The (in)adequacy of legal contingency reporting

Abigail Allen*
Brigham Young University
aallen@byu.edu

Kevin Standridge
Duke University
kevin.standridge@duke.edu

Jake Thornock
Brigham Young University
thornock@byu.edu

October 2023

Abstract: Do firms provide adequate, timely, and transparent reporting on impending contingent litigation losses? Despite intense regulatory debate, related empirical evidence is sparse, dated, and lacks empirical identification. We use a hand-collected sample of firm disclosures together with novel legal dates to empirically identify conformity with the probability and estimability conditions of ASC 450. This innovation allows us to distinguish what *should be* reported from what *is* reported. Contrary to regulators' expressed optimism, our findings suggest that current reporting of litigation losses is inadequate, untimely, and lacks transparency. In a high-powered setting where losses are unambiguously material, probable, and estimable, we find that roughly one sixth of firms fail to observably report accruals or estimated losses. Further, we find that less than 10% of material litigation losses are reported in advance of preliminary lawsuit resolution. Additionally, more than half of disclosures lack transparency about the underlying accounting treatment. Finally, our evidence suggests that legal contingency reporting is insensitive to a dramatic shift in the probability of litigation losses but highly sensitive to changes in estimability. Our results imply that managers overwhelmingly report contingent liabilities more like regular liabilities, waiting to report until contingent losses are nearly certain and precisely quantified.

**Corresponding author.* *We are grateful to Clark Asay, Jim Cox, Mike Drake, Travis Dyer, John Heater, Hannah Judd, Antonis Kartapanis, Josh Lee, Ken Merkley, Tim Seidel, Amy Sheneman, Melissa Western, Jeff Wilks, Chris Yust and workshop participants at Baruch College, BYU, Duke University, Emory University, The Ohio State University, Texas A&M University, and Texas Christian University. We thank Ryan Anderson, Brayden Bulloch, Daniel Case, Henry Lindeman, Carmen Payne-Mann, Emma Shin, Jacob Summers and Ben Yates for research assistance, and an unidentified FASB employee for helpful insights on contingent liability standard setting.*

1.0 Introduction

Our primary objective in this study is to provide new evidence on the adequacy, timeliness, and transparency of contingent legal liability reporting to stakeholders relative to ASC 450 guidelines and SEC "early-warning" admonitions. While a few prior studies have examined contingency reporting (e.g., Desir 2010; Hennes 2014; Cen et al., 2018; Huang et al., 2021), prior research has lacked the empirical identification to provide conclusive evidence on the adequacy, timeliness, and transparency of legal contingency reporting relative to private managerial assessments of loss probability and estimability. We introduce a novel identification strategy, combined with a highly granular analysis of financial reporting data, to overcome these issues and re-examine firms' contingent legal liability reporting. In summary, we find clear, conclusive, and contemporary evidence that legal contingency reporting is frequently inadequate, untimely, and lacking in transparency, suggesting poor adherence to the guidelines of ASC 450.[1]

Standard setters, regulators, and financial statement users alike have long expressed concerns that existing contingent loss reporting is insufficient to resolving information asymmetries. Both the FASB and the IASB commenced projects in the early 2000s to consider these issues. The proposed projects were met with significant opposition, however, as opponents argued that low levels of loss contingency recognition appropriately reflected the highly uncertain and unpredictable nature of most litigation events, consistent with the intentional leeway afforded in ASC 450's tiered recognition requirements. Ultimately, both the FASB and the IASB cancelled their contingent liabilities projects in 2012 and 2010, respectively, with the FASB citing its diminished urgency in light of "improved disclosures" in response to "increased [regulatory] scrutiny of loss contingency disclosures" (Chasan 2012). However, the concerns about reporting adequacy are alive and well, as the SEC continues to monitor contingent loss reporting, issuing "Dear CFO" letters and comment letters asking companies to improve both the timeliness and transparency of contingency reporting (Deloitte 2023). The SEC has recently undertaken litigation against companies for failing to provide timely loss

[1] In this study, our primary constructs of interest relate to the *adequacy*, *timeliness*, and *transparency* of loss contingency reporting, specifically as they correspond to the probability and estimability conditions outlined under ASC 450. We define and discuss these concepts further in Section 2. For each of these, we also emphasize that all discussion and analyses necessarily measure to what is *observable* in financial statements and disclosures, based on the intuition that decision usefulness is inherently tied to what is observable to outside stakeholders.

contingencies.[2] Likewise, investor action groups and stakeholders have repeatedly listed contingency reporting as some of the "most troublesome disclosures" (p. 9; CFA Institute 2013). Based on these fact patterns, a contemporary examination of the adequacy of contingent liability reporting is needed.

Despite the continued concern over the adequacy of litigation-related contingency reporting, the scope and conclusions of extant empirical research have been limited by several issues. First, and foremost, is a lack of identification. Because contingent liability recognition is predicated upon increasing hurdles relative to the probability and estimability of future losses, it is difficult to assess when an accrual or estimated loss disclosure *should* have been made, namely because probability and estimability are difficult to observe for an outside stakeholder. While prior research has estimated the *existence* of accrued estimated losses, lacking any identification of private managerial assessments related to the probability or estimability of losses, it inherently cannot draw reliable conclusions about the *adequacy* and *timeliness* of those such accruals (or lack thereof). Second, prior research has examined contingent liabilities without reference to the underlying transparency of disclosure (i.e., the extent to which an informed stakeholder can discern the underlying accounting treatment from a firm's disclosure). As discussed below, both the FASB and SEC have expressed concerns regarding lacking transparency; as a result, research that quantifies the extent to which a sophisticated investor can actually discern the existence of accruals is needed.[3] Finally, the samples employed by prior research largely pre-date major changes, including the IASB/FASB's choice to abandon deliberations about the adequacy of contingency reporting and the SEC's amplification of enforcement. Thus, there is no evidence in prior literature from which to assess regulatory assertions of significant improvement in the current contingency reporting landscape.

We overcome the limitations of prior literature using a novel empirical identification strategy applied to high-quality lawsuit data. To develop our empirical identification strategy, we hand-collect and vet legal

[2] For instance, in 2021, the SEC pursued Health Care Services Group for failing to adequately accrue a loss contingency for several class action lawsuits, despite having already entered into preliminary settlement agreements. https://www.sec.gov/litigation/admin/2021/33-10967.pdf
[3] For example, the current FASB chair, Richard R. Jones, has on several occasions advocated for "greater disaggregation of financial reporting information" to aid in decision investor making, which in our case implies that firms provide timely and transparent loss accruals and/or disclosures related to potential litigation losses.

dates from court dockets related to lawsuit filing, motion to dismiss, preliminary settlement, and final settlement. These crucial legal dates are new to the literature and facilitate several research settings with precise empirical identification of reporting adequacy and timeliness relative to the probability, estimability, and disclosure hurdles within ASC 450.

Our sample is comprised of all settled securities class action lawsuits between 1996 – 2021 from the Stanford Class Action Clearinghouse (SCAC). For each of these lawsuits, we hand collect and validate disclosed contingent liability accruals, estimated loss disclosures, and other contingency disclosures from a company's annual reports. We examine the entire 10-K preceding the lawsuit's settlement for any discussion or tabulation of recognized accruals, estimated losses, or other indications in both quantitative and qualitative statements that suggest the existence of an accrual.[4] Relying on the specific language in ASC 450 as a guide, we also code observations as to the transparency of *disclosure* about recognized accruals – quantifying the proportion of disclosures for which the existence of accruals (or lack thereof) can be ascertained with certainty from 10-K disclosures as opposed to requiring researcher judgement.[5]

We begin with baseline descriptive evidence on the extent of legal contingency reporting using a setting where the SEC has indicated that the absence of quantified loss disclosures should be rare – the 10-K disclosure immediately prior to a class-action lawsuit the company loses.[6] Consistent with research from past decades, we find that a substantial proportion of firms – roughly half – provide no evidence of an accrual in this window about future material losses, begging the question as to why.

This question provides the primary impetus for our study. Specifically, utilizing the unique identification afforded by key legal milestones, we vet the competing argument that such low rates of accrual may appropriately reflect the inherent uncertainty and inestimability of future losses against opposing claims

[4] Acquiring and encoding accruals, estimated losses and disclosures requires some degree of researcher judgment, which we acknowledge is inherent in all our analyses and inferences. However, we took great precautions to ensure this process was independent and reliable and achieved a high degree of inter-rater reliability. We discuss this process in detail in Section 2 and Appendix B.

[5] It is possible for firms to record an accrual without explicitly disclosing it. Our view in this study that this reporting choice generally represents poor transparency, which is consistent with arguments presented by the SEC and the FASB. See, for instance, FASB ED 1040-100 ¶BC3. We discuss this issue at length in Section 5.3.

[6] For example, the SEC states that "circumstances where a loss was accrued for a claim without disclosure in prior filings…should be rare" (SEC 2006) https://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf.

that low rates provide evidence of inadequate reporting. The accounting standards for contingencies provide some leeway for subjectivity and management discretion in recognizing or disclosing legal contingencies based on a) uncertainty about the outcome likelihood or b) difficulty in estimating the loss amount. Therefore, using our novel identification strategy, we employ empirical settings that allow us to examine these two explanations that might justify low rates of providing legal contingency accruals.

The first explanation relates to the inherently uncertain nature of litigation, which may give leeway to firms to avoid providing a contingency accrual under the premise that a legal loss is not probable. To test this explanation, we conduct two tests. First, we examine the disclosure of loss estimates, which are required under ASC 450 whenever the likelihood of loss is "reasonably possible." Because the bar for providing a loss estimate is quite low (i.e., disclose an estimate if loss probability is more than remote), we expect that the vast majority of non-accruing firms should provide disclosure of loss estimates prior to lawsuit resolution. However, we find that disclosure in this category is negligible – we find only 1 non-accruing firm in our entire sample that provides a loss estimate. That is, in addition to the observed low rate of disclosed accruals, we find that there is almost no disclosure of loss estimates at lower probability thresholds, suggesting extremely low compliance with the three-tiered approach of ASC 450.[7]

Second, we examine whether the incidence of reported accruals is higher after a shock that clearly increases the probability of legal loss – when the lawsuit's motion to dismiss has been denied. Following this event, more than 99% of lawsuits settle rather than proceed to litigation (Klausner and Hegland 2010). Thus, this important legal date clearly demarcates a point at which legal losses are highly and unambiguously probable. Comparing the sub-sample of firms whose 10-K date exogenously falls after versus before a failed motion to dismiss, we find no significant difference in observable accruals, and continue to observe surprisingly high rates of non-recognition. For nearly half of the material loss sample whose 10-K dates fall post denial of the motion to dismiss, we find no evidence of either an accrual or estimated loss disclosure,

[7] Because we employ a conservative coding strategy – giving credit for accrual recognition when a settlement amount is disclosed but there is no explicit reference to a loss provision – it is possible some of the observations we code as accruals are really estimated loss disclosures. If this is the case, it means even *fewer* firms provide accruals than our reported results suggest and leads to the same conclusion that probability exceptions do not explain the observed low accrual rates.

despite the near-term certainty of legal loss. These findings suggest that poor accrual reporting rates are not explainable based on the probability criterion of ASC 450 – rather, we find strong evidence that a large proportion of firms fail to report accruals or estimated loss disclosures for contingencies that are unambiguously probable.

The second possible explanation for the observed paucity of accrual and loss estimate disclosures relates to difficulty in estimating the potential loss (i.e., estimability). That is, at the time of 10-K filing, there may still be sufficient uncertainty regarding the *amount* of future settlement, which allows firms to avoid accrual and quantitative estimated loss disclosure by asserting that losses cannot be "reasonably estimated" (ASC 450 25-2). To assess the impact of this exception, we develop a novel identification technique. We compare the subsample of 10-K firms whose 10-K reporting exogenously falls after versus before the date the firm enters into a preliminary settlement agreement with the plaintiff. Subsequent to preliminary settlement, contingent losses are both highly probable and clearly estimable as the amount has already been agreed to by both parties.[8]

Our results suggest that accrual reporting increases dramatically around the preliminary settlement date. This finding yields two important implications: First, our results suggest that the estimability criterion in ASC 450 provides the primary hurdle (or scapegoat) to accrual (or for avoiding accrual). Specifically, we observe accrual disclosure for only 8% of the sample with a 10-K date occurring prior to preliminary settlement, compared to 80% after preliminary settlement. These findings suggest both that preliminary settlement appears to trigger disclosure and that disclosure of true estimates which pre-date the existence of an agreement are extremely rare. The implication is that sample firms appear to treat legal contingent liabilities as more akin to regular as opposed to truly *contingent* obligations, waiting to report until after virtually all uncertainty about future loss amounts is resolved.

Second, for the sub-sample of firms with 10-K dates falling after preliminary settlement, our results suggest that roughly one-sixth of material loss firms fail to provide any evidence of an accrual or estimate loss

[8] Indeed, our empirical descriptives (untabulated) suggest that more than 90% of preliminary settlements are within 1% of final settlements, indicating that our event-study design empirically identifies a point in time when the amount of future loss is indisputably estimable and probable.

disclosure, despite the presence of a highly probable and estimable loss. Overall, this lack of observable accruals at this late stage is highly incongruous with the thresholds of ASC 450, as well as FASB statements, SEC comment letters, recent SEC lawsuits, and practitioner statements, all of which convey support for the notion that firms should provide "early-warning" disclosures prior to the resolution of the lawsuit.[9] Accordingly, to further vet these reporting omissions, for the subsample of post-preliminary-settlement non-reporting firms we examine other potentially relevant disclosures (10-Qs and 8-Ks) filed with the SEC between the preliminary settlement and final settlement dates to determine if firms are reporting through other channels. The results of this analysis bolster our conclusions about the inadequacy and untimeliness of reporting. We find that roughly half of firms provide no additional disclosure outside the 10-K nearly one quarter provide disclosures which confirm that no accrual is ever made prior to final settlement. The remaining quarter indicate that they make an accrual subsequent the 10-K, providing evidence that they knowingly chose to delay recognition until after the annual report despite the prior existence of a preliminary settlement. Together, these findings offer new and compelling evidence on the inadequacy and untimeliness of loss contingency reporting that prior research, lacking identification, could not provide.

