# LITIGATION CONTINGENCY DISCLOSURES

# BY CANADIAN PUBLIC COMPANIES

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## ABSTRACT

Litigation-type contingencies represent one of the most frequent and most important uncertainties faced in business. Inspired by the Entwistle et al. (1994) study, this study focuses on two aspects of litigation contingencies: the current status of disclosure practices by public firms, and the relationship between various environmental factors and litigation disclosure patterns.

Using the 1994 financial statements of public companies, this study examines 44 firms' specific note disclosures of both litigation gains and losses. Disclosure scores are analyzed and compared to Entwistle et al. (1994) based on the information across nine aspects of the disclosures. In addition, seven disclosure environment characteristics, including size, capital structure, ownership structure, profitability, industry, SEC listing and nature of the lawsuit, are examined for their relationship with firms' litigation disclosure practices.

The findings indicate that despite the repeated expressed dissatisfaction with litigation disclosures made by public firms, no significant improvements have been made in public companies' financial statement litigation disclosures over the three-year time frame from 1991 to 1994. Further, and interestingly, the findings also fail to identify any statistically significant associations between the seven environmental factors explored and firms' disclosure patterns.

The results of this study should be of interest to both accounting standard setters, and to future researchers in their efforts to better understand the possible causes of firms' litigation disclosure decisions.

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# CHAPTER ONE

# INTRODUCTION

## 1.1 Introduction to the Study

Uncertainty is acknowledged as a natural aspect of all business activities (Boritz, 1990), with the sources of uncertainty being various economic, technological, environmental, social and political forces. From an accounting perspective, uncertainty is perhaps best captured in the area of contingencies. Indeed, the Canadian Institute of Chartered Accountants (CICA) Handbook (Section 3290.02) defines a contingency as "an existing condition or situation involving *uncertainty* (emphasis added) as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur". Examples of contingencies include threats of expropriation of assets, guarantees of the indebtedness of others and potential liabilities arising from discounted bills of exchange or promissory notes.

An additional type of contingency, and the specific focus of this research, is litigation contingencies, contingencies which have been found to be the most frequent and most important uncertainty arising in the ordinary course of business (CICA 1993; Boritz 1990; Thornton 1983). Indeed, according to a 1992 survey of the accounting practices of 300 Canadian public firms, litigation-type contingencies constitute almost half (45 percent) of all firms' reported contingencies (CICA 1993), while a more recent survey, conducted in 1998, found an even greater (58 percent) proportion (CICA 1999). Further, in terms of their potential impact, Thornton (1983) noted that litigation-type contingencies could be so significant that "if their probable effects could be quantified,

(they) would swamp the uncertainty inherent in doing business in the firm's industry" (p.125).

This research will examine two main aspects of litigation-type contingencies. First, for a sample of Canadian public companies, it will describe the disclosure practices for contingent losses and contingent gains. Second, it will explore whether a relation exists between the firms' litigation disclosure of contingent losses and various characteristics such as firm size, industry, and stock exchange listing status.

## 1.2 Motivations for and Potential Contributions of the Study

This research is primarily motivated by the Entwistle et al. (1994) study (henceforth E et al.), in which litigation disclosures were examined within a sample of Canadian public companies' 1989 to 1992 notes to financial statements. Specifically, the E et al. study explored three dimensions of firms' litigation disclosures: existence, revision and resolution. The E et al. study found that firms' litigation disclosures generally failed to provide detailed background information, or an estimated dollar amount for the outstanding lawsuits. In addition, information describing the eventual outcomes of resolved lawsuits was usually lacking in subsequent years' notes to financial statements. This "incompleteness" of litigation disclosure led the authors to question whether users were provided sufficient and appropriate information with which to adequately assess and predict the future impact of the contingencies. This research study, using 1994 data, builds upon the E et al. study. This building involves both an update of E et al.'s existence dimension of firms' litigation disclosure practices, and an exploration of factors related to the disclosures.

A second motivation for the study is that in both Canada and the U.S., the accounting standards for contingencies continue to have a decidedly disclosure-based orientation. That is, in Canada, loss contingencies are to be *accrued* only when the loss is both likely and reasonably estimable; the comparable terms in the United States are probable and reasonable estimable. Meanwhile, any material contingencies falling below this accrual threshold are to be disclosed in the notes of the financial statements. As the accrual requirement reflects a "strong condition" seldom satisfied in the evaluation of contingencies, both countries' standards favor disclosure over the recognition of contingencies. In addition, the accrual of contingent gains is not allowed in either Canada or the United States, while disclosure of such gains is often either encouraged or recommended when their ultimate realization is assessed as likely. This disclosure orientation for contingencies therefore provides a rich context within which to examine firms' disclosure behaviors, and from which to contribute to the academic disclosure literature.

The final motivation for the study relates to the Canadian Accounting Standards Board's (AcSB) attempt, beginning in 1990, to implement new accounting standards for contingencies. Although the AcSB's initiative eventually failed (i.e., the project was formally discontinued in 1999), it is conceivable the standards may be revisited at some future point. Hence, this study will provide useful empirical evidence for standard setters in any future reconsideration.

## 1.3 Organization of the Thesis

The remainder of the study proceeds as follows. Chapter Two reviews the research on contingencies. Chapter Three then introduces the research design. Chapter Four presents the results of the analysis and discusses the results. Chapter Five concludes the thesis.

# CHAPTER TWO

# LITERATURE REVIEW

This literature review describes the research that has examined the accounting standard for contingencies, both in Canada and the United States. The review is divided into two sections: research exploring the "interpretation" of the accounting standard for contingencies, and research on actual reporting practice.

## 2.1 The "Interpretation" of the Accounting Standard for Contingencies

The historical position of accounting standard setters both in Canada (CICA) and the U.S. (FASB) towards contingency reporting utilizes what can be described as a "qualitative" or "judgmental" approach. For example, in Canada, the accounting rules for contingencies (CICA Handbook Section 3290, CICA 1978) incorporate the qualitative terms "likely", "unlikely", and "not determinable" for estimating the probability of a future confirmatory event (i.e., the outcome of a contingency), while in the U.S. (SFAS No. 5, FASB 1975), such terms as "reasonably possible" and "probable" are used. These resulting probability estimates, as made by management, subsequently determine the accrual/non-accrual and disclosure of contingencies. In incorporating these various qualitative definitions, as opposed to providing "quantitative" guidance (e.g., numerical probability ranges), the accounting standard setters left significant room for professional judgment in determining the accounting for contingencies, judgment which research evidence suggests both "might lead" and "has led" to substantial reporting inconsistency. The following discussion describes this research.

**Canada**

In Canada, Chesley (1986) using experiments, and Chesley and Wier (1985) using surveys, tested the consistency of interpretation of such contingency terminology as "probable", "likely", and "not reasonably estimable", and found wide variations in interpretation. The studies also found that such complementary words as "likely" and "unlikely" were not symmetric in their interpretation. Both studies consequently proposed that a number scale for probability communication be adopted to reduce the inconsistencies caused by the ambiguous, "qualitative", standards.

Also in Canada, due to a bilingual population, the CICA's accounting and assurance standards are published in both English and French. This raises an additional concern with the effectiveness of any translation of accounting standards. That is, while qualitative uncertainty terms within accounting standards can give rise to considerable variation in interpretation among people speaking a common language, language differences, as suggested by Davidson and Chrisman (1994), constitute an important factor which can exacerbate the extent of disagreement on the meanings of uncertainty expressions. In their study of this language issue, Davidson and Chrisman (1994) found that of the 58 English/French uncertainty expression pairs examined, 31 resulted in significant differences in the probability levels attached between the Anglophone and Francophone respondents. In addition, Francophone respondents in general exhibited both greater extremeness (i.e., attached more extreme mean probability levels) and lower precision (i.e., had greater variability) in their responses.

**United States**

In the United States, SFAS No. 5 governs the accounting for contingencies, with the relevant criteria for determining contingency reporting including such terms as "remote", "reasonably possible", and "probable". As in Canada, such terminology has been found to result in a lack of consensus in interpretation. For example, Raghunandan et al. (1991), through a survey of 64 audit partners, provided evidence indicating that auditors' judgments for note disclosure decisions were not consistent with their own interpretation of the verbal probability terms used in the standard.

Harrison and Tomassini (1989) conducted a survey of 46 auditors to examine the correspondence between the verbal probability terms used in SFAS No.5 and numerical probability values. Subjects in the survey were asked to provide numerical probability thresholds between the "remote" and "reasonable possible" criterion (R-RP) and between the "reasonably possible" and "probable" criterion (RP-P). The authors found significantly less consensus about the R-RP threshold than the RP-P threshold, and based on their findings, suggested that numerical probabilities be included in accounting standards.

Jiambalvo and Wilner (1985) meanwhile used a survey of 80 auditors to test the consistency of auditors' evaluation of contingent claims. Two important findings emerged. First, the authors found that auditors varied significantly in their interpretation of the terms used to express uncertainty in SFAS No.5 (e.g., remote, probable). Second, and more important, it was demonstrated that this variation led to different recommended disclosure in two of the four contingency cases used in the study.

Finally, in an experiment using a group of partners from one Big Eight accounting firm, Schultz and Reckers (1981) noted that even where a contingency constituted approximately 14 percent of operating income, a situation regarded by the authors as "highly material", the subjects viewed any probability of occurrence of less than 40 percent as "remote", and hence not requiring disclosure. This observation led the authors to suggest that the partners' definition of "remote" could give rise to "serious problems in audit reviews or courtroom defenses" (p.493).

## 2.2 Actual Reporting Practice

The above mentioned ambiguity of interpretation in the accounting standards on contingencies would lead one to expect significant inconsistency in actual reporting practice. The studies below, using both cross-sectional and longitudinal designs, provide evidence of this inconsistency.

### Canada

In Canada, Entwistle et al. (1994), using the note disclosure to financial statements of 64 Canadian public companies issued from 1989 through 1992, examined three interrelated dimensions of firms' litigation-type contingency disclosures: existence, revision, and resolution. The "existence" dimension related to the firm's disclosure of various background information of its ongoing lawsuits as well as management's estimated dollar amounts for the lawsuits. "Revision" meanwhile was concerned with both how and whether firms updated their disclosures in subsequent years' notes to financial statements. Finally, the study explored whether firms provided information

regarding each lawsuit's ultimate "resolution". In total, 66 litigation contingencies were examined including 47 "specific" disclosures upon which the majority of the analysis was performed, as well as 19 "non-specific" disclosures that were judged by the authors to contain only minimal useful information.

In terms of the existence dimension, the CICA Handbook (Section 3290) states that disclosures of contingent gains or losses in the financial statements should include both a description of the nature of the contingency, and the estimated dollar gain or loss (or a statement that such an estimate cannot be rendered). The Handbook, however, does not provide any detailed guidelines on how the "nature" of the contingency should be defined. E et al. therefore developed eight items that provided a surrogate for "nature". These eight items include the plaintiff and the defendant involved in the legal proceedings, reasons for the allegation, dates regarding when the lawsuit was initiated, when the underlying action occurred, and when the lawsuit was expected to be resolved, the lawsuit's whereabouts in the legal process, and the dollar claim sought by the plaintiff.

For the 47 specific litigation contingencies, E et al. found most firms failed to disclose sufficient information on launch dates, action dates, and the lawsuit's whereabouts in the legal process. In addition, none of the 47 disclosures provided an expected resolution date for the lawsuit. The dollar amount involved in the lawsuit was found to be disclosed in most of the contingent gain situations, but in only half of the contingent loss situations. Significant disclosure shortcomings were also identified for both the "revision" and "resolution" dimensions.

Gagnon-Valotaire and Chlala, in their 1993 study, analyzed approximately 100 Canadian companies' 1991 annual reports and concluded that note disclosures of contingencies were often vague and did not allow for an assessment of the risk of contingent losses. They also criticized current practice in that most contingency notes to the financial statements did not incorporate useful quantitative information, and that some companies tended to repeat the same information from one year to the next.

Finally, Thornton (1983), as part of his study of the financial reporting of contingencies, reviewed the 1978 annual reports of 600 Canadian public firms. From this review, he suggested that improvement in the financial reporting of legal uncertainty was possible. Further, he concluded that the existing litigation disclosure might contain a bias that could result in financial statements that either significantly overstate or understate the litigation risks facing the firm, and hence reduce the reliability of the financial statement information.

