

THE ANALYSIS OF ACCOUNTING CONSERVATISM IN HUNGARY

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Abstract

Conservatism influences financial reporting in several ways. According to Basu (1997) and Watts (2003), it seems not only to have survived but also increased in the last three decades. There are different explanations for this, for example the contractual explanation, the increase in shareholder litigation, the tax system's influence on financial reporting accounting methods and the regulatory explanation. The most common explanation is the contractual explanation. Literature suggests that financial contracts require conservative accounting practice to mitigate agency problems. To test the trend of accounting conservatism, we examined timely loss recognition for the last 20 years in Hungary. Our sample contained data from 877 financial statements. The distribution of the statements allowed us to study the tendency of the change in accounting conservatism. We found not significant association between timely loss recognition and the date of financial statements, which suggests that accounting conservatism has not increased in the last 20 years in Hungary.

Key words: *Accounting quality, Conservatism, Earning management, Timely Loss Recognition, Hungarian Law of Accountancy*

JEL: M41

A konzervatív számviteli szabályozás magyarországi helyzetének elemzése

Összefoglalás

A konzervatív szabályozás számos módon befolyásolja a pénzügyi beszámolást. Basu (1997) és Watts (2003) szerint, úgy tűnik, hogy a konzervatív szemlélet nem csak fennmaradt, de növekedett is az elmúlt 3 évtized során. Erre a jelenségre különböző magyarázatokkal szolgál a szakirodalom. Ilyenek többek között a szerződéses magyarázat, a részvényesek által indított peres ügyek számának növekedése, az adózás számvitelre gyakorolt hatása és a szabályozói magyarázat. A legelterjedtebb a szerződéses magyarázat. A korábbi kutatások szerint, ezek a szerződések megkövetelik a számviteli eljárásoktól, hogy csökkentsék az ügynöki problémákat. A konzervatív számviteli gyakorlat tesztelésére a veszteségek időbeli kimutatását vizsgáltuk, magyarországi vállalkozások beszámolóit elemezve. A mintánk 877 pénzügyi kimutatás adatait tartalmazta, melyek az 1997 és 2016 közötti évekről kerültek összeállításra. A kimutatások eloszlása lehetővé tette számunkra, hogy a veszteségek kimutatásának időbeli trendjét vizsgáljuk. A vizsgálatba bevont beszámolók elemzését követően elmondhatjuk, hogy a veszteségek időbeli kimutatása nem mutat növekvő trendet Magyarországon. A konzervatív beszámolási gyakorlatot a közzétett nagy összegű veszteségekkel megragadva nem mondhatjuk, hogy konzervatívabbá váltak a közzétett számviteli beszámolók.

Kulcsszavak: Számviteli minőség, Konzervativizmus, Eredmény manipuláció, Veszteségek kimutatása, Számviteli törvény

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Introduction

Conservatism is one of the most influencing principles of accounting regulations. Accounting conservatism has several different definitions. Basu (1997: 7-8p) collected the following:

- “anticipate no profits but anticipate all losses”
- “... if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate”
- “as denoting accountants’ tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses.”

Watts (2003) studied conservatism in accounting and stated that it appears not only survived for many centuries, but also have increased in the last 30 years. Basu (1997) found that the strength of the association between earnings and concurrent negative returns has increased relative to the association between earnings and concurrent positive returns over the last thirty years, also suggesting that conservatism has increased.

Watts (2003) suggests as long as income and net asset measures have meaning and are used in a way that affects management welfare, conservatism is likely to be an optimal accounting principle. Possible explanations for accounting conservatism are:

- contracting explanation,
- the increase in shareholder litigation,
- the tax system’s influence on financial reporting accounting methods,
- a regulatory explanation.

Many prior research studies defined contracts as formal contracts between parties to a firm, for example: debt, management and compensation contracts. Watts extended this definition to a firm’s organizational arrangements such as its managerial accounting and control systems and also the tax explanation linked to it. When the firm cannot make enough profit to cover the promised payments to the debt-holders, limited liability causes debt-holders to receive a sum below the contracted amount. During a liquidation procedure, the liquidator anticipates all possible losses and no unverifiable gains, and therefore employs conservative accounting principles. For example, many intangible assets are likely to have a value of zero in case of liquidation. Dividends restrictions rules are essential because the manager likely has more information than the other parties to the firm. Verification is necessary for the contract to be enforced in a court of law, but much information cannot be easily verified. The estimates are not verifiable because they often depend on assumptions, so they are not used in contracts. The parties of these contracts demand timely measures of net asset values and earnings. Conservative financial statements are asymmetric,

but this is appropriate because the parties to the firm have asymmetric payoffs from the contracts. The conservatism also has critics. They say that conservative rules make the future statements non-conservative. (Watts, 2003)

Overstatement earnings and assets is much more likely to generate litigation than understatement earnings and assets. This fact might lead to conservatism because this means incentives to managers and auditors to be conservative. (Watts, 2003)

Income taxes are tied to reported earnings and influences the calculation of it. On average the existence of this association leads to understatement of net assets. (Watts, 2003)

The regulators and standard setters have incentives to be conservative. This is similar to the litigation incentives. The losses from overstated earnings and overvalued assets are more observable and usable in political process than foregone gains. (Watts, 2003)

