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The Effect of Securities Litigation Reform and regulation Fair Disclosure on Forward-Looking Disclosures

Chuck Pier, Angelo State University

In the late 1990s, both Congress and the Securities and Exchange Committee (SEC) sought to encourage more forward-looking disclosures. This led to three specific items of legislation/regulation: the Private Securities Litigation Reform Act of 1995 (PSLRA), the Securities Litigation Uniform Standards Act of 1998 (SLUSA), and Regulation Fair Disclosure (Reg.-FD) (2000). Although the specific purposes of each of these Acts were different, they each were founded on the desire of Congress and the Securities and Exchange Commission to improve the flow of information, particularly information about future operations from firms to investors. This paper looks at the effectiveness of these three Acts in increasing the number of forward-looking disclosures provided by companies in three disparate industries. Using a sample of 150 firms in the Consumer Staples, Consumer Durables, and Software industries, it was found that the number of forward-looking disclosures significantly increased following the passages of the SLUSA, and Reg.-FD, but not after the passage of the PSLRA.

The Securities and Exchange Commission (SEC) has two underlying purposes for disclosure requirements: access to information to aid in decision-making and the prevention of fraudulent reporting (Skousen, 1991). In addition, the SEC has expressed a desire for fairness in reporting for many years. Bentson (1973, p. 134) noted that “Perhaps even more important is the concept of ‘fairness’, the belief that all investors, large and small, insiders and outsiders, should have equal access to relevant information.”

Before being able to make decisions about firms, investors must first have access to information regarding those firms. Although historical financial data are abundant, prospective or “forward-looking” data have been much less available to the investing public. Numerous studies Baker and Haslem (1973), Chandra (1975), Frazier and Ingram (1983), Frazier, et al. (1984), Hawkins and Hawkins (1986), Hoskin, et al. (1986), Epstein and Pava (1994), The Jenkins Report (AICPA, 1994), Epstein and Pava (1995), Bryan (1997), and Barron, et al., (1999) among others] have found that accountants, investors, academicians, and other interested parties consider forward-looking disclosures of financial and other corporate information relevant to decision making.

At several points over the past two decades, the SEC and Congress have attempted to increase the number of forward-looking disclosures provided by public companies. Two Congressional Acts and one SEC regulation have been implemented with at least an indirect impact on the issuance of forward-looking disclosures: (1) the Private Securities Litigation Reform Act of 1995 (PSLRA), (2) the Securities Litigation Uniform Securities Act of 1998 (SLUSA), and (3) Regulation Fair Disclosure (Reg. FD). While it may be argued that the specific intent of each of these actions was not to increase the quantity of forward-looking disclosures, it was always considered to be an important indirect outcome from the regulations. In 1996, then-SEC Chairman Arthur Levitt declared, in a speech regarding his thoughts on the PSLRA (Levitt 1996) that, “Most of the interaction between the SEC and Capitol Hill centered on the bill’s safe harbor provisions. Our goal was to encourage companies to provide more meaningful forward-looking information to the market by affording them greater protection” (emphasis added).

LITERATURE REVIEW

Corporate disclosure is necessary for the efficient functioning of capital markets and there is a rich history of research in required financial disclosures. However, there has been little research on voluntary corporate disclosures (Healy and Palepu 2001). Such disclosures can be provided through regulated financial reports (including the financial statements, footnotes, management discussion and analysis, and other regulatory filings). In addition many firms will voluntarily disclose information such as management forecasts as well as sales and earnings results in conference calls, press releases, internet sites and other, non-regulated reports.

Disclosure studies assume, that even in efficient markets, managers possess superior information on their firms' expected future performance when compared to the knowledge of outside investors and analysts (Healy and Palepu 2001). However, some studies have shown that it is in a firm's best interest to disclose more as opposed to less. For example, Milgrom (1981) found that, assuming both credible disclosures and no cost to disclose, full disclosure will occur because investors will assume that firms not making voluntarily disclosures have the worst possible circumstances. Lang and Lundholm (1993) found that the more information a firm voluntarily discloses the higher the return on that firm's stock. In addition to the increase in stock performance, Healy, et al., (1999) found that firms that increased their disclosure levels experienced increases in institutional ownership, the number of analysts following the stock and stock liquidity.

