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A THEORETICAL AND EMPIRICAL INVESTIGATION OF THE RELEVANCE AND RELIABILITY OF CERTAIN OPINIONS CONCERNING PENDING LITIGATION

by

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TITLE

A Theoretical and Empirical Investigation of the Relevance and

Reliability of Certain Opinions Concerning

Pending Litigation

BY

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A THEORETICAL AND EMPIRICAL INVESTIGATION
OF THE RELEVANCE AND RELIABILITY
OF CERTAIN OPINIONS
CONCERNING PENDING LITIGATION

Matthew Martin Skaro, Ph.D
University of Nebraska, 1987
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This study gathered theoretical and empirical evidence about the relevance and reliability of opinions presented in notes to annual reports in which either (or both) management or the company's legal counsel indicates that the conclusion of a lawsuit will not result in a material loss to the reporting company. Doubts had been raised about the reliability of these opinions by the apparent contradiction between the presentation of an opinion indicating that the likelihood of loss from litigation is remote and the fact that accounting standards do not require the disclosure of pending litigation when the likelihood of such a loss is judged remote.

An analysis, based on the descriptions of relevance and reliability in Statement of Financial Accounting Standards

_No. 2_ and on evidence in the accounting literature, was made of whether such opinions appear to be relevant and reliable, the prerequisites of useful financial information. Tests were conducted of the predictive ability--an indicator of accuracy--of such opinions presented with litigation in the 1978 annual reports of _Fortune_ 500 companies.

The analysis suggested that such opinions are relevant, but left doubts about the accuracy and the verifiability of these opinions and, therefore, about their reliability. The test results indicated that such opinions accurately predict that litigation will not result in material losses. The results also implied that auditors find such opinions sufficiently verifiable to prevent their blatant misuse.

The study concluded that such opinions are useful to decision makers and that, despite doubts about their reliability, many decision makers may be willing to accept them as such. Since the Financial Accounting Standards Board considers usefulness to decision makers as the most important determinant of appropriate financial information, most likely it would find the current system of voluntary use of such opinions acceptable.

To my parents,

Joseph and Mary Skaro

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CHAPTER ONE

INTRODUCTION

Statement of Purpose

This study gathers theoretical and empirical evidence about whether certain opinions contained in annual reports reliably indicate to investors, creditors and other decision makers the effects of the conclusions of pending lawsuuits. The opinions of interest here are those in which either (or both) management or the company's legal counsel indicates that the conclusion of a lawsuit will not result in a material loss to the reporting company.

Description of Opinions

Such opinions appear in the notes to financial statements included in corporate annual reports. Almost all of these opinions fall into either of two categories: (I) Opinions which indicate that the conclusion of the lawsuit will not have a material effect on the company's financial position or on its results of operations, and (II) opinions which indicate that the conclusion of the lawsuit will not have a material effect on the company's financial position. In this study, these opinions will be referred to as Type I opinions and Type II opinions, respectively. An example of each of these types is presented in Figure 1-1.

FIGURE 1-1

Examples of Type I and Type II Opinions

Type I Opinion

"In the opinion of management, the outcome of this lawsuit will not have a material effect on the financial position or results of operations of the company."

Type II Opinion

"In the opinion of management, the outcome of this lawsuit will not have a material effect on the financial position of the company."

Statement of Problem

Certain evidence raises doubts about whether Type I and Type II opinions are reliable. For instance, Dennis and Keith (1981) implicitly question the reliability of such opinions when they comment that there is an unusually great number of disclosures of pending litigation which contain Type I and Type II opinions.[1] Their perception is based, it seems, on the Statement of Financial Accounting Standards No. 5 "Accounting for Contingencies" (SFAS 5) which does not require the disclosure of pending litigation when the likelihood of a material loss resulting from such litigation is

[1]D.M. Dennis and R.M. Keith, "Are Litigation Disclosures Adequate?" *Journal of Accountancy* 151 (March, 1981): 56.

judged to be remote.[2] Thus, if one is to believe that all Type I and Type II opinions found in notes are reliable, one must also believe that management is disclosing many lawsuits that it is not required to disclose. The frequency with which a Type I or Type II opinion appears raises a question about whether such opinions are the management's and the company's legal counsel's actual assessments of the likelihood of loss from the conclusion of lawsuits.

While the additional literature reviewed[3] does not specifically address the possibility of deliberate management deception suggested above, it does seem to support doubts concerning the reliability of these opinions. More particularly, this literature supports doubts about whether such opinions accurately describe the likelihood that lawsuits will result in material losses to their companies, and about whether outside parties (e.g. auditors) are able to verify the accuracy of such descriptions. While supporting doubts of the reliability of such opinions, the literature does not

[2]Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5 "Accounting for Contingencies," (Stamford, Connecticut: FASB, 1975), par. 10. See Appendix 1-1 at the end of this chapter for a description of the contents of SFAS 5 including the reporting requirement for lawsuits pending against a company.

[3]This literature and the evidence it presents concerning the reliability of Type I and Type II opinions is described in Chapter Two.

provide direct evidence on this matter. The empirical research within this study may begin to fill this gap.

As discussed in Chapter Two, Type I and Type II opinions apparently provide information that can affect the actions of investors, creditors and other decision makers, so it seems that decision makers would want such opinions to be presented when justified. However, if Type I and Type II opinions are unreliable, they cannot be of use for decision-making. Not only are such opinions of no value to decision makers, they may actually prove costly to them. If decision makers actually depend on unreliable opinions concerning the outcome of pending litigation, they may make sub-optimal decisions.

