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Legal disclaimers make inaccurate company statements more palatable to investors, finds study

Even when company management provides forward-looking statements in bad faith, the report says

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When forward-looking statements are accompanied by a legal disclaimer, inexperienced investors are more likely to forgive a company missing its projections – even when management is shown to have knowingly misled investors, according to a new academic study published this month in ***The Accounting Review***.

The research was led by H Scott Asay of the University of Iowa and Jeffrey Hales of the Georgia Institute of Technology. They contend that legal disclaimers protect public companies from reprisal and therefore harm vulnerable investors in the process – going so far as to cite one attorney's description that these disclaimers afford management the 'license to lie'.

The report co-authors conducted two separate studies to examine the influence legal disclaimers have on non-professional investors, as they call them in the study.

In the first study, the researchers separated a group of 241 people into two groups. Each group was provided with an earnings release about an anonymized large-cap company. The release announced disappointing results but included optimistic forward-looking statements from company management about how the company would recover from the previous quarter.

One group of study subjects received the release without a legal disclaimer, while the other group's release included a 120-word disclaimer concerning the forward-looking statements. The latter group expressed less enthusiasm about the company's future results. But when both groups were asked to provide a valuation of the company, the results were very similar.

'Cautionary disclosures are viewed by non-professional investors as informative warnings, but they have difficulty translating that belief into a change in how they view the prospects of the firm when making a valuation judgment,' the report authors write.

Although the subjects of the study 'process the disclaimer as a warning… [it] has little impact on the extent to which they incorporate information from positive forward-looking statements into their valuation judgments [and so provides] little protection from the economic harm that can result from undue reliance on forward-looking statements,' the report authors also note.

In the second study, 200 people were given the same company release and told to assume the positive forward-looking statements had motivated them to increase their individual investment in the stock. They were then told the company had missed its forecasts, resulting in a drop in share price and personal losses for the individual investor.

The survey subjects were split into four groups:

- Group one was told management had acted in good faith and believed it could hit its targets. Its press release included the legal disclaimer.
- Group two was also told management had acted in good faith, but its press release didn't include the legal disclaimer.
- Group three was told management knew it couldn't meet the targets outlined in its forward-looking statements. Its press release included the legal disclaimer.
- Group four was also told management knew it couldn't hit its forward-looking statements but its press release didn't include the legal disclaimer.

Groups three and four were more likely to feel entitled to financial compensation as a result of management's actions. Group four were even more motivated to make a claim because of the lack of a legal disclaimer. Groups one and two were less likely to feel entitled to financial compensation, and their stance was unaffected by whether or not the press release included a legal disclaimer.

The report authors contend that this shows legal disclaimers dissuade investors from seeking compensation when they have lost money, even when management has been proven to have acted in bad faith.

'Non-professional investors might protect themselves from placing undue reliance on positive forward-looking statements… by generating counter-explanations for why management plans might fail,' the co-authors write.

'Cautionary disclaimers might be more effective if they contain less boilerplate language, are written in plain English, are presented more saliently or are integrated within the disclosure so that they qualify specific forward-looking statements rather than qualifying forward-looking statements more generally.'