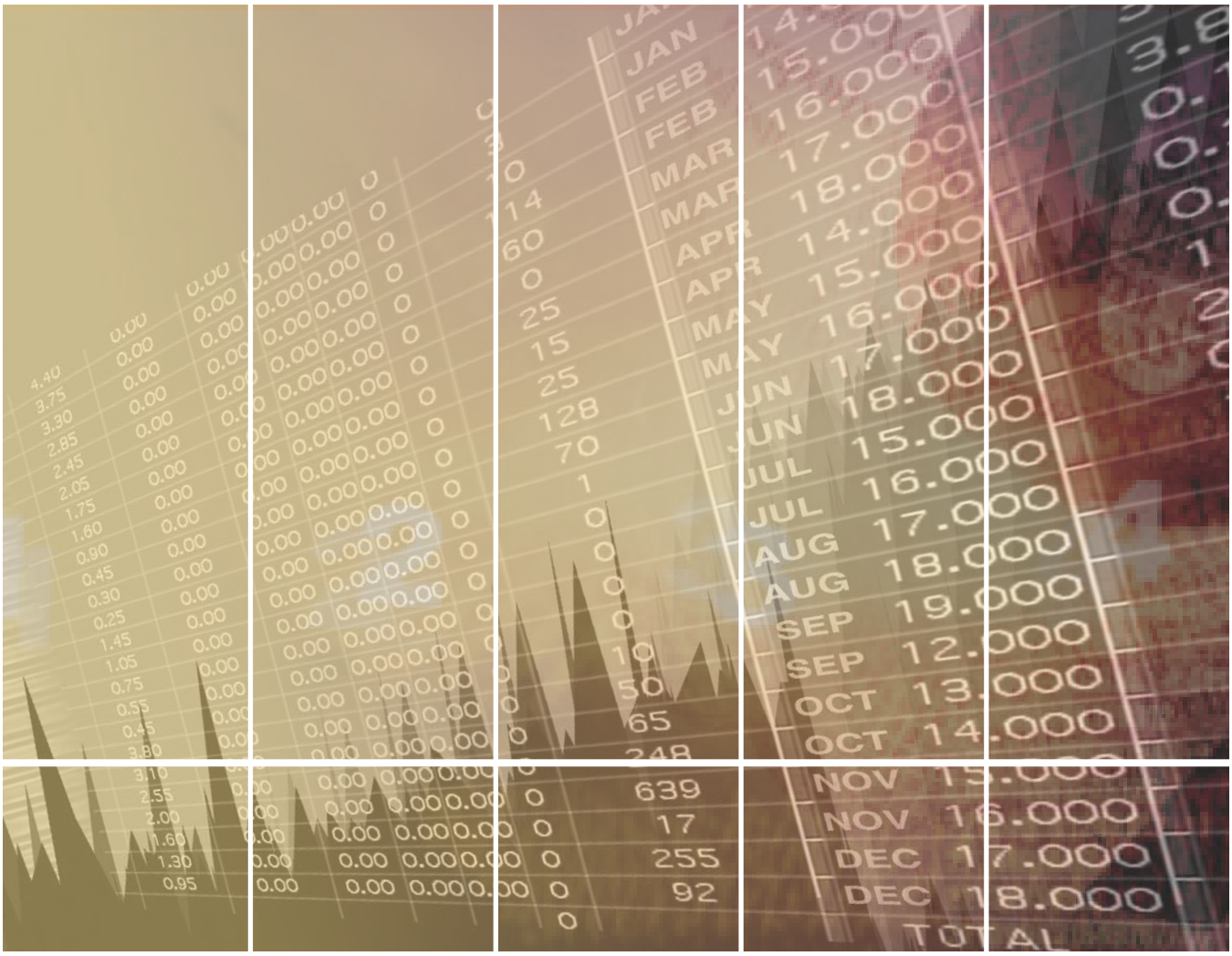
CORNERSTONE RESEARCH

ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

Accounting Class Action Filings and Settlements

2012 Review and Analysis



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INTRODUCTION

Our study of 2012 securities class actions involving accounting allegations is conducted against the backdrop of a year marked by the end of new filings related to the credit crisis, a waning of filings against Chinese issuers listed on U.S. exchanges through reverse mergers (Chinese reverse mergers), and a considerable slowdown in filing activity in the second half of the year. These factors contributed to a sharp decline in class action filing activity overall and in filings of accounting cases specifically.[1]

In contrast, while the number of overall securities class action settlements declined in 2012, the proportion of accounting case settlements increased in 2012 compared with the prior year. In addition, accounting case settlement dollars increased to over 90 percent of the total value of all settled cases in 2012.

In this report, we highlight several unique characteristics of accounting cases and trends in those cases over the past few years. We also discuss events that may affect filings and settlements of accounting cases in the future.

KEY FINDINGS

- The number of accounting case filings has been variable in recent years. Increased filing activity in 2011 was followed by a sharp decline in 2012 that brought the total number of new filings of accounting cases to its lowest level in recent years.
- For the second consecutive year, approximately one in three new accounting cases involved a financial statement restatement.
- Over the last three years, we have seen a trend in which new filings are increasingly likely to include internal control allegations without corresponding allegations of GAAP violations.
- Accounting cases continue to be less likely to be dismissed and typically take longer to resolve than non-accounting cases.
- Accounting case settlement dollars increased to over 90 percent of the total value of all settled cases in 2012, up from 73 percent in 2011.
- Cases involving company announcements of internal control weaknesses increased to almost 45 percent of all cases settled in 2012 and were associated with higher settlements.
- For cases with GAAP allegations, settlements in relation to shareholder losses are the highest for those that involve a financial statement restatement and/or accounting irregularity.

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[1] Cases are considered "accounting cases" if they involve allegations of violations of Generally Accepted Accounting Principles (GAAP) and/or of weaknesses in internal control over financial reporting.

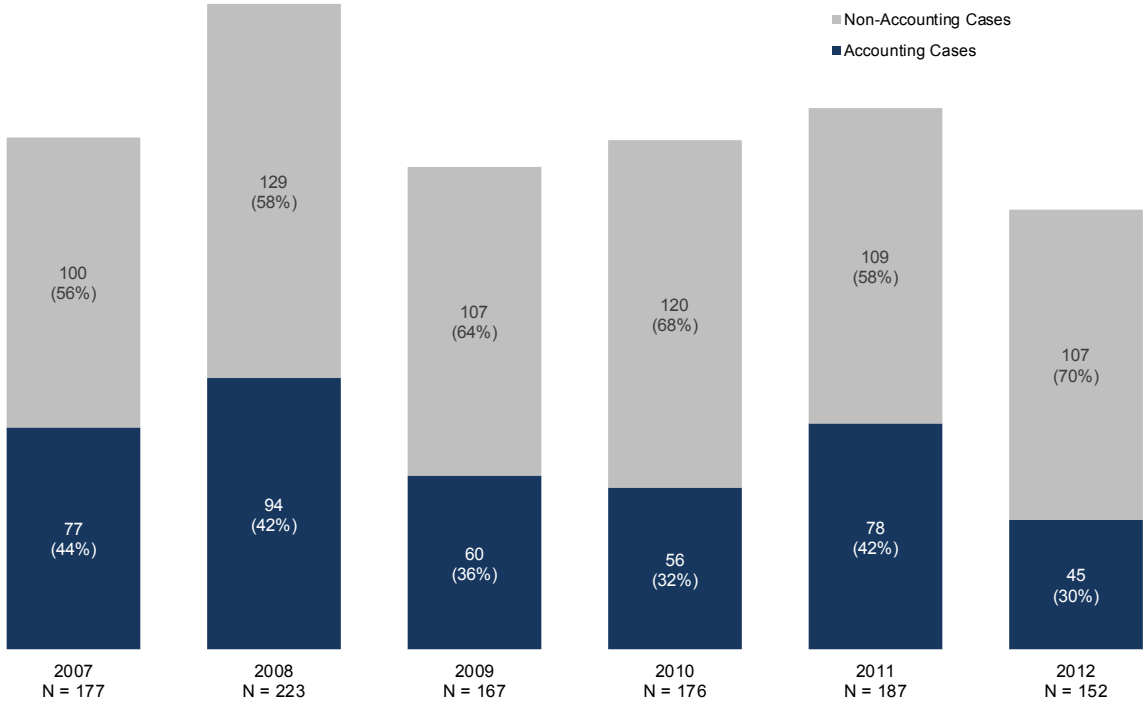
CASE FILINGS

During 2012, new accounting case filings decreased both in number and as a proportion of total securities class action filings, to the lowest levels in the last six years (Figure 1). The number of accounting cases decreased from 78 in 2011 to 45 in 2012, and the proportion of total filings represented by accounting cases decreased from 42 percent to 30 percent. This decline is consistent with trends in overall filing activity:

- **Chinese reverse merger cases decreased significantly in 2012**. There were 21 fewer Chinese reverse merger cases filed in 2012 compared with 2011, accounting for approximately two-thirds of the drop in accounting cases over the same period. As discussed in *Securities Class Action Filings—2011 Year in Review* (*2011 Filings Report*),[2] 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 GAAP in those cases than in other types of securities class actions.