Next, we examine the transparency of loss contingency reporting. These tests examine possibility that firms do in fact make accruals, but they are indiscernible or ambiguous to an informed stakeholder due to limited or poor 10-K disclosure. The SEC has asserted that the decision usefulness of contingent losses hinges on transparent and timely disclosure, and that firms should avoid "unclear language in disclosures" (Deloitte 2017), thus we expect firm disclosures to provide clarity about the underlying accounting treatment. The test reveals otherwise – we find strong evidence of "unclear language" in the disclosures related to loss contingencies. Specifically, we find that, in just under half of material loss observations, the existence or non-existence of an accrual is certain from the disclosed text – that is, more often than not, external stakeholders are provided ambiguous disclosure (requiring judgement) about whether an accrual has been made.[10] We

[9] See, for example: https://www.sidley.com/en/insights/newsupdates/2019/10/sec-charges-highlight-need-for-timely-disclosure-of-loss-contingencies-and-material-business-risks

[10] Given the need for researcher judgement in classifying firm disclosures for accruals, Appendix B provides a detailed rubric for classification. In Section 5, we further discuss and provide evidence of the reliability of our coding relative to observable changes in balance sheet liabilities where we expect to find recorded contingent losses.

believe this is an important contribution relative to prior literature, as it provides novel evidence of poor transparency of contingency disclosure (in addition to poor accrual reporting) and its potential implications for stakeholder usefulness.

Given regulatory statements that reporting has improved over time, in our final analyses, we examine whether there is an improvement in the timely reporting of legal accruals over the last decade relative to key litigation milestones. While we do find some cross-sectional evidence of improved contingent liability reporting in response to industry specific SEC attention as well as variables intended to proxy for auditor scrutiny, our results suggest that on over time such oversight has had a negligible impact on average firm behavior. That is, we find no temporal evidence to suggest that that either the overall rate of contingent liability accrual or the timeliness of accruals relative to the date of preliminary settlement has improved in this last decade, which does not support regulators' optimistic contention that increased SEC scrutiny and auditor attention obviated the need for a revision to existing standards.

One important limitation of our analyses is that they can only speak to *observable* accruals provided in SEC filings. To the extent that accruals are made by firms without any indication in disclosure, provided exclusively through channels other than SEC filings, or that ambiguous disclosures are misclassified (in either direction) by researchers, this could influence our data, tests, and inferences. Notwithstanding, we believe that quantifying the extent of observable accruals is of critical importance because it provides evidence on the information set that is available and usable by interested stakeholders. In addition, we conduct several analyses which give us confidence in the reliability of our coding. First, all observations in our sample are independently coded by at least two coauthors. Dual-coder initial agreement rates are 98%, suggesting a high degree of intercoder reliability. Second, in supplemental analyses, we perform validation tests to show that our coding of *reported* accruals is significantly associated with an independent measure of *recorded* accruals using changes in Compustat liabilities. These findings suggest that, on average, our measures are reliably associated with firm reporting choices.

The literature on contingent litigation losses is limited, with only a handful of papers tackling the topic in the past two decades. We believe our study adds value to this field in several crucial ways. While prior research has examined what *is* reported, we can examine what *should be* reported. This distinction is crucial for assessing loss contingency reporting relative to accounting standards (ASC 450). That is, because of empirical limitations, prior research has not been able to determine whether the lack of contingency recognition is an indication of poor-quality reporting or an appropriate usage of accounting discretion. At issue is the discretionary nature of ASC 450, which allows preparers to bow out of reporting legal contingencies based on two criteria: estimability and probability of loss. We introduce a novel empirical identification strategy that moves beyond simply measuring the *existence* of legal contingency accruals and instead allows us to cleanly identify changes in the probability and estimability of legal losses. Therefore, relative to prior work, we approach the adequacy, timeliness, and transparency of loss contingency reporting from a very different perspective that more directly connects to accounting standards. Because of this unique approach, we are able to demonstrate specific instances and ways that firms are failing to comply with both the letter and spirit of ASC 450.

We provide several important inferences that are new to the literature. First, we provide strong evidence that a significant fraction of material-loss-firms do not report accruals, even when expected losses are unambiguously probable and estimable. Second, we identify that within the standard (ASC 450), reporting inadequacies are most prevalent for estimated loss disclosures and the estimability exception. Third, we provide novel evidence on the stark lack of timeliness that is far worse than prior research suggests – not only do relatively few firms provide accrual disclosure in advance of lawsuit settlement, those who do generally only do so after they have entered into a preliminary settlement; waiting until all uncertainty is nearly resolved. Fourth, we provide novel evidence on the lack of transparency in reporting loss contingencies. Finally, our evidence is based on recent data and can therefore provide evidence of the current state of loss contingency reporting. In summary, we provide unique, well-identified, and contemporaneous evidence on the adequacy, timeliness, and transparency of loss contingency reporting.

2.0 Background and Prior Research

2.1 Background

Many companies are involved in ongoing events for which the outcome is uncertain. A contingent liability captures the potential loss related to the uncertain future outcome—in particular, uncertainty related to the probability and magnitude future losses. To deal with this uncertainty, accounting standards per ASC 450 require the company to accrue a loss contingency (a liability) whenever losses are deemed to be both probable and estimable. They also establish a lower threshold that requires the disclosure of estimated loss amount (without a related accrual) whenever estimated losses are "reasonably possible" but not "probable." If losses are at least reasonably possible but not estimable, ASC 450 provides an exception from quantifying estimated loss amounts but still requires qualitative disclosure about the nature of the litigation.

One of the challenges specific to contingent litigation liabilities, however, is that timely disclosures of anticipated losses may actually increase the probability of future legal losses, to the extent that these disclosures are used by opposing counsel. For example, the American Bar Association argues that any estimate of potential exposure that the entity provides "tip the reporting entity's hand…and it will almost certainly distort the course of possible settlement or resolution by putting a floor under the amount that will be required to resolve the matter."[11] Legal scholars have also suggested that financial disclosures may lead to expanded and targeted discovery, which can likewise bias case outcomes (Barrett 2004, Allen 2018). In light of these concerns, companies may resort to less informative disclosure techniques, such as failure to report an estimated loss liability, strategically delaying the disclosure until settlement outcomes are reasonably certain, or obscuring disclosure related to underlying loss contingency accruals. Additionally, firms contend that the inherent nature of litigation is highly uncertain and unpredictable, precluding any meaningful estimation of future losses in advance of resolution.

In this study, we develop the following three constructs related to the reporting of legal contingencies: adequacy, timeliness, and transparency. We define adequacy as the reporting of a loss contingency accrual at the point where legal losses are deemed to be both probable and estimable. That is,

[11] https://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175818387660&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1853808&blobheadervalue1=filename%3D52265.pdf&blobcol=urldata&blobtable=MungoBlobs

legal contingency reporting is considered adequate if accruals are reported whenever estimable and probable losses are clearly indicated.[12] As we discuss below, from an empirical standpoint, we define adequacy very conservatively as the reporting of an accrual after the preliminary settlement date. We define timeliness as the reporting of a legal contingency accrual prior to its effective realization. From an empirical perspective, we conservatively measure timeliness as reporting an accrual prior to the preliminary settlement of the lawsuit. Finally, we define transparency as sufficient quantitative or qualitative disclosure for an outside stakeholder to clearly identify the accounting treatment (accrue or not).

The adequacy of contingent legal liability reporting has been a hot topic of significant regulatory and investor importance. Of particular concern was that both the "probability" and "estimability" exception provided significant latitude to firms to avoid quantitative disclosure. The SEC directly addressed this tension in its 2006 annual report on "Current Accounting and Disclosure Issues," stressing the importance of advance warning, stating that "circumstances where a loss was accrued for a claim without disclosure in prior filings…should be rare."[13] The FASB has expressed similar concerns. In 2008, citing user concern that current reporting lacked information content relevant to the assessment of future cash flows, the FASB issued an exposure draft intended to expand and enhance reporting of loss contingencies.[14]

However, the FASB's proposal was met with overwhelming disapproval from auditors, lawyers, and preparers, all of whom remained concerned about the potential for increased exposure to adverse litigation outcomes, despite specific provisions designed to shield firms from specific disclosure of prejudicial information. Importantly, many constituents expressed views that high rates of non-disclosure did not represent a failure in reporting but rather reflected appropriate treatment of litigation losses in accordance with their highly uncertain and unpredictable nature. The FASB revised the exposure draft in 2010, but it too

[12] Our adequacy measure focuses on existence and does not consider the magnitude of the accrual relative to its ultimate realization for two reasons. First, there are some instances where disclosure indicates the existence of the accrual, but we cannot observe the amount of the accrual. Second, one of our most important findings is that the vast majority of all accruals are reported after the preliminary settlement date. This means that the magnitude of the accrual amount for these late accruals is obviated/uninformative as they are mechanically highly correlated to the settlement amount– firms are reporting on what is already settled rather than providing estimates.

[13] https://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf

[14] https://www.fasb.org/ed_contingencies.pdf

met with severe criticism, and ultimately the project was discontinued. Thus, even at the time of the FASB initiative, there was not a consensus interpretation regarding the adequacy of contingent loss reporting. The project was initiated in response to concerns about low levels of quantitative loss reporting, but the counter argument espoused was that low levels might actually comprise appropriate reporting treatment based on the true underlying uncertainty and volatility of future legal outcomes.

Loss contingencies were then and continue to be a hot button of regulatory attention and enforcement by the SEC. The SEC during that same period began aggressively targeting contingent liability disclosures in staff speeches[15] and through hundreds of comment letters on the subject.[16] In particular, the SEC highlighted the lack of "early-warning" disclosures preceding the resolution of loss contingencies as well as unsubstantiated statements about the inestimable nature of potential loss amounts as target issues for non-compliance.[17] Similarly, in 2010 the PCAOB issued an Audit Practice Alert warning that heightened audit risks pertaining to contingent liability disclosures persisted and would be a topic of considerable scrutiny in the audit inspection process.[18] In announcing its decision to stop work on the project, the FASB expressed optimism that increased regulatory scrutiny would result in more robust compliance with existing guidelines. In particular, they noted that disclosures had improved as a result the SEC's 2010 "Dear CFO" letter asking for improved disclosure about loss contingencies.[19] However, the Board also left open the option to consider improving loss contingencies disclosure as part of its broader disclosure frameworks project.[20]

[15] Current Accounting and Disclosure Issues Outline (Nov. 30, 2006), at http://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf. ; Wayne Carnall, Chief Accountant, Division of Corporation Finance, Slide Presentation (PDF): Remarks before the 2010 AICPA Conference on Current SEC and PCAOB Developments, Washington, D.C. (Dec. 7, 2010)("AICPA Slide Deck"), available at http://www.sec.gov/divisions/corpfin/cfspeeches.shtml.

[16] http://blogs.reuters.com/alison-frankel/2012/07/11/accounting-board-drops-call-for-beefed-up-litigation-risk-disclosure/ citing http://newsandinsight.thomsonreuters.com/Legal/News/2011/02_-_February/SEC_cracks_down_on_disclosure_of_lawsuit_costs/

[17] https://corpgov.law.harvard.edu/2011/03/15/sec-disclosure-and-corporate-governance-financial-reporting-challenges-for-2011/

[18] SEC Disclosure and Corporate Governance: Financial Reporting Challenges for 2011 (harvard.edu)

[19] https://blogs.wsj.com/cfo/2012/07/10/fasb-dumps-loss-contingency-disclosure-project/

[20] http://cfodirect.pwc.com/CFODirectWeb/Controller.jpf?ContentCode=THUG-8W2QXD&SecNavCode=MSRA-84YH44&ContentType=Content

In more recent years, the topic of contingent liabilities has remained an important topic of compliance and regulatory monitoring. In the FASB's recent *Conceptual Framework: Elements* project, contingent liabilities were considered in the context of the updated definition of a liability (E60). In 2015, the IASB initiated an ongoing research project to assess the need for targeted revisions to IAS 37. Additionally, SEC attention to the usefulness of loss liability disclosures has remained high. In 2016, the SEC filed the first ever lawsuit against a firm for failure to disclose loss contingencies[21] and has followed that with multiple related lawsuits. Further, loss contingency disclosures continue to be a common subject of SEC comment letters (Deloitte 2023).

In summary, based on the fact patterns above, we believe a contemporary examination of the quality of contingency reporting is warranted for several reasons. First, from a regulatory perspective, when ASC 450 was being considered for changes in the early 2000s, there was insufficient evidence and significant divergence of opinion about whether observed low rates of accrual were appropriate relative to the underlying uncertainty of future losses. Furthermore, the SEC continues to monitor and enforce loss contingency reporting as if it is a current, unresolved concern. From an academic vantage, and as discussed in the next section, existing literature lacks proper identification to provide compelling evidence to the adequacy, timeliness, or transparency of reporting relative to ASC 450 probability and estimability thresholds. Finally, existing literature largely pre-dates targeted regulatory interventions and therefore cannot speak to the current status of contingent loss reporting in light of these initiatives.

