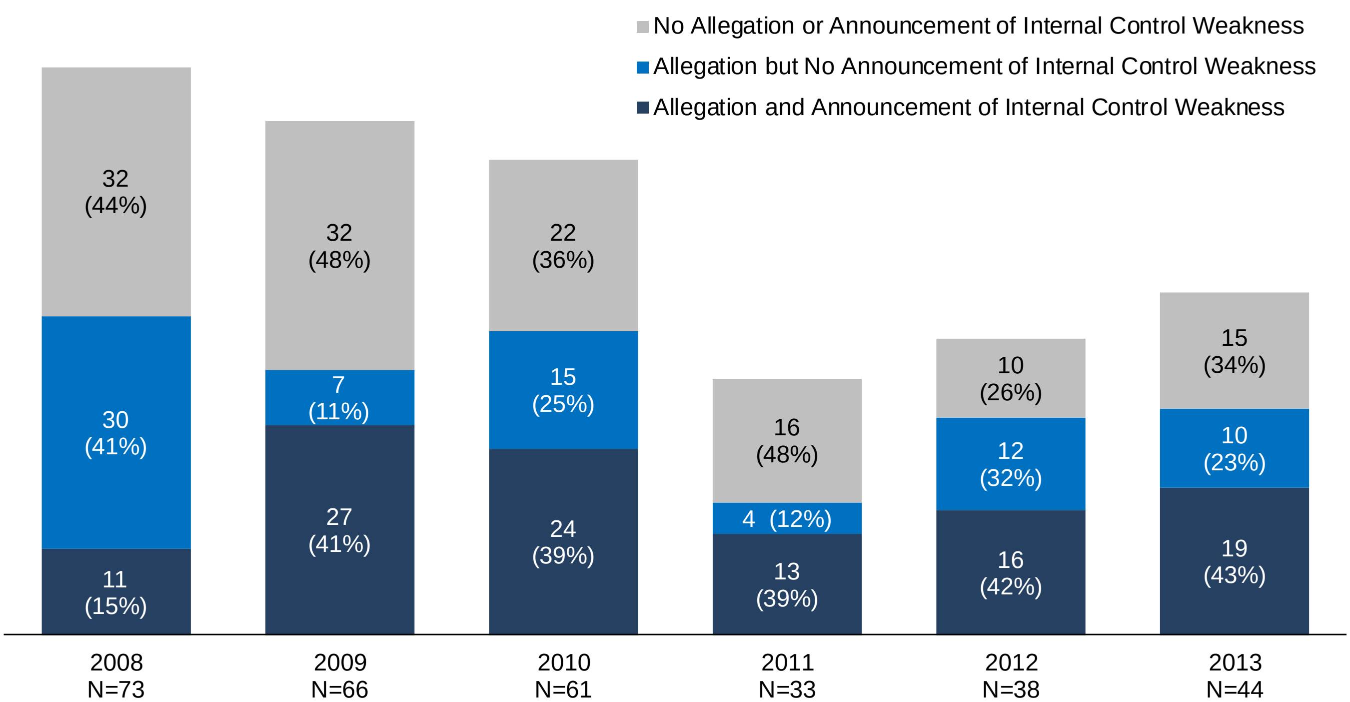
Note: Percentages may not add to 100 due to rounding.

ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES

- Since 2009, the proportion of settlements of cases involving an announcement by the company of an internal control weakness has fluctuated within a narrow range of 39 to 43 percent.
- While plaintiffs often allege internal control weaknesses, such allegations are not associated with higher settlement amounts, unless accompanied by company announcements reporting the presence of such weaknesses.
- Cases that involve a company announcement of internal control weaknesses settle for substantially higher amounts and higher settlements as a percentage of shareholder losses compared to cases with no such announcements (medians of $12.4 million and 2.9 percent compared with $7.1 million and 2.3 percent, respectively).

Over 65 percent of accounting cases that settled in 2013 involved allegations of internal control weaknesses.