- **Filing activity slowed considerably during the second half of the year**. The decline in overall filing activity and in new accounting filings was particularly sharp in the second half of the year. During the first half of 2012, 31 of the 88 filings (35 percent) were accounting cases. In contrast, only 14 accounting cases were filed during the second half of the year, representing only 22 percent of the 64 class action filings.

FIGURE 1: FILINGS AND SHARE OF ACCOUNTING CASES 2007–2012



2 Cornerstone Research, *2011 Filings Report*.

Recent regulatory developments may affect future trends in securities class action filings in general and accounting cases in particular. The Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the SEC to give monetary awards to eligible individuals who, in certain cases, voluntarily provide original information that leads to successful SEC enforcement actions. Fiscal year 2012 represented the first full year of results under this new whistleblower program.

According to the SEC's annual report on the whistleblower program, there were 3,001 whistleblower tips received from October 1, 2011, through September 30, 2012.[3] Notably, the most common tip category was Corporate Disclosures and Financials, which represented 547 of total whistleblower tips (18 percent). The large volume of whistleblower tips may lead to future SEC enforcement activity, which may in turn lead to class action litigation.[4]

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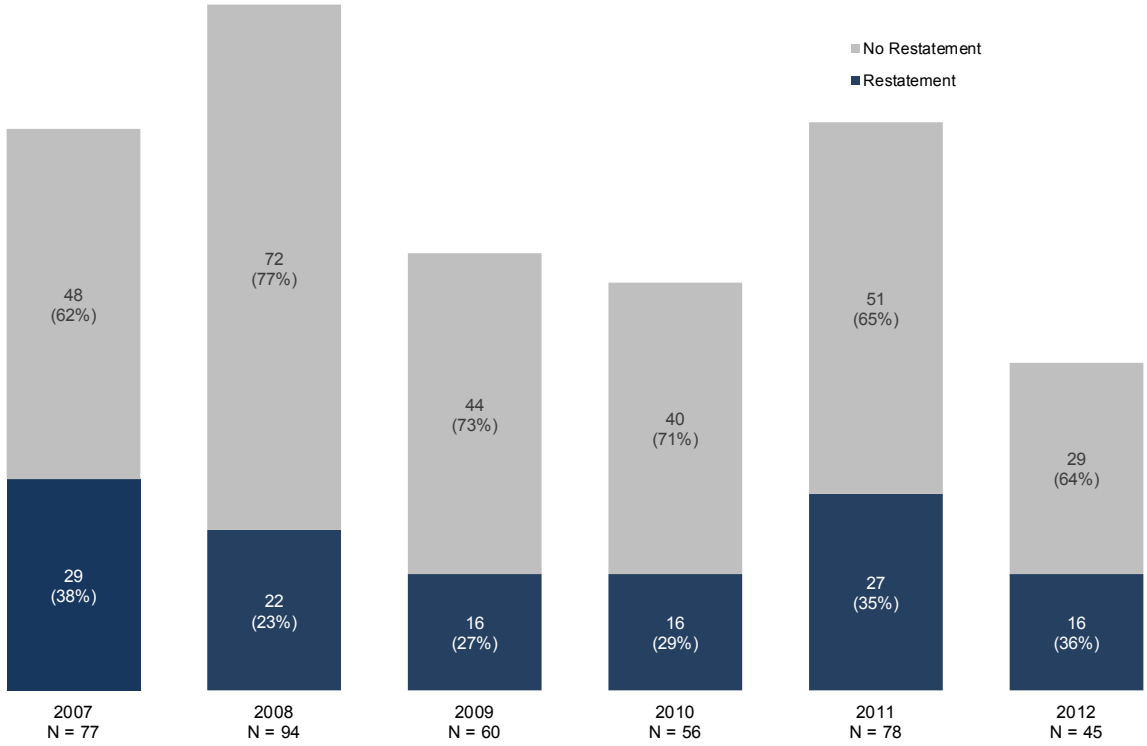
[3] U.S. Securities and Exchange Commission, "Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2012," November 2012, Appendix A.

[4] See Cornerstone Research, *Securities Class Action Filings—2012 Year in Review* (*2012 Filings Report*). There is a difference in the percentage of whistleblower tips received and the areas in which the SEC has taken enforcement action in 2012. Specifically, although Corporate Disclosures and Financials represented 18 percent of whistleblower tips, only 11 percent of SEC enforcement actions focused on Financial Fraud or Issuer Disclosure. The difference suggests that an increase in SEC enforcement action in accounting-related areas may occur in the future.

FILINGS INVOLVING RESTATEMENTS

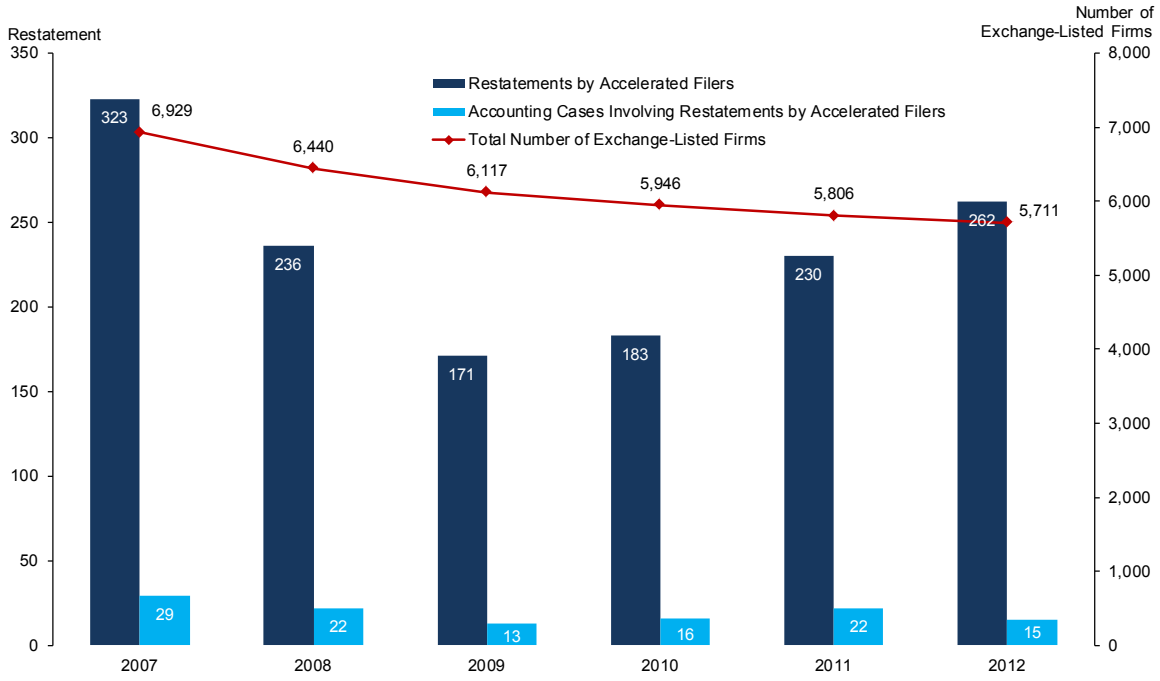
During 2012, the total number of accounting cases involving financial statement restatements decreased, returning to the level of activity in 2009 and 2010 (Figure 2). However, the proportion of accounting cases involving restatements was higher in 2012 than in those years and has remained relatively constant at approximately 35 percent since 2011.