Questions for Research

The foregoing discussion indicates the need to gather additional evidence concerning the reliability of Type I and Type II opinions. This study attempts to gather such evidence through research by addressing two questions:

> How often are lawsuits presented with Type I or Type II opinions concluded without a material loss to the company?

> Are lawsuits presented with such opinions more likely to be concluded without a material loss to the company than lawsuits presented without such opinions?

Method of Research[4]

To address the first research question, a number of lawsuits presented with Type I or Type II opinions were selected and traced to determine whether or not they resulted in material losses to the reporting companies.[5] The percentage of lawsuits in the group which did not result in material losses was determined. The computation of a confidence interval around this percentage will enhance the presentation of results. However, no fixed standard exists for determining whether the percentage of lawsuits which did not result in material loss is high enough to suggest that Type I and Type II opinions correctly predict the impact of lawsuits on the reporting companies. Hence, individuals must use their own standards to interpret the results.

In order to address research question #2, another group of lawsuits were selected and traced to determine whether or not they resulted in material losses to the reporting companies. The disclosure of these lawsuits did not include the type or types of opinions tested in the first research

[4] Research methodology is discussed in detail in Chapter Three.

[5] Two tests of this question were conducted. In one test, both lawsuits presented with Type I opinions and lawsuits presented with Type II opinions were selected. In the other test, only lawsuits with Type I opinions were selected. See explanation in Chapter Three.

question.[6] The percentage of lawsuits in this second group which were concluded <u>without</u> a material loss to their companies was determined and compared to the percentage of lawsuits concluded without a material loss computed for the first research question. The results of this comparison will be supplemented by a chi-square test of the null hypothesis that "the percentage of lawsuits which did not result in a material loss to the company is the same in both groups." If the lawsuits presented with the type or types of opinions tested in the first question are concluded with a greater percentage of material losses than the lawsuits disclosed without such opinions, it may be difficult to claim predictive ability for such opinions.

Relationship of Research Questions to Reliability

In order to be reliable, a Type I or Type II opinion must faithfully report what it claims to present (representational faithfulness).[7] That is, at the time the opinion

[6]Two tests of this question also were conducted. For one test, the second group selected included lawsuits without any opinion concerning the impact of the conclusion of the case on the reporting company. For the second test, the second group included the lawsuits in the second group above and the lawsuits with Type II opinions which were selected for the first test of research question #1. See note 5 above and Chapter Three.

[7]Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2 "Qualitative Characteristics of Accounting Information," (Stamford, Connecticut: FASB, 1980), par. 59.

is given, the likelihood must be no greater than slight that the lawsuit reported upon will result in a material loss to the company.[8] Ideally, this study would provide direct evidence concerning the representational faithfulness of Type I and Type II opinions. However, for reasons to be discussed in Chapter Two, it seems difficult -- if not impossible -- to verify the representational faithfulness of such opinions. Therefore, direct tests of representational faithfulness are not used in this study.

The research questions addressed by this study concern the ability of Type I and Type II opinions to correctly predict that the conclusion of lawsuits will not result in a material loss (predictive ability). These questions were chosen for study because the predictive ability of such opinions appears to provide an effective indicator of their representational faithfulness.

If Type I and Type II opinions are representationally faithful, one would expect the predictions in the opinions to be correct as well. Therefore, a research finding that

[8]Even though an opinion states that a lawsuit will not result in a material loss, the knowledgeable reader will realize that there is at least a slight chance of a material loss. This assertion derives from the fact that opinions claim to represent management's best judgment of the expected events and their effects related to litigation. Whenever expectations are involved, there is a chance they will prove incorrect.

such opinions did have predictive ability would suggest that such opinions were also representationally faithful. Conversely, a finding that such opinions did not possess predictive ability would call into question the representational faithfulness of such opinions.

Although the predictive ability of Type I and Type II opinions appears to provide an effective indicator of their representational faithfulness, not every lawsuit with a representationally faithful Type I or Type II opinion should be expected to be concluded without a material loss. This assertion derives from the fact that opinions claim to represent management and/or the company's legal counsel's best judgment of the expected events and their effects related to litigation. Whenever one deals with expectations, the possibility exists that the expectations will prove incorrect. For example, management might reasonably expect that any judgment against the company in connection with an adverse verdict would be so small as to be immaterial to the company. However, a jury might decide to award the plaintiff twice the damages sought. Such an unexpected event might turn a representationally faithful opinion into an incorrect prediction.

Use of Findings

The Financial Accounting Standards Board (FASB) may find

evidence concerning the reliability of Type I and Type II opinions useful. The FASB is responsible for determining not only what information should appear in financial statements and in the notes accompanying such financial statements, but also how that information should be presented. According to its Statement of Financial Accounting Standards No. 1 "Objectives of Reporting by Business Enterprises" (SFAC 1), the FASB's decisions concerning the form and content of financial reporting should be motivated by a desire to provide useful information to investors, creditors and other decision makers.[9] Currently, the FASB does not have a stated position on the use by management and/or legal counsel of opinions in notes concerning the impact of the conclusion of lawsuits on the reporting company. However, evidence concerning the reliability of Type I and Type II opinions may cause the FASB to consider whether or not such opinions are useful to decision makers. If such opinions are actually shown to be unreliable, the FASB might decide, for instance, to prohibit their use, since, as mentioned above, lack of reliability may prove costly to decision makers.

[9] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1 "Objectives of Reporting by Business Enterprises," (Stamford, Connecticut: FASB, 1978), note on conceptual framework project and par. 34.