FIGURE 11: **ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES**
2008–2013



FACTORS AFFECTING ACCOUNTING CASE SETTLEMENTS

MEDIAN "ESTIMATED DAMAGES"

This section examines case attributes across different types of allegations and accounting issues, with comparisons to non-accounting cases.[9] The measure "estimated damages" is discussed in detail in *Securities Class Action Settlements—2013 Review and Analysis*. As a brief overview, this measure is a simplified calculation of shareholder losses measured consistently across years; thus, it is not intended to represent actual damages borne by shareholders but enables the identification and analysis of potential trends.[10]

- Overall, accounting cases involve substantially higher median "estimated damages" than cases without accounting-related allegations.
- Cases involving allegations of asset write-downs rank second in median "estimated damages," driven in part by the fact that these cases often have involved large financial institutions.

Cases involving reported accounting irregularities are associated with the highest median "estimated damages."

FIGURE 12: **MEDIAN "ESTIMATED DAMAGES"**
2008–2013
(Dollars in Millions)

Note: "Estimated Damages" are adjusted for inflation based on class period end dates. Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

MEDIAN SETTLEMENT AMOUNTS

- Since shareholder losses are the most important determinant of settlement amounts, the patterns in median settlement amounts closely parallel those observed with "estimated damages."
- Cases involving accounting issues tend to be associated with accompanying SEC actions and accompanying derivative actions, both of which are also associated with higher median settlement amounts.
- In recent years, cases involving restatements have not been associated with substantially higher median settlement amounts. These cases are, however, associated with higher settlement amounts when other important settlement determinants are controlled for (i.e., when regression analysis is used to examine multiple factors simultaneously).

The median settlement amount for accounting cases is higher than for non-accounting cases.

FIGURE 13: **MEDIAN SETTLEMENT AMOUNTS**
2008–2013
(Dollars in Millions)

Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used. Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

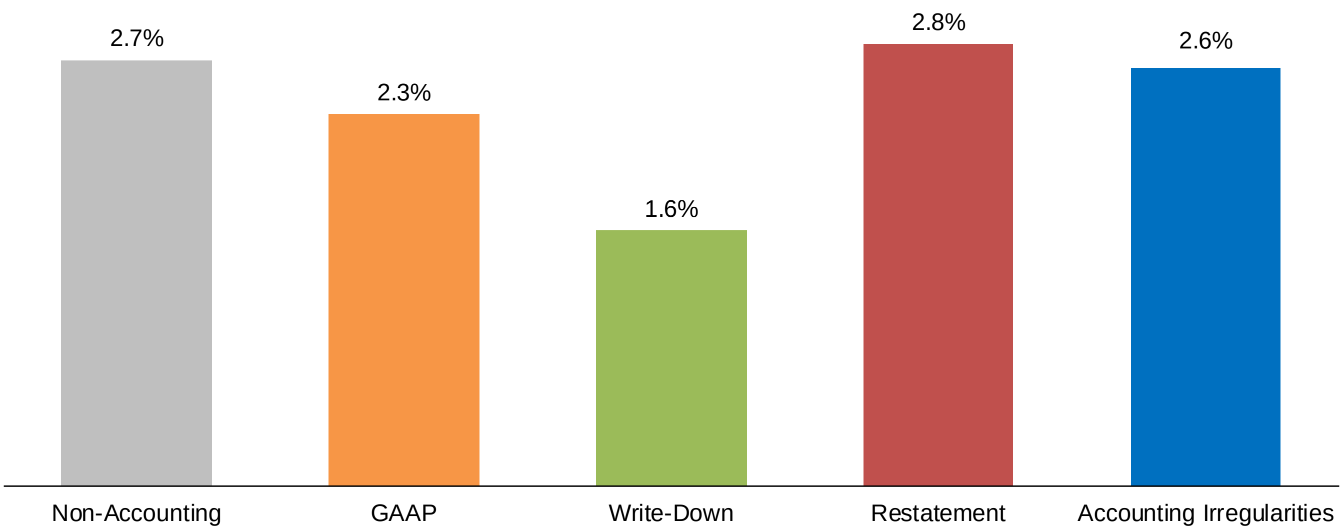
MEDIAN SETTLEMENT AMOUNTS AS A PERCENTAGE OF "ESTIMATED DAMAGES"

As the most important factor affecting settlement amounts, it is useful to consider settlement amounts in relation to shareholder losses.