The history of forward-looking statements is fairly short. Prior to 1972, so-called "soft" forward-looking information was prohibited in SEC-filed documents because such information was believed to be inherently unreliable and unpredictable (Kerr, 1987). However, in 1979, the SEC reversed its position with the enactment of Rule 175 (Hiler, 1987). Rule 175 provided that forward-looking statements would not be deemed fraudulent if they were made in "good-faith" and if they had a "reasonable basis" of assumptions (Calderon and Kowal, 1997). This introduction of a "safe harbor" for forward-looking disclosures was severely limited. The main drawback to Rule 175 was its application only to written forward-looking statements filed with the SEC or oral statements that reaffirmed in writing with the SEC. In other words, oral statements by themselves were not provided any safe harbor protection. Both Skinner (1995) and Pownall et al., (1993) found that despite the SEC's encouragement, forward-looking disclosures were rare due to potential stockholder litigation.

The first mention in SEC literature of a required forward-looking disclosure occurred in 1980 (SAR No. 33-6231). This release required a more comprehensive discussion of the financial statements as a whole with particular regard to liquidity, capital resources, and results of operations, as well as a discussion of forward-looking disclosures in the same three areas. This change in emphasis brought about the new reporting section entitled Management's Discussion and Analysis (MD&A).

There was substantial criticism of the new requirement due to the lack of guidance on the form of the MD&A section. To address these concerns and provide guidance, the SEC issued Financial Reporting Release No. 36 (FRR-36) in 1989. FRR-36 sought to address inadequacies in prior disclosures in the MD&A section. Of particular interest to this paper was the inclusion of guidance on the use of the safe harbor provisions provided by Rule 175 to encourage more complete forward-looking information with a lower level of legal liability.

Studies by Hooks and Moon (1993) and Eikner (1994) found that the implementation of FRR-36 led to a very small increase in the number of forward-looking disclosures. A1994 survey of the Manufacturers Alliance (a group of 500 manufacturing companies) indicated that only 17% of its members made any type of forward-looking disclosures. Of the 83% not making forward-looking disclosures, nearly half (49%) said that additional protection from legal liability would encourage them to make forward-looking disclosures (Barlas, 1995). Frost (1998) found that the number of firms making forward-looking disclosures in the United States was significantly less than in countries where legal actions for misleading statements are infrequent.

The Private Securities Litigation Reform Act (PSLRA) was enacted in response to claims of widespread abuse in the area of securities litigation (Conference Report, 1995; Avery 1996). The Act's proponents alleged that federal securities laws promoted the filing of "strike" suits based solely on a decline in stock price. These same proponents expressed concern that frivolous suits were severely limiting managers' communication of forward-looking information to the marketplace (Johnson, et al., 2001). The proponents argued that shareholders would benefit from the passage of the PSLRA through decreased litigation costs associated with frivolous litigation. Coffee (1985) found that frivolous litigation significantly increased costs to companies involved with all forms of litigation. It was also thought that the PSLRA's safe harbor and the increased difficulty in filing suit might encourage firms to adopt a more forthcoming disclosure policy which would yield a lower cost of capital (Botosan, 1997) and more interest by investors (Lang and Lundholm, 1996).

These arguments were countered by PSLRA opponents who argued that the safe harbor would increase the risk of firms disclosing less accurate information. Additionally, although there may be increased disclosures, the ability to create cautionary statements to accompany the new disclosures would be more important than the actual information disclosed (Spiess and Tkac, 1997).

On December 22, 1995, after being vetoed by President Clinton, both the House and the Senate overrode the President's veto and the PSLRA became effective on January 1, 1996 (PL 104-67).

The PSLRA defines the term "forward-looking statement" as a projection of revenues, income, or other financial items; a statement of management's plans and objectives for future operations (including products or services); a statement of future economic performance; and a statement of assumptions underlying these projections (PSLRA, Sec. 13A (b) of U.S. Public Law 67, 104th Congress). The basic framework of the safe harbor provided in the PSLRA is quite simple. The PSLRA safe harbor has two tests that operate in an 'or' fashion. If either test is met, the person or issuer making the statement is protected from private liability (cases filed in civil courts as opposed to criminal cases), but not necessarily from the SEC. In other words, a statement that meets one of the two prongs cannot be sued by investors but can still be subject to SEC action.