FIGURE 2: ACCOUNTING CASE FILINGS AND RESTATEMENTS 2007–2012



Audit Analytics' most recent study, *2012 Financial Restatements: A Twelve-Year Comparison*, reported that restatements by accelerated filers increased in 2012 (Figure 3).[5] Despite this increase, the number of accounting cases involving restatements by accelerated filers remained relatively low in 2012 and declined from 2011.[6] This may be because many of the restatements during 2012 did not have a significant effect on stock price and/or the time lag between company announcements of a restatement and when a class action may be filed has delayed the filings into 2013. However, if the increasing trend of restatements by accelerated filers continues, we may see an increase in restatement-related litigation in the future.

FIGURE 3: TOTAL RESTATEMENTS AND ACCOUNTING CASES INVOLVING RESTATEMENTS BY ACCELERATED FILERS 2007–2012



Source: Stanford Securities Class Action Clearinghouse; Audit Analytics, *2012 Financial Restatements: A Twelve-Year Comparison,* March 2013; SEC Rule 12b-2; *CRSP*

Note: An accelerated filer is defined by SEC Rule 12b-2 as, among other things, an issuer that "had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more." Market capitalization of $75 million was used as a proxy for the accelerated filer status. "Restatements" refers to the total number of unique registrants that made restatements during that year. The "Total Number of Exchange-Listed Firms" refers to the total number of firms listed on the Amex, NASDAQ, or NYSE.

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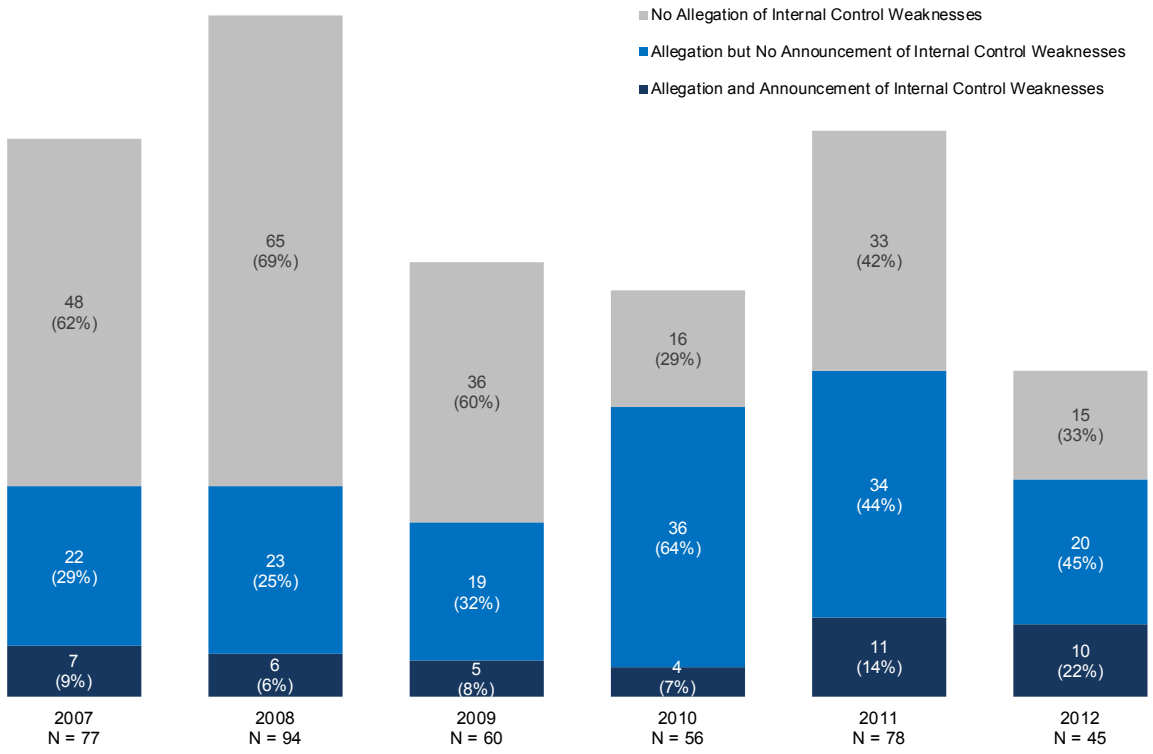
5 See Audit Analytics, *2012 Financial Restatements: A Twelve-Year Comparison*, March 2013. Accelerated filers are defined as companies with an aggregate worldwide market value of the voting and non-voting common equity of $75 million or more. Audit Analytics identified accelerated filers based on the last filing for the company of the relevant year.

6 For purposes of this analysis, we identified accelerated filers based on the maximum market capitalization during the year.

FILINGS INVOLVING INTERNAL CONTROL WEAKNESSES

Consistent with the overall decline in accounting case filings, during 2012 there was a sharp decline in the total number of cases filed that included allegations of internal control weaknesses (Figure 4). However, the number of cases that included those allegations and involved a company announcement of internal control weaknesses remained very close to the 2011 level.[7] In addition, for the third consecutive year, the majority of accounting cases included allegations of internal control weaknesses. Over the last three years, nearly two out of three accounting cases included such allegations, much higher than the proportion that included those allegations from 2007 through 2009.

FIGURE 4: CASE FILINGS INVOLVING ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES 2007–2012



[7] Determination of whether a case involved a company announcement of internal control weaknesses 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.

Because plaintiffs' internal control allegations relate specifically to controls over financial reporting, we expect cases involving internal control allegations to also include alleged violations of GAAP. However, during 2012 we saw the continuation of a trend that began in 2010 in which accounting cases were filed with allegations of internal control weaknesses but without accompanying allegations of GAAP violations (Figure 5). Twenty-three cases, representing 13 percent of total accounting case filings during the last three years, included internal control allegations alone compared with only one such case filed during 2008 (and none in 2007 or 2009). Although these cases did not include GAAP allegations, the vast majority of them (83 percent) included allegations of false forward-looking statements (e.g., allegedly false projected financial results).

FIGURE 5: CASE FILINGS THAT INCLUDED ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES WITH AND WITHOUT GAAP ALLEGATIONS

	2010	2011	2012	2010–2012
GAAP and Internal Control	33 (83%)	37 (82%)	22 (73%)	92 (80%)
Internal Control Alone	7 (17%)	8 (18%)	8 (27%)	23 (20%)
Total	40	45	30	115

To determine whether plaintiffs added GAAP allegations or dropped the internal control allegations as these cases progressed, we reviewed amended complaints filed during the last three years for cases that included internal control allegations alone. Plaintiffs filed amended complaints in the majority of these cases by the end of 2012 (18 amended complaints were filed, representing 78 percent of the cases). In half of these amended complaints, plaintiffs changed their accounting allegations, reducing the number of cases with internal control allegations alone from 23 to 14 and increasing the number of cases with both GAAP and internal control allegations from 92 to 97.[8]

New legislation enacted in 2012 may affect the number of cases with internal control allegations in the future. The Jumpstart Our Business Startups Act (JOBS Act), enacted in April 2012,[9] created an exemption from the requirement that an auditor report on the effectiveness of internal controls for a new category of companies called emerging growth companies. Emerging growth companies, whose revenues are less than $1 billion annually, may be exempted from the requirement for up to five years after an IPO.[10] To the extent that auditor reports on the effectiveness of internal controls have led to improved corporate governance, the exemption from that requirement may lead to increased litigation involving emerging growth companies in the future.[11]

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8 Based on a study of amended complaints filed during 2011, accounting allegations were more likely to be added in amended complaints than dropped. See *Cornerstone Research, Accounting Class Action Filings and Settlements—2011 Review and Analysis*.

9 U.S. Securities and Exchange Commission, *Jumpstart Our Business Startups Act: Frequently Asked Questions*, http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

10 See http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. Prior to the JOBS Act, SOX 404 reporting was not required in an IPO and in the first annual report after an IPO.

11 See "The Tenth Anniversary of SOX: Its Impact and Implications for Future Securities Litigation and Regulatory Enforcement Activity," by Elaine Harwood and Laura Simmons, *Bloomberg BNA Corporate Accountability Report* 10, no. 28 (July 13, 2012).