2.2 Prior Literature and Setting

Despite the significant attention from both regulators and investors, the extent of empirical evidence on contingent litigation losses has been meager due to the unstructured nature of disclosures and lack of database coverage. What limited research exists generally provides small sample evidence that a significant proportion of firms omit disclosures about material litigation losses (Fesler and Haggler 1989; Little et al 1995, Desir 2010). However, the estimated percentages in these studies vary significantly, and it is difficult to generalize across the varied lawsuit types and definitions of adequate reporting employed.

[21] https://www.sec.gov/litigation/complaints/2016/comp23639.pdf

Moreover, lacking an identification strategy, prior research has been limited to an examination of *what is* reported, as opposed to the critical question of what *should be* reported. Utilizing a somewhat larger sample of 212 employee discrimination cases from 1996-2010, Hennes (2014) finds that many firms fail to provide quantitative disclosures of estimated losses. However, Hennes (2014) also provides evidence that a reasonable number provide "advance-warnings" (which includes qualitative statements indicating accruals or anticipated material losses), and that such warnings are predictive of future material litigation losses "despite all of the criticism leveled at the currently application of SFAS 5" (p. 45). Thus, Hennes (2014) both points to low levels of reporting but simultaneously provides evidence consistent with the reporting choice reflecting appropriate lawsuit level variation in real outcomes.

Cen et al. (2018) and Chen et al. (2018) examine a similar sample period to Hennes (2014) and provide larger sample evidence that the timing of litigation reporting varies strategically with firm incentives and auditor expertise. Both papers provide evidence that factors beyond managerial judgement under ASC 450 can affect firms' contingent loss reporting decisions. However, like their predecessors, neither paper attempts, nor has an identification strategy, to quantify the proportion of unreported "pre-warnings" that *should* have been reported in the absence of these incentives. Timeliness in those studies is measured relative to lawsuit length and lacks any benchmark to discern timeliness relative to when estimated loss estimates should have been made relative to probability and estimability constraints. Additionally, due to the inclusion of qualitative cautionary language in the definition of a pre-warning, Cen et al (2018) reports that only 8% of their "pre-warning" observations are comprised of accruals or estimated loss disclosures; thus, it is unclear whether the findings from these papers would apply to the reporting of accruals/estimated losses specifically.[22]

Most recently, Huang et al (2021) examines the choice between accrual and estimated loss disclosure for a sample of 612 mixed-type lawsuits from 2009 to 2014 for which firms explicitly disclose in their 10-K

[22] Both Chen et al (2018) and Cen et al (2018) define a pre-warning to include (1) narrative statements about potential future losses (2) estimated loss disclosures and (3) accruals. However, while Cen et al reports robustness to an analysis confined to just group (1) which they indicate comprises 92% of the sample, neither paper discusses whether results hold if limited to the 8% of observations comprising subsample of (2) and (3).

that either (1) an accrual was made or (2) an estimated loss was disclosed but that accrual is not required under GAAP thresholds. The study reports that only 33% of the sample provides an accrual, and that the reporting choice is strategically associated with meet or beat activity and varies with auditor characteristics; these results seem to suggest that some percentage of the estimated loss versus accrual choice is strategic. However, the study does not provide any direct evidence to assess what proportion of the reporting choice is non-strategic – i.e., appropriately reflects differences in the underlying estimated probabilities of future losses. Moreover, because the sample excludes firms that neither accrue nor disclose estimated losses, it is unclear how these results generalize to contingent loss reporting more broadly. By limiting its analysis to only those firms which do report estimated losses, the study's results cannot speak to accrual rates in the overall population, to the application of ASC 450's estimability criterion, nor to regulatory concerns about early-warning disclosures.

Collectively, considering prior research, several empirical features limit the contemporary relevance of these prior studies. First, in all cases, the sample periods employed by prior research are at least a decade stale and accordingly cannot address the contemporarily urgent question of reporting adequacy in light of expanded SEC oversight, FASB attention and auditor monitoring. Second, final samples for prior studies have been limited to lawsuits which are disclosed in firm 10-K filings after lawsuit resolution and therefore omit instances where lawsuits are never disclosed (i.e., will overstate disclosure rates). This sample selection concern is even more pronounced in Huang et al (2021), which excludes all firms who neither accrue nor disclose quantitative loss estimate. Third, variation in variable definitions and the reporting choices studied by prior research (qualitative pre-warnings, accrual vs estimated loss etc.) potentially limit comparability of prior research. Fourth, prior research does not provide evidence on the transparency of disclosures – i.e., the extent to which an informed stakeholder can discern the reporting choice.

Finally, and most importantly, prior research on the adequacy of contingent loss reporting does not provide a clean identification strategy to assess what should have been reported based on applying ASC 450. That is, while prior research has provided evidence on the existence of contingent loss reporting, it lacks the identification strategy needed to draw clear conclusions about the adequacy of firms' contingent legal liability reporting relative to ASC 450 guidelines. Lacking better identification, existing research cannot address the pressing regulatory questions concerning whether low observed rates of accruals indicate low levels of reporting compliance or merely reflect the inherent uncertainty of litigation outcomes as explicitly asserted by non-accruing firms (Huang et al., 2021). Similarly, conclusions about timeliness reflect temporal proximity but cannot assess timeliness relative to the time when managers could have provided disclosures (i.e., when losses become reasonably possible and estimable).

Our research design overcomes these limitations by identifying unique temporal periods within the evolution of class action lawsuits where there is no ambiguity that contingent losses are both "probable" and "estimable." Specifically, the evolution of class action lawsuits contains two important litigation milestones which contain critical information signals of ultimate loss magnitude and probability and therefore provide clean identification of the latest points at which losses should have been reported under ASC 450.

First, the standard evolution of a class action lawsuit involves the filing of a motion to dismiss by defending counsel. The outcome of this motion, which is publicly observable, virtually guarantees the probability of loss; more than 99% of cases that survive the motion to dismiss are ultimately settled.[23] Thus, any significant outcome uncertainty regarding the probability of loss is effectively resolved with the motion to dismiss ruling, and litigation that survives the motion to dismiss should unambiguously meet the "probable" threshold for accrual.

Second, prior to the approval of the *final* settlement, both the plaintiffs and defendants must agree to a *preliminary* agreement which outlines the exact terms and amount of settlement. This milestone therefore provides a conclusive point at which the contingent liability not only clearly meet the threshold of "probable" but is also indisputably "estimable"; because the agreed upon amount has been quantified in the preliminary settlement agreement management cannot contend that it is unable to "reasonably estimate" the amount of future losses.[24] Crucial to our research design, these preliminary settlements on average predate the final

[23] Less than 1% that pass the motion to dismiss progress to trial verdict (i.e., are not settled). Securities Class Action Filings—2019 Year in Review (harvard.edu) accessed 5/8/2023

[24] In untabulated analyses we show that these preliminary settlements are 98% correlated with final settlements, further validating that these numbers constitute a reasonable estimate of final settlement.

approval of settlement by 196 days, affording a unique time window during which to evaluate whether firms are reporting the necessary accruals required by ASC 450.

Thus, relative to prior research, our unique identification of key milestones throughout the legal process allows us to precisely identify instances where the failure to accrue a loss contingency is clearly inconsistent with ASC 450 (adequacy) and to assess the timeliness relative to when firms should have reported losses (prior to effective resolution). We also examine contingent loss reporting transparency – providing evidence on how often firms reporting choices are obscured to stakeholders. Finally, we select a time period for examination which spans beyond the 2008-2012 period when the SEC, FASB and IASB were prominently considering changes to the accounting standards/regulations for contingency reporting to provide contemporary evidence as to whether such initiatives have shifted the reporting landscape in favor of more frequent and timely contingent loss reporting.

3.0 Sample and Variable Measurement

3.1 Lawsuit Sample

We build a sample of settled securities class action lawsuits filed against public firms between 1996 and 2021.[25] We rely on data from two unique sources: Stanford University's Securities Class Action Clearinghouse (SCAC) and the Public Access to Court Electronic Records (PACER) database. SCAC provides important information on a lawsuit's case status (e.g., settled, dismissed, remanded or ongoing), filing and final resolution dates; SCAC also provides gives access to a limited set of court documents related to lawsuit proceedings.

We match each SCAC lawsuit to PACER, where all publicly available court documents are electronically housed. We use SCAC and PACER to manually collect all available court documents (i.e., dockets, stipulations, motions, etc.) for each lawsuit. From these documents, we hand-collect collect the following:

- the date the lawsuit was filed;

[25] We require lawsuits to be settled to be in the sample. Because the average lawsuit length is 1,250 days, most lawsuits from 2019-2021 are excluded from our sample as they are still ongoing as of the date of writing. Nevertheless, we retain lawsuits from these more recent years in order to maximize the sample size.

- if there was a motion to dismiss, the date the motion was denied;
- if a preliminary settlement was submitted to the court, the date it was submitted;
- the amount, if provided, agreed to in the preliminary settlement;
- the date the lawsuit reached final settlement; and
- the amount, if provided, for which the lawsuit ultimately settled.

To our knowledge we are the first to identify and hand-collect these important legal dates, in particular those related to the lawsuit's preliminary settlement and denial of dismissal. In contrast to prior literature, which could not establish a benchmark for the appropriate reporting relative to probability and estimability thresholds of ASC 450, these dates allow us to cleanly identify instances where lawsuits clearly meet the threshold for recognition/disclosure. In particular, they allow us to 1) identify the dates at which it became highly probable a firm would lose a lawsuit, 2) identify when that loss became incontrovertibly estimable. By extension, they allow us to provide better estimates of the extent to which firms' reporting of contingent losses complies with GAAP than has been possible in prior research.

Table 1 presents our sample selection criteria. We begin with the set of all securities class actions filed between 1996 and 2021. To home in on the subset of lawsuits with higher ex-ante expected probability of losses, we exclude lawsuits which were ultimately dismissed, remanded, or ongoing as of our data pull. We require lawsuits to have a ticker to link them to Compustat. To collect relevant contingent liability disclosures, we require that each lawsuit must have a 10-K within one year before lawsuit resolution and after lawsuit filing. We require that each lawsuit have stock returns within one day of both the lawsuit filing and lawsuit resolution dates. Finally, we exclude lawsuits with mismatched tickers, as well as one set of consolidated lawsuits all related to the same underlying event (IPO registrations in the early 2000s). As noted in Table 1, these requirements yield a set of 543 settled securities class action lawsuits.

We make a series of deliberate sample design choices. First, we focus on securities class actions (as opposed to other types of lawsuits) because they allow for precise empirical identification of the evolving probability and estimability of legal loss. Specifically, securities class actions are unique in that once a plaintiff's preliminary motion to dismiss has been dismissed by the judge, substantially all lawsuits settle. This allows us to identify a date at which it is unambiguously probable that a firm will settle its lawsuit suggesting that all lawsuits in our sample meet the threshold of at least "reasonably possible." Next, we focus on *settled* securities class actions – as a result, this setting assures that all sample firms bear some legal loss, which if estimable and reasonably possible ex-ante, very likely should have been disclosed ex-ante in accordance with interpretations of ASC 450. We do not include dismissed lawsuits because firms may not report losses because of private information that indicated the lawsuit would have a remote chance of settling.

3.2 Measuring Contingent Liability Accruals and Estimated Loss Disclosure

An important aspect of our identification strategy is our ability to identify legal contingent liability reporting in the 10-K. For each lawsuit in our sample, we begin by reading the last 10-K prior to settlement to classify any reporting related to the lawsuit.[26] For each 10-K adjacent to the lawsuit's settlement, we determine the following: 1) whether the firm has made an accrual pertaining to our sample lawsuit; 2) whether the firm provides textual disclosure of the amount of that accrual; and 3) where no accrual was made, whether the firm disclosed an estimated loss amount. We also construct a novel measure of the transparency of contingent liability disclosures by identifying which researcher classifications were made with certainty, and which required judgement. Measuring contingent liability transparency is important in light of the SEC's statement that "accessible and usable disclosures are central to the SEC's mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation."[27] To our knowledge, we are the first paper to consider the transparency of contingent loss reporting.

We also record whether the 10-K states that a preliminary settlement has been reached between parties, which with the preliminary settlement submission dates on PACER, allows us to determine whether a 10-K disclosure was made after preliminary settlement.[28] For any lawsuit where an accrual or estimated loss disclosure is found in the 10-K prior to settlement, we also manually examine prior years' 10-Ks to identify

---

[26] On occasion, the last 10-K prior to settlement will not mention the lawsuit. This typically occurs for lawsuits that take many years to ultimately resolve. To ensure that all firms are given credit for any potential disclosure they made, when the last 10-K does not mention the lawsuit in question, we examine all 10-Ks after lawsuit filing and prior to lawsuit resolution to identify the last 10-K in which the lawsuit was mentioned.

[27] https://www.sec.gov/page/osdhistoryandrulemaking

[28] A preliminary settlement may be reached between parties before it is submitted to the court, making it unidentifiable using PACER documents. For this reason, we use the 10-K disclosures as well as PACER court documents to determine whether a firm has a preliminary settlement.

the earliest point of accrual/disclosure. For any lawsuit not specifically identified in the proximate 10-K, we also manually examine prior years' 10-Ks to confirm no mention was ever made.