The first test is one of "actual knowledge" (Avery, 1996). Under this test, the person or issuer is protected with respect to the forward-looking statement if the plaintiff fails to prove that the statement was made with actual knowledge that the statement was false or misleading. The "actual knowledge" test does not need to be accompanied by any cautionary language. (U.S. Public Law 67, 104th Congress).

The second test is known as the "bespeaks caution" test. (Avery, 1996) Under this test the person or issuer making the statement is protected if the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement (Boyle and Knopf, 1996). This test has two interesting aspects. First, the test protects statements that are immaterial. Second, and perhaps more interesting, is the fact that, if read literally, the "bespeaks caution" test would protect knowingly false statements as long as they were accompanied by meaningful cautionary statements. Specifically, the Statement of the Managers in the Conference Report that approved the final version of the PSLRA specifically instructed the courts to examine only the cautionary statement accompanying the forward-looking statement and "not examine the state of mind" of the issuer making the statement (Congressional Record H13703, 1995). Numerous critics of the PSLRA cited this as a, "license to lie." There are two citations that attribute the phrase, "license to lie" (with regard to the PSLRA) to specific individuals. Janis (1996) attributes the phrase to consumer activist Ralph Nader. Carney (2002) and Spector (2002) attribute the remark to then Sen. Joseph Biden during the debate to override the Presidential veto of the PSLRA.

Despite the significance of the PSLRA on corporate financial reporting, and particularly on forward-looking disclosures, there has been limited research on it. Grundfest and Perino (1997) were among the first to look at the effects of the passage of the PSLRA. They found that in the year following the PSLRA's passage there was a drop in the number of lawsuits filed, but not the numbers expected. Despite the fact that the overall litigation rate was relatively unchanged after the passage of the PSLRA, Grundfest and Perino (1997) found that there was a significant drop in the number of complaints alleging false forward-looking disclosures as the basis for filing a lawsuit. Although this decline was welcome news and seemed to satisfy the intentions of Congress, the same report noted that an almost equal increase in filings was noted in state courts. Grundfest and Perino (1997) attributed this increase in state court filings to a "substitution effect" where plaintiffs chose to file in state courts to avoid the more stringent requirements of the new law in federal courts.

The SEC, in its report to the President and Congress on the first year of practice after passage of the PSLRA, noted that the "quality and quantity of forward-looking disclosures has not significantly improved following enactment of the safe harbor for forward-looking statements" (SEC 1997). However, the SEC performed no empirical tests and based its statements on anecdotal evidence only. Additionally the SEC called the shift of securities fraud cases from federal to state courts "the most significant development in securities litigation" since the passage of the PSLRA (SEC 1997). The report also noted that the increases in state court filings were almost wholly attributable to the passage of the PSLRA, given that there was essentially no significant securities litigation in state courts prior to the passage of the PSLRA.

In late 1997, legislation was introduced in Congress to address the issue of plaintiffs attempting to circumvent the PSLRA by filing in state courts. The Securities Litigation Uniform Standards Act (SLUSA) was designed to make federal court the exclusive venue for most securities suits, preventing plaintiffs from seeking to evade the provisions of the PSLRA. The SLUSA also enables defendants to force all actions arising out of the same set of facts into one court, thereby avoiding the common problem of being forced to litigate in several state and federal courts simultaneously (Hamilton and Trautmann, 1998).

Studies completed since the passage of the SLUSA (Day 1999, Rosen 1999) have found that the number of lawsuits filed decreased only minimally. However, it should be noted that these studies dealt with only the number of filings. Although quantity of lawsuits is an important piece of information it is not totally reflective of actions; many cases that are filed never make it to the courtroom because they are dismissed on procedural or other grounds, such as being frivolous. No studies were found that investigated the actual number of cases filed versus the number that actually make it to trial. However Cashin (1999) cites anecdotal evidence that both the PSLRA and SLUSA have been successful in reducing the number of cases actually going to trial.