**United States**

Three U.S. studies also examined actual litigation reporting practice, with each using a longitudinal research design. First, Raghunandan (1993) examined the predictive accuracy of 92 litigation note disclosures made in various 1983 and 1984 annual reports. For 33 notes initially classified as "optimistic", and where the disclosure anticipated no materially adverse resolution of the lawsuit, nine (27%) were resolved materially *against* the defendant firm. Also, of the 59 notes classed as "non-optimistic", only 27 (46%) were resolved in a materially adverse manner.

Deakin's (1989) case study of the Pennzoil-Texaco lawsuit presented a side-by-side comparison of the plaintiff (Pennzoil) and defendant (Texaco) illustrating the difference in practice between accounting for contingent gains and losses. First, on the contingent liability (i.e., the defendant firm) side, the criterion of "reasonably possible" (i.e., the disclosure threshold), was considered to be met at the *time of filing* of the lawsuit, while the "probable" criterion (i.e., the accrual threshold) was determined to be met when *judgment was entered* against the defendant (although the actual accrual did not take place until an agreement on actual payment terms had been reached). In contrast, on the contingent asset (i.e., the plaintiff firm) side, disclosure was not considered necessary until *after the judgment was issued* but before final resolution of all appeals. Further, recognition (i.e., accrual) of the litigation gain was deferred until *actual payment* of the settlement took place.

Finally, Fesler and Hagler (1989), using 10-K reports, documented the results of a disclosure study of 126 lawsuits lost by publicly traded corporations in the early 1980's. The results demonstrated that adequate forewarning for 54 of the 126 lawsuits had not been provided in the prior year's annual reports. More importantly, 44 of these 54 firms made no disclosure, while the rest made strongly worded *disclaimers*. The authors also found that smaller firms provided more satisfactory forewarning.

## 2.3 Summary

In summary, the ambiguity and judgment inherent in the current accounting standard for contingencies, both in Canada and the United States, allow and have led to significant variation in interpretation, which in turn has led to inconsistency in accounting

and reporting practice. This inconsistency is evidenced in terms of firms failing to disclose material contingencies on a timely basis, and/or failing to provide satisfactory disclosures. This thesis research, using 1994 financial statement data, provides additional, and updated, empirical evidence regarding Canadian firms' contingency reporting. As noted in Chapter One, the study will also attempt to provide explanations for the evidenced reporting practices.

# CHAPTER THREE

# OVERVIEW OF THE RESEARCH DESIGN

As noted, this study will enrich the extant literature on disclosure management by examining litigation reporting by Canadian firms. Specifically, the research has two main objectives. First, it will present an updated picture of Canadian disclosure practice of litigation gains and losses. Second, it will explore various environmental factors that may affect the firms' litigation loss disclosure decisions. This chapter provides an overview of the research design related to each of these objectives.

## 3.1. Litigation Disclosure Practice – A Description

The first objective of the study is to provide an updated picture of disclosures of litigation gains and litigation losses by Canadian public firms by replicating the existence aspect of the Entwistle et al. (E et al.) study. In order to obtain a relevant and comparable set of firms for study, a similar approach to E et al. was undertaken. Specifically, a list of companies making contingency disclosures in their 1994 financial statements was obtained from the CICA. This list was compiled and used by the CICA in preparing its 1995 version of *Financial Reporting in Canada*, a bi-annual publication describing the financial reporting practices of 300 large Canadian public companies. According to the list, in 1994, 109 companies made litigation loss disclosures, four made litigation gain disclosures, and eight companies disclosed both litigation losses and gains. Of these 121

firms, six of the firms' financial statements were deemed inappropriate for the study[1]. Of the remaining 115 firms, 100 were selected for examination, including all 11 firms with at least one litigation gain disclosure[2].

The 100 sample firms have an industry breakdown similar to the 300 original firms surveyed by the CICA, and comparable to those used in the E et al. study, with nearly half (42%) coming from the manufacturing sector.[3] For these 100 firms, the average total assets were $3,057 million, average shareholders' equity was $811 million, and average net income was $67 million. These amounts are substantially larger that the E et al. study, with comparative figures being $1,207 million, $414 million, and $19 million, respectively. Table 3.1 provides a list of these 100 firms classified into ten industries.

[1] Intermetco Limited and Avenor Limited were dropped from the sample due to misclassifications by the CICA (i.e., their financial statements contained no litigation disclosure). Four other companies were also discarded during the data selection process as their stocks were not traded on the TSE, the stock exchange of interest in this study: ARC International Corporation (AMEX), Glenex Industries Inc. (Vancouver Stock Exchange), Goodfellow Inc. (Montreal Stock Exchange), Northwest Sports Enterprises Ltd. (Montreal Stock Exchange and Vancouver Stock Exchange).

[2] The financial statements of AGRA Industries Limited did not contain the litigation gain disclosure as described by *Financial Reporting in Canada*.

[3] Of the 300 firms in the 1994 CICA study, 51% were in manufacturing; the E et al. study had 52% of its firms from the manufacturing sector.

**TABLE 3.1**
**Summary of Companies Selected**
**(Companies with Contingent Gain Disclosures Identified with *)**

| INDUSTRY | COMPANY NAME | |
|---|---|---|
| **MANUFACTURING (N= 42)** | Alcan Aluminium Limited | GSW Inc.* |
| | Bombardier Inc. | Harris Steel Group Inc. |
| | Brampton Brick Company | Inter-city Products Corporation |
| | CAE Inc.* | Irwin Toy Limited |
| | Canadian Marconi Company* | Jannock Limited |
| | The Canam Manac Group Inc. | Kaufel Group Ltd. |
| | Cascades Inc. | Larfarge Canada Inc. |
| | CCL Industries Inc. | Linamar Corporation |
| | Celanese Canada Inc. | Magna International Inc. |
| | CGC Inc. | Maple Leaf Foods Inc. |
| | Derlan Industries Limited | Mitel Corporation |
| | Domtar Inc. | Moore Corporation Limited |
| | Donohue Inc. | Patheon Inc. |
| | Dreco Energy Services Ltd. | Quebecor Inc. |
| | Du Pont Canada Inc. | Repap Enterprises Inc. |
| | Electrohome Limited | Slater Industries Inc. |
| | Emco Limited | St. Lawrence Cement Inc. |
| | Federal Industries Ltd. | Telemedia Inc. |
| | Gandalf Technologies Inc. | Tembec Inc.* |
| | Geac Computer Corporation Limited | The Toronto Sun Publishing Corporation |
| | Great Pacific Enterprises Inc. | United Dominion Industries Limited |
| **WHOLESALE/RETAIL (N=12)** | Ackland Limited | Loblaw Companies Ltd. |
| | Algonquin Mercantile Corporation | Scott's Hospitality Inc. |
| | The Becker Milk Company, Limited | Silcorp Limited |
| | Canadian Tire Corporation Limited | Unican Security Systems Ltd.* |
| | Glentel Inc. | United Grain Growers Limited |
| | The Jean Coutu Group (PJC) Inc. | Univa Inc. (Provigo Inc.)* |
| **MINING (N=12)** | Agnico-Eagle Mines Limited | Imperial Oil Limited |
| | Barrick Gold Corporation | Nowsco Well Services Ltd. |
| | Canadian Occidental Petroleum Ltd. | Placer Dome Inc.* |
| | Computalog Ltd. | Rio Algom Limited |
| | Denison Mines Limited* | Shell Canada Limited |
| | Gulf Canada Resources Limited | Suncor Inc. |
| **SERVICES (N=9)** | AGRA Industries Limited | Laidlaw Inc. |
| | BOVAR Inc. | The Loewen Group Inc. |
| | Cineplex Odeon Corporation | MDS Health Group Limited* |
| | DMR Group Inc.* | SHL Systemhouse Inc. |
| | Extendicare Inc. | |
| **UTILITIES (N=7)** | Alberta Natural Gas Company Ltd. | Philip Environmental Inc. |
| | ATCO Ltd. | TransCanada Pipelines Limited |
| | BC Gas Inc. | Westcoast Energy Inc. |
| | Canadian Utilities Limited | |
| **COMMUNICATION (N=7)** | Astral Communication Inc. | Rogers Communication Inc. |
| | BCE Inc. | Teleglobe Inc. |
| | Cableshare Inc. | Tele-Metropole Inc. |
| | Canadian Satellite Communications Inc. | |
| **DIVERSIFIED (N=6)** | George Weston Limited | Nova Corporation |
| | Imasco Limited | Onex Corporation |
| | The Molson Companies Limited | Trimac Limited |
| **REAL ESTATE/ CONSTRUCTION (N=3)** | Banister Foundation Inc. | Industra Service Corporation* |
| | Coscan Development Corporation | |
| **TRANSPORTATION (N=1)** | Vitran Corporation Inc. | |
| **BANKING/CREDIT AGENCY (N=1)** | CT Financial Services Inc. | |

To obtain the original data, a request for copies of the 1994 annual reports was first made to the selected companies via phone. A majority of companies responded within two weeks by sending the required information. For the rest of companies, after a failed second follow-up phone call, it was decided to use the 1994 Compact Disclosure CDRom Database as an alternative data source for their financial statements. The database contains financial records on approximately 8,500 Canadian public and private companies, including financial statements and notes thereto, financial ratios, directory-type information, and various text fields that may include: letters to shareholders from annual reports, mergers and acquisitions information, operating statistics, capital stock changes, and a list of subsidiaries.

For the 100 selected companies, 201 individual contingency disclosure items were identified. Figure 3.1 provides an overview of these 201 disclosure items.

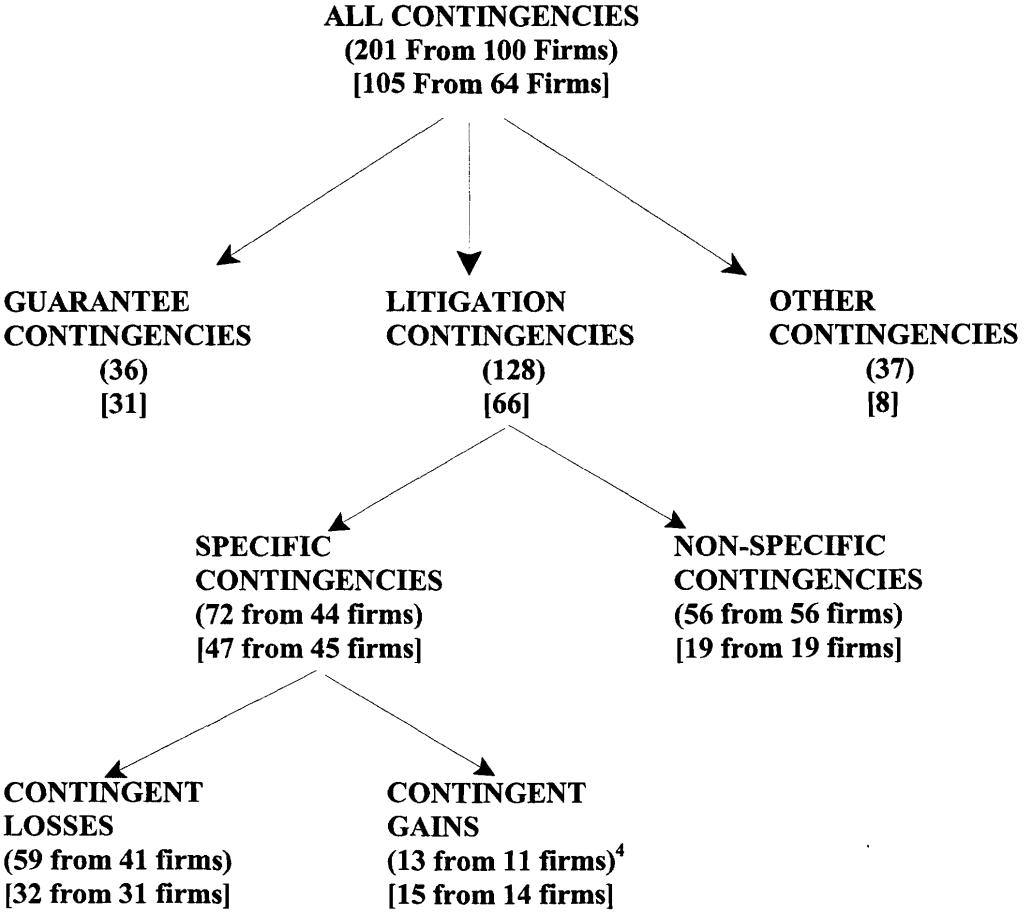


**Figure 3.1 Contingency Disclosures within the 1994 Financial Statements Comparative Figures for E et al. shown in [ ]**

Of the 201 contingency disclosures identified, 128 (63.7%) were identified as "litigation-type" contingencies. It is important to note that this prevalence of litigation-type contingencies supports the observation that litigation is the most frequent and important form of contingency (Entwistle et al. 1994; Boritz 1990; Thornton 1983). The remaining 73 contingency disclosures outlined in Figure 3.1 include thirty-six "guarantee-type" contingencies and thirty-seven "other" contingencies. Appendix A and

[4] The 11 companies include eight companies with both contingent gains and contingent losses.