Appendix B provides the rubric employed by researchers in making these determinations. Because it is highly complex to identify both the specific lawsuit due to changes in court venue, consolidation of related actions and variation in the level of detail and location within the 10-K of relevant disclosures, neither research assistants nor scraping algorithms can reliably classify contingent liability reporting. Instead, each of the three co-authors hand collected two-thirds of the sample of 10-Ks. By independently collecting two-thirds of the sample, this means that each lawsuit was reviewed by at least two different co-authors. The initial agreement percentage from this process was over 98%, suggesting very high levels of inter-rater reliability. Any discrepancies across co-authors were then reconciled by the full coauthor team. Though time consuming, this process allowed us to ensure that our final assessment of contingent liability reporting was as accurate/replicable as possible. Based on these efforts, we believe that researcher judgement has been applied in a way that is highly transparent for in-sample observations and replicable out of sample, and that our accrual measures meaningfully capture variation in the true underlying distribution of reporting choices.

3.3 Descriptive Statistics

We provide descriptive information about our various measures in Table 2. Of our sample of 543 lawsuits, the average lawsuit length is 1,250 days, suggesting that the average lawsuit will span approximately three to four 10-Ks. As of their last 10-K prior to settlement, 64% of lawsuits will have failed the motion to dismiss, while 59% will have already entered into a preliminary settlement.[29] Of those firms who have a either a motion to dismiss decision or preliminary settlement submitted to the court, the number of days between the motion to dismiss/submission of preliminary settlement, and final lawsuit resolution are 695 and 196, respectively, meaning there is ample opportunity for reporting of contingent losses during these windows of heightened certainty regarding lawsuit outcome. The average (median) lawsuit in our sample settles for $49 ($10) million, which for our sample, is equivalent to an average (median) of 4% (1%) of total assets. Average

[29] Fewer lawsuits have a motion to dismiss denied than have a preliminary settlement because many lawsuits are settled prior to the denial of the motion to dismiss.

abnormal returns in the [-10,+1] window around the filing date of the lawsuit amount to -15%.[30] This suggests that sample lawsuits on average are both large and material to the firm.

We collect firm-level control variables such as total assets, profitability, leverage, etc. from Compustat. We collect SEC comment letters from Audit Analytics. We also collect a series of controls for various potential securities class action triggers (i.e. whether a firm had an internal control weakness, misstatement, etc.) from Audit Analytics. Descriptive statistics for each of these measures are provided in Table 2.

4.0 Research Design and Results

4.1 Accrual recognition

We begin by testing and quantifying the extent that firms will report legal contingency accruals prior to lawsuit resolution. In light of the SEC's contention that failure to accrue for material losses in advance of lawsuit resolution should be very rare and the PCAOB's assertion that the auditing of such missing accruals or estimated loss disclosures will be heavily scrutinized, we seek to establish the baseline levels of reporting being provided by firms.

Table 3 presents the results of this test. Column (1)-(2) provide descriptive statistics for the entire sample. Of the 543 lawsuits, we find that 239 firms (44%) report having recorded a contingent accrual and disclose the amount pertaining to the sample lawsuit. Another 6% disclose having made the accrual but do not specify the amount. The remaining 50% of our sample firms fail to provide any early warning accrual in advance of litigation losses that manifest within the next year. That is, half of our sample firms fail to provide early-warning accruals, despite extant regulatory pressure to do so.

Because firms are not required to report liabilities which are immaterial, in the right columns of Table 3, we limit our analyses to a subset of lawsuits which are deemed material to the firm. In Columns (3)-(4), we employ an ex-post definition of materiality, which requires that ultimate settlement amounts exceed 0.5% of

[30] Abnormal filing date returns are measured using a market model over a 13 [-10,1] day window consistent with prior research (Gande and Lewis 2009). The magnitude of the abnormal returns we observe are consistent with Gande and Lewis (2009) who find that firms have negative abnormal returns at least 10 days prior to lawsuit filing date and have an average return of -14% on securities class action lawsuits filed between 1996 and 2003.

total assets (in line with Eilifsen and Messier, 2015).[31] These tests are important because it is possible that while the average lawsuit in our sample is material, a subset of lawsuits may settle for insignificant amounts. If this is the case, the lack of accrual is neither required nor of significant consequence to users of financial statements. As shown in Table 3, regardless of materiality, we continue to find that almost half of sample firms (46%) fail to provide any advance warning accruals relative to litigation losses. These contemporary results are within the range of prior research estimates (e.g., Hennes 2014, Desir et al 2010), and suggest that despite regulatory optimism a substantial subset firms still fail to accrue material legal loss contingencies in advance of resolution.

4.2 The probability exception

Having documented and quantified the extent of non-recognition of loss contingency accruals in our contemporary setting, we turn to a major objective of this study, which is to examine reasons why firms fail to adequately accrue for potential legal losses. Understanding the answer to this question is critical for assessing loss contingency reporting relative to the standard as in ASC 450, because firms can fail to accrue for legitimate reasons.

The recognition and disclosure requirements for contingent liabilities are determined under ASC 450-20 based on a three-tier probabilistic assessment of loss uncertainty as one of: 1) probable, 2) reasonably possible, or 3) remote. Because it is difficult to assess ex-ante whether future losses are probable, the top-tier probability threshold contained in ASC 450 may create a reasonable exception through which firms can claim that the loss is not probable and avoid accruing contingent losses. To vet this possibility in our sample, we devise two tests.

First, allowing for the fact that firms may argue that even in the final months of litigation the outcome still cannot be deemed probable, we examine whether non-accruing firms demonstrate compliance with the lower-tier probability threshold in ASC, which requires disclosure of estimated losses that are

[31] Because managers may not accurately anticipate the magnitude of losses prior to settlement, in untabulated analysis, we also re-estimate the results in Table 3 for a sub-sample of firms with significantly negative reactions to the lawsuits filing date defined as more than two standard deviations below 0 relative to firm specific 12 day return results from months [13,1]. Our findings are robust to this alternative measure of materiality.

"reasonably possible." Under ASC 450, the notion of reasonably possible is defined as any probability greater than "remote." This threshold comprises a very low hurdle. Given we restrict our sample to firms that settle within a matter of months, it would be hard to argue that the assessed probability of loss could be deemed remote. Therefore, we examine the 10-K disclosures of all non-accruing firms to determine whether they provide either a point estimate or range estimates of possible future loss, as required when estimated losses are reasonably possible. The sample for this test is comprised of the 271 non-accruing firms from Table 3.

Table 4 summarizes the result. We find that across the entire sample of non-accruing firms, only 1 firm provides an estimated loss disclosure. The picture is no better for material losses; we find that amongst firms with lawsuits which settle out of favor for material amounts within the next reporting period, only 1 of the non-accruing firms provide an estimated loss disclosure. In other words, we find that virtually none of the non-accruing firms provide information to users about estimated losses, despite the lower-tier probability hurdle of ASC 450.

In our second test of the probability thresholds, we employ the court's decision regarding the motion to dismiss as an impactful shock that starkly increases the probability of lawsuit settlement. This test has several advantages. First, the motion to dismiss date is arguably exogenous to the filing date of the 10-K. Second, the court's denial of dismissal decision as a clear indicator that the likelihood of adverse outcome has clearly crossed over the bright line of probable loss given that virtually all lawsuits settle after this point (Klausner and Heglund 2010). Accordingly, in our next test, we conduct a differences analysis which compares rates of accrual and estimated loss disclosure in 10-K filings that fall pre- versus post-denial of the motion to dismiss.

Table 5 presents the results of our motion to dismiss test. Panel A presents a univariate comparison for all lawsuits, while Panel B provides the comparison for material lawsuits. Panel C presents the results of estimating the following linear probability model via OLS regression:

$$Contingency = \alpha_{FE} + \beta_1 Post\ MTD + \gamma Controls + \varepsilon, \qquad (1)$$

where *Contingency* is one of the following contingency reporting measures: *Accrual Ind* or *Accrual Amount*. *Accrual Ind* is an indicator variable set equal to 1 for 10-Ks which either indicate the existence of an accrual (regardless of whether the amount is disclosed) or provide a loss estimate and 0 otherwise. *Accrual Amount* is an indicator variable set equal to 1 only for 10-Ks that disclose the actual amount of contingency accrual and 0 otherwise. The variable of interest in this test is *Post MTD*, which takes a value of 1 if a firm's last 10-K is issued subsequent to the denial of dismissal date. Our vector of *Controls* includes lawsuit specific characteristics, including *Lawsuit Length*, *Settlement Amount*, *Filing Date Return*; these characteristics control for the materiality and severity of the lawsuit, among other things. We also include the following firm-specific controls: *Total Assets*, *BTM*, *Leverage* and *ROA*, all of which are defined in Appendix A. We estimate Eq (1) with and without industry and year fixed effects and cluster observations at the firm level.

As shown in Table 5, we find no evidence that contingency reporting significantly improves after a company's motion to dismiss is denied by the courts, despite the company's probability of loss being virtually guaranteed after this point. While we do observe some evidence of a weakly significant increase in the rate of reported accruals with numeric disclosure or for the full sample of lawsuits in univariate (Panel A), the difference is insignificant for the subsample of material lawsuits (Panel B), as well as in regression (Panel C). Thus, it does not appear that firms improve contingent loss reporting in response to this dramatic increase in the probability of litigation loss.

Equally important, Table 5 Panels A and B reveal that even after the motion to dismiss is denied by the court, nearly half of firms still fail to report accruals or estimated losses. For the subsample of 10-Ks falling *after* the motion to dismiss, when legal loss is certain, we find no evidence of accruals in 47% (44%) of all (material) lawsuits. And, as in Table 4, virtually no firms provide estimated loss disclosures. Thus, our evidence suggests that even in a setting where the probability of loss is virtually guaranteed, nearly half of firms fail to report early warning accruals or estimated loss disclosures. We conclude from these tests that the probability exception in ASC 450 does not appear to meaningfully alter firms' loss contingency reporting.

4.3 The estimability exception

The estimability exemptions contained in ASC 450 allow an exemption from accrual of probable loss amounts or disclosure of reasonably possible estimated losses in circumstances where future loss cannot reasonably be estimated. That is, even when a contingent loss meets the probability hurdles of ASC 450, firms may be able to avoid recognition if they can assert that the amount of future loss is so uncertain as to be *inestimable*.

To assess the impact of this exception, we home in on the tightest of our empirical identification settings – the period of time between when a firm has entered into a preliminary settlement agreement and when that agreement receives final approval from the courts. During this time window, the amount of loss is both highly probable and incontrovertibly estimable. Because the timing of a firm's final 10-K filing date is plausibly exogenous relative to this milestone, the setting allows us to quantify the upper bound adequacy of legal loss reporting. To the extent that firms use estimability as an excuse to avoid reporting, we expect to see a significant increase in contingent loss accruals after the preliminary settlement date. We also expect that *subsequent to* preliminary settlement, all firms will report accruals for material losses. We interpret any failure to do so as inadequate relative to the requirements of ASC 450.

In Table 6, we repeat our analysis in Table 5, but replacing *Post MTD* with the indicator *Post Settle,* which indicates whether a firm's last 10-K prior to settlement was after the firm had already entered into a preliminary settlement. As shown in Table 6 Panel A and B, we find that the occurrence of preliminary settlement significantly predicts the reporting of contingent losses regardless of materiality; only 7.3% (=2.9%+3.6%+0.7%) of firms report material contingent losses in our pre-preliminary settlement sample compared to 84.1% (=79.1%+5.0%) of firms in our post preliminary settlement sample. This difference is highly significant in univariate (Panels A & B) and in multivariate tests (Panel C). That is, the evidence in Table 6 provides strong evidence that the estimability criterion in ASC 450 is viewed a significant hurdle (or excuse) to recording (or for avoiding) contingent loss reporting. We believe standard setters would find this insight useful.

Table 6 also provides stark evidence that a non-trivial proportion of lawsuits are in likely violation of ASC 450. Panels A and B reveal that firms fail to report accruals or estimated loss disclosures for 21% (16%) of all (material) lawsuits for which the 10-K falls *after* the preliminary settlement date - at a point in time when they are unambiguously known and estimable. As these firms arguably have no remaining viable excuse to avoid reporting contingent losses, their failure to transparently accrue or disclose estimated losses is highly inconsistent with GAAP.[32]

To further validate these seemingly egregious reporting omissions, for the subset of 35 firms in Table 6 which 1) have material settlement amounts, 2) have a final 10-K after preliminary settlement, and 3) fail to disclose an accrual in their final 10-K, we examine alternate potentially relevant filings to determine whether disclosure occurs through an alternative channel. Specifically, we inspect all 10-Qs and 8-Ks released after preliminary settlement through final settlement date. Of the 35 lawsuits, we find 18 instances where no additional disclosure occurs outside the 10-K. For the remaining 17 who do provide additional disclosure, we find 8 instances where additional disclosures confirm that no accrual was ever made prior to final settlement and an additional 8 which establish conclusively that the timing of a subsequent accrual occurs after 10-K filing. These 16 observations provide conclusive evidence of omitted contingent loss accruals in firms 10-K filings despite the existence of a preliminary settlement rendering such losses nearly certain and clearly estimable. For the remaining 1 observation we find some evidence that an accrual may made prior to the 10-K.[33] While this single observation may suggest timelier recording of the accrual it also points to poor transparency in the 10-K where the accrual was not apparent. Together, these results confirm the conclusions of Table 6, that a non-trivial subset of firms' reporting choices are highly inconsistent with GAAP.