CASE STATUS AND PROGRESSION

Figures 6a and 6b present the status of cases at the end of 2012, categorized by the year in which the cases were 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 2007, only 35 percent of accounting cases were dismissed by the end of 2012, compared with 52 percent of non-accounting cases. Following from the lower dismissal rate, accounting cases are more likely to settle than non-accounting cases. For example, 60 percent of the accounting cases filed in 2007 settled by the end of 2012, compared with 41 percent of non-accounting cases. Figures 6a and 6b also show that accounting cases continue to take longer to resolve than non-accounting cases. For example, of the class actions filed in 2011, 74 percent of accounting cases were continuing at the end of 2012, compared with only 52 percent of non-accounting cases.

FIGURE 6A: STATUS OF ACCOUNTING CASES AT THE END OF 2012
2007–2012

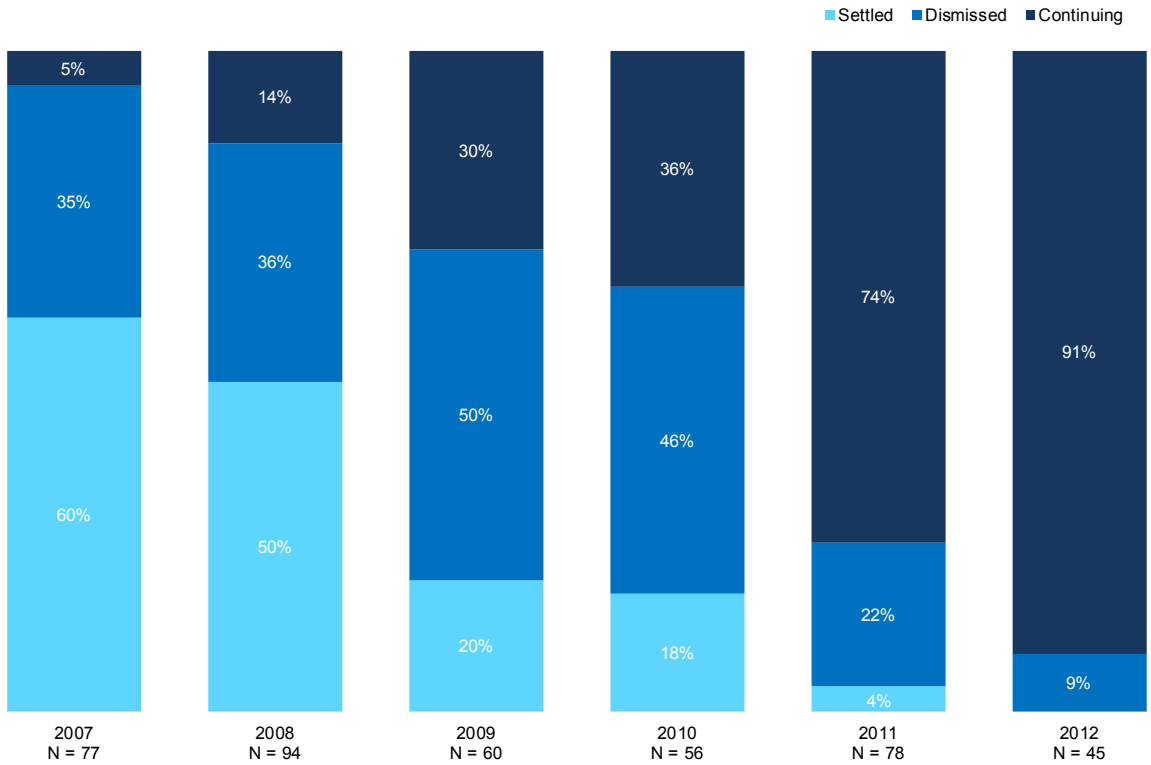
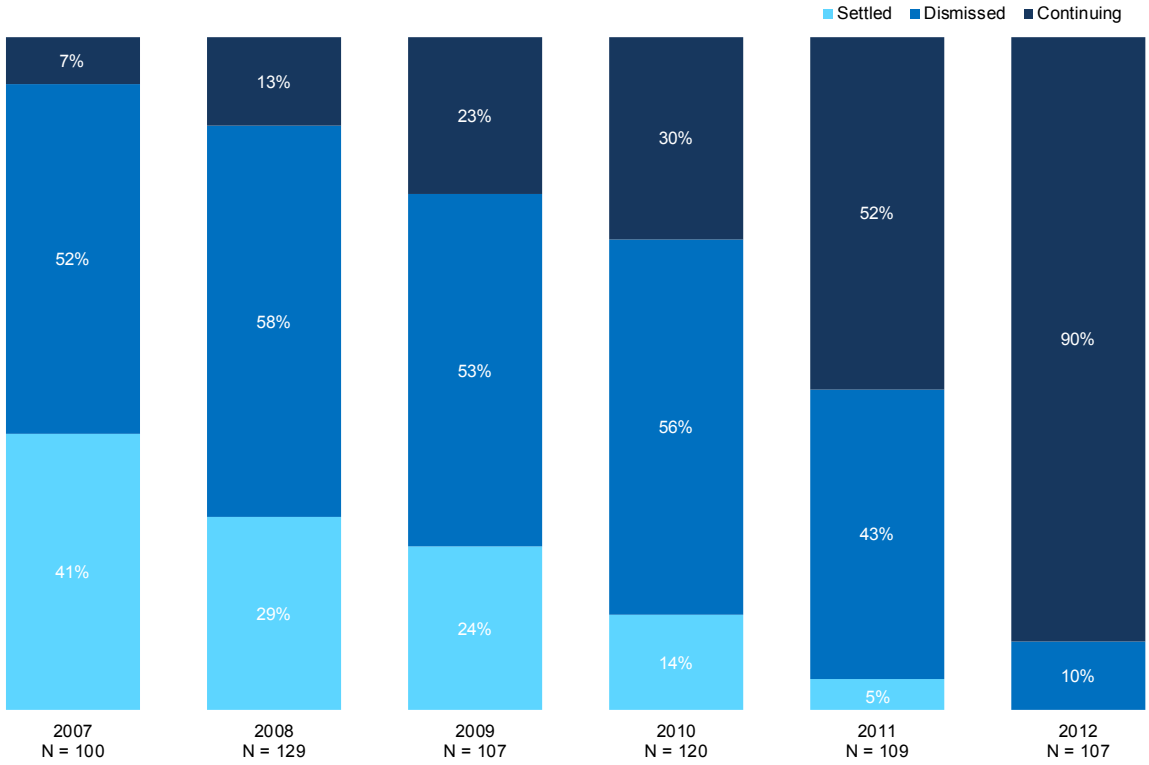


FIGURE 6B: STATUS OF NON-ACCOUNTING CASES AT THE END OF 2012
2007–2012



For cases that have reached disposition, Figures 7a and 7b present the stage at which the case is resolved for accounting cases and non-accounting cases, respectively. As shown, only 5 percent of accounting cases were voluntarily dismissed prior to a ruling on motion to dismiss, compared with 24 percent of non-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 7A: STAGES AT WHICH ACCOUNTING CASES ARE RESOLVED 2007–2010