Appendix B provide additional information about these disclosures. Next, and again consistent with the E et al. study, the 128 litigation-type contingencies were further classified into two categories:

**Specific Contingencies (72)**

These are disclosures which provide specific factual information on the nature of the pending lawsuit and which may also disclose management's best estimate of the monetary loss or gain. As an example of such a disclosure, the 1994 financial statements of Inter-City Products Inc. included the following note:

> *"In February 1995, an action was commenced against ICP Canada in the Ontario Court (General Division) by GEC Alsthom Limited and GEC Alsthom Australia Limited (collectively "GEC"), claiming damages for breach of contract or negligence in the amount of Cdn $7.0 million, plus interest and costs, arising out of alleged defective cooling banks which were designed, manufactured and delivered by Unifin International, a former division of ICP Canada, to GEC between 1981 and 1984. The Company denies GEC's allegations and intends to vigorously defend its position against this claim."*

As noted in Figure 3.1, these 72 specific contingencies were provided in the financial statements of 44 firms. Of these 44 firms, 33 (75%) had only litigation loss disclosures, three (6.8%) disclosed only litigation gains, and eight (18.2%) disclosed both litigation gains and losses. Information about these 72 specific contingencies is used extensively in presenting an updated picture of Canadian litigation disclosure practice. As with the E et al. study, these specific litigation disclosures will be analyzed for information in the following nine areas:

- the plaintiff(s)
- the defendant(s)
- the reason for the lawsuit
- the launch date (when the lawsuit was initiated)
- the action date (when the underlying action occurred)
- the expected resolution date (when the lawsuit was expected to be resolved)
- the legal whereabouts (the lawsuit's whereabouts in the legal process)
- the dollar claim involved
- management estimate of dollar loss or gain

The first eight items were developed in E et al. to capture "the nature of the contingency" as required by the CICA Handbook (Section 3290). The last item, management estimate of dollar loss or gain, is specifically spelled out in the accounting standard as part of the disclosure requirement.

As part of the analysis, the findings will be compared with the E et al. study.

**Non-Specific Contingencies (56)**

These are disclosures that provide minimal information on the litigation contingency. A typical non-specific litigation disclosure is reflected in Telemedia Inc.'s 1994 financial statements as follows:

*"Claims and suits are brought against the Company and its subsidiaries in the ordinary course of business. In the opinion of management, all such claims and suits are adequately covered by insurance, or if not so covered, the results are not expected to materially affect the Company's financial position."*

These 56 non-specific litigation contingencies will not be the focus of this study.

To summarize, this first part of the study is designed to achieve three things. First, is to update and increase our understanding of the litigation reporting provided by Canadian firms. Second, is to identify any trends or changes in litigation reporting since the E et al. study. Third, is to serve as a starting point for the relationship analysis in the second part of the study, described next.

## 3.2 Litigation Disclosure Practice - An Explanation

The second part of the study focuses on litigation losses and extends E et al. in two ways. First, the study examines a number of disclosure environment characteristics for their possible relation to 41[5] firms' specific litigation loss disclosure practices. These characteristics include firm size, capital structure, ownership structure, performance (profitability), industry, and SEC listing status, all factors which have received previous attention in the disclosure research. The unit of analysis in this part of the study is the firm. Additional discussion of this analysis is described in section 3.2.1.

Second, in reviewing all the sample firms' disclosures, it was revealed that 15 firms had more than one specific litigation loss disclosure in the notes to their financial

[5] Three of the 44 firms making specific litigation contingency disclosures had only contingent gains.

statements. Further, and more importantly, it was found that for none of these 15 firms, were there similar types of information being disclosed across their different lawsuits. The review also suggested that this "differential" disclosure might bear some relation to the "type" or "nature" of the lawsuit itself. Hence, it was decided that an additional disclosure environment variable would be introduced and examined - the nature of the lawsuit. In this part of the study, the unit of analysis becomes the lawsuit and accordingly, the 59 contingent losses will be studied on an individual basis. Additional discussion of this analysis can be found in Section 3.2.2.

### 3.2.1 Explanations – Factors from Existing Literature

This part of the study examines whether a firm's specific litigation loss disclosure (the dependent variable) is related to various environmental factors (the independent variables). These variables are discussed below.

**Dependent variable**

For purposes of this study, a firm's litigation disclosure is measured using a disclosure index incorporating the nine items used in the E et al. study (refer Section 3.1). Using this disclosure index, a disclosure score was determined for each firm, with the score capturing, or proxying for, the "extent" of the firm's disclosure. Based on the review of the relevant literature, nothing was noted that suggested assigning differing weighting to the various items, hence all items in the disclosure index are equally

weighted.[6] The nine items were coded as being present (1) or not (0), and then summed. For those firms that disclosed multiple lawsuits in their financial statements, each lawsuit is equally weighted and an average score obtained. The coding of the individual litigation disclosure was conducted twice with more than one month apart to ensure the consistency and accuracy. Disclosure scores are shown, in the context of each independent variable, in Tables 4.5 through 4.10 inclusive.

**Independent variables**

A number of environmental factors common to the disclosure research will be examined to offer explanations for the firms' litigation disclosures. These are: size, capital structure, ownership structure, profitability, industry, and SEC listing. Each of these factors is described below.

**Size**

A relation between firm size and disclosure has been widely researched and supported in the disclosure literature (e.g., Entwistle 1999). One reason posited for this size effect is that information collection and dissemination is a costly exercise, and hence only large firms possess the necessary resources to afford such expenses. Moreover, larger firms are able to enjoy economies of scale in disclosure costs (Entwistle 1999). As there may be a fixed component to disclosure costs, the cost per unit of disclosure decreases as firm size increases.

[6] Prior research (e.g., Chow and Wong-Boren 1987) failed to identify any significant difference between weighted and unweighted disclosure indices.

A size effect has also been linked to proprietary costs associated with the disclosure of strategic information, such as R&D expenditures, segment data, and pending lawsuits. According to Craswell and Taylor (1992), while proprietary costs are usually industry specific, they are also inversely related to firm size. That is, compared to small firms, large firms are less fearful of losing competitiveness because of disclosing negative news with an inherent proprietary cost, such as outstanding lawsuits faced by the firm. Hence, they are relatively more willing to increase their disclosure to satisfy the information demand from various parties.

These arguments support a positive relation between the extent of litigation disclosure and firm size.

***H1: The extent of litigation disclosure is positively related to firm size.***

A wide range of measures have been used in prior research to proxy for firm size, with no empirical evidence to date indicating the superiority of one particular measure.[7] Similar to Downie and Fortin (1997), this study will operationalize firm size as total assets. Table 3.2 provides information on this variable.

[7] For example, size has been operationalized as total assets (Downie & Fortin, 1997), revenue (Neu et al., 1998), market value of equity (Botosan 1997), number of shareholders (McKinnon & Dalimunthe 1993), number of subsidiaries (McKinnon & Dalimunthe 1993), net income (Deegan & Hallam 1991), and Fortune 500 rank (Cowen et al., 1987).

**TABLE 3.2**

**Size (Total Assets)**

**(in thousands)**

| Industry | Average ($) | Maximum ($) | Minimum ($) | ≥$1B | $500M to $1B | ≤$500M | Total |
|---|---|---|---|---|---|---|---|
| Manufacturing | 996,743 | 4,493,300 | 69,848 | 5 | 3 | 9 | 17 |
| Wholesale/Retail | 1,370,006 | 2,947,200 | 281,123 | 2 | 1 | 2 | 5 |
| Communication | 9,595,275 | 38,092,000 | 1,449 | 1 | 0 | 3 | 4 |
| Mining | 1,400,262 | 3,150,689 | 107,471 | 2 | 0 | 2 | 4 |
| Utilities | 3,424,602 | 9,926,400 | 685,529 | 2 | 2 | 0 | 4 |
| Diversified | 20,324,733 | 53,482,000 | 2,748,198 | 3 | 0 | 0 | 3 |
| Services | 1,774,516 | 3,633,200 | 125,194 | 2 | 0 | 1 | 3 |
| Transportation | 64,502 | 64,502 | 64,502 | 0 | 0 | 1 | 1 |
| **Total** | **$3,778,632** | **$53,482,000** | **$1,449** | **17** | **6** | **18** | **41** |

For the 41 firms, the average total assets are $3.8 billion, ranging from $64.5 million for transportation firms to $20.3 billion for diversified firms. In terms of absolute total assets, the firms range from a minimum of $1.4 million for Communication firm Cableshare Inc. to a maximum of $53.5 billion for Diversified firm Imasco Limited. For purposes of analysis, three size categories were used: 17 firms (41.5%) with total assets of greater than $1 billion, six firms (14.6%) with total assets between $500 million and $1 billion, and 18 firms (43.9%) with total assets less than $500 million.[8]

## Capital Structure

Jensen and Meckling (1976) note that agency costs are higher for firms with proportionally more debt in their capital structures. That is, since an increase in the firm's debt load (i.e., debt/equity ratio) increases the possibility of bankruptcy, and hence also expected bankruptcy costs, more highly leveraged firms face higher costs of debt

[8] A review of prior literature utilizing size as an independent disclosure variable indicates that no theoretical justification has generally been provided in terms of how specific size categories were determined. Categorization in this study is judgmental.

capital. Therefore, it is in the interest of the firm to establish certain monitoring mechanisms to maintain debtholders' confidence. More detailed financial statements, Jensen and Meckling suggest, are one (monitoring) vehicle that firms can use to assure debtholders that they are not assuming excessive risks vis-a-vis shareholders and managers. In other words, management in a highly leveraged firm has an incentive to provide a more comprehensive report regarding various aspects of the operating activities within the organization, including litigation activities. Hence the following hypothesized relation

***H2: The extent of litigation disclosure is positively related to the extent of debt in the firm's capital structure.***

As with Downie and Fortin (1997), the capital structure is determined as total liabilities divided by shareholders' equity. Firms are then classified into high or low debt/equity groups depending on how their ratios compare to the average industry debt/equity ratio as per Dun & Bradstreet[9]. Table 3.3 provides information on this variable.

[9] Dun & Bradstreet Canadian Industry Norms & Key Business Ratios use total liabilities/net worth (shareholders' equity) as one of its key ratios to measure solvency.

**TABLE 3.3**

**Capital Structure**

**(Total Liabilities/Shareholders' Equity)**

| Industry | High | Low | Industry D/E n/a | Total |
|---|---|---|---|---|
| Manufacturing | 10 | 7 | 0 | 17 |
| Wholesale/Retail | 1 | 4 | 0 | 5 |
| Communication | 3 | 1 | 0 | 4 |
| Mining | 3 | 1 | 0 | 4 |
| Utilities | 4 | 0 | 0 | 4 |
| Diversified | 0 | 0 | 3 | 3 |
| Services | 3 | 0 | 0 | 3 |
| Transportation | 0 | 1 | 0 | 1 |
| **Total** | **24** | **14** | **3** | **41** |

Twenty-four (63%) of thirty-eight firms for which Dun & Bradstreet ratings were available have a debt/equity ratio higher than the industry average, while fourteen (37%) are below the industry average. The three diversified firms for which Dun & Bradstreet ratings were not available were dropped in the analysis.