Of particular interest to this study was the finding by Rosen (1999) that, based on a quantitative analysis of cases, the PSLRA's safe harbor provision was deterring the filing of cases in which a securities issuer made a projection and met the PSLRA requirements. Rosen noted that relatively few pure projection cases were being filed.

Although both the PSLRA and SLUSA had the potential to increase the number of forward-looking disclosures, SEC Regulation-FD (Reg FD) may actually lead to the largest increase. This regulation was designed to promote the full and fair disclosure of information by issuers (SEC Regulation FD, 2000). Former SEC Chairman Arthur Levitt pushed for this rule that would prohibit the selective disclosure of material nonpublic information in an effort to level the playing field. The SEC believed that selective disclosure created a loss in investor confidence in the integrity of the capital markets (Hamilton and Trautmann, 2000).

Numerous criticisms have been made against Reg. FD, but the most common concern was that the regulation would have the effect of 'chilling corporate disclosure' (Hamilton and Trautmann, 2000; Hassett, 2000; and Anonymous, 2000). These critics felt that rather than risk sanctions from the SEC regarding selective disclosures, many companies would simply discontinue all disclosures.

An article in The CPA Journal (Anonymous 2001) described two surveys that expressed opposite opinions on the initial results of Reg FD. The first survey, conducted by the Association for Investment Management and Research (AIMR) found that analysts believed (emphasis added) that Reg FD had reduced the amount of information provided by companies. This survey also noted that information regarding forecasts was particularly less available after implementation. Also, a PricewaterhouseCoopers survey of top corporate executives believed (emphasis added) that Reg FD had favorably affected company disclosures in quantity, quality, and frequency.

Implementation of Reg FD has produced a significant quantity of research in the area of information dissemination. These studies have found that Reg FD has reduced selective disclosures without impairing the flow of information to investors (Straser, 2002; Sunder, 2002; Zitzewitz, 2002; Aslan, 2003; Bailey et al., 2003; and Heflin et al., 2003).

Research Questions and Methodology

This paper seeks to determine whether the passage of the PSLRA, the SLUSA and Reg FD lead to an increase in the number of forward-looking disclosures. Since this research relates to the passage of three

Advances in Business Research
2011, Vol. 2, No. 1, 138-148

pieces of legislation/regulations, the effects of these regulations were measured both pre- and post-implementation of each piece of legislation/regulation. (See Figure 1 on next page for study time line). The operational hypothesis, stated in the alternate form, is:

H: The mean number of forward-looking disclosures is different between at least two of the periods under study. In notational form, this hypothesis is expressed as: H: $A \neq B \neq C \neq D$, where:

A = the mean number of forward-looking disclosures prior to passage of the PSLRA (data from the second quarters of 1993, 1994, and 1995).
B = the mean number of forward-looking disclosures after passage of the PSLRA (data from the second quarter of 1996).
C = the mean number of forward-looking disclosures after passage of the SLUSA (data from the second quarter of 1999).
D = the mean number of forward-looking disclosures after implementation of Reg. FD (data from the second quarter of 2001).

Statistical Tests

The effects of passage of the PSLRA and SLUSA as well as the implementation of Reg. FD are measured by the use of a single-factor, within-subjects ANOVA. If the overall ANOVA is significant, the inference can be made that there was a change in the number of forward-looking disclosures after the implementation of the legislation/regulations.

When the ANOVA F ratio is significant and more than two sample means are involved, multiple comparison procedures must be used to determine which means are significantly different from the other means. Because this study is interested in all possible pairwise comparisons, the most appropriate test is the Tukey HSD (Sheskin, 2000).

Sample Size

A sample size of 150 companies in total, with 50 from each industry subset was selected for this study. The following requirements were placed on the firms in this study:

1. Firms must be included in the Standard & Poor's Research Insight (formerly known as CompuStat) database.
2. Firms must have a Global Industry Classification Standard (GICS) of 2520 (Consumer Durables); 3010, 3020, and 3030 (Consumer Staples); and 4510 (Software).
3. Firms must be reporting in the second quarter of the periods under study.
4. Firms must end their fiscal year on December 31.