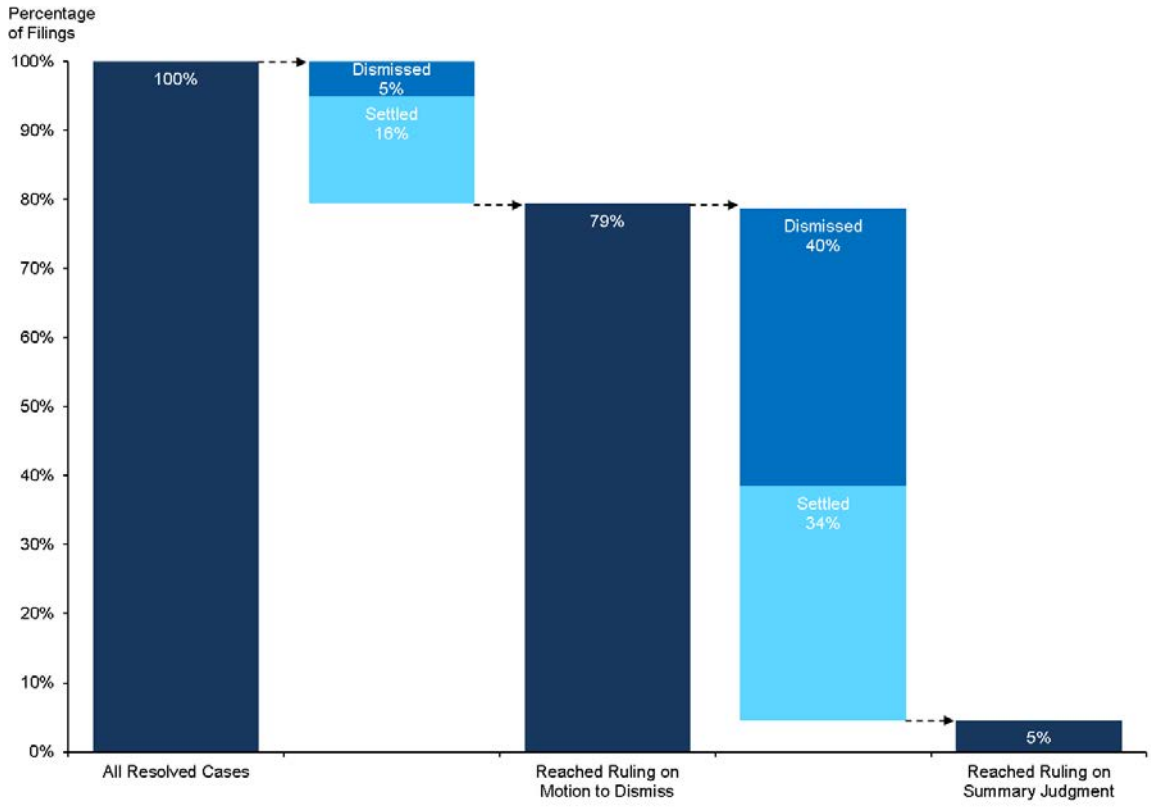
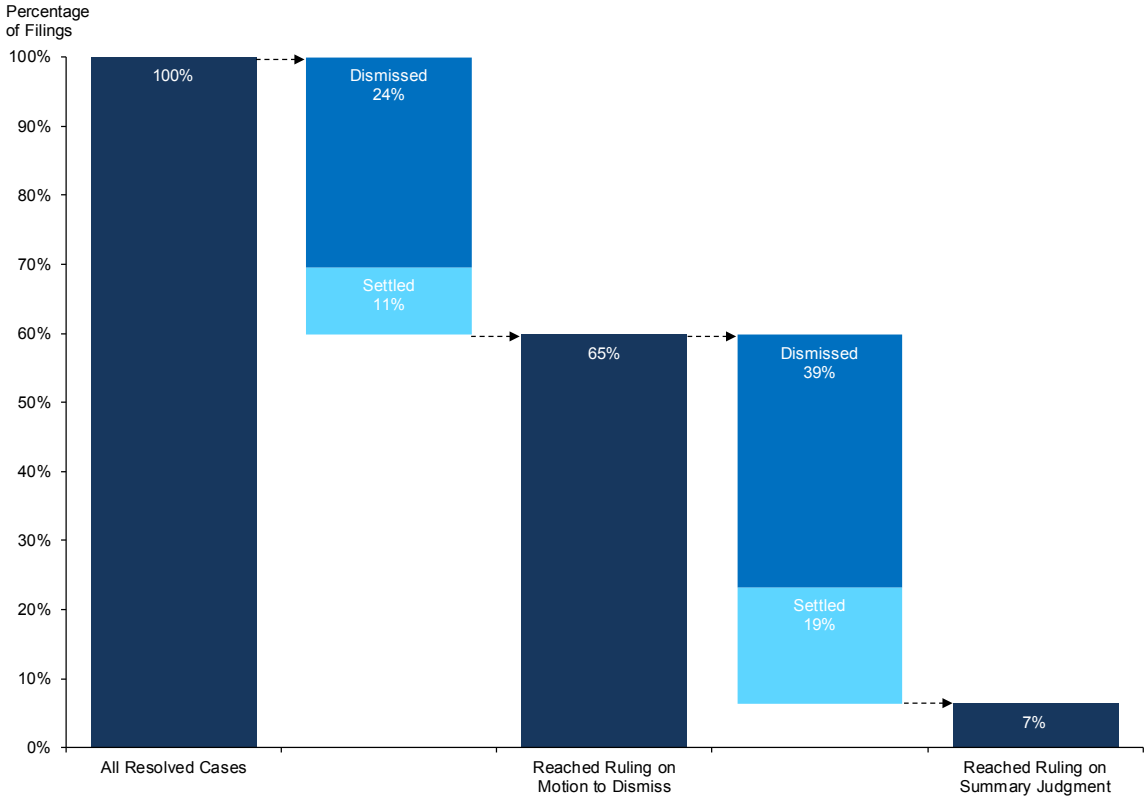


FIGURE 7B: STAGES AT WHICH NON-ACCOUNTING CASES ARE RESOLVED 2007–2010

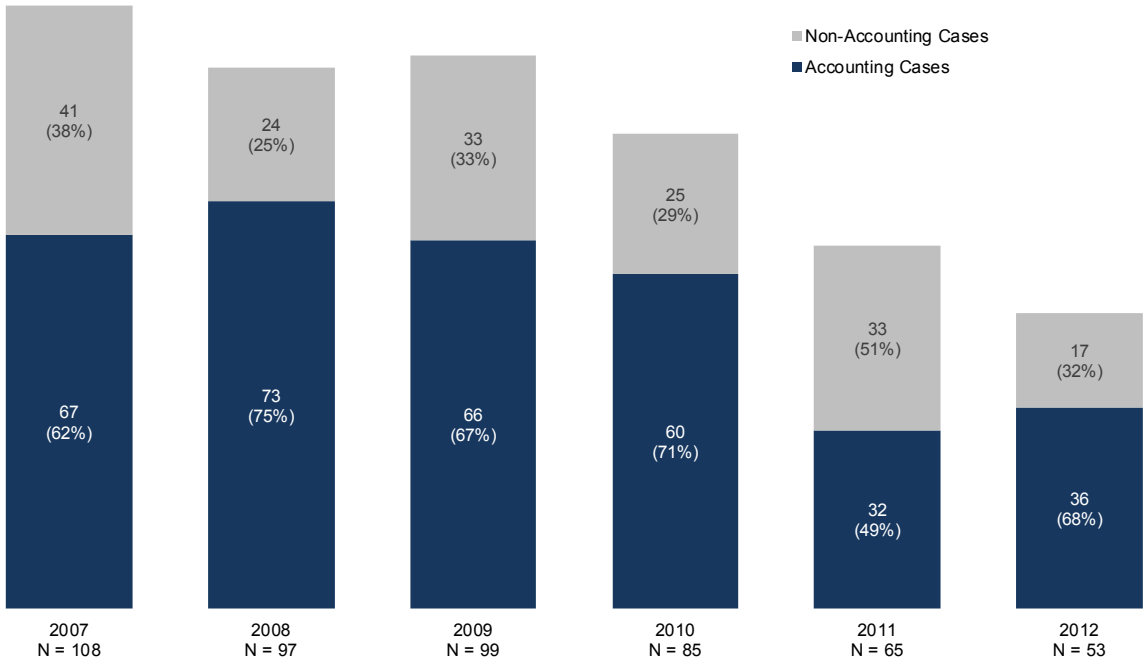


CASE SETTLEMENTS

In 2012, the proportion of securities class action settlements involving accounting allegations increased to almost 70 percent from less than 50 percent in 2011 (Figure 8). The proportion in 2011 was unusually low; accordingly, the current year proportion is closer to that observed for 2007 through 2010.