- Across the different types of allegations, median settlements as a percentage of "estimated damages" are quite different from the patterns observed in median settlement amounts.
- The lowest settlements in relation to "estimated damages" are for cases involving asset write-downs. This may be due to the fact that:
  - These cases tend to be larger, and larger cases tend to settle for smaller percentages of "estimated damages."
  - Write-downs involve accounting judgment, and it may be more difficult for plaintiffs to substantiate claims of wrongdoing in these cases.

Cases involving asset write-downs are associated with the lowest median settlement as a percentage of "estimated damages."

FIGURE 14: **MEDIAN SETTLEMENT AMOUNTS AS A PERCENTAGE OF "ESTIMATED DAMAGES"**
2008–2013



Note: Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

AUDITOR DEFENDANTS

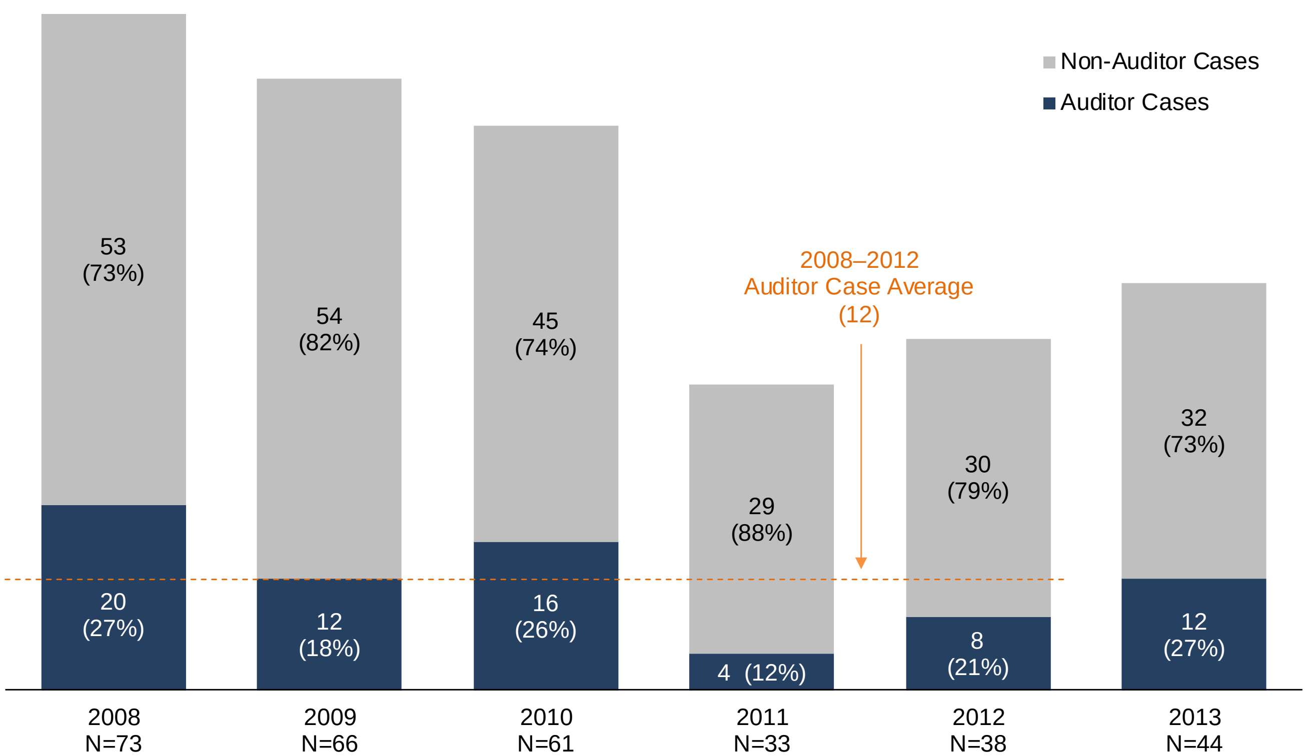
ACCOUNTING CASE SETTLEMENTS AND AUDITOR DEFENDANTS

Overall, auditor participation in class action settlements in the last several years has been lower than in the early years following passage of the Private Securities Litigation Reform Act (PSLRA). This is likely due in part to U.S. court decisions that have reduced auditor liability,[11] as well as the changing nature of restatements (see page 9). The latter is due to the fact that auditor liability in securities class actions is closely tied to whether audited financial statements were restated, as well as the nature of any restatement.

- Reflecting an increase over the last couple of years, auditors were named as defendants in 12 out of 44 accounting cases that settled in 2013. This is due in part to the fact that auditors have been named more frequently in CRM cases (6 out of the 14 CRM settlements in 2013 involved auditors as named defendants).
- Cases involving auditors as named defendants tend to settle for higher amounts.[12]

In 2013, the proportion of accounting case settlements involving auditor contributions was the highest in several years.

FIGURE 15: **ACCOUNTING CASE SETTLEMENTS AND AUDITOR DEFENDANTS 2008–2013**



RESEARCH SAMPLE

This report utilizes the databases described in *Securities Class Action Filings—2013 Year in Review* and *Securities Class Action Settlements—2013 Review and Analysis*. Most of the charts in this report focus on cases filed or settled in 2008 or later; thus, the samples consist of subsets of the full databases described in these related Cornerstone Research reports.

ENDNOTES

[1] For purposes of this research, cases are considered “accounting cases” if they include allegations related to Generally Accepted Accounting Principles (GAAP) violations, auditing violations, or internal control weaknesses.

[2] Mary Jo White, chair of the SEC, “Chairman’s Address at SEC Speaks 2014” (speech, Washington, DC, February 21, 2014).

[3] Craig M. Lewis, chief economist and director, Division of Risk, Strategy, and Financial Innovation, SEC, “Risk Modeling at the SEC: The Accounting Quality Model” (speech, Financial Executives International Committee on Finance and Information Technology, December 13, 2012).

[4] See *Securities Class Action Settlements—2013 Review and Analysis*, Cornerstone Research.

[5] See *Securities Class Action Filings—2013 Year in Review*, Cornerstone Research.

[6] See *Securities Class Action Settlements—2013 Review and Analysis*, Cornerstone Research.

[7] See *2012 Financial Restatements: A Twelve Year Comparison*, Audit Analytics, March 2013.

[8] See *2012 Financial Restatements: A Twelve Year Comparison*, Audit Analytics, March 2013.

[9] The accounting allegations and issues analyzed are: (1) GAAP—cases with allegations of GAAP violations; (2) Write-Down—cases with allegations involving an asset write-down or reserve increase; (3) Restatement—cases involving a restatement (or announcement of a restatement) of financial statements; and (4) Accounting Irregularities—cases in which the defendant has reported the occurrence of accounting irregularities (intentional misstatements or omissions) in its financial statements.

[10] As described in *Securities Class Action Settlements—2013 Review and Analysis*, “estimated damages” are not necessarily linked to the allegations included in the associated court pleadings. Accordingly, damages estimates presented in this report are not intended to be indicative of actual economic damages borne by shareholders.

[11] For example, see *Janus Capital Group Inc. v. First Derivative Traders*.

[12] This finding refers to the total settlement amount and does not imply any information about amounts actually paid by auditors to the class. Overall, auditors contribute to securities class action settlements relatively infrequently. Moreover, the association between auditor involvement and settlement amounts is not necessarily causal; it is possible that plaintiffs choose to name auditors as defendants in certain cases that result in higher settlements due to unobservable factors not captured by our research.

Please reference Cornerstone Research in any reprint of the figures or findings included in this report.

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