**Ownership Structure**

Jensen and Meckling (1976) also suggest that the separation of ownership and control is one of the major sources of agency costs. Likewise, McKinnon and Dalimunthe (1993) argue that the agency costs of equity will be higher where a firm's shares are widely held. As such, voluntary disclosure of information related to the firm's activities (such as its legal activities) may be used to reduce these agency costs. Both Entwistle (1999) and McKinnon and Dalimunthe (1993), using R&D and segment disclosure respectively, find evidence supporting a positive ownership structure-voluntary disclosure relation. That is, the more widely held the shares, the greater the

amount of voluntary disclosure provided. Hence the following hypothesis is developed for this research

***H3: The extent of litigation disclosure is positively related to the extent of widely held shares in the firm's ownership structure.***

Consistent with Entwistle (1999), a firm is defined as widely held when no one entity (individual or firm) owns greater than or equal to 20% of the firm's voting shares. Relevant information for this assessment was acquired from the 1994 Compact Disclosure CDRom database. This database incorporated an ownership statement obtained from the firm's Information Circulars that identified individuals or firms that owned greater than 10% of the firm's voting shares. Table 3.4 describes the firms based on their ownership structure.

**TABLE 3.4**

**Ownership Structure**

| Industry | One entity owns ≥ 20% of voting shares (non-widely held) | No one entity owns ≥ 20% of voting shares (widely held) | Ownership information n/a | Total |
|---|---|---|---|---|
| Manufacturing | 12 | 5 | 0 | 17 |
| Wholesale/Retail | 4 | 1 | 0 | 5 |
| Communication | 3 | 1 | 0 | 4 |
| Utilities | 1 | 3 | 0 | 4 |
| Mining | 1 | 3 | 0 | 4 |
| Diversified | 3 | 0 | 0 | 3 |
| Services | 2 | 0 | 1 | 3 |
| Transportation | 1 | 0 | 0 | 1 |
| **Total** | **27** | **13** | **1** | **41** |

Of the 40 firms, for which ownership information was available, 27 (67.5%) have one entity that owns greater than or equal to 20% of the firm's voting shares (hence not widely held), while 13 firms (32.5%) are considered to be widely held. One company's ownership information was not available through the Compact Disclosure CDRom database and therefore is dropped in the analysis.

**Performance (Profitability)**

A number of theoretical models, for example, Darrough and Stoughton (1990), Dye (1985), and Verrecchia (1983), all suggest that firms tend to disclose when their performance (profitability) is above a certain threshold, while those that fall below the threshold will not disclose. Hence, disclosure is linked to financial performance. Diamond (1985) and King et al. (1990) meanwhile posit that firms precommit to disclosure in a desire to reduce the incentives for private information acquisition, while Skinner (1994) argues that management will voluntarily disclose "bad news" earnings-related information in order to reduce the likelihood of legal liability caused by a large negative stock price response. In these authors' models, the firms' performance bears no relationship to disclosure. As noted in Lang and Lundhlolm (1993), the results from empirical research are mixed in that disclosure could be increasing, constant, or even decreasing related to firm performance. Taken as a whole, the magnitude and direction of the relationship between performance and disclosure are unclear and therefore no a priori hypothesis is used.

***RQ1: Is the extent of litigation disclosure related to the firm's performance (profitability)?***

Profit margin is used in this study to proxy for financial performance and is calculated as net income divided by sales revenue. This approach is consistent with prior research (e.g., Wallace et al. 1994) and also allows the usage of Dun & Bradstreet published industry profitability ratios for comparison purposes. To reduce the noise introduced by cross-sectional variation, the individual firm's profit margin is compared to the average industry ratio as obtained from Dun & Bradstreet. Firms with a profit margin ratio above the average industry ratio are classified as high performance firms, while those below are categorized in the low performance group. Table 3.5 describes the firms based on this variable.

**TABLE 3.5**

**Profitability**

**(Net Income/Sales Revenue)**

| Industry | High | Low | Industry Ratio n/a | Total |
|---|---|---|---|---|
| Manufacturing | 7 | 10 | 0 | 17 |
| Wholesale/Retail | 2 | 3 | 0 | 5 |
| Communication | 1 | 3 | 0 | 4 |
| Mining | 4 | 0 | 0 | 4 |
| Utilities | 1 | 3 | 0 | 4 |
| Diversified | 0 | 0 | 3 | 3 |
| Services | 2 | 1 | 0 | 3 |
| Transportation | 0 | 1 | 0 | 1 |
| **Total** | **17** | **21** | **3** | **41** |

Seventeen (45%) of the 38 firms have a profit margin higher than the industry average and are placed in the high performance group, while 21 (55%) of the firms are

categorized as low performance firms. The three diversified companies were discarded for further analysis due to the absence of relevant industry profit margin ratios.

**Industry**

Gibbins et al. (1992) suggest an important function that financial reporting fulfills is to establish and maintain the organization's legitimacy by showing compliance with the values (including reporting values) shared within particular communities (i.e., industries). Further, companies in the same industry sector are usually confronted with similar operational opportunities and risks, for instance, litigation risks. Therefore, belonging to the same industry sector should bear some relation to the litigation disclosure policy adopted by individual companies. Empirical research, including Entwistle (1999), has found support for an industry effect on disclosure. Hence, the following hypothesis is developed.

***H4: The extent of litigation disclosure is related to the firm's industry sector.***

In this study, the 41 sample firms are drawn from eight industries. These include:

- Manufacturing (17)
- Wholesale/Retail (5)
- Communication (4)
- Mining (4)
- Utilities (4)
- Diversified (3)
- Services (3)
- Transportation (1) (This industry is dropped from further analysis of this variable due to its limited size.)

**SEC (Cross) Listing**

Prior empirical research (e.g., Entwistle 1999; Wallace et al. 1994; Buzby 1975) has documented mixed results with respect to the effect of listing status on disclosure practice. This study will compare litigation disclosures made by firms listed on the Toronto Stock Exchange and firms cross-listed on both the Toronto Stock Exchange and a U.S. exchange governed by the Securities and Exchange Commission (SEC).

In contrast to the somewhat ambiguous contingency disclosure guidelines provided by the CICA[10], the SEC imposes more detailed and comprehensive requirements on registered firms regarding outstanding legal proceedings. Specifically, item 103 of Regulation S-K governs litigation disclosure for firms falling under the

[10] Ontario Securities Commission guidelines specifically require its governed entities to "prepare their annual financial statements in accordance with both Canadian GAAP and the requirements of Rule 52-501". Per review of OSC Rule 52-501, no additional contingency disclosure requirements are identified and therefore TSE listed firms are subject to the same GAAP disclosure rules as found in the CICA Handbook.

regulation of the SEC. It requires the registrants to

> *"describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities."*

The disclosure terms under SEC regulations are in accord with most of the items developed in Entwistle et al. (1994). Firms governed by the SEC are required to disclose the plaintiff and defendant involved in the lawsuit (item 1 & 2), reasons for the allegation (item 3), initiation date (item 4), legal whereabouts (item 7), and the monetary claim that is sought (item 8). As both 10-K and 10-Q reports filed by SEC listed firms constitute public information (and "sunk costs"), it is reasonable for cross-listed firms to incorporate similar information in their financial statements. Hence, the following hypothesis:

***H5: The extent of litigation disclosure is positively related to the existence of the firm's SEC listing status.***

Table 3.6 provides a summary of the listing status of the 41 firms, showing that nine (22.0%) of the 41 firms were cross listed on both the TSE and U.S. Exchanges in 1994. For the cross-listed companies, five are listed on the New York Stock Exchange, and four on the American Stock Exchange. None of the companies selected by the study

is listed on NASDAQ.

**TABLE 3.6**

**SEC Listing Status**

| Industry | SEC Listed | Non-SEC Listed | Total |
|---|---|---|---|
| Manufacturing | 3 | 14 | 17 |
| Wholesale/Retail | 0 | 5 | 5 |
| Communication | 1 | 3 | 4 |
| Mining | 3 | 1 | 4 |
| Utilities | 1 | 3 | 4 |
| Diversified | 0 | 3 | 3 |
| Services | 1 | 2 | 3 |
| Transportation | 0 | 1 | 1 |
| **Total** | **9** | **32** | **41** |

### 3.2.2 Explanations - Nature of the Lawsuit

Of the 100 sample firms in this study, 41 made specific litigation loss disclosures (refer Figure 3.1). Of these 41 firms, 15 disclosed more than one litigation loss contingency. Furthermore, casual observation of the disclosures by these 15 firms revealed that none of the firms reported the legal proceedings consistently across their different lawsuits. Hence, an interesting question arises whether the observed divergence in reporting practice is attributable to the nature of the specific lawsuit. Consequently, an additional disclosure environment factor - nature of the lawsuit - will be examined to determine whether a disclosure pattern exists. In doing so, the individual lawsuit itself (59 in total) will become the unit of analysis.

***RQ2: Is the extent of litigation disclosure related to the nature of the lawsuit?***

The 59 specific litigation loss note disclosures were carefully reviewed and classified into six subcategories based on the commonality of the nature of the lawsuits. In some cases, judgment had to be exercised due to the vagueness existing in some of the disclosures. The six subcategories are as follows.

**Breach of Contract (24):** e.g., breach of contractual obligations; disputes over the termination and settlement of the contract/agreement; royalty payment; commission payment.

**Product Liability (10):** e.g., defective products; negligence actions with respect to non-performance; damages caused by products (e.g., tobacco addiction).

**Financial Reporting of Transactions (9):** e.g., misrepresentation of the financial conditions of the purchased firm/assets; important information undisclosed; aggressive dividend payments; insider trading.

**Environment (6):** e.g., clean-up of contaminated properties.

**Competition (5):** e.g., violation of Competition Act; breach of antitrust law.

**Miscellaneous (5):** e.g., accident-related damages.

The next chapter of the thesis presents the results of the study.

# CHAPTER FOUR

# PRESENTATION OF DATA RESULTS

This chapter is divided into two main sections to present and analyze the research data. The first section provides an overview of the litigation disclosure practices of Canadian firms. The second section explores the relationship between the litigation disclosure practices and various environmental factors.

## 4.1 Litigation Disclosure Practices Of Canadian Firms

As noted in Chapter Three, 44 of the 100 Canadian public companies examined in this study provided specific litigation disclosures of contingent gains and losses. In total, 72 such disclosures were provided, including 59 litigation losses and 13 litigation gains. This part of the study focuses on these 72 litigation items as the unit of analysis to identify possible improvements in litigation disclosure scores. Tables 4.1 and 4.3 present information on these 72 disclosures based upon the nine aspects of litigation disclosure used in the Entwistle et al. (E et al.) 1994 study. The data in Tables 4.1 and 4.3 were also converted to percentages for purposes of statistical analysis. Given the unknown distributions of the data sets in the two studies, both parametric and non-parametric tests were conducted to compare the results of the two independent samples. The statistical results are presented in Tables 4.2 and 4.4.