As discussed in *Securities Class Action Settlements—2012 Review and Analysis* (*2012 Settlements Report*),[12] the 53 securities class action settlements in 2012 is a post–Reform Act low. Therefore, although the proportion increased, the number of accounting case settlements remained relatively low. Since cases often take several years to reach settlement, the decline in the number of cases settled in 2012 can in part be traced to reduced filing activity in 2009 and 2010.[13]

FIGURE 8: SETTLEMENTS AND SHARE OF ACCOUNTING CASES 2007–2012



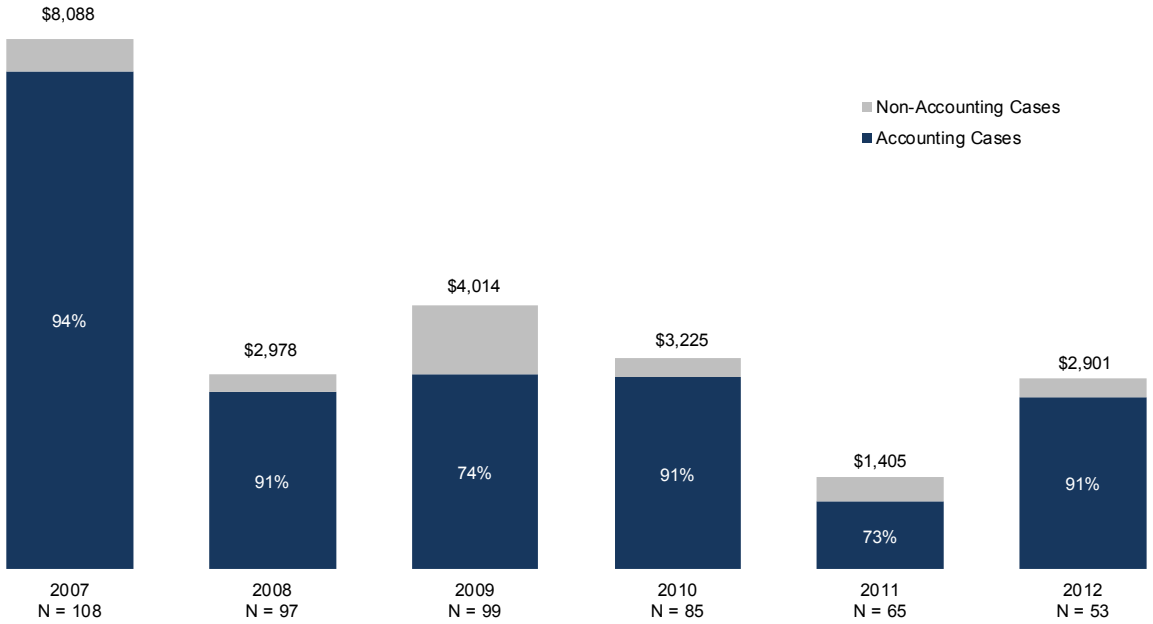
12 Cornerstone Research, *2012 Settlements Report*.

13 In 2009 and 2010, case filings averaged approximately 150 per year, compared with an average of approximately 200 case filings per year during 2007 and 2008. See *2012 Filings Report* and *2012 Settlements Report*.

Accounting cases continue to represent a substantial portion of the dollar value of all settlements (Figure 9). While accounting cases represented less than 70 percent of the number of 2012 case settlements, they represented over 90 percent of the total value of settlements.

FIGURE 9: SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES 2007–2012

Dollars in Millions



Note: Settlement dollars adjusted for inflation; 2012 dollar equivalent figures used.

Both average and median settlement amounts are higher for accounting cases compared with non-accounting cases. For example, in 2012, the average and median settlement amounts for accounting cases were approximately $73 million and $15 million, respectively, compared with $16 million and $6 million for non-accounting cases.

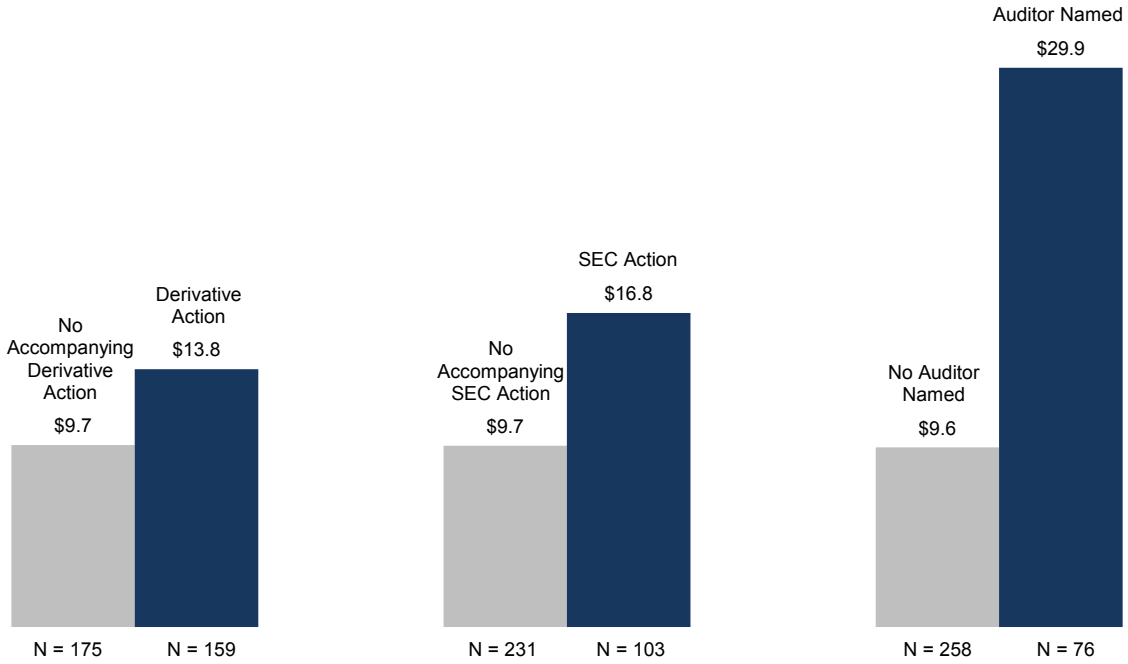
Part of this difference is due to the fact that accounting cases often involve other factors that are also associated with higher settlement amounts, such as accompanying SEC actions (evidenced by the filing of a litigation release or administrative proceeding). In fact, over 30 percent of settled accounting cases involved accompanying SEC actions, compared with less than 10 percent of non-accounting case settlements.

OTHER FACTORS ASSOCIATED WITH ACCOUNTING SETTLEMENTS

Historically, accounting cases accompanied by derivative actions, SEC actions, and/or involving auditors as named defendants have settled for higher amounts than accounting cases not involving these factors (Figure 10).

FIGURE 10: ADDITIONAL FACTORS AFFECTING MEDIAN CASE SETTLEMENT AMOUNTS 2007–2012

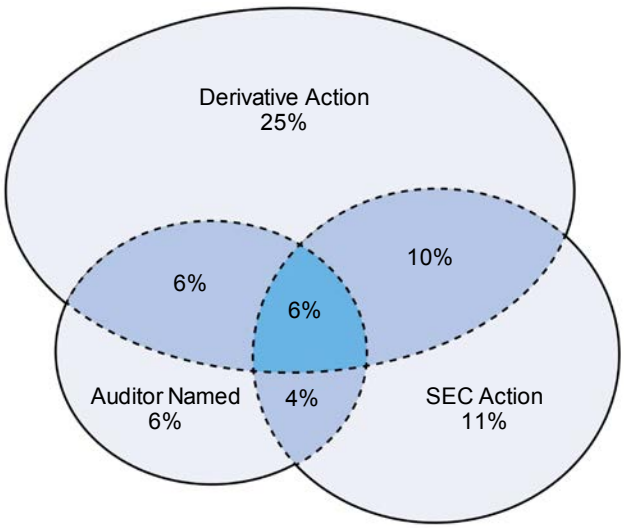
Dollars in Millions



Note: Settlement dollars adjusted for inflation; 2012 dollar equivalent figures used.

Almost 70 percent of settled accounting cases are accompanied by one or more of these factors, and over 25 percent of settled accounting cases are accompanied by two or more of these factors (Figure 11).