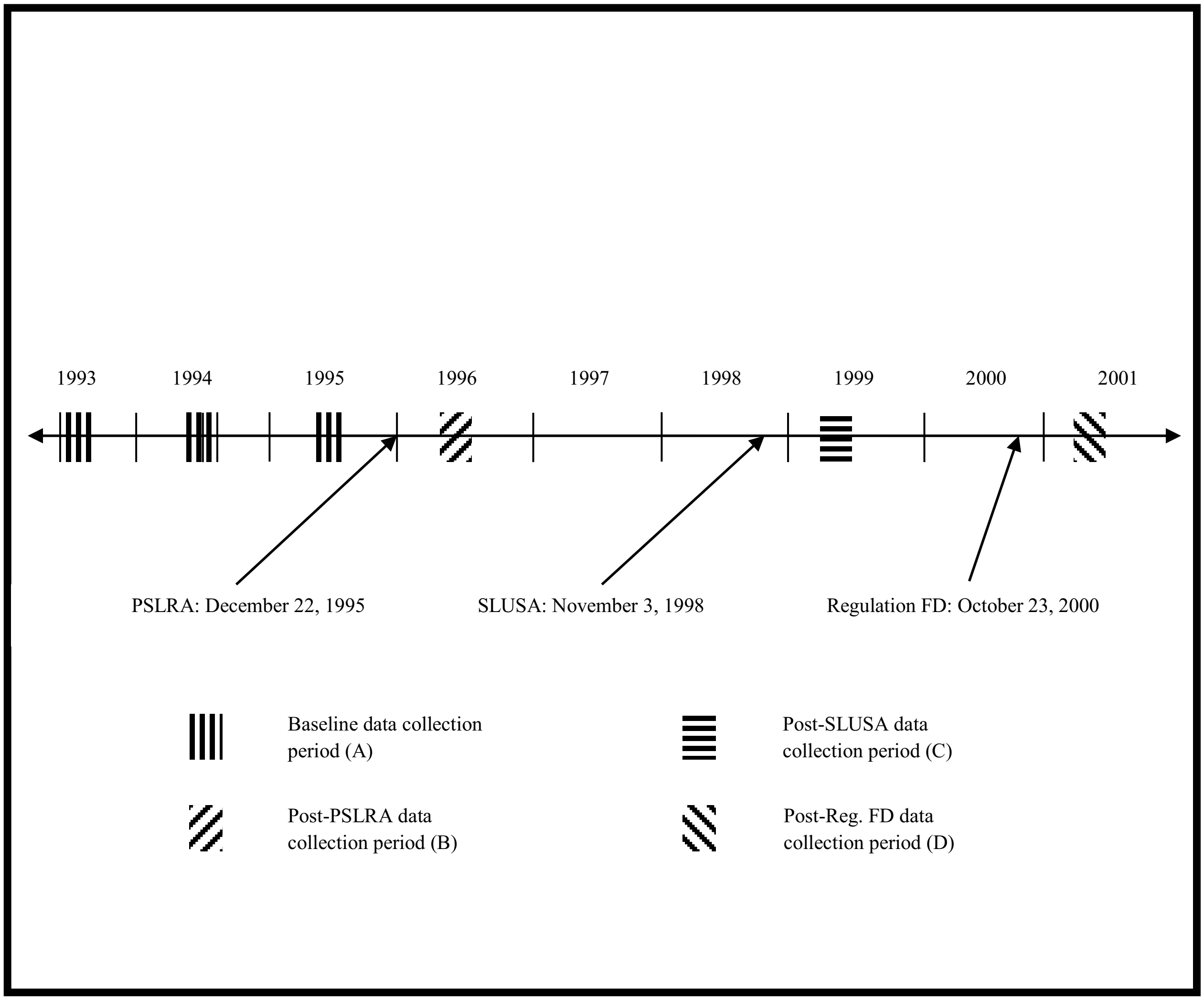
The GICS included in this study were chosen to provide a diverse group of sectors. GICS 2520 (Consumer durables) were chosen to represent a cyclical sector; GICS's 3010, 3020, and 3030 (Consumer staples) were chosen to represent a defensive sector; and GICS 4510 (Software) were chosen to represent a high growth sector.