## TABLE 4.1

### Existence Disclosure Overview – 1994

### Contingent Losses

| **Item**<br>**1-8:Nature (S.3290.22a)**<br>**9: $ Amount (S. 3290.22b)** | **Contingent Losses (59)** | **E et al. (32)** |
|---|---|---|
| 1. Plaintiff disclosed? | Yes – 37<br>No - 22 | Yes - 26<br>No - 6 |
| 2. Defendant disclosed? | Yes – 59<br>No - 0 | Yes - 32<br>No - 0 |
| 3. Reason disclosed? | Yes – 59<br>No - 0 | Yes – 27<br>No - 5 |
| 4. Launch date disclosed? | Yes – 26<br>No – 33 | Yes – 17<br>No - 15 |
| 5. Action date disclosed? | Yes – 22<br>No - 37 | Yes – 13<br>No - 19 |
| 6. Expected resolution date disclosed? | Yes – 6<br>No - 53 | Yes – 0<br>No - 32 |
| 7. Legal whereabouts disclosed? | Yes – 18<br>No - 41 | Yes – 8<br>No - 24 |
| 8. Dollar ($) claim disclosed? | Yes – 30<br>No - 29 | Yes – 16<br>No - 16 |
| 9. Management estimate of dollar ($) loss disclosed? | Yes – 26<br>($ amount – 8)<br>($0 - 4)<br>(Immaterial - 9)<br>(Not estimable - 5)<br>No - 33 | Yes – 15<br>($0 – 7)<br>(Immaterial - 7)<br>(Not estimable - 1)<br>No - 17 |

**TABLE 4.2**

**Existence Disclosure Overview - 1994**

**(% Of Litigation Item With Specific Disclosures)**

**Contingent Losses**

| **Item**<br>**1-8:Nature (S.3290.22a)**<br>**9: $ Amount (S. 3290.22b)** | **Contingent Losses (59)** | **E et al. (32)** |
|---|---|---|
| 1. Plaintiff disclosed? | 62.71% | 81.25% |
| 2. Defendant disclosed? | 100.00% | 100.00% |
| 3. Reason disclosed? | 100.00% | 84.38% |
| 4. Launch date disclosed? | 44.07% | 53.13% |
| 5. Action date disclosed? | 37.29% | 40.63% |
| 6. Expected resolution date disclosed? | 10.17% | 0% |
| 7. Legal whereabouts disclosed? | 30.51% | 25.00% |
| 8. Dollar ($) claim disclosed? | 50.85% | 50.00% |
| 9. Management estimate of dollar ($) loss disclosed? | 44.07% | 46.88% |

**Statistics**

**t-test**

T = -0.0122; P = 0.9904

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = -0.1328; P = 0.4472

No category differences are statistically significant at alpha = 0.05

Both t-test and Mann-Whitney tests indicate no statistical difference in the litigation loss disclosures in the two studies. For the nine disclosure factors, item 2 (defendant) and item 3 (reason of lawsuit) are the best disclosed (100%) among all the aspects. Expected resolution (item 6), although improved over Entwistle et al. (1994),

remains the least disclosed in both studies. This tendency is understandable given that a considerable number of lawsuit cases are eventually resolved out of court (Cooter and Rubinfeld, 1989). Even for those cases that do proceed to a court hearing, the unpredictable nature of litigation often causes companies to exercise additional caution in outlining any specific timetable for ongoing cases. Moreover, settlement is not considered final until the appeal process is exhausted. Therefore, affected companies naturally would fear that any speculation of the ultimate resolution might jeopardize their opportunity to successfully negotiate out of court or litigate for a favorable outcome.

For the rest of disclosure items, the percentage of companies with disclosures of legal whereabouts (item 7) and dollar amounts (item 8) has increased slightly in this study. On the other hand, a lower percentage of companies in this study have disclosed the plaintiff (item 1), launch date (item 4), action date (item 5), and a management estimate (item 9).

## TABLE 4.3

### Existence Disclosure Overview – 1994

### Contingent Gains

| **Item**<br>**1-8:Nature (S.3290.22a)**<br>**9: $ Amount (S. 3290.22b)** | **Contingent Gains (13)** | **E et al. (15)** |
|---|---|---|
| 1. Plaintiff disclosed? | Yes - 13<br>No - 0 | Yes – 15<br>No - 0 |
| 2. Defendant disclosed? | Yes - 9<br>No - 4 | Yes – 13<br>No - 2 |
| 3. Reason disclosed? | Yes – 13<br>No - 0 | Yes – 14<br>No - 1 |
| 4. Launch date disclosed? | Yes – 5<br>No - 8 | Yes – 5<br>No – 10 |
| 5. Action date disclosed? | Yes – 8<br>No - 5 | Yes – 8<br>No - 7 |
| 6. Expected resolution date disclosed? | Yes – 0<br>No - 13 | Yes – 0<br>No - 15 |
| 7. Legal whereabouts disclosed? | Yes – 3<br>No - 10 | Yes – 3<br>No - 12 |
| 8. Dollar ($) claim disclosed? | Yes – 7<br>No - 6 | Yes – 11<br>No - 4 |
| 9. Management estimate of dollar ($) gain disclosed? | Yes – 6<br>($ amount – 1)<br>($0 – 0)<br>(Immaterial - 5)<br>(Not estimable - 0)<br>No - 7 | Yes – 11<br>($0 - 7)<br>(Immaterial - 0)<br>(Not estimable - 4)<br>No - 4 |

**TABLE 4.4**

**Existence Disclosure Overview – 1994**

**(% Of Litigation Item With Specific Disclosures)**

**Contingent Gains**

| **Item**<br>**1-8:Nature (S.3290.22a)**<br>**9: $ Amount (S. 3290.22b)** | **Contingent Gains (13)** | **E et al. (15)** |
|---|---|---|
| 1. Plaintiff disclosed? | 100.00% | 100.00% |
| 2. Defendant disclosed? | 69.23% | 86.67% |
| 3. Reason disclosed? | 100.00% | 93.33% |
| 4. Launch date disclosed? | 38.46% | 33.33% |
| 5. Action date disclosed? | 61.54% | 53.33% |
| 6. Expected resolution date disclosed? | 0% | 0% |
| 7. Legal whereabouts disclosed? | 23.08% | 20.00% |
| 8. Dollar ($) claim disclosed? | 53.85% | 73.33% |
| 9. Management estimate of dollar ($) gain disclosed? | 46.15% | 73.33% |

**Statistics**

**t-test**

T = -0.2850; P = 0.7793

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = -0.2657; P = 0.3952

No category differences are statistically significant at alpha = 0.05

Despite the slight improvement in the statistical results over litigation losses, the statistical tests show no significant differences in the disclosures of litigation gains between the current study and the E et al. study. For the nine disclosure factors, item 1 (plaintiff) and item 3 (reason of lawsuit) are disclosed by all selected companies in this

study. However, similar to E et al. (1994), none of those companies present any information with respect to the possible resolution date of the involved litigation. Compared to E et al. (1994), more companies in this study provide details related to the reason for the litigation (item 3), launch date (item 4), action date (item 5), and legal whereabouts (item 7). The percentage of companies with disclosures of the defendant (item 2), dollar claim (item 8) and making a management estimate (item 9), however, has decreased.

Overall, notwithstanding the repeated claim that litigation is the most frequent form of loss contingencies (CICA 1999; Dopuch et al., 1987) and the widespread expressed dissatisfaction with litigation disclosure made by public firms (Entwistle et al., 1994; Boritz, 1990; Thornton, 1983), this study fails to identify any significant improvement in public companies' litigation disclosures, for both gains and losses, over the three year time span from the E et al. study (1991 data) to the current research (1994 data). Indeed, disclosures for some litigation loss features, such as the plaintiff, launch date, action date, and a management estimate, and for some litigation gain features, such as the defendant, dollar claim, and a management estimate, have decreased. Disclosure within the remainder of the nine items ranges from a high of 100% (defendant and reason of lawsuit) to a low of 10% (resolution date) for losses, and from a high of 100% (plaintiff and reason of lawsuit) to a low of 0% (resolution date) for gains.

## 4.2 Relationship Between Disclosure Environment And Disclosure Characteristics

### 4.2.1 Specific Disclosures

This section uses company as the unit of analysis and focuses on the 41 companies with specific litigation loss disclosures as identified in Figure 3.1. Disclosure scores are presented based on the six independent variables identified in Chapter Three (size, capital structure, ownership structure, profitability, industry, and SEC listing). For each variable, a table is first used to describe the absolute scores obtained by the companies in each category. To better demonstrate the variances in disclosure scores, a column chart is also provided for each independent variable (except for the variable of industry) to display both the average and the total disclosure score per company.

For hypothesis testing purposes, both parametric and non-parametric tests were used. The non-parametric tests were necessary due to the relatively small sample size and hence the possibility that the underlying assumption of the parametric test (ANOVA) may not have been met. In terms of the non-parametric tests, the Kruskal-Wallis test was used for the size and industry independent variables and the Mann-Whitney test for the remaining four variables. Kruskal-Wallis is a generalized version of the Mann-Whitney test. The Mann-Whitney test was used when the independent variable had two categories (e.g., widely owned vs. nonwidely owned companies), while the Kruskal-Wallis test was applied when the independent variable had more than two categories (e.g., large vs. medium vs. small companies).

**Size**

## TABLE 4.5

### Disclosure Overview - Size

| Small Companies | | Medium Companies | | Large Companies | | Total | |
|---|---|---|---|---|---|---|---|
| Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items |
| 1 | 8 | 0 | 8 | 0 | 8 | 1 | 8 |
| 1 | 7 | 0 | 7 | 4 | 7 | 5 | 7 |
| 2 | 6 | 1 | 6 | 2 | 6 | 5 | 6 |
| 1 | 5.33 | 0 | 5.33 | 0 | 5.33 | 1 | 5.33 |
| 7 | 5 | 1 | 5 | 5 | 5 | 13 | 5 |
| 1 | 4.5 | 0 | 4.5 | 0 | 4.5 | 1 | 4.5 |
| 0 | 4.33 | 1 | 4.33 | 1 | 4.33 | 2 | 4.33 |
| 1 | 4 | 1 | 4 | 1 | 4 | 3 | 4 |
| 1 | 3.5 | 0 | 3.5 | 2 | 3.5 | 3 | 3.5 |
| 0 | 3 | 2 | 3 | 3 | 3 | 5 | 3 |
| 2 | 2 | 0 | 2 | 0 | 2 | 2 | 2 |
| **Total = 17** | **Mean = 4.90** | **Total = 6** | **Mean = 4.22** | **Total = 18** | **Mean = 4.96** | **Total = 41** | **Mean = 4.85** |

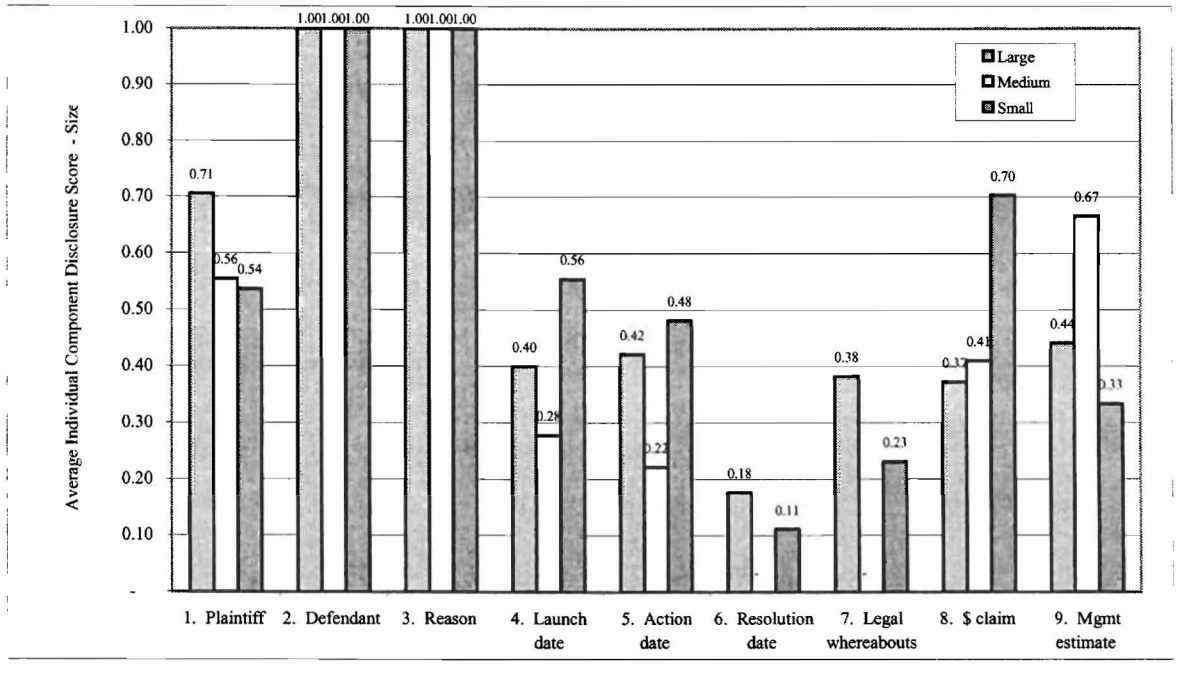


**Figure 4.1 Average Individual Components Disclosure Score - Size**

**Statistics**

N = 41

**ANOVA**

F = 0.7257; P = 0.4906

No category differences are statistically significant at alpha = 0.05

**Kruskal –Wallis**

H = 1.7817; P = 0.4103

No category differences are statistically significant at alpha = 0.05

The results indicate the size hypothesis is not supported. Large and small sized companies have similar overall disclosure scores, albeit possibly arising from different motives. As a litigation claim represents a possibility of future losses to the reporting company, the materiality level of the claim should be critical in affecting the decision to disclose. A relatively small loss can pose a significant threat to the survival of a small company. A close look at Figure 4.1 indicates that a high percentage of small firms disclosed the dollar claim amount of the pending litigation. It seems that even with the same disclosure threshold required by the accounting standard, small companies are generally more sensitive to the likely financial loss arising from the ongoing legal disputes.

