The Effects of Potential Litigation Costs on Accounting Conservatism*
잠재적 소송비용에 보수주의적 회계선택에 미치는 영향*

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ABSTRACT: It is an interesting issue to investigate whether companies recognize the potential litigation costs properly and reflect them on their management behavior because the potential litigation costs have grown with the adoption of Class-action litigation. Using a sample of firms excluding financial institutions listed on the Korea Stock Exchange between 2000 and 2006, this study verifies the relationship between potential litigation costs and management behavior. An increase in potential litigation cost is closely related to the size of expected future losses. When the potential litigation cost is realized, it can beget enormous losses and force a company into bankruptcy, such as occurred in the Enron and Worldcom. Henceforth, managers have a reason to make an effort to control potential litigation costs and losses. Here needs to be noticed is that most of the lawsuits against companies are related to accounting. Also, accounting-related lawsuits are the most costly of all lawsuits that companies face. Therefore, companies

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are expected to tend to reduce potential litigation costs and improve public confidence and transparency in accounting. This study confirms the relationship between potential litigation costs and the preference for accounting conservatism as a means of abating expected losses in companies with large potential litigation costs.

The result from this study shows that a company with high potential litigation costs tends to consolidate accounting conservatism. It consistently verifies that high potential litigation costs promote accounting conservatism by the Basu model (1997) and the performance matched adjustment modified Jones model (2005). As such, the results ascertain that the reformation of the legal framework in accounting after the economic crisis gives influences on management or auditor's behavior. Moreover, it is expected that the encouragement of accounting conservatism followed by potential litigation costs leads to an improvement in accounting transparency.

This study presents a positive framework for empirically analyzing litigation risk under domestic conditions which have a relatively short history and a small number of cases of litigation against companies in South Korea. Particularly, ex post litigation risk such as the number of lawsuits or litigation probability is difficult to measure within domestic circumstances because of the limited litigation history and number of cases. As such, application of questionnaire research or experimental research is not appropriate to represent litigation risk, even if they were used in other studies. Therefore, unlike previous studies, this study carried out D&O premiums as a measure of ex ante litigation risk derived from insurance companies which professionally measure potential litigation risk. It is significant that the study is distinctive with other studies by implementing a quantified measure of potential litigation risk to analyze the effects of potential litigation costs on management behavior. Most domestic studies on litigation risk and accounting conservatism and transparency in South Korea depend on only analytical methodology or positivism. Even though there are some empirical studies, they only compare those issues before and after the economic crisis, or before and after the adoption of class-action litigation. This methodology cannot prove the difference in magnitude of potential litigation costs among companies and control compounding effect. Since this study considers differences in potential litigation costs, which have been previously overlooked, it is significant that the research has higher validity and covers a wider area. Also, this research has value both to academics and to