4.4 The timeliness of contingency reporting

The results of Table 6 are also surprising in that we find that the vast majority of firms (92%) do not report contingent losses in our *pre*-preliminary settlement sample inconsistent with the SEC's timely warning mandate. That is, the findings suggest that managers are treating contingent liabilities more like regular liabilities (i.e., by the time the accrual is recorded, there is no remaining contingency). These results support

[32] To further vet the possibility of lingering uncertainty/inestimability after preliminary settlement, in untabulated analysis we correlate preliminary settlement amounts with final settlement amounts. We find correlations of approximately 98% with the vast majority of all final settlements within 1% of the preliminary settlement amount.
[33] In an earning press release the firm talks about aggregate charges to earnings resultant from a restatement, associated audit fees, SEC investigation and shareholder lawsuits. It is unclear whether such charges include contingent losses, but consistent with our coding of 10-Ks we err on the side conservativeness in allowing for this possibility.

conjectures in the legal literature about firms' incentives to avoid costly disclosures that may be prejudicial to litigation losses (e.g., Barrett 2004, Allen 2018).[34]

To further vet this timeliness result, we examine prior disclosures to determine the first date of contingent loss reporting. For firms who do report accruals in our *post*-preliminary settlement sample, it is possible that they also previously reported in an earlier 10-K. Accordingly, for each firm in our sample that report losses in its last 10-K, we manually examine the disclosures of all previous 10-Ks to trace accruals and estimated loss disclosures back to their earliest incidence. As noted previously, given the near certainty and publicity of outcomes after preliminary settlement, we consider reporting that first occurs only *after* the date of preliminary settlement to be untimely relative to the SEC's early-warning mandate. That is, decision usefulness of contingent loss disclosures is predicated on timely warnings which pre-date the public realization of losses that occurs through the filing of preliminary settlement documents.

Table 8 reports the results, which demonstrate remarkably poor timeliness of contingency loss reporting. For the full (material) sample of 273 (195) lawsuits which reported an accrual or an estimate in their last 10-K before final settlement, we find that 86% (87%) delay the reporting of an initial accrual until *after* the preliminary settlement, and <1% of firms provide estimated loss disclosures. That is, we find that only 14 % (13%) of *reported* (material) contingent loss accruals or estimates are timely. Given that only 50% (55%) of the (material) sample reports an accrual or loss estimate (see Tables 3 and 4), this finding suggests that just 7% (=39/543) of our full sample and 7% (=26/357) of our material sample lawsuits report timely accruals.[35] For the remaining 93% (93%), investors are either never informed of anticipated losses, or are informed only after losses are entirely fixed and determinable (i.e., are no longer really contingent). While such late reporting may protect firms from adverse legal costs, they also appear deeply inconsistent with the intent of ASC 450 and the SEC's early warning admonitions.

[34] Contingent loss disclosures may bias litigation outcomes by providing a floor for settlement negotiations. Further, plaintiffs may use accounting disclosures to direct the discovery process and enable discovery of sensitive auditor work papers and backup about the litigation reserve.
[35] These estimates likely represent an upper bound on true timeliness as we consider any disclosure that pre-dates preliminary settlement as timely. However, there is likely at least some delay between when firms informally decide settle within a narrow range, and when the legal team irons out all the finer details for inking, such that some of the pre-settlement disclosures may also be fairly "late" in the sense that they occur after most uncertainty has been fully resolved.

4.5 The transparency of contingency accruals

To this point, our analyses have focused on observable accruals. This focus reflects pragmatic measurement limitations, but also conceptually proxies the information set which is visible to sophisticated users in capital allocation decisions (i.e., the value relevance of accruals is moderated by their transparency to users). Additionally, to the extent that firms comply with ASC 450 and SEC guidelines that articulate clear disclosure standards for recognized accruals or estimated loss disclosures, the (non)existence of accruals should readily discernable from a firm's 10-K (i.e. observable accruals should closely correspond with recorded accruals). However, regulators have expressed concerns that firms may use "unclear language in disclosures" (Deloitte 2017), which makes it difficult to discern whether or not an accrual has been made. To the extent that disclosures are ambiguous, investors may be misinformed about the underlying accounting treatment, with implications for efficient valuation.[36]

In this section, we probe this concern by directly examining the transparency of contingent loss reporting. Specifically, we examine the proportion of contingent liability disclosure that provide sufficient information for a sophisticated stakeholder to assess with certainty the existence (or non-existence) of an accrual. We do so by carefully reading through all litigation-related disclosure in the 10-K for direct assertions of accounting treatment or clear reference to ASC 450 probability and estimability thresholds that allow for unambiguous classification of contingent liability accruals. 10-K's providing clear disclosure are classified as "certain," while those which provide only clues from which to assess the accounting treatment are classified as requiring "judgement". Appendix B provides full details of the classification rubric.

We present the results of our descriptive analysis in Table 9. We find that, in 24% (18%) of observations, the existence (non-existence) of an accrual is certain. That is, less than half of the time, external stakeholders are provided unambiguous disclosure. For the remaining 58.0%, judgement is required in determining the existence (or non-existence) of an accrual, suggesting that value relevant information is potentially obscured from interested stakeholders. These results are surprising given the clear disclosure

[36] To the extent that disclosures are ambiguous it also suggests that observable accruals may exhibit imperfect correlation with recorded accruals. We probe this possibility further in Section 5.3.

requirements of ASC 450 and support SEC concerns that the transparency of litigation contingency disclosures is lacking, potentially undermining the usefulness of legal contingency accounting to external stakeholders.

4.6 Discussion

Collectively, the results of Tables 3-9 suggest that (1) a substantial proportion of firms omit reporting of contingent losses for highly probable, material, and clearly estimable litigation losses in advance of loss realization, (2) the estimability (but not the probability) criterion represents the primary excuse for failing to record loss contingency accruals, (3) the vast majority of *reported* contingent liability accruals are untimely relative to an early-warning standard of usefulness and (4) roughly half of contingent loss disclosures are lacking in transparency. These findings are important to inform standard setters regarding the application of ASC 450, and from a regulatory perspective, which prioritizes early-warning accruals for valuation implications. The timeliness finding is also particularly relevant in the context of prior research, as it implies that what prior research has classified as adequate or timely loss reporting is actually *late* reporting. In particular, our finding that nearly all of reported contingent liability accruals occur only after preliminary settlement has implications for prior research which has documented variation in accrual timeliness (Chen et al 2018, Cen et al 2018). Our well-identified setting suggests the vast majority of all accruals are released far too late to be deemed useful. As such, our results also suggest that any correlational analysis in prior work between reported accruals and future settlement amounts is likely mechanical – manifesting because of untimely reporting as opposed to value-relevant pre-warnings of contingent losses.

5.0 Additional Analysis

5.1 Contemporary improvement in contingent loss reporting

In this section, we examine the evolving regulatory and standard setting environment over the past twenty years. As discussed, the issue of adequate contingent liability reporting has been of pressing regulatory significance. Importantly, as SEC and PCAOB monitoring heightened the FASB opted to drop its contingent liability project on faith that the reporting landscape of contingent liability reporting had and would continue to improve in response to increased regulatory and audit oversight. However, to the best of our knowledge this optimism remains an open question and critical unvetted assumption. Further, the sample periods employed by prior research pre-date the cancellation of FASB/IASB projects and heightened SEC/PCAOB oversight. As a result, none of the studies from previous research can address the contemporary question of contingent loss reporting adequacy or timeliness.

To test for contemporary improvement in reporting, we develop a measure of the adequacy of legal contingency accruals. Specifically, we use an ordinal scale of increasing compliance with ASC 450 and regulatory calls for early warning disclosures (*Conting Accrual Adequacy*). We assign the highest score to 10-Ks for which the first legal contingency accrual pre-dates the date of preliminary settlement ("Adequate"), a middle score ("Benchmark") to 10-Ks that do accrue but only after preliminary settlement or who do not have a preliminary settlement as of their last 10-K, and the lowest score to 10-Ks that fail to accrue even after preliminary settlement ("Inadequate"). We examine whether this measure improves subsequent to the time when the FASB deliberated altering the loss contingency standard, ASC 450. We employ an ordered logit regression per the following equation:

$$OLOGIT(Conting\ Accrual\ Adequacy) \sim \alpha_{FE} + \beta_1 FASB\ Deliberation + \beta_2 Post\ FASB + \gamma Controls + \varepsilon. \quad (2)$$

In Eq (2), *FASB Deliberation* is an indicator variable which takes a value of 1 for the years spanning 2008-2012 when FASB/IASB deliberations and SEC/PCAOB warnings were at their peak and *Post FASB* takes a value of 1 for years after 2012.[37] To the extent that regulatory interventions have led to improvements in contingent loss accounting over time, we expect β_1 and β_2 will be positive. We also include a similar set of controls and fixed effects as used in Eq (1), all of which are defined in Appendix A.

The results reported in Table 10 do not provide evidence of an improvement in legal contingency reporting over time. Specifically, we find that *FASB Deliberations* and *Post FASB* are not statistically different from zero, suggesting that there was no change in reporting quality relative to the pre-period. These results do not support optimistic claims that heightened regulatory attention/oversight has led to significant improvements in the reporting landscape. Rather, our findings suggest that contingent liability reporting remains a contemporarily pressing concern.

---

[37] The choice of which years to include in *FASB Deliberation* centers around the period of FASB (and IASB) exposure drafts, as well as notable SEC/PCAOB speeches/comment letters. Alternative definitions of 2008-2010 and 2010 only do not change our inferences.

5.2 Determinants of contingent loss reporting

To this point in our analysis, we have primarily been interested in establishing the extent to which contingent liability accruals are timely and adequate relative to ASC 450. Our evidence suggests that the vast majority are neither. However, we do observe some variation across these dimensions, which prompts the question of what factors may explain variation in contingency reporting adequacy. To explore this question, we estimate the following regression:

$$OLOGIT(Conting\ Accrual\ Adequacy) \sim \alpha_{FE} + \beta Regulatory + \theta Audit + \delta Lawsuit + \gamma Firm + \varepsilon \quad (3)$$

In Eq (3), we include a vector of exploratory variables that can explain variation in legal contingency reporting quality, including regulatory factors (*Regulatory*), audit factors (*Audit*), litigation-specific factors (*Lawsuit*), and firm-level factors (*Firm*). To capture regulatory scrutiny, we measure *SEC Scrutiny* as the number of contingent liability comment letters received by firms in the focal firm's industry in the 5 years leading up to the 10-K. This variable may load positively if industry-level SEC scrutiny motivates better future compliance. To capture audit related factors, we include the following variables: *Going Concern, Firm Comment Letters, Internal Control Weakness, Misstatement, Fraud Misstatement,* and *Error Misstatement* which reflect the instance of these audit concerns over a 5-year lagged periods. To the extent that these factors lead to increased monitoring/scrutiny, we might expect to observe a positive result. However, to the extent these factors capture persistent firm weaknesses in the reporting and control environment, we might observe the opposite. To capture litigation attributes, we include *Settlement Amount* and *Filing Date Returns* to proxy for materiality, as well as *Lawsuit Length* to proxy for complexity/uncertainty. To capture firm-level factors, we include *Total Assets, BTM*, and *ROE*. All variable sources and definitions are defined in Appendix A.

The results of these analyses are presented in Table 11. The results suggest several cross-sectional associations with contingent accrual adequacy. First, Table 11 suggests that contingent accrual adequacy is decreasing the lawsuit length and the size of settlement amounts, suggesting that both complexity and materiality may influence loss contingency reporting. Second, we find some evidence that auditor monitoring may be influential, although the results are somewhat mixed. While we find that the prior existence of internal control weakness leads to better contingent accrual adequacy consistent with increased auditor scrutiny, we also find weak evidence that the existence of prior error misstatements *decreases* contingent reporting adequacy consistent with a poor reporting environment. We also find some limited evidence that contingent liability reporting varies meaningfully with industry-level regulatory attention; Column (2) provides significant evidence that firms in industries receiving a higher number of contingent liability comment letters from the SEC are more likely to provide better quality legal contingency accruals (potentially suggesting higher salience) but the result is flipped for our firm specific measure (potentially suggesting persistently poor reporting for certain firms) and neither result is significant in Columns (1) or (3). Thus, our results provide only limited evidence that regulatory/auditor scrutiny has the potential to influence contingent liability reporting.

Coupled with our earlier findings of very low accrual rates, these results suggest that, while external factors (including monitoring and regulation) have the *potential* to motivate higher quality reporting, it appears the level at which they currently exist is insufficient to generate meaningful improvement for the broad population of firms. That is, while our evidence supports the notion that the problem of poor contingent liabilities reporting might be ameliorated through amplified oversight, to date such efforts do not appear to have meaningfully turned the dial. Rather the stark evidence of inadequate reporting documented in our sample suggests that significant reform is likely still warranted.

5.3 Transparency – Observable versus unobservable accruals

An important caveat to our analyses is that they can only speak to observable accruals. To the extent that accruals are made by firms without any indication in disclosure, or ambiguous disclosures are misclassified (in either direction) by researchers, this could influence reported descriptives. As discussed in Section 4.5, we believe that quantifying the extent of *observable* accruals is of critical importance because it provides evidence on the information set that is most likely internalized by interested stakeholders. In line with this, the FASB exposure draft basis for conclusions articulates the exigency of the project in light of stakeholder concern that decision relevance is impaired when "amounts recognized in the financial statements related to loss contingencies are not transparent to users".[38] Notwithstanding, given the results in Table 9 suggest poor

[38] FASB ED 1040-100 ¶BC3

transparency in firm reporting, we conduct two additional analyses to give us confidence in the reliability of our coding and to provide evidence on the correlation between researcher coded observable accruals and recorded accruals. First, as previously noted, all observations in our sample are independently coded by at least two coauthors. Initial agreement rates across authors are greater than 98%, suggesting a high degree of intercoder reliability. Second, we regress changes in the balance sheet liability accounts where contingent liabilities may be recorded on our accrual measures to provide evidence for the existence of actual accruals. Specifically, the three liability accounts we examine are: *Other Current Liabilities, Accrued Expenses* and *Other Long-Term Liabilities.*[39] We regress changes in these accounts on indicator variables for our firm reporting classifications and a set of controls. Specifically, we create indicator variables for if an accrual was made with certainty (*Accrual – Certain Ind.)*, if an accrual was deemed made with researcher judgement *(Accrual – Judgement Ind.),* and if no accrual was deemed made with researcher judgement *(No Accrual – Judgement Ind.)*. Implicitly, the baseline group are firms that we are certain did not record an accrual.