One noteworthy finding, however, emerges. Medium sized firms seem to have quite a different disclosure pattern from both large and small firms. For five out of the nine identified disclosure items, the disclosure for the medium firms falls below the other

two size groups, as does the total disclosure score. This may be explained by the reduced public attention and analyst following received by medium firms compared to large ones. Meanwhile, the medium firms may also be under less pressure than small firms to generate satisfactory financial information to raise capital. As a result, it may be that fewer incentives exist for medium firms to make complete and detailed disclosures.

**Capital Structure**

**TABLE 4.6**

**Disclosure Overview - Capital Structure**

| **Highly Leveraged** | | **Low Leveraged** | | **Total** | |
|---|---|---|---|---|---|
| Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items |
| 1 | 8 | 0 | 8 | 1 | 8 |
| 4 | 7 | 1 | 7 | 5 | 7 |
| 4 | 6 | 1 | 6 | 5 | 6 |
| 0 | 5.33 | 1 | 5.33 | 1 | 5.33 |
| 5 | 5 | 6 | 5 | 11 | 5 |
| 1 | 4.5 | 1 | 4.5 | 2 | 4.5 |
| 2 | 4.33 | 0 | 4.33 | 2 | 4.33 |
| 1 | 4 | 1 | 4 | 2 | 4 |
| 1 | 3.5 | 1 | 3.5 | 2 | 3.5 |
| 3 | 3 | 2 | 3 | 5 | 3 |
| 2 | 2 | 0 | 2 | 2 | 2 |
| **Total = 24** | **Mean = 4.94** | **Total = 14** | **Mean = 4.74** | **Total = 38** | **Mean = 4.87** |

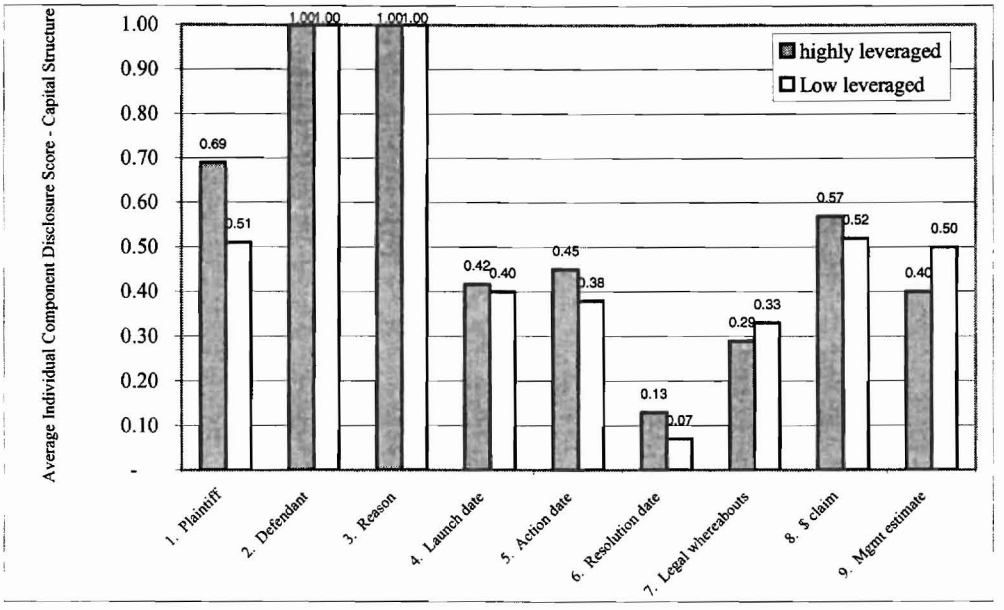


**Figure 4.2 Average Individual Components Disclosure Score – Capital Structure**

**Statistics**

N = 38

**ANOVA**

F = 0.1709; P = 0.6818

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = -0.35356; P = 0.3618

No category differences are statistically significant at alpha = 0.05

The results indicate that the capital structure hypothesis is also not supported. Disclosure of plaintiff (item 1) has the widest difference between the two groups. Companies who borrow more heavily from debtholders witnessed average higher scores

in litigation plaintiff (item 1), action date (item 4), legal whereabouts (item 7), dollar claim (item 8), and management estimate (item 9). However, except for item 1 (plaintiff), all the other disclosure differences seem marginal. It appears that the existence of a large number of debtholders does not cause a different disclosure pattern in the litigation area.

**Ownership Structure**

**TABLE 4.7**

**Disclosure Overview – Ownership Structure**

| **Non-widely Owned** | | **Widely Owned** | | **Total** | |
|---|---|---|---|---|---|
| Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items |
| 0 | 8 | 1 | 8 | 1 | 8 |
| 4 | 7 | 1 | 7 | 5 | 7 |
| 4 | 6 | 1 | 6 | 5 | 6 |
| 1 | 5.33 | 0 | 5.33 | 1 | 5.33 |
| 6 | 5 | 7 | 5 | 13 | 5 |
| 1 | 4.5 | 0 | 4.5 | 1 | 4.5 |
| 2 | 4.33 | 0 | 4.33 | 2 | 4.33 |
| 2 | 4 | 1 | 4 | 3 | 4 |
| 2 | 3.5 | 0 | 3.5 | 2 | 3.5 |
| 4 | 3 | 1 | 3 | 5 | 3 |
| 2 | 2 | 0 | 2 | 2 | 2 |
| **Total = 28** | **Mean = 4.70** | **Total = 12** | **Mean = 5.25** | **Total = 40** | **Mean = 4.86** |

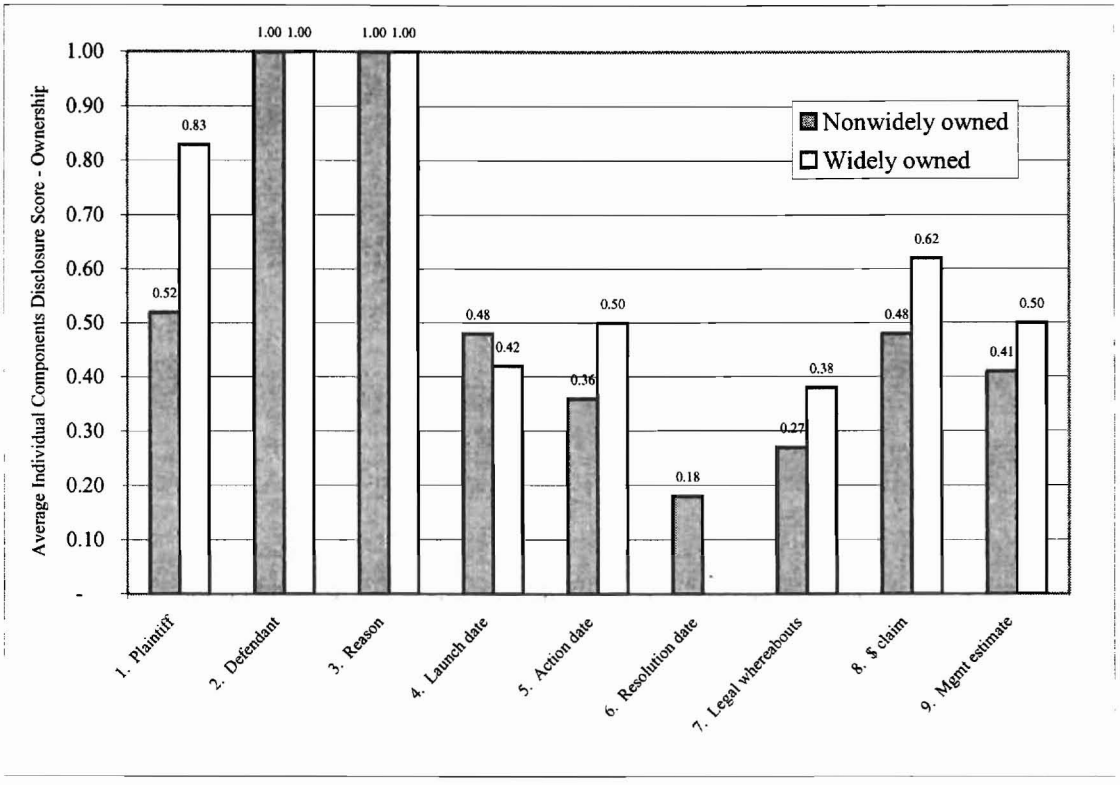


**Figure 4.3 Average Individual Components Disclosure Score – Ownership Structure**

**Statistics**

N = 40

**ANOVA**

F = 1.2797; P = 0.2651

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = 0.9943; P = 0.1600

No category differences are statistically significant at alpha = 0.05

The ANOVA and Mann-Whitney tests indicate that the hypothesized relationship for ownership structure is also not supported. A detailed breakdown of individual disclosure categories in Figure 4.3 reveals that widely owned firms' financial statements normally provide more information related to the plaintiff (item 1), action date (item 5), legal whereabouts (item 6), dollar claim (item 8), and a management estimate (item 9). On the other hand, the disclosures of launch date (item 4) and resolution date (item 6) are less forthcoming.

Notwithstanding the weak statistical results, the variable of ownership structure, (along with the variable of SEC listing (as discussed in the following pages)), yields the biggest difference in the absolute disclosure scores in all the independent variables identified in this study. This limited finding, to a certain extent, supports the observation in prior studies that a greater incentive exists for widely held companies to provide voluntary disclosures to reduce agency costs. Future research opportunities may exist in this area to look at the internal structure of the two groups of companies to identify possible factors that could have a bearing on the disclosure decisions.

**Profitability**

**TABLE 4.8**

**Disclosure Overview – Profitability**

| High Profitability | | Low Profitability | | Total | |
|---|---|---|---|---|---|
| Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items |
| 1 | 8 | 0 | 8 | 1 | 8 |
| 3 | 7 | 2 | 7 | 5 | 7 |
| 1 | 6 | 4 | 6 | 5 | 6 |
| 1 | 5.33 | 0 | 5.33 | 1 | 5.33 |
| 6 | 5 | 5 | 5 | 11 | 5 |
| 1 | 4.5 | 1 | 4.5 | 2 | 4.5 |
| 0 | 4.33 | 2 | 4.33 | 2 | 4.33 |
| 2 | 4 | 0 | 4 | 2 | 4 |
| 2 | 3.5 | 0 | 3.5 | 2 | 3.5 |
| 1 | 3 | 4 | 3 | 5 | 3 |
| 1 | 2 | 1 | 2 | 2 | 2 |
| **Total = 19** | **Mean = 4.99** | **Total = 19** | **Mean = 4.75** | **Total = 38** | **Mean = 4.87** |

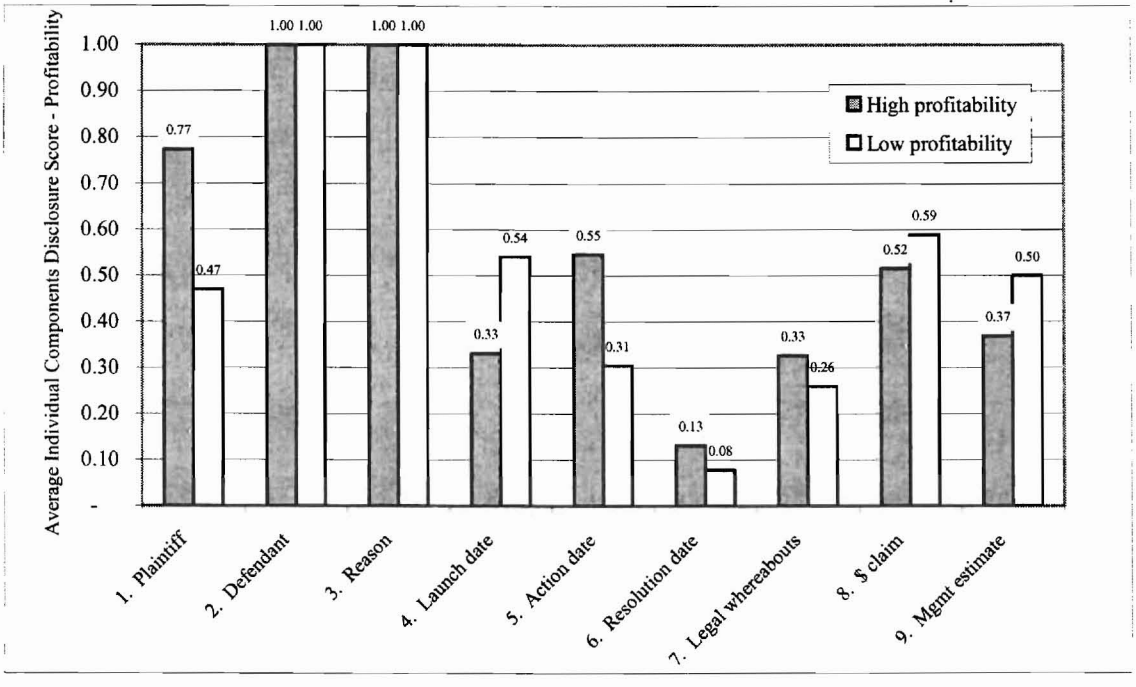


**Figure 4.4 Average Individual Components Disclosure Score – Profitability**

**Statistics**

N = 38

**ANOVA**

F = 0.2656; P = 0.6095

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = -0.4301; P = 0.3336

No category differences are statistically significant at alpha = 0.05

Although Table 4.8 demonstrates that more highly profitable firms do possess overall higher total disclosure scores than less profitable ones, the ANOVA and Mann-Whitney tests indicate that the variance does not constitute a statistically significant difference. The result supports the findings of Diamond (1985) and King et al. (1990) that profitability bears no statistically significant relationship to disclosure.