Each piece of legislation/regulation (PSLRA, SLUSA, and Reg.-FD) was enacted in the fourth quarter of the calendar year. Since some of the legislation was passed very late in the fourth quarter (the PSLRA was passed on December 22nd), it may not have been implemented at the beginning of the first calendar quarter. Therefore the second calendar quarter was chosen as the period to analyze the number of forward-looking disclosures.

In addition to these periods for post-implementation data gathering, a baseline had to be established. The pre-implementation data were pulled from the second calendar quarter of 1995. To ensure that an anomaly in this quarter did not affect the study, it was decided that the baseline data should be the mean number of forward-looking disclosures of the second calendar quarter of the three years (1993, 1994, and 1995) preceding the first act's implementation.

Advances in Business Research
2011, Vol. 2, No. 1, 138-148

Figure 1: Time line of study



Note: All data collection occurs in the second calendar quarter of the year in question.

Based on the criteria discussed above, all firms selected must be reporting in the second quarter of 1993, 1994, 1995, 1996, 1999, and 2001.

Results and Analysis

The initial sample of firms was selected from Standard & Poor's Research Insight database. A random sample of 50 firms from each GICS Industry classification that met the criteria listed above was then selected for study. The samples were randomized to allow for generalization of the results across the industry in each sample. (See Appendices A through C at the end of the paper for a complete list and size of companies in the each of the samples.)

Lexis-Nexis Academic Universe's (News) Wire Service Reports was searched for both the company name and ticker symbol of the selected firms. In addition to firm name, various keywords typically associated with forward-looking disclosures or forecasts were used. The specific search string used was, "expect! or predict! or forecast! or project! or anticipate! or estimate! or outlook or foresee! or believe." The wildcard "!" allows for the return of any wire that contains the base form of the word depicted, therefore the search term "expect!" would return disclosures that contained the words "expect," expectations," "expected," etc.. This string was based on the search string used in Johnson, et al., (2001).

Since most firms simultaneously send out press releases to many wire services, the list of disclosures in the wire services generated numerous duplications. All redundant disclosures were eliminated. Examples of typical forward-looking disclosure are listed in Appendix D at the end of the paper and an example of a redundant disclosure is provided in Appendix E. The criteria above resulted in a total of 612 unique (non-redundant) forward-looking disclosures identified for the sample firms. The breakdown by industry and time period is provided in Table 1.

Table 1: Forward-Looking Disclosure Sample Distributions

Year	Consumer Durables Industry GICS 2520	Consumer Staples Industry GICS 3000	Software Industry GICS 4510	Total
1993	11	16	4	31
1994	12	17	17	46
1995	19	18	23	60
1996	15	27	23	65
1999	44	48	61	153
2001	60	73	124	257
Totals	161	199	252	612

ANOVA Results

The hypothesis posits that there is a statistical difference between the mean number of forward-looking disclosures in each of the periods analyzed. Results of the ANOVA are shown in Table 2. Descriptive statistics are provided in Table 3. Overall, the ANOVA shows that there is a statistical difference between at least two of the data points measured, with an F value of 39.159, which generates a P-value of < 0.000.

Table 2: ANOVA Results for Hypothesis (H)

Source of Variation	SS	df	MS	F	P-value	F crit
Between Groups	47.527	3	15.842	39.159	0.000	2.620
Within Groups	241.125	596	0.405			
Total	288.652	599				

Table 3: Descriptive Statistics

	N	Mean	Std. Dev.	Min.	Max.
Average of Square Root of Baseline Data	150	.3446	.43238	.00	1.63
Square Root of 1996 Data	150	.3797	.53957	.00	2.00
Square Root of 1999 Data	150	.7292	.70108	.00	2.45
Square Root of 2001 Data	150	1.0339	.80542	.00	3.46

Table 4: Test of Multiple Comparisons Analysis

Paired Differences of Forward-Looking Disclosures	Calculated q
Baseline to 1996	-1.28065
Baseline to 1999	-7.1098***
Baseline to 2001	-13.9988***
1996 to 1999	-5.82915***
1996 to 2001	-12.7182***
1999 to 2001	-6.889***