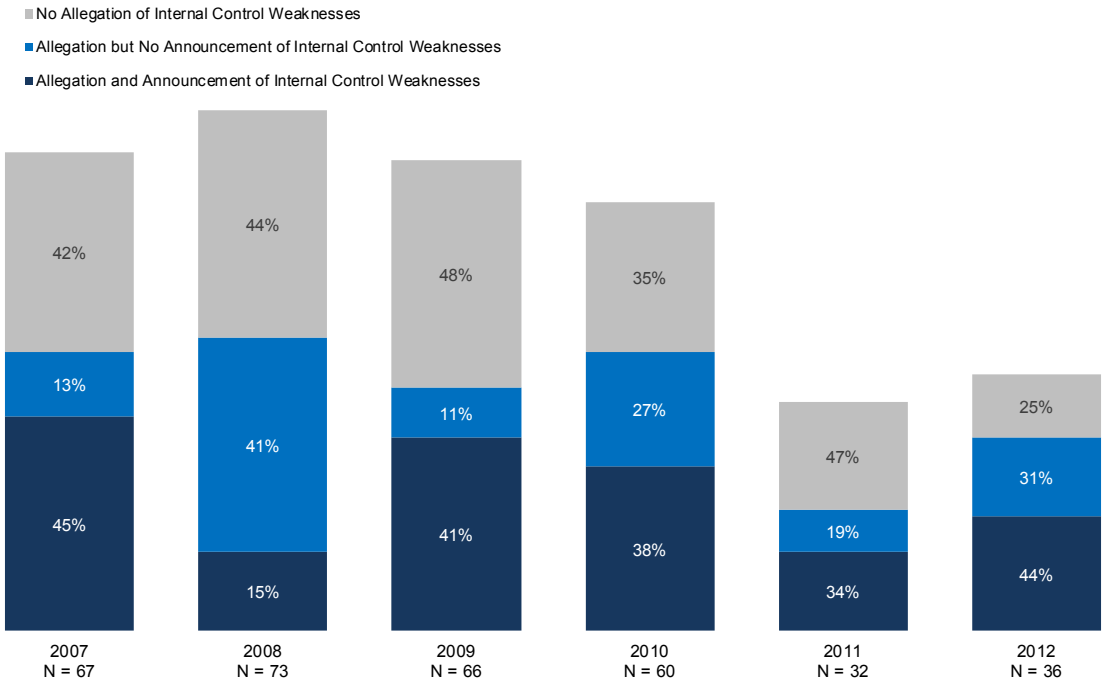
FIGURE 11: CHARACTERISTICS OF ACCOUNTING CASE SETTLEMENTS 2007–2012



ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES AND SETTLEMENT OUTCOMES

Allegations related to weaknesses in internal controls are prevalent in accounting cases. For many of these cases, the complaints reference the fact that the company announced the presence of internal control weaknesses. In 2012, almost 45 percent of settled accounting cases included allegations of internal control weaknesses and referenced a company announcement, compared with just over 30 percent of cases with allegations of internal control weaknesses but no such company announcement (Figure 12). As subsequently illustrated, company announcements of internal control weaknesses are important to settlement outcomes.

FIGURE 12: ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES 2007–2012

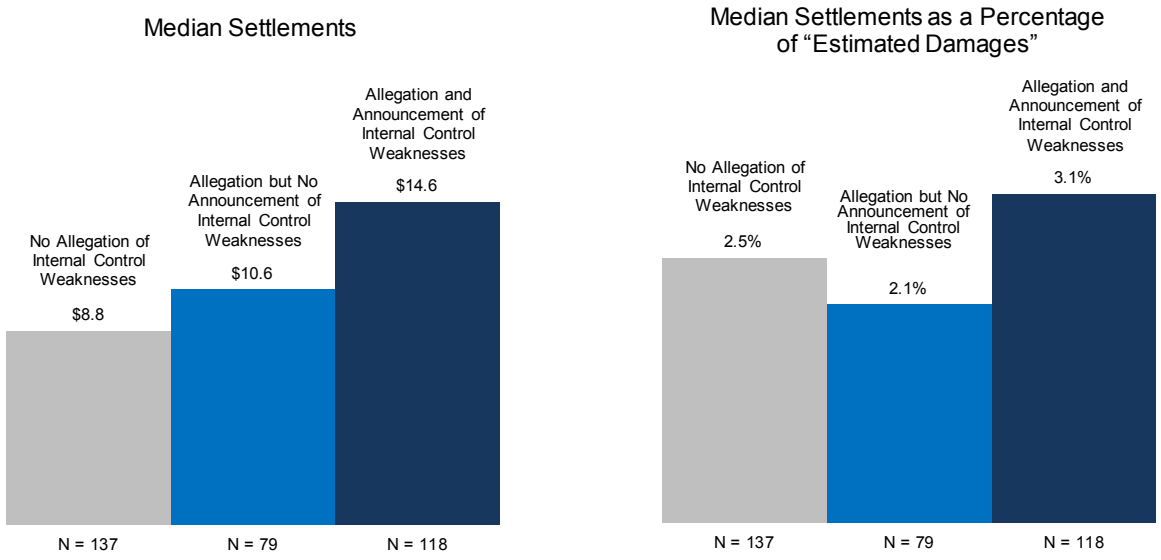


In Figure 13, we compare settlement amounts for accounting cases with no internal control allegations, cases with internal control allegations but no company announcement reporting the presence of internal control weaknesses, and cases with allegations of internal control weaknesses accompanied by company announcements acknowledging the presence of weaknesses.[14]

We examine both median settlement amounts and settlement amounts as a percentage of "estimated damages."[15] Our research has consistently found that shareholder losses are the single most important factor in determining settlement amounts (larger shareholder losses generally result in larger settlements).[16] Thus, it is useful to analyze not only settlement values but also settlements as a percentage of "estimated damages" when considering the effect of various factors on settlements. Although higher "estimated damages" are associated with larger settlements, higher "estimated damages" are also associated with lower settlement amounts as a percentage of "estimated damages." In other words, higher "estimated damages" translate into a nonlinear increase in settlement values.

Cases in which the company announced internal control weaknesses are associated with both higher median settlement amounts and a higher median settlement share of "estimated damages." This is consistent with the notion that allegations bolstered by company acknowledgements of internal control weaknesses provide more leverage for plaintiffs in settlement negotiations.

FIGURE 13: MEDIAN ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES
2007–2012
Dollars in Millions



Note: Settlement dollars adjusted for inflation; 2012 dollar equivalent figures used.

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14 We determine whether a company announced an internal control weakness based on the information included in plaintiffs' complaints.

15 Our variable "estimated damages" is discussed in detail in Cornerstone Research's *2012 Settlements Report*. As a brief overview, this measure is a highly simplified approach to estimating plaintiff-style damages, and, although not intended to represent actual damages borne by shareholders, consistent application of this method allows us to examine trends over time.

16 For example, see *2012 Settlements Report*.

ALLEGATIONS OF GAAP VIOLATIONS AND SETTLEMENT OUTCOMES

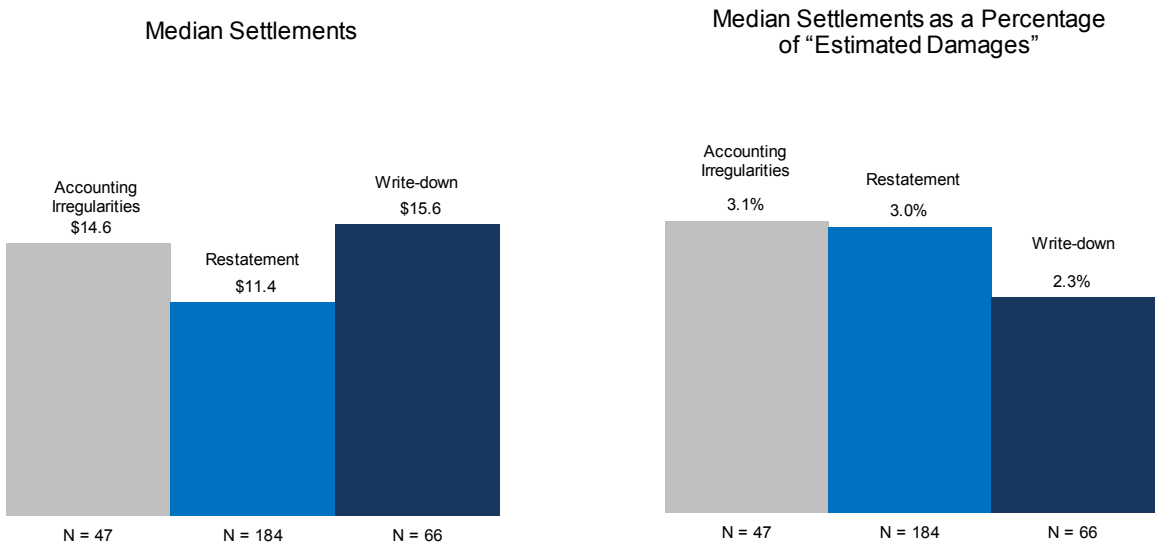
Plaintiffs' allegations regarding GAAP violations can vary widely. For purposes of this report, we focus on three major areas: cases involving accounting irregularities, cases involving restatements of financial statements, and cases involving company announcements of asset write-downs.[17] Cases involving accounting irregularities represent suits in which the company has acknowledged the presence of intentional misstatements or omissions in its financial statements, and thus, intuitively, would be expected to be associated with higher settlement amounts. Restatements and company announcements of asset write-downs also involve a change in a company's financial statements. The distinction between them is that asset write-downs are considered changes in estimates and are accounted for prospectively, rather than through a retroactive restatement of the financial statements. Neither restatements nor asset write-downs necessarily involve a misstatement made with intent.