Table 12 reports the results of these analyses. As shown in Table 12, we find that firms classified as recording an accrual both with certainty and with judgement are associated with significantly greater increases in *Other Current Liabilities* than firms we are certain did not report an accrual consistent with our classification system accurately capturing true accruals. Additionally, the coefficient on *Accrual – Certain Ind.* is larger (though not statistically significant) than the coefficient on *Accrual – Judgement Ind.,* suggesting that, if anything, our coding is conservative; in exercising judgement, we erred on the side of giving firms credit for making an accrual. Importantly, we do not find any statistically significant association between firms that we coded as non-accruals with judgement and changes in balance sheet liabilities consistent with our judgement-based coding on average reflecting true instances of non-accrual. That is, while we cannot trace each observation to

[39] In Compustat, Total Liabilities (LT) is equal to Long Term Debt (DLTT) + Deferred Taxes and Investment Tax Credit (TXDITC) + Debt in Current Liabilities (DLC) + Accounts Payable (AP) + Taxes Payable (TP) + Accrued Expenses (XACC) + Other Liabilities Excluding Deferred Revenue (LOXDR) + Other Current Liabilities Sundry Excluding Deferred Revenue (LCOXDR) + Current Deferred Revenue (DRC) + Long Term Deferred Revenue (DRLT). Of these values, we believe that there are three potential candidates in which a firm could reasonably accrue for a legal contingent liability: Accrued Expenses (XACC), Other Liabilities Excluding Deferred Revenue (LOXDR), and Other Current Liabilities Sundry Excluding Deferred Revenue (LCOXDR).

firm reporting choices with certainty, the evidence in Table 12 suggests that on average our judgement-based measures of observable (non) accruals are reliably associated with actual firm reporting choices.

5.4 Offsetting Insurance receivables

Under ASC 450-20-S99-1, firms are encouraged to disclose the extent to which contingent losses are "expected to be recoverable through insurance". Notwithstanding, both ASC 720 and SAB 92 suggest that the recognition/disclosure of contingent losses must be evaluated and reported independent of any insurance recoveries.[40] Gross (as opposed to net) consideration of legal contingencies and insurance coverage is valuable to investors for at least two reasons. First, legal settlements may exhaust insurance policies coverage limits, meaning that firms will be fully exposed to the negative consequences of future lawsuits. Second, adverse settlements may cause insurance companies to raise premiums. In both cases, consideration of gross amounts allows investors to better forecast firms' cash flows compared to net presentation which potentially obscures important information about the "full magnitude of the liability… lull[ing] [stakeholders] into a less rigorous consideration".[41]

Consistent with these regulatory assertions, throughout our analyses we employ materiality thresholds which are gross of any anticipated insurance recovery. This choice is also pragmatic. From an empirical perspective, evaluating materiality after insurance would induce significant measurement bias because we can only observe coverage when firms *choose* to disclose it. This is empirically problematic, as insurance disclosure is likely endogenous to the accrual decision because information about insurance coverage may be prejudicial to settlement outcomes.[42] Notwithstanding, to better understand whether materiality after insurance provides an alternative explanation for the lack of accruals observed in our primary results, we conduct the following additional analysis. For every observation in our sample, we examined

[40] According to ASC 720-20-45-1, "Unless the conditions of paragraph 210-20-45-1 are met, offsetting prepaid insurance and receivables for expected recoveries … would not be appropriate." The conditions of ASC 210-20-45-1 are unlikely to be satisfied because firms are generally required to pay losses, if the insurance company fails to do so. This same point was argued in the 2010 FASB exposure draft which proposed making explicit a requirement that "When assessing the materiality of loss contingencies to determine whether disclosure is required, the entity shall not consider the possibility of recoveries from insurance or other indemnification arrangements." (file id ref: 1840-100)
[41] https://www.sec.gov/news/speech/speecharchive/1995/spch039.txt
[42] Deloitte & Touche LLP. 2010. Comment Letter on FASB ED Ref: 1840-100.

firms' disclosures for mention of insurance, specifically noting (1) quantitative information sufficient to assess settlement amount after insurance, (2) qualitative statements that assert an expectation of immateriality after insurance, and (3) qualitative references to insurance that do not provide any information about the potential materiality after coverage but indicate the existence of insurance.

Table 13 presents the results. The results suggest more than half of the accruing firms in our sample mention insurance in their disclosures compared to only about a fifth of non-accruing firms. Were materiality after insurance to be a primary driver of accrual decisions, we would expect to see the reverse relation – that is these results are inconsistent with insurance coverage excusing poor accrual rates. However, as shown in our earlier analyses, firms tend to report accruals only after preliminary settlement at which point in time the insurance coverage is likely known/negotiated and, disclosure about insurance cannot negatively bias the outcome of negotiations. Thus, it might be expected that firms are strategically more likely to report insurance after preliminary settlement at the same time as they are disclosing accruals. The results of this table should be interpreted with this endogeneity in mind.

Table 13 also shows that amongst firms that do mention insurance, roughly half of accruing firms (29% of the 61% in Panel B) assert immateriality after insurance – this finding is consistent with SAB 92's instructions that firms should not net against insurance in the reporting of contingent losses (i.e. insurance coverage does not seem to deter accrual). For non-accruing firms we observe that closer to two-thirds of firms who mention insurance (14%/22% in Panel B) assert immateriality after insurance. This higher proportion may suggest that there is some small effect of insurance on the accrual choice – however, again we caveat that the disclosure of insurance is endogenous.

6.0 Conclusion

In this study, we employ multiple legal-dates hand collected from legal filings to provide clear evidence on the adequacy and timeliness of contingent legal liability reporting relative to the probability and estimability thresholds outlined in ASC 450 and the SEC's early warning mandate. In particular, whereas prior research primarily examines the *existence* of legal contingency reporting, we identify a setting where we can evaluate such rates relative to benchmark of when and how often contingent legal losses *should* be reported.

Our paper offers several novel insights compared to prior literature. First, we find that a significant fraction of material loss firms fail to report observable warnings about anticipated losses even after signing a preliminary settlement agreement – a point in time when losses are unambiguously probable and estimable. Second, we find that the overwhelming majority of firms who do report accruals do so only after the preliminary settlement date suggesting that existing accruals are extremely untimely from a decision relevance perspective, inconsistent with the SEC's "early-warning" mandate. Third, we find no evidence to suggest that firms respond to changes in the probability of losses when distinguishing between estimated loss disclosure and accrual. A negligible proportion of firms in our sample report estimated losses that are not accrued, and accrual rates do not increase in response to a failure in the motion to dismiss – a milestone which makes losses unambiguously probable. Fourth, we find strong evidence that the estimability criterion of ASC 450 likely comprises the primary hurdle (or excuse) for recording (or failing to record) loss contingency accruals with firms waiting to record losses until after preliminary settlement when losses are no longer uncertain but are precisely quantified. These results are particularly important as they imply that what prior research has interpreted as evidence of high quality accruals (i.e. the existence of accruals which are highly predictive of future outcomes) is likely instead a consequence of untimely (low quality) reporting whereby managers withhold information until (virtually) all uncertainty is resolved. Finally, we provide unique evidence on the transparency of reported losses, finding that for nearly half of our sample, discerning the existence of accruals requires sophisticated judgement contrary to transparent disclosure guidelines.

Our results also have important implications for the disclosure quality literature and for standard setting. Standard setters, regulators, and financial statement users alike have expressed concerns that existing contingent loss reporting is insufficient to resolving information asymmetries. Notwithstanding, preparers contend that existing reporting accurately reflecting the underlying uncertainty of litigation and in 2010 the FASB expressed optimism that reporting had improved and would continue to do so because of heightened regulatory oversight. Our results provide clear evidence in contrast to this optimism. Our evidence points to the need for continued and potentially heightened regulatory oversight and also suggests potential expediency for renewed standard setting initiatives which could seek to clarify the bounds of probability and estimability exceptions contained in ASC 450. Our findings that firms seemingly implement the quantitative requirements of ASC 450 as an all or nothing proposition - either accruing a liability or providing no quantitative disclosure - call into question the impactfulness of the existing three-tiered guidance. Likewise, our findings that firms wait to report accruals until the legal loss is already precisely quantified and nearly certain based on prior legal actions suggest the need for expanded guidance on what is and is not permissible under the estimability exception. Our results suggest that the vast majority of firms report only those legal contingency accruals that are akin to standard liabilities with next to nothing contingent remaining about them. In summary, because our well-identified setting, we believe that we can draw much stronger conclusions regarding the poor adequacy, transparency, and timeliness of legal contingency reporting. Our results suggest that either standard setters or regulators should amplify discussion of this important standard.

References:

CFA Institute (2013). Financial reporting disclosures: Investor perspectives on transparency, trust and volume. ISBN 978-0-938367-76-5

Cen, L., Chen, F., Hou, Y., & Richardson, G. D. (2018). Strategic disclosures of litigation loss contingencies when customer-supplier relationships are at risk. The Accounting Review, 93(2), 137-159.

Chen, C. W., Collins, D. W., Kravet, T. D., & Mergenthaler, R. D. (2018). Financial statement comparability and the efficiency of acquisition decisions. Contemporary Accounting Research, 35(1), 164-202.

Chasan, E., (2012). FASB Dumps Loss Contingency Disclosure Project. Wall St. Journal, July 10 2012. Available at: https://www.wsj.com/articles/BL-CFOB-2328

Deloitte LLP (2017). SEC Comment Letters — Including Industry Insights. Available at: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/us-aers-sec-comment-letters-including-industry-insights-2017.pdf Accessed 6/20/2023

Deloitte LLP (2023). Contingencies and Loss Recoveries. Available at: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-audit-2023-life-science-contingencies-and-loss-recoveries.pdf Accessed 6/20/2023

Desir, R., Fanning, K., & Pfeiffer, R. J. (2010). Are revisions to SFAS No. 5 needed?. Accounting Horizons, 24(4), 525-545.

Eilifsen, A., & Messier Jr, W. F. (2015). Materiality guidance of the major public accounting firms. Auditing: A Journal of Practice & Theory, 34(2), 3-26.

Fesler, R. D., & Hagler, J. L. (1989). Litigation disclosures under SFAS No. 5: A study of actual cases. Accounting Horizons, 3(1), 10.

Gande, A., & Lewis, C. M. (2009). Shareholder-initiated class action lawsuits: Shareholder wealth effects and industry spillovers. Journal of Financial and Quantitative Analysis, 44(4), 823-850.

Hennes, K. M. (2014). Disclosure of contingent legal liabilities. Journal of Accounting and Public Policy, 33(1), 32-50.

Huang, H. Y., Lohwasser, E., Yu, Z., & Chang, H. (2021). Opportunistic avoidance of litigation loss accruals and the mitigating effects of auditors. Journal of Accounting, Auditing & Finance, 0148558X211068585.

Klausner, M., & Hegland, J. (2010). When are securities class actions dismissed, when do they settle, and for how much?. Plus Journal, 23(3).

Little, P., Muoghalu, M.I., Robison, H.D., 1995. Hazardous waste lawsuits, financial disclosure, and investors' interests. Journal of Accounting, Auditing and Finance 10 (2), 383–398.

Appendix A – Variable Measurement and Descriptions

Variable	Description
Lawsuit Length	The number of days between the filing date and the resolution date of the lawsuit as listed on SCAC. In the descriptive table it is unlogged, but in all regressions, it is logged.
Settlement Amount	The settlement amount of the lawsuit as listed in the lawsuits' court documents. Court documents are acquired from either SCAC or PACER.
Post MTD	An indicator for whether a firm's last 10-K was after (before) a motion to dismiss was denied. When a lawsuit settles before the motion to dismiss is denied, it is set to 0.
Post Settle	An indicator variable for whether a firm's last 10-K was released after its preliminary settlement was submitted to the court or if its last 10-K mentions the firm has agreed to a preliminary settlement. Set equal to 0 if a firm provides an accrual prior to preliminary settlement.
Accrual Ind.	An indicator variable for whether a firm ever reports an accrual in a 10-K related to the lawsuit.
Accrual Number	An indicator variable for whether the firm ever provides a specific accrual number in a 10-K related to the lawsuit.
Filing Date Return	The cumulative abnormal return on the period [-10,1] around the filing date of a lawsuit (RET-VWRETD). Stock returns are from CRSP, filing dates are provided by SCAC.
Total Assets	The total assets (AT) of the defendant firm as of the last 10-K before the lawsuit settles. In the descriptive table it is unlogged, in all other tables it is logged.
Leverage	Total liabilities divided by total assets (LT/AT) of the defendant firm as of the last 10-K before the lawsuit settles.
BTM	Market value of equity divided by book equity (CEQ /PRCC_F/CSHO) of the defendant firm as of the last 10-K before the lawsuit settles.
ROA	Income before extraordinary items divided by total assets (IB/AT) of the defendant firm as of the last 10-K before the lawsuit settles.
Change in Other Current Liabilities	The change in other current liabilities (sundry) excluding deferred expenses (LCOXDR) from the 10-K two years prior lawsuit settlement to one year prior to lawsuit settlement scaled by total assets (AT) and divided by 100.
Change in Accrued Expenses	The change in accrued expenses (XACC) from the 10-K two years prior lawsuit settlement to one year prior to lawsuit settlement scaled by total assets (AT) and divided by 100.
Change in Other Long-Term Liabilities	The change in other long term liabilities excluding deferred expenses (LOXDR) from the 10-K two years prior lawsuit settlement to one year prior to lawsuit settlement scaled by total assets (AT) and divided by 100.
Conting Accrual Quality	An ordinal variable that takes on its highest value if a firm provides an accrual in a 10-K prior to preliminary settlement, its lowest value if it fails to provide an accrual in a 10-K after preliminary settlement, and an intermediate value otherwise.