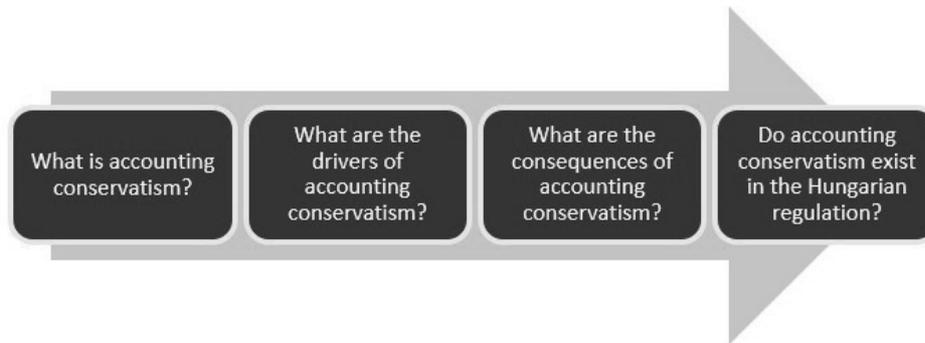
Alternative explanations from Basu (1997):

- Shareholders' liquidation or abandonment option,
- Delayed disclosure of bad news by opportunistic managers,
- Managers' incentives to disclose bad news early (for example: litigation costs),
- Effect of mandated accounting changes.

The researches in the field of accounting conservatism studied this explanations and associations suggested by prior researchers. The aim of this paper is to study the trend of accounting conservatism in the last 20 years in Hungary.

Literature review

The literature review of this article was built around four main questions. These questions are illustrated in the following figure.



1. Figure - The main questions of the literature review

Source: authors' own collection

The first question was answered in the introduction. The second and third questions are difficult to distinguish. The fact that something is a driver or a consequence is not always clear. Numerous factors influence the level of accounting conservatism, which can be grouped differently. A possible way of grouping can be based on what the influencing factor directly influences, the person, the company or the national economy. At the lowest level are among others the educational background of CEOs, the gender of the CFO or the personal litigation risks of the CFOs.

The directors and the managers also can influence the quality of the financial statements, the level of accounting conservatism. These executives can be different in many ways, for example in educational background. Hu et. al (2017) labelled the CEO-s as CEOs with accounting background and CEOs without accounting background. They used a large sample archival data and found that if CEO of the firm has accounting background the level of accounting conservatism is lower.

The gender of the CFO also can influence the level of accounting conservatism. Francis et. al (2015) examined how the gender of the CFO impact on the corporate financial reporting. They used a sample which contained financial statement of companies that experience changes of CFO from male to female. They found that the financial statements disclosed under a female CFO are more conservative. This risk aversion is associated with less equity-based compensation, lower firm risk, a higher tangibility level, and a lower dividend payout level.

Levy et al. (2018) studied the personal litigation risk's effect on firms' disclosure and accounting choices. They used to this the change in regulation that the corporate officers owe the same fiduciary duty to the firm and shareholders as do board members. Their results suggest that CFOs respond to their personal litigation risk more than to the litigation risk of the corporate.

In the second level, for example, the debt maturity, auditor-client negotiations and auditor tenure can be found.

Bens et al. (2018) studied the effect of aggregation of accounting information via segment reporting on accounting conservatism and found that higher quality segment reporting leads to an increase in timely loss recognition.

Ahmed et. al (2002) used both a market based and an accrual based measure of conservatism and found that firms facing more severe conflicts over dividend policy tend to use more conservative accounting. Their results also suggest that accounting conservatism is associated with a lower cost of debt, they controlled for other factors of firms' debt costs.

Gong & Luo (2018) examined the "supply-chain lenders" and the need for accounting conservatism. "Supplychain lenders" are the lenders with lending relationship with borrowers' major customers. They found that firms borrowing from supply-chain lenders are less conservative compared to companies' borrowing from non-supply-chain lenders. This is because of the lower demand of high quality financial statements, "supply-chain lenders" more often use informal channel than non-supply-chain lenders.

Kang et al. (2017) found positive relationship between conservatism and debt maturity. Their findings suggest that the demand for accounting conservatism is different across the different debt maturity horizons.

Antle and Nalebuff (1991) studied conservatism and auditor-client negotiations. The clients prefer higher reported income, the auditor wants to present as correctly as possible. During the negotiations three auditor strategies arise tough (conservative), business as usual (may or may not conservative) and accommodating (never conservative). The applied audit strategy influences the level of accounting conservatism.

Li (2010) results suggest that the positive association between conservatism and auditor tenure only exists for large firms or firms strongly monitored by their auditors. In case of smaller firms or weakly monitored firms the association is significantly negative between auditor tenure and conservatism.

Khan and Watts (2009) found that young firms, firms with longer investment cycles, and firms with higher idiosyncratic uncertainty are more conservative. They warn the future researchers that the C_Score they used may not be an appropriate measure for countries with a weak legal enforcement regime, where contracts are more easily vitiated and litigation (and litigation liabilities) is more easily circumvented.

At the top level, for example, political uncertainty, legislation and the influence of national culture are found.

Political uncertainty causes agency problems by leading to greater information asymmetry. Dai & Phong (2018) results suggest that political uncertainty leads to asymmetric timeliness of news recognition. The political uncertainty effect is stronger if the firm has greater incentives to enhance contracting efficiency and if the firm has stronger internal corporate governance mