Companies that use conservative accounting principles less likely to face lawsuits, study finds

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Firms that use accounting practices that basically require more verification for good news than bad news can more easily avoid securities class-action lawsuits and improve the outcomes of litigation, according to a study that includes a University of Kansas accounting researcher.

"Past research has suggested that risk of litigation leads to more accounting conservativism. There has been little empirical evidence on whether and how it works," said Michael Ettredge, the Crown/Sherr Professor of Business at KU.

Accounting conservatism refers to the practice of requiring more verification to recognize a firm's positive news as gains than to recognize bad news as losses. In recent decades after corporate accounting scandals, the number of accounting-related class-action lawsuits has increased, which has imposed billions of dollars of direct and indirect costs to public companies and their shareholders.

The researchers' findings were published recently in the journal *Accounting Horizons* and featured in the Columbia Law School's blog on corporations and the capital markets. His co-authors are KU graduate Ying (Julie) Huang, associate professor in the Department of Accountancy at the University of Louisville College of Business, and Weining Zhang, associate professor of accounting at the Cheung Kong Graduate School of Business in Beijing.

In accounting-related class-action lawsuits, plaintiffs often claim that managers intentionally or recklessly overstate earnings. The later revelation of improper accounting can cause stock prices to drop, which could harm the investments of plaintiff shareholders.

Pursuing class-action litigation against publicly funded companies is risky for plaintiffs and their attorneys, and costs are high with uncertain outcomes. Accountants employing conservative financial reporting can reduce the expected value of plaintiffs' lawsuits because they avert or reduce potentially overstated earnings and drops in stock price.

More readily recognizing losses than financial gains can lead to the systematic understatement of earnings and net assets in audited financial statements. Typically, courts are more likely to rule that shareholder harm occurred when earnings and net assets have been overstated rather than understated.

"More conservative reporting can also reduce the value of litigation by decreasing the likelihood that plaintiff shareholders can prove they suffered financial harm through stock price drops," Ettredge said. "The timely recognition of bad news through accounting conservatism reduces the likelihood of temporarily overpriced stock and of subsequent sharp stock-price crashes."

The researchers tested a sample of 363 shareholder lawsuits alleging violations filed from 1996 through 2011 and resolved by mid-2014.

Their key finding was that firms in the top percentile of the average conservatism ranking face a 30 percent lower probability of a lawsuit than those in the bottom percentile.

The stock market reacts less negatively to the filing of lawsuits against companies with conservative accounting.

They found that courts are 31 percent more likely to dismiss lawsuits against the most conservative accounting defendants compared with firms in the bottom percentile. And for judgments, the top percentile firms pay a penalty amount that is on average $145 million less than for firms in the bottom percentile. Also, the researchers found cases are resolved more swiftly for more conservative firms, by roughly one year.

"Our results suggest substantial economic benefits to conditionally conservative accounting methods," Ettredge said.

More information: Conservative Reporting and Securities Class Action Lawsuits. papers.ssrn.com/sol3/papers.cf … ?abstract_id=2129800

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