Firm Comment Letters	An indicator variable for whether a firm received a comment letter related to contingent liabilities in the last 5 years according to Audit Analytics.
FASB Deliberation	An indicator for if a firms' last 10-K before settlement fell between 2008 and 2012.
Post FASB	An indicator for if a firms' last 10-K fell after 2012.
Going concern	An indicator variable for whether a firm had a going concern in the last 5 years in Audit Analytics
Internal Control Weakness	An indicator variable for whether a firm had an internal control weakness in the 5 years prior to lawsuit filing in Audit Analytics
Misstatement	An indicator variable for whether a firm had a misstatement in the 5 years prior to lawsuit filing in Audit Analytics
Fraud Misstatement	An indicator variable for whether a firm had a misstatement related to fraud in the 5 years prior to lawsuit filing in Audit Analytics
Error Misstatement	An indicator variable for whether a firm had a misstatement related to a clerical error in the 5 years prior to lawsuit filing in Audit Analytics

Appendix B – Rubric for Classifying Legal Contingency Accruals

Accruals are deemed certain if:

- Specific statement about recording of liability, provision, reserve etc. regardless of whether an amount is reported.
- 10-K provides sufficient detail to trace aggregate accrual to lawsuit in our sample or specifies that the sample lawsuit is included in the aggregate accrual.

Lack of accrual is certain if:

- Specific statement indicating no liability (accrual/reserve etc.) has been recorded.
- Specific statement indicating that the amount of potential losses is "inestimable" / "cannot be estimated" etc.
- Statement that the probability of losses is "remote"
- 10-K provides sufficient detail to tie out full amount of aggregate accrual to other lawsuits not in our sample.
- No specific identification of the lawsuit anywhere in the sample 10-K or any preceding 10-K during the lawsuit period. ASC 450 requires that all "reasonably possible" or "probable" lawsuits must be accompanied by qualitative disclosure.

Factors increasing the likelihood of an accrual (judgement required):

- Firm discloses existence and amount of a preliminary settlement
- Firm discloses existence of preliminary settlement without disclosing a number but indicates that the amount has been funded or expresses optimism that settlement will be approved.
- Statements that losses are probable without inestimability disclaimer
- Disclosure of aggregate accrual amount or statement that aggregate accrual has been made with no indication that our sample lawsuit is excluded from the aggregate accrual.

Factors decreasing the likelihood of an accrual (judgement required):

- Statements asserting that the lawsuit is "without merit" / firm intends to "defend vigorously"
- Statements that assert significant uncertainty around lawsuit outcome (ex: outcome cannot be determined; management cannot predict the outcome)
- Language suggesting losses are "possible" rather than "probable"
- Language suggesting management expects that any losses arising from litigation will be immaterial.
- Firm discloses the existence of a preliminary settlement, but no amount is provided and uses uncertainty disclaimers about approval of settlement.

Accrual vs Loss Estimate Disclosure:

- Employ a conservative strategy by giving credit for accrual when there is a number reported in the financial statements unless specific language indicates the amount is not accrued.
- The above strategy may result in loss estimates being incorrectly counted as accruals – i.e. may overstate accruals relative to loss estimates.
- By definition in ASC 450, no loss estimate disclosure exists if no numeric estimate is present in the disclosure.

Table 1: Sample Selection.

This table lists the sample selection criteria used to arrive at our final sample of settled securities class action lawsuits. Although information pertaining to the lawsuits was extracted over several months, the initial sample of lawsuits was extracted from Stanford Securities Class Action Clearinghouse on February 23, 2021.

Criteria	# Lawsuits
All Securities Class Action Lawsuits	5,938
Less: Non settled Lawsuits	(3,293)
	2,645
Less: Lawsuits with no ticker in Compustat	(1,442)
	1,203
Less: Lawsuits with no 10-K between lawsuit filing and resolution	(262)
	941
Less: Lawsuits with no 10-K within a year of lawsuit resolution	(201)
	740
Less: Lawsuits with no stock returns around lawsuit filing or resolution	(126)
	614
Less: Tech IPO Lawsuit	(51)
	563
Less: Mismatched ticker	(20)
	543

Table 2: Descriptive Statistics.

This table presents descriptive statistics for the 545 lawsuits in our sample. Listed are features of the lawsuit and the defendant firm. When not clearly described by the name, all variables are defined in Appendix A. Continuous variables are winsorized at the 1% level.

	Count	Mean	Q1	Q2	Q3
Lawsuit Length (Days)	543	1,250	797	1073	1507
Has a motion to dismiss denied before last 10-K	543	0.64	0	1	1
Length of lawsuit after motion to dismiss denied (Days)	365	695	391	579	884
Has a Preliminanry Settlement as of last 10-K	543	0.59	0	1	1
Length of lawsuit after Preliminary Settlement (Days)	540	196	104	132	174
Settlement Amount ($ millions)	535	49.04	4.58	10.15	29.40
Settlement Amount to Total Assets	535	0.04	0.00	0.01	0.04
Filing Date Return	543	-0.15	-0.28	-0.09	0.00
Total Assets	543	41,547	200	958	5,780
Leverage	543	0.58	0.35	0.55	0.77
BTM	543	0.44	0.23	0.45	0.77
ROA	543	-0.09	-0.12	0.00	0.05
Change in Other Current Liabilities	543	0.37	-0.15	0.00	0.49
Change in Accrued Expenses	543	0.36	-0.35	0.00	1.14
Change in Other Long-Term Liabilities	543	0.10	-0.43	0.00	0.66
Firm Comment Letters	543	0.19	0	0	0
Going Concern	486	0.07	0	0	0
Internal Control Weakness	486	0.26	0	0	1
Misstatement	486	0.44	0	0	1
Fraud Mistatement	486	0.04	0	0	0
Error Mistatement	486	0.02	0	0	0

Table 3: Early Warning Accruals and Probable Losses.
This table presents the number and proportion of lawsuits in our full sample and in our material subsamples where accruals for contingent losses are provided in the 10-K immediately prior to lawsuit resolution. *Material* lawsuits are defined as lawsuits with settlement amounts greater than 0.5% of total assets (*Material Settlement*).

	All Lawsuits		*Material Settlement* Lawsuits	
	Count	Percent	Count	Percent
Number of Lawsuits	543	100.0%	357	100.0%
Records an accrual and discloses the amount	239	44.0%	178	49.9%
Records an accrual but does not disclose the amount	33	6.1%	16	4.5%
No Accrual	271	49.9%	163	45.7%

Table 4: Disclosure of Loss Estimates – Reasonably Possible Outcomes.
The sample for this table is the 271 lawsuits from Table 3 for which no accrual was made. This table presents the number and proportion of these lawsuits for which estimated loss disclosure amounts were provided in the 10-K immediately prior to lawsuit resolution. *Material* lawsuits are defined as lawsuits with settlement amounts greater than 0.5% of total assets (*Material Settlement*).

	All Lawsuits		*Material Settlement* Lawsuits	
	Count	Percent	Count	Percent
Number of Non-Accruing Lawsuits	271	100.0%	163	100.0%
Discloses an estimated loss amount	1	0.2%	1	0.3%
No Estimated Loss Disclosure	270	99.8%	162	99.7%

Table 5: Contingent Reporting around the Denial of the Motion to Dismiss.

This table compares the reporting litigation contingencies for the subsamples of lawsuits where the last 10-K falls before versus after the denial of a lawsuits' motion to dismiss. Panel A includes all lawsuits, while Panel B includes only *Material Settlement* lawsuits defined as those for which the final settlement amount exceeded 0.5% of assets. Panel C presents a regression analysis of Eq (1). *Accrual Ind* is an indicator variable set equal to 1 for 10-Ks which either indicate the existence of an accrual (regardless of whether the amount is disclosed) or provide a loss estimate and 0 otherwise. *Accrual Amount* is an indicator variable set equal to 1 only for 10-Ks that disclose the actual amount of contingency accrual and 0 otherwise. Our variable of interest, *Post MTD*, is an indicator variable set to 1 for observations where the 10-K filing occurs after the date that the motion to dismiss was denied. We include control variables for *Lawsuit Length*, *Settlement Amount*, *Filing Date Return*, *Total Assets*, *BTM*, *Leverage* and *ROA*, as defined in Appendix A as well as FF 17 industry and year fixed effects. ***, ** and * indicate significance at the 1%, 5% and 10% level respectively for a two tailed test.

Panel A: All Lawsuits

	Post-MTD		Pre-MTD		Difference
	Count	Percent	Count	Percent	(T-stat)
Number of Lawsuits	345	100.0%	198	100.0%	
Records an accrual and discloses the amount	163	47.2%	76	38.4%	2.01
Records an accrual but does not disclose the amount	18	5.2%	15	7.6%	-1.11
Discloses an estimated loss amount	1	0.3%	0	0.0%	0.76
No Accrual or Estimated Loss Disclosure	163	47.2%	107	54.0%	-1.52

Panel B: Material Settlement Lawsuits

	Post-MTD		Pre-MTD		Difference
	Count	Percent	Count	Percent	(T-test)
Number of Lawsuits	232	100.0%	125	100.0%	
Records an accrual and discloses the amount	121	52.2%	57	45.6%	1.18
Records an accrual but does not disclose the amount	8	3.4%	8	6.4%	-1.29
Discloses an estimated loss amount	1	0.4%	0	0.0%	0.73
No Accrual or Estimated Loss Disclosure	102	44.0%	60	48.0%	-0.73

Panel C: Regression of contingent loss reporting on the timing of denial of the motion to dismiss

	(1)	(2)	(3)	(4)
Dep. Var.	*Accrual Ind*	*Accrual Amount*	*Accrual Ind*	*Accrual Amount*
Post MTD	0.009	0.034	-0.022	0.015
	(0.20)	(0.72)	(-0.46)	(0.31)
Lawsuit Length	0.018	0.040	0.003	0.015
	(0.37)	(0.81)	(0.06)	(0.28)
Settlement Amount	0.091***	0.096***	0.091***	0.096***
	(4.77)	(5.17)	(4.47)	(4.82)
Filing Date Return	-0.091	-0.087	-0.107	-0.113
	(-0.94)	(-0.91)	(-1.06)	(-1.15)
Total Assets	-0.042***	-0.054***	-0.042***	-0.053***
	(-3.03)	(-4.15)	(-2.60)	(-3.47)
BTM	0.005	0.014	0.009	0.013
	(0.52)	(1.45)	(0.84)	(1.38)
Leverage	0.150**	0.121*	0.168**	0.125*
	(2.18)	(1.83)	(2.13)	(1.67)
ROA	0.084	0.074	0.097	0.073
	(1.01)	(0.90)	(1.08)	(0.82)
Fixed Effects	None	None	Industry & Year	Industry & Year
Cluster	Firm	Firm	Firm	Firm
Observations	535	535	534	534
R-Squared	0.055	0.063	0.121	0.137

Table 6: Contingent Reporting around the Preliminary Settlement.
This table compares the reporting litigation contingencies for the subsamples of lawsuits where the last 10-K falls before versus after a lawsuit's preliminary settlement. Panel A includes all lawsuits, while Panel B includes only *Material Settlement* lawsuits defined as those for which the final settlement amount exceeded 0.5% of assets. Panel C presents a regression analysis of Eq (1). *Accrual Ind* is an indicator variable set equal to 1 for 10-Ks which either indicate the existence of an accrual (regardless of whether the amount is disclosed) or provide a loss estimate and 0 otherwise. *Accrual Amount* is an indicator variable set equal to 1 only for 10-Ks that disclose the actual amount of contingency accrual and 0 otherwise. Our variable of interest Post Settle is an indicator variable set to 1 for observations where the 10-K filing occurs after it has entered into a preliminary settlement. We include control variables for *Lawsuit Length*, *Settlement Amount*, *Filing Date Return*, *Total Assets*, *BTM*, *Leverage* and *ROA*, as defined in Appendix A as well as FF 17 industry and year fixed effects. ***, ** and * indicate significance at the 1%, 5% and 10% level respectively for a two tailed test.