## Industry

**TABLE 4.9**

**Disclosure Overview - Industry**

| Weighted Average Number of Disclosure Items | Number of Companies | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Manufact'g | Mining | Services | Utilities | Wholesale /Retail | Commun'n | Diversified | Total |
| 8 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 1 |
| 7 | 3 | 1 | 0 | 0 | 0 | 1 | 0 | 5 |
| 6 | 2 | 0 | 1 | 0 | 1 | 1 | 0 | 5 |
| 5.33 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |
| 5 | 4 | 2 | 0 | 2 | 2 | 1 | 2 | 13 |
| 4.5 | 1 | 0 | 1 | 0 | 0 | 0 | 0 | 2 |
| 4.33 | 0 | 0 | 0 | 0 | 1 | 1 | 0 | 2 |
| 4 | 2 | 0 | 0 | 0 | 0 | 0 | 1 | 3 |
| 3.5 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 2 |
| 3 | 2 | 0 | 0 | 2 | 0 | 0 | 0 | 4 |
| 2 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| | **Total = 17 Mean = 4.75** | **Total = 4 Mean = 6.25** | **Total = 3 Mean = 4.67** | **Total = 4 Mean = 4.00** | **Total = 5 Mean = 4.77** | **Total = 4 Mean = 5.58** | **Total = 3 Mean = 4.67** | **Total = 40 Mean = 4.90** |

**Statistics**

N = 40

**ANOVA**

F = 1.1384; P = 0.3623

No category differences are statistically significant at alpha = 0.05

**Kruskal-Wallis**

H = 7.5214; P = 0.4490

No category differences are statistically significant at alpha = 0.05

The results also indicate that the industry hypothesis is not supported. Notwithstanding the weak statistical relationship, one finding from Table 4.9 raises some interesting questions. The financial statements of two highly regulated industries, mining

and communication, are found to contain the most litigation disclosures among all selected industries. A similar disclosure pattern, however, is not observed in the utility industry, which is also subject to heavy regulation and government controls in Canada. Indeed, utility companies included in this study provide the least litigation information in their financial statements. The contrast between these three industries' litigation disclosures warrants further research.

## SEC (Cross) Listing

**TABLE 4.10**

**Disclosure Overview – SEC Listing** [10]

| SEC Listed | | Non-SEC Listed | | Total | |
|---|---|---|---|---|---|
| Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items | Number of Companies | Weighted Average Number of Disclosure Items |
| 1 | 8 | 0 | 8 | 1 | 8 |
| 2 | 7 | 3 | 7 | 5 | 7 |
| 0 | 6 | 5 | 6 | 5 | 6 |
| 0 | 5.33 | 1 | 5.33 | 1 | 5.33 |
| 3 | 5 | 10 | 5 | 13 | 5 |
| 1 | 4.5 | 1 | 4.5 | 2 | 4.5 |
| 0 | 4.33 | 2 | 4.33 | 2 | 4.33 |
| 1 | 4 | 2 | 4 | 3 | 4 |
| 0 | 3.5 | 2 | 3.5 | 2 | 3.5 |
| 0 | 3 | 5 | 3 | 5 | 3 |
| 1 | 2 | 1 | 2 | 2 | 2 |
| **Total = 9** | **Mean = 5.28** | **Total = 32** | **Mean = 4.73** | **Total = 41** | **Mean = 4.85** |

[10] In 1998, two more firms became SEC listed. As the application for SEC listing is understood to be a lengthy process, it can be assumed that these two firms initiated their application before 1994. Hence, they were perhaps indirectly influenced by SEC disclosure requirements for 10-K and 10-Q reports in 1994 even though the formal listing was not yet approved. Additional statistic testing was conducted by grouping these two newly listed firms with those listed in 1994. Results from both ANOVA and Mann-Whitney tests are similar to the original ones presented in Table 4.10.

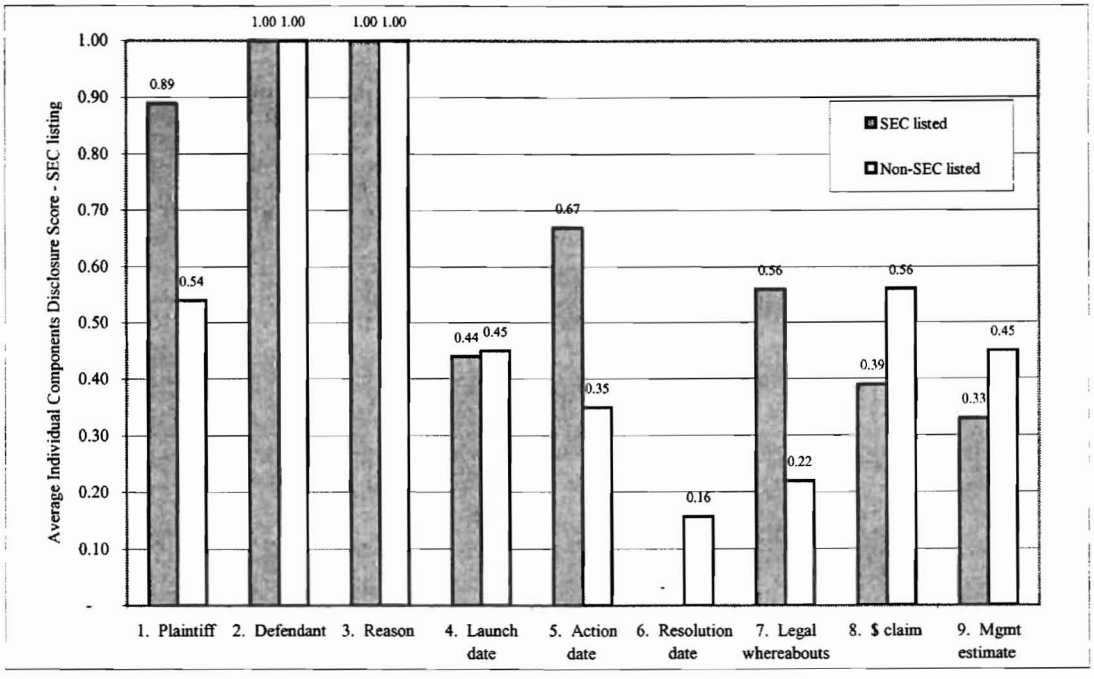


**Figure 4.5 Average Individual Components Disclosure Score – SEC Listing**

**Statistics**

N = 41

**Anova**

F = 1.0482; P = 0.3122

No category differences are statistically significant at alpha = 0.05

**Mann-Whitney**

Z = 0.8027; P = 0.2111

No category differences are statistically significant at alpha = 0.05

The hypothesized disclosure difference is also not found for the variable of SEC listing. Non-SEC listed firms do however show higher disclosure scores in four out of the nine litigation items: item 4 (launch date), item 6 (resolution date), item 8 (dollar

claim), and item 9 (management estimate). Of the five items specifically required by the SEC regulations (refer Section 3.2.1), SEC listed companies have higher disclosure scores in only item 7 (legal whereabouts) and item 1 (plaintiff).

Overall, the SEC listed companies, as a group, have a higher total disclosure score than companies that are only listed on the Toronto Stock Exchange. It appears that some cross-listed companies do recognize that information disclosed in the 10-K and 10-Q reports is public information and therefore do not hesitate to include it in their financial statements.

**Regression Analysis**

Due to the failure to find statistical significance when separately examining each independent variable, an additional analysis was then conducted to factor all six independent variables into a regression analysis. This enables, in a somewhat exploratory way, an examination of each variable while controlling for other independent variables. The results are reported in Table 4.11. Table 4.12 presents correlation coefficients between all variables. The regression analysis was done using only those firms (36 in total out of an original 41 firms) that had no missing data on any of the independent variables.

**Table 4.11 Regression Statistics for Specific Disclosures**

| Regression Statistics | |
|---|---|
| Multiple R | 0.446495793 |
| R Square | 0.199358494 |
| Adjusted R Square | -0.167602197 |
| Standard Error | 1.588425535 |
| Observations | 36 |

ANOVA

| | df | SS | MS | F | Significance F |
|---|---|---|---|---|---|
| Regression | 11 | 15.07792589 | 1.37072054 | 0.5432693 | 0.854051076 |
| Residual | 24 | 60.55429633 | 2.52309568 | | |
| Total | 35 | 75.63222222 | | | |

| | Coefficients | Standard Error | t Stat | P-value |
|---|---|---|---|---|
| Intercept | 4.729957039 | 1.378842783 | 3.43038169 | 0.0021878 |
| Size1 | -0.071578825 | 0.658699211 | -0.1086669 | 0.9143701 |
| Size2 | -0.634805935 | 0.909349068 | -0.6980883 | 0.4918309 |
| Capst | 0.14982309 | 0.68951304 | 0.21728826 | 0.8298204 |
| Ownst | 0.41281246 | 0.638853612 | 0.64617692 | 0.5242962 |
| Profit | -0.187981434 | 0.603895224 | -0.3112815 | 0.7582744 |
| Ind1 | 0.063413791 | 1.279693614 | 0.04955389 | 0.960888 |
| Ind2 | 0.118336523 | 1.42266768 | 0.08317932 | 0.9343989 |
| Ind3 | 0.784823973 | 1.421016221 | 0.55229769 | 0.5858516 |
| Ind4 | 1.452235209 | 1.586519633 | 0.91535912 | 0.3691092 |
| Ind5 | -0.595537241 | 1.481625803 | -0.4019485 | 0.6912791 |
| SECList | -0.173864085 | 0.818512356 | -0.2124147 | 0.8335773 |

Where:

- Size1 is a dummy variable coded as 1 if total assets are equal to or greater than $1 billion and 0 if less than $1 billion.
- Size2 is a dummy variable coded as 1 if total assets are less than $1 billion and greater than $500 million and 0 if greater than $ 1 billion or less than $500 million.
- Capst is a dummy variable coded as 1 if the ratio of total liabilities to shareholders' equity is greater than the industry average and 0 if less than industry average.
- Ownst is a dummy variable coded as 1 if no one entity owns greater than or equal to 20% of voting shares and 0 if one entity owns greater than 20% of voting shares.

- Profit is dummy variable coded as 1 if the ratio of gross profit to gross income is greater than industry average and 0 if less than industry average.
- Ind1 is a dummy variable coded as 1 if manufacturing and 0 if wholesale/retail, communication, mining, utilities, or services.
- Ind2 is a dummy variable coded as 1 if wholesale/retail and 0 if manufacturing, communication, mining, utilities, or services.
- Ind3 is a dummy variable coded as 1 if communication and 0 if manufacturing, wholesale/retail, mining, utilities, or services.
- Ind4 is a dummy variable coded as 1 if mining and 0 if manufacturing, wholesale/retail, communication, utilities, or services.
- Ind5 is a dummy variable coded as 1 if utilities and 0 if manufacturing, wholesale/retail, communication, mining, or services.
- SECList is a dummy variable coded as 1 if cross-listed on a SEC exchange and 0 if not cross-listed.