***Significant at $\alpha < 0.01$

Multiple Comparison Results

Although the ANOVA provides proof that there is a significant difference in the means of the four periods under study, it does not provide the necessary information to know which of the means differed significantly. To determine this, each pair of time periods under study were compared, producing six different test statistics (q). The results from these multiple comparisons are listed in Table 4. The absolute value of a calculated q must be equal to or greater than 3.63 for significance at the .05 level and greater than or equal to 4.40 for significance at the .01 level. Table 4 shows that the only pair of sample means

Advances in Business Research
2011, Vol. 2, No. 1, 138-148

that failed to show significance was from the period just prior to the implementation of the PSLRA (Baseline data from 1993, 1994 and 1995) and the first data collected after the implementation of the PSLRA (1996).

Analysis

The results of the statistical tests showed that there was a significant difference in the mean number of forward-looking disclosures during the periods under study. In addition, multiple comparisons were conducted to determine which periods differed significantly from other periods. These results showed significance at < 0.01 for five out of the six comparisons. The only pair of samples that failed to show significance was the sample immediately prior to the passage of the PSLRA and the sample immediately after passage of the PSLRA.

These results would support Grundfest and Perino (1997), Hamilton and Trautmann (1998), and the SEC (in its 1997 report on the first year of practice under the PSLRA) that the passage of the PSLRA did not alter the total securities litigation landscape. Instead the PSLRA just served to shift litigation from federal courts to the state courts. This shifting, as opposed to a reduction in the threat of litigation could explain why firms failed to issue more forward-looking disclosures following the passage of the PSLRA. Once this bypassing of the PSLRA through state courts was removed by passage of the SLUSA a significant increase in the mean number of forward-looking disclosures was noted. Another significant increase in forward-looking disclosures was found after implementation of Reg.-FD.

Limitations of the Current Study

This study has three primary limitations. First, because only three industries were sampled, no generalization can be made to firms in all industries. Although care was taken to ensure that a random and complete sample in each industry was obtained, many firms in other industries were not analyzed.

Second, the possibility of confounding events within the time periods under study was not addressed. Use of three different industries and a fairly large sample from each industry would help to mitigate individually occurring confounding events, but systemic events that would affect either all companies in the study or all of the companies within a particular industry however were not addressed.

Finally, inferences that can be made from the current study are also limited because of the use of archival data. The use of archival data means there is inability to manipulate or control variables. Any significance attributed to certain aspects under study may be due to a simple association, as opposed to a causality relationship between the variables.

Conclusions and Future Research

As this study has shown, an increase in forward-looking disclosures was brought about by the passage of laws and regulations. However, despite the increases in forward-looking disclosures over prior periods, the level of disclosures desired by Congress, the SEC, and the investing public has yet to materialize. While empirical evidence has shown a reduction in cost of capital for firms that voluntarily disclose forward-looking information, anecdotal evidence and the feelings of executives regarding a fear of litigation has overridden the benefits of this reduction in capital costs. Laws and regulations mandating more disclosures or further reducing litigation risks could be passed, and have the potential to provide stakeholders with beneficial information, but the prospects for these types of intervention appear limited for the foreseeable future.

As noted above, there are several limitations to the current study. As with most limitations, these areas provide for future research projects. Since this study looked only at the immediate impact of the legislation, a more detailed long-range study to see the impact on future disclosures would be of interest. In addition, a more detailed study that looked at each company within a sector could look to see if there are characteristics that lead to more disclosures by one company over another. It is possible that the results of this study were skewed based on just a few companies in each sector.

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Advances in Business Research
2011, Vol. 2, No. 1, 138-148

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Chuck Pier is an assistant professor of accounting at Angelo State University. He received his Ph.D. in business, with a concentration in accounting, from the University of Texas at Arlington. His primarily teaches in the areas of taxation and financial accounting. He has published in Journal of Corporate Accounting and Finance, CPA Journal, Journal of Accountancy, Issues in Accounting Education and others.