Panel A: All Lawsuits

	Post-Settle		Pre-Settle		Difference
	Count	Percent	Count	Percent	(T-stat)
Number of Lawsuits	322	100.0%	221	100.0%	
Records an accrual and discloses the amount	233	72.4%	6	2.7%	22.13
Records an accrual but does not disclose the amount	23	7.1%	10	4.5%	1.25
Discloses an estimated loss amount	0	0.0%	1	0.5%	-1.21
No Accrual or Estimated Loss Disclosure	66	20.5%	204	92.3%	-23.16

Panel B: Material Settlement Lawsuits

	Post-Settle		Pre-Settle		Difference
	Count	Percent	Count	Percent	(T-test)
Number of Lawsuits	220	100.0%	137	100.0%	
Records an accrual and discloses the amount	174	79.1%	4	2.9%	20.78
Records an accrual but does not disclose the amount	11	5.0%	5	3.6%	0.60
Discloses an estimated loss amount	0	0.0%	1	0.7%	-1.27
No Accrual or Estimated Loss Disclosure	35	15.9%	127	92.7%	-21.37

Panel C: Regression of contingent loss reporting on the timing of preliminary settlement

	(1)	(2)	(3)	(4)
Dep. Var.	*Accrual Ind*	*Accrual Amount*	*Accrual Ind*	*Accrual Amount*
Post Settle	0.726***	0.693***	0.735***	0.709***
	(25.30)	(23.98)	(24.22)	(23.51)
Lawsuit Length	-0.078**	-0.046	-0.077**	-0.054
	(-2.36)	(-1.25)	(-2.18)	(-1.41)
Settlement Amount	0.067***	0.075***	0.065***	0.074***
	(4.59)	(5.39)	(4.29)	(5.19)
Filing Date Return	-0.069	-0.065	-0.062	-0.067
	(-1.05)	(-0.95)	(-0.93)	(-0.95)
Total Assets	-0.017	-0.030***	-0.020	-0.032***
	(-1.59)	(-2.97)	(-1.65)	(-2.63)
BTM	0.008	0.016	0.008	0.012
	(1.27)	(1.51)	(1.34)	(1.39)
Leverage	0.083	0.056	0.081	0.038
	(1.50)	(0.99)	(1.34)	(0.62)
ROA	0.089	0.084	0.121*	0.103
	(1.29)	(1.24)	(1.67)	(1.44)
Fixed Effects	None	None	Industry & Year	Industry & Year
Cluster	Firm	Firm	Firm	Firm
Observations	535	535	534	534
R-Squared	0.547	0.517	0.576	0.565

Table 7: Alternate Sources of Accrual Information

This table examines alternate sources of accrual information for the set of 35 *Material* lawsuits in Table 6 Panel B whose final 10-K is issued after preliminary settlement but does not report an accrual or disclose an estimated loss amount. The table displays whether additional disclosure (8-K, 10-Q), issued between the preliminary settlement date and final settlement date confirms the absence of an accrual as of the post-preliminary settlement 10-K date. *Material* lawsuits are defined as lawsuits with settlement amounts greater than 0.5% of total assets (*Material Settlement*).

Material Lawsuits with 10-K after Preliminary Settlement coded as No Accrual or Estimated Loss

	Count	Percent
Number of Lawsuits	35	100.0%
8-K or 10-Q suggests possible Accrual or Estimated Loss recorded *prior to* 10-K	1	2.9%
8-K or 10-Q confirms Accrual or estimated is recorded only *after* 10-K	8	22.9%
8-K or 10-Q confirms no Accrual or Estimated Loss is recorded	8	22.9%
No additional information in 8-K or 10-Q	18	51.4%

Table 8: Earliest incidence of contingent loss reporting.
This table examines the relative timing of the first accrual or estimated loss disclosures reported in firm's 10-Ks relative to the date of preliminary settlement. *Material* lawsuits are defined as lawsuits with settlement amounts greater than 0.5% of total assets (*Material Settlement*).

	All Lawsuits		*Material Settlement*	
	Count	Percent	Count	Percent
Total lawsuits with accrual or estimated loss	273	100.0%	195	100.0%
Records and accrual and discloses the amount *prior* to preliminary settlement	21	7.7%	15	7.7%
Records an accrual *prior* to preliminary settlement but does not disclose amount	17	6.2%	10	5.1%
Discloses and estimated loss *prior* to preliminary settlement	1	0.4%	1	0.5%
First accrual or estimated loss disclosure is *after* preliminary settlement	234	85.7%	169	86.7%

Table 9: Level of certainty on contingent loss reporting judgements.
This table displays the number and proportion of lawsuits for which researchers were certain that an accrual was (not) made, as well as the number and proportion of lawsuits for which such determination required researcher judgement. Further details about how this classification was made are provided in Appendix B. *Material* lawsuits are defined as lawsuits with settlement amounts greater than 0.5% of total assets (*Material Settlement*).

	All Lawsuits		*Material Settlement*	
	Count	Percent	Count	Percent
Researchers certain the lawsuit has an accrual	132	24.3%	99	27.7%
Researchers believe the lawsuit has an accrual but needed judgement	140	25.8%	95	26.6%
Researchers believe the lawsuit does not have an accrual but needed judgement	175	32.2%	97	27.2%
Researchers certain the lawsuit does not have an accrual	96	17.7%	66	18.5%
Number of Lawsuits	543	100.0%	357	100.0%

Table 10: Time Trends in Contingent Accrual Quality.

This table presents an ordinal logistic regression of Conting Accrual Adequacy on various time indicators. Conting Accrual Adequacy is an ordinal variable that takes on the highest value for firms who provide an accrual prior to entering into a preliminary settlement, takes on a middle value if they provide an accrual after preliminary settlement or if there is no preliminary settlement as of their last 10-K, and takes on the lowest value if there is a preliminary settlement as of their last 10-K but no accrual has been provided. FASB Deliberation is an indicator for if a firms' last 10-K before settlement fell between 2008 and 2012. Post FASB is an indicator for if a firms' last 10-K fell after 2012. We include control variables for Lawsuit Length, Settlement Amount, Filing Date Return, Total Assets, BTM, Leverage and ROA, as defined in Appendix A as well as FF17 industry fixed effects. ***, ** and * indicate significance at the 1%, 5% and 10% level respectively for a two tailed test.

	(1)	(2)	(3)	(4)
Dep. Var	*Contingency Accrual Adequacy*			
FASB Deliberation	-0.316	-0.456	-0.330	-0.462
	(-0.79)	(-1.06)	(-0.77)	(-1.05)
Post FASB	0.315	0.286	0.290	0.274
	(1.27)	(1.12)	(1.15)	(1.02)
Lawsuit Length		-0.686**		-0.748***
		(-2.52)		(-2.63)
Settlement Amount		0.482***		0.480***
		(4.15)		(3.83)
Filing Date Return		-0.569		-0.576
		(-1.05)		(-1.06)
Total Assets		-0.071		-0.069
		(-0.86)		(-0.71)
BTM		0.060		0.042
		(1.20)		(0.97)
Leverage		0.239		0.223
		(0.54)		(0.48)
ROA		0.868*		0.989**
		(1.79)		(2.02)
Fixed Effects	None	None	Industry	Industry
Cluster	Firm	Firm	Firm	Firm
Observations	512	506	511	505

Table 11: Determinants of Contingent Accrual Adequacy

This table presents an ordinal logistic regression of *Conting Accrual Adequacy* on measures of SEC scrutiny and proxies for FRQ and auditor monitoring. *Conting Accrual Adequacy* is an ordinal variable that takes on the highest value for firms who provide an accrual prior to entering into a preliminary settlement, takes on a middle value if they provide an accrual after preliminary settlement or if there is no accrual and no preliminary settlement as of their last 10-K, and takes on the lowest value if there is a preliminary settlement as of their last 10-K but no accrual has been provided. *SEC Scrutiny, Going Concern, Internal Control Weakness, Misstatement, Fraud Misstatement and Error Misstatement*, and are defined in appendix A along with all control variables. Industry fixed effects are at the Fama French 17 level. ***, ** and * indicate significance at the 1%, 5% and 10% level respectively for a two tailed test.

	(1)	(2)	(3)
Dep. Var	*Contingency Accrual Adequacy*		
SEC Scrutiny	0.000	0.001**	0.001
	(1.32)	(2.44)	(0.78)
Firm Comment Letters	-0.368	-0.600*	-0.532
	(-1.17)	(-1.73)	(-1.49)
Going Concern	-0.250	-0.355	-0.359
	(-0.49)	(-0.65)	(-0.63)
Internal Control Weakness	0.547*	0.688**	0.749**
	(1.81)	(2.11)	(2.16)
Misstatement	0.336	0.422	0.370
	(1.20)	(1.48)	(1.29)
Fraud Mistatement	-0.528	-0.452	-0.338
	(-0.84)	(-0.68)	(-0.46)
Error Mistatement	-0.907	-1.363*	-1.332
	(-1.37)	(-1.83)	(-1.64)
Lawsuit Length	-0.751**	-0.718**	-0.760**
	(-2.45)	(-2.26)	(-2.36)
Settlement Amount	0.473***	0.513***	0.511***
	(3.86)	(4.02)	(3.83)
Filing Date Return	-0.577	-0.470	-0.426
	(-1.05)	(-0.82)	(-0.74)
Total Assets	-0.025	-0.041	-0.057
	(-0.29)	(-0.48)	(-0.56)
BTM	0.060	0.096*	0.085*
	(1.25)	(1.95)	(1.88)
Leverage	0.204	0.128	0.064
	(0.44)	(0.26)	(0.12)
ROA	0.809	0.892	1.005*
	(1.54)	(1.63)	(1.77)
Fixed Effects	None	Year	Industry & Year
Cluster	Firm	Firm	Firm
Observations	469	469	469

Table 12: Balance Sheet recognition of researcher coded accruals.
This table displays regressions of changes in various balance sheet items on indicator variables for researcher accrual classifications. *Other Current Liabilities, Accrued Expenses,* and *Other Long-Term Liabilities* are calculated as changes in LCOXDR, XACC, and LOXDR in Compustat from two years prior to lawsuit settlement to one year prior to lawsuit settlement, scaled by total assets. *Accrual – Certain Ind. (Accrual Judgement – Ind.)* are indicator variables for whether the firm was classified as having made an accrual with certainty (with judgement). *No Accrual – Judgement Ind.* is and indicator variable for whether the firm was classified as having not made an accrual with judgement. See Appendix B. The P. Value of an F-Test for whether the coefficient on *Accrual – Certain Ind. = Accrual – Judgement Ind.* is displayed below the table. We include control variables for *Lawsuit Length*, *Settlement Amount*, *Filing Date Return*, *Total Assets*, *BTM*, *Leverage* and *ROA*, as defined in Appendix A as well as FF17 industry fixed effects. ***, ** and * indicate significance at the 1%, 5% and 10% level respectively for a one tailed test.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Dep. Var - Change in:	*Other Current Liabilities*			*Accrued Expenses*			*Other Long-Term Liabilities*		
Accrual - Certain Ind.	1.948***	1.636***	1.591***	0.548*	0.547*	0.296	0.164	0.099	0.007
	(3.00)	(2.83)	(2.66)	(1.37)	(1.35)	(0.74)	(0.45)	(0.28)	(0.02)
Accrual - Judgement Ind.	0.861**	0.668	0.811*	0.254	0.304	0.101	0.215	0.235	0.078
	(1.65)	(1.26)	(1.51)	(0.72)	(0.87)	(0.28)	(0.65)	(0.70)	(0.22)
No Accrual - Judgement Ind.	0.314	0.128	0.436	0.265	0.418*	0.135	0.254	0.351	0.174
	(0.76)	(0.27)	(0.93)	(0.89)	(1.35)	(0.40)	(0.77)	(1.04)	(0.47)
Lawsuit Length		-0.421	-0.616*		-0.056	-0.154		0.283	0.101
		(-0.85)	(-1.33)		(-0.19)	(-0.53)		(1.13)	(0.39)
Settlement Amount		0.400**	0.449***		0.144	0.143		0.196*	0.242**
		(2.31)	(2.40)		(1.25)	(1.14)		(1.55)	(1.81)
Filing Date Return		0.017	-0.662		-0.763	-0.792		0.457	0.817*
		(0.02)	(-0.63)		(-1.02)	(-1.11)		(0.85)	(1.51)
Total Assets		-0.069	-0.098		-0.041	0.001		-0.080	-0.066
		(-0.51)	(-0.64)		(-0.49)	(0.01)		(-1.09)	(-0.81)
BTM		-0.022	0.044		0.019	0.019		-0.007	-0.003
		(-0.21)	(0.41)		(0.19)	(0.20)		(-0.09)	(-0.04)
Leverage		0.857	1.047		-0.811*	-0.499		-0.138	-0.131
		(1.07)	(1.17)		(-1.39)	(-0.77)		(-0.33)	(-0.28)
ROA		-2.669**	-2.679**		0.257	0.232		-0.183	-0.414
		(-2.09)	(-2.15)		(0.28)	(0.26)		(-0.33)	(-0.68)
P. Value: Accrual - Certain Ind. = Accrual - Judgement Ind.	0.11	0.13	0.22	0.50	0.58	0.65	0.86	0.64	0.81
Fixed Effects	None	None	Industry & Year	None	None	Industry & Year	None	None	Industry & Year
Observations	543	535	534	543	535	534	543	535	534
R-Squared	0.025	0.076	0.143	0.003	0.019	0.089	0.001	0.015	0.078

Table 13: Insurance Reporting

This table displays the reporting of insurance information for the subsample of lawsuits where an accrual was made compared to the subsample where it was not. Panel A includes all lawsuits, while Panel B includes only *Material Settlement* lawsuits defined as those for which the final settlement amount exceeded 0.5% of assets.

Panel A: All Lawsuits

	Accrual		No Accrual	
	Count	Percent	Count	Percent
Number of Lawsuits	272	100.0%	271	100.0%
Mentions Insurance	157	57.7%	51	18.8%
Lawsuit Immaterial After Insurance	82	30.1%	38	14.0%
Company Payment in Excess of Insurance	65	23.9%	0	0.0%
Doesn't Mention Insurance	115	42.3%	220	81.2%

Panel B: Material Settlement Lawsuits

	Accrual		No Accrual	
	Count	Percent	Count	Percent
Number of Lawsuits	194	100.0%	163	100.0%
Mentions Insurance	118	60.8%	35	21.5%
Lawsuit Immaterial After Insurance	56	28.9%	22	13.5%
Company Payment in Excess of Insurance	55	28.4%	0	0.0%
Doesn't Mention Insurance	76	39.2%	128	78.5%