**Table 4.12 Correlation Coefficients between Variables**

Ranked variable (obs. = 36)

| | Size1 | Size2 | Capst | Ownst | Profit | Ind1 | Ind2 | Ind3 | Ind4 | Ind5 | SECList |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Size1 | 1 | | | | | | | | | | |
| Size2 | -0.3362 | 1 | | | | | | | | | |
| Capst | 0.2040 | 0.1810 | 1 | | | | | | | | |
| Ownst | 0.0818 | 0.1581 | 0.1636 | 1 | | | | | | | |
| Profit | 0.1735 | -0.1491 | -0.1735 | 0.1179 | 1 | | | | | | |
| Ind1 | -0.1319 | 0.0249 | -0.2156 | -0.0787 | -0.1669 | 1 | | | | | |
| Ind2 | 0.0325 | 0.0359 | -0.1997 | -0.1136 | -0.0803 | -0.3799 | 1 | | | | |
| Ind3 | -0.0818 | -0.1581 | 0.0818 | -0.0625 | -1.96E-17 | -0.3344 | -0.1420 | 1 | | | |
| Ind4 | 0.1022 | -0.1581 | 0.0818 | 0.3125 | 0.3536 | -0.3344 | -0.1420 | -0.1250 | 1 | | |
| Ind5 | 0.1022 | 0.3162 | 0.2658 | 0.1250 | 4.91E-18 | -0.3344 | -0.1420 | -0.1250 | -0.1250 | 1 | |
| SECList | 0.2937 | -0.2390 | 0.2628 | 0.3307 | 0.1336 | -0.1041 | -0.2147 | 0.0236 | 0.4488 | 0.0236 | 1 |

As seen in Table 4.11, none of the coefficients in the regression model are statistically significant, again suggesting that the hypothesized relationships for all six independent variables are not supported. The results in Table 4.12 suggest that

multicollinearity is not a potential statistical problem as the highest correlation between independent variables is 0.45.

### 4.2.2 Relationship Between The Nature Of The Lawsuits And Firms' Reporting Practices

This section further examines the relationship between the disclosure environment and disclosure characteristics by considering the lawsuit as the unit of analysis. For the 59 specific litigation loss disclosures identified (refer Section 3.2.2), five are classified as miscellaneous type and therefore not included in the discussion. The remaining 54 disclosures are classified in five categories. Table 4.13 provides a summary of the average disclosure scores using the individual lawsuit as the unit of analysis.

**TABLE 4.13**

**Disclosure Overview – Nature of Lawsuit**

| Number of Disclosure Items | Number of Litigation Losses | | | | | | |
|---|---|---|---|---|---|---|---|
| | Breach of Contract | Product Liability | Financial Reporting | Environm't | Competit'n | Other | Total |
| 9 | 0 | 0 | 0 | 0 | 0 | 1 | 1 |
| 8 | 1 | 0 | 0 | 0 | 0 | 0 | 1 |
| 7 | 1 | 3 | 2 | 1 | 0 | 0 | 7 |
| 6 | 3 | 2 | 1 | 1 | 0 | 0 | 7 |
| 5 | 10 | 0 | 4 | 2 | 1 | 2 | 19 |
| 4 | 6 | 0 | 1 | 1 | 1 | 1 | 10 |
| 3 | 3 | 4 | 0 | 1 | 2 | 1 | 11 |
| 2 | 0 | 1 | 1 | 0 | 1 | 0 | 3 |
| 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | **Total =24 Mean = 4.83** | **Total =10 Mean = 4.70** | **Total = 9 Mean = 5.11** | **Total = 6 Mean = 5.00** | **Total = 5 Mean = 3.40** | **Total = 5 Mean = 5.20** | **Total =59 Mean = 4.78** |

**Statistics**

N = 54

**ANOVA**

F = 1.2594; P = 0.2987

No category differences are statistically significant at alpha = 0.05

**Kruskal-Wallis**

H = 5.0718; P = 0.2800

No category differences are statistically significant at alpha = 0.05

Both ANOVA and Kruskal-Wallis tests fail to detect a statistically significant difference based on the nature of the lawsuit. However, it is evident in Table 4.13 that competition-type litigation has a lower average disclosure score compared to the other categories. Specifically, fewer details are supplied with respect to plaintiff (item 1), launch date (item 4), resolution date (item 6), and dollar claim (item 8). The lack of disclosures may be explained by its being a litigation situation less commonly encountered by public firms and hence there is increased uncertainty surrounding its ultimate outcome. The highest total average disclosure is provided for financial reporting lawsuits. This may be because financial reporting represents a highly sensitive type of litigation. There is a significant impact on stock prices when public companies' accounting or financial dealings are under investigation. Companies in question therefore have a strong incentive to come forward with full details of the contingency to fend off possible speculation and prevent a slide of stock prices.

# CHAPTER FIVE

# CONCLUSION

This chapter concludes the thesis by discussing: the study's contributions to the academic literature, implications for accounting standard setting, limitations, and areas for future research.

## 5.1 Contributions to the Academic Literature

This thesis is inspired by a prior study, Entwistle et al. (1994), on Canadian public companies' contingency disclosures. Part of this thesis is a partial replication of this previous research, updating from 1991 to 1994 our understanding of Canadian firms' disclosures of litigation gains and losses contained in their annual financial statements. In addition, the research goes further to explore the potential relationship that certain firm specific characteristics may have on litigation loss contingency disclosures. Specifically, the study contributes to the academic literature in two main ways:

1. It provides additional evidence to support the frequently cited allegation that public companies' litigation disclosures are lacking important, useful information required by users to make informed investment decisions.
2. It introduces six firm-specific factors to litigation disclosure research: size, capital structure, ownership structure, profitability, industry, and stock exchange listing. In addition, the nature of the lawsuit is also considered. However, the failure to find statistical support for any of the hypotheses examined suggests these various environmental factors may not be key

elements in affecting companies' litigation loss disclosure decisions, or that litigation disclosure is somewhat unique that variables commonly examined in prior disclosure literature cannot provide adequate explanations for.

## 5.2 Implications for Accounting Standard Setting

In Canada, corporate reporting of litigation disclosures in financial statements is governed by CICA Handbook Section 3290 (CICA 1978). The Handbook outlines criteria for disclosing and accruing contingent gains and losses. However, the fact that the standard is judgment oriented, coupled with the complex nature of litigation contingencies, has caused considerable diversity and inconsistency in interpretation and application in practice. As a result, for years, academic researchers and practitioners have been concerned with the quality of contingency disclosures and have been calling for additional, more precise guidelines in accounting standards (e.g., Entwistle et al., 1994; Gagnon-Valotaire and Chlala, 1993; Boritz, 1990; Chesley and Wier, 1985; Thornton, 1983). By focusing on the nine specific disclosure items developed by E et al. to capture the relatively general disclosure descriptions required by the CICA Handbook, this study advances further factual evidence on the current litigation disclosure practice by Canadian public firms. Specifically, the study indicates that the problem of incomplete disclosures of litigation details is commonly shared by public companies operating in various industries. The findings suggest that accounting standard setters should set out more specific and precise requirements on disclosure of contingency details, for example, the nine factors adopted by this study for litigation cases. It is also advisable that additional disclosure factors be developed for other types of contingencies

to guide companies in their disclosure process. Further, additional attention should be devoted to enforcing adherence to those standards in practice, such as disclosure of management estimates, which this study finds was not conformed to by some of the selected public companies in their financial statements. Accounting standard setters can achieve a better balance of costs and benefits by working hand in hand with stock exchange governing bodies and leveling up contingency standards accordingly.

## 5.3 Limitations of the Study

Due to the limited sample size of the study, any conclusions drawn from the analysis are preliminary and await further research efforts to extend the conclusions to broader arenas. Further, the disclosure environment variables examined in this study that were adopted from previous disclosure literature do not appear to embrace the critical factors affecting companies' disclosure decisions. No fieldwork was conducted (e.g., interviews with managers) to attempt to develop different variables.

## 5.4 Areas for Future Research

To extend the current study, future research can be carried out in the following areas:

1. Interviewing management of public companies to investigate the reasons leading to litigation disclosure decisions, for example, the existence of the internal legal counsels.

2. Expanding the sample size, applying the research design to different years, and incorporating additional (or different) disclosure variables identified during fieldwork.

3. Focusing on disclosures of a few predominant types of litigation, for example, environmental charges.

4. Extending the research to other types of contingencies, such as tax reassessments, or loan guarantees. Disclosure patterns may vary due to the different nature of those contingencies.

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## Appendix A "Non-Litigation" Contingencies

### Guarantee-type Contingencies (36)

| Type of Guarantee Contingencies | Company |
|---|---|
| Letters of Credit (13) | Derlan Industries Limited<br>Dreco Energy Services Ltd.<br>Electrohome Limited<br>Geac Computer Corporation Limited<br>Glentel Inc.<br>Imasco Limited<br>Imperial Oil Limited<br>Mitel Corporation<br>Nowsco Well Service Ltd.<br>Onex Corporation<br>Rio Algom Limited<br>Scott's Hospitality Inc.<br>United Dominion Industries Limited |
| Guaranteed Indebtedness (9) | Agra Industries Limited<br>Alcan Aluminium Limited<br>The Canam Manac Group Inc.<br>The Jean Coutu Group (PJC) Inc.<br>Imasco Limited<br>Laidlaw Inc.<br>MDS Health Group Limited<br>Placer Dome Inc. (2) |
| Guaranteed Performance (Including Performance Bonds) (5) | Banister Foundation Inc.<br>Bombardier Inc.<br>Gandalf Technologies Inc.<br>Geac Computer Corporation Limited<br>SHL Systemhouse Inc. |
| Guaranteed Obligations Related to Joint Venture Liabilities (2) | Banister Foundation Inc.<br>Dreco Energy Services Ltd. |
| Guarantees Pursuant to Contract & Agreements (2) | Gandalf Technologies Inc. |
| Potential Liability re: Stock Repurchase Agreements (1) | Philip Environmental Inc. |
| Guarantees of Long-term Financing Related to Products Sold (1) | Bombardier Inc. |
| Potential Liability re: Buyback Agreements Related to Franchise Obligations (1) | The Jean Coutu Group (PJC) Inc. |
| Potential Liability re: Product Repurchase Agreement (1) | United Dominion Industries Limited |
| Potential Liability re: Receivables under Recourse Agreement (1) | United Dominion Industries Limited |

**Other Contingencies (37)**

| Type of Other Contingencies | Company |
|---|---|
| Potential Environmental Obligations (17) | Dension Mines Limited<br>Domtar Inc. (2)<br>Donohue Inc.<br>Electrohome Limited<br>Imperial Oil Corporation<br>Inter-City Products Corporation (2)<br>Laidlaw Inc.<br>Nova Corporation<br>Philip Environmental Inc.<br>Placer Dome Inc.<br>Quebecor Inc.<br>Slater Industries Inc.<br>Suncor Inc.<br>Unican Security Systems Limited<br>United Dominion Industries Limited |
| Possible Tax Reassessment (8) | Alberta Natural Gas Company Ltd.<br>ATCO Ltd.<br>Barrick Gold Corporation<br>Cineplex Odeon Corporation<br>Denison Mines Limited<br>Gandalf Technologies Inc.<br>Placer Dome Inc.<br>Trimac Limited |
| Potential Repayment of Government Assistance (3) | Electrohome Limited<br>Gandalf Technologies Inc.<br>Mitel Corporation |
| Contingent Liability Related to Lease Obligation (2) | Onex Corporation<br>Univa Inc. (Provigo Inc.) |
| Contingent Consideration re: Business Combinations (1) | Philip Environmental Inc. |
| Possible Suspension of the Ongoing Project due to Government Review (1) | Alcan Aluminium Limited |
| Potential Liability re: Construction Contract (1) | Repap Enterprises Inc. |
| Potential Liability re: Contribution Agreement (1) | Repap Enterprises Inc. |
| Potential Liability re: Government Audits of Contract Costs (1) | SHL Systemhouse Inc. |
| Potential Liability re: Revenue Increase Arising from Acquired Customer Base (1) | Mitel Corporation |
| Recovery of Costs of Assets (1) | Barrick Gold Corporation |