As shown in Figure 14, cases involving write-downs are associated with the highest settlement amounts, while cases involving accounting irregularities and/or financial statement restatements are associated with higher settlements as a percentage of "estimated damages." These results reflect the fact that, overall, cases involving asset write-downs are associated with higher "estimated damages," and cases with higher "estimated damages" tend to settle for lower percentages of "estimated damages."

Cases involving write-downs are also associated with larger issuer defendants. Specifically, the median defendant asset size for settled cases involving a write-down was approximately $1.45 billion, compared with only approximately $570 million for cases not involving a write-down. The substantial difference in size is likely due in part to the fact that a number of the firms involved with asset write-downs are in the financial sector.

FIGURE 14: MEDIAN ACCOUNTING CASE SETTLEMENTS AND ACCOUNTING EVENTS 2007–2012

Dollars in Millions

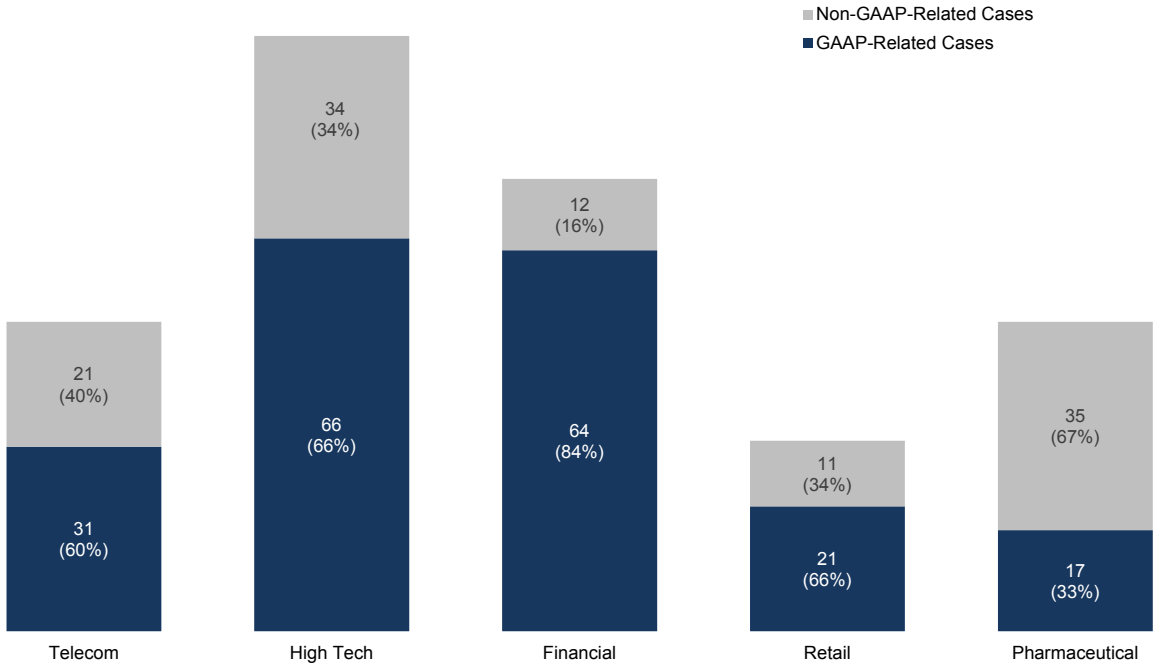


Note: There are 15 cases in which both a restatement and write-down occurred. There are 37 cases with accounting irregularities and either a restatement (N = 34) or write-down (N = 1) or both (N = 2). Settlement dollars adjusted for inflation; 2012 dollar equivalent figures used.

[17] Asset write-downs include additions to allowances that offset asset balances (e.g., the allowance for loan losses). Company announcements of such write-downs are based on the allegations described in the complaint.

For accounting case settlements, the frequency of GAAP allegations varies across industry sector. As shown in Figure 15, the financial industry represents the sector in which settled cases are most likely to include GAAP allegations—84 percent of settled cases in the financial sector involved GAAP allegations. Of the 64 financial sector case settlements involving GAAP allegations, 27 related to the credit crisis. In contrast, only 33 percent of pharmaceutical settlements have involved GAAP allegations. This is likely due to the fact that such cases often revolve around non-accounting-related allegations, such as FDA approval status.

FIGURE 15: NUMBER OF ACCOUNTING CASE SETTLEMENTS WITH GAAP ALLEGATIONS BY INDUSTRY 2007–2012



CORNERSTONE RESEARCH'S SETTLEMENT PREDICTION ANALYSIS

Features of securities cases that may affect settlement outcomes are often correlated. Regression analysis makes it possible to examine the effects of these factors simultaneously. Accordingly, as part of our ongoing research on securities class action settlements, we apply regression analysis to study factors associated with settlement outcomes.

Our analysis reveals that several accounting-related variables are statistically significant predictors of settlement amounts, even when controlling for other important settlement outcome determinants. These include GAAP allegations, restatements of financial statements, announcements of internal control weaknesses, and auditors as named defendants. The presence of any of these factors is associated with higher settlement amounts. These results are consistent with our earlier discussion of the effect of these factors on settlements as a percent of "estimated damages."

For further discussion of our settlement prediction analysis, see Cornerstone Research's *2012 Settlements Report*.

CONCLUDING REMARKS

During 2012 there was a sharp decline in initial filings of all securities class actions and of those with accounting allegations as well. The decline in accounting case filings is attributable, at least in part, to a general slowdown in filing activity during the second half of the year and a substantial decline in filings of Chinese reverse merger cases. Recent developments, such as the significant number of whistleblower tips related to Corporate Disclosures and Financials and the exemption from auditor reports on internal controls for emerging growth companies, may result in increased litigation in the future.

Although the total number of new accounting cases declined, during 2012 we saw the continuation of a number of interesting trends. For the third consecutive year, the majority of accounting cases included allegations of internal control weaknesses, often when a company had *not* announced such a weakness. Over the last three years, we have also seen a trend for initial filings to include internal control allegations without corresponding allegations of GAAP violations. As these cases progressed, plaintiffs added GAAP allegations slightly more often than they dropped the internal control allegations entirely. As in prior years, accounting cases have continued to take longer to resolve and are more likely to settle than be dismissed. This may be attributable at least in part to the tendency for accounting cases to involve higher investor losses and/or to be more complex than non-accounting cases.

The proportion of securities class action settlements involving cases with accounting allegations increased substantially compared with 2011. As a result of this increase and the fact that accounting cases settle for higher amounts, settlements of accounting cases represented over 90 percent of the total value of settlements in 2012. Accounting-related factors such as accounting irregularities and restatements may suggest stronger plaintiff cases, thereby leading to higher settlements. These factors are also correlated with other factors that tend to further increase settlement amounts, such as the presence of accompanying SEC actions, which may provide plaintiffs with greater leverage in settlement negotiations.

Accounting cases often involve allegations of internal control weaknesses, and when these allegations are accompanied by company announcements of weaknesses, they are associated with both higher settlement amounts and higher settlements as a percentage of "estimated damages."

While the recent decrease in accounting-related case filings suggests that we may observe fewer accounting case settlements in the near future, we expect that cases involving accounting allegations will continue to represent a significant portion of the value of case settlements.

RESEARCH SAMPLE

This report utilizes the databases described in the *2012 Filings Report* and the *2012 Settlements Report*. We focus on cases filed or settled since 2007; thus, our samples consist of subsets of the full databases described in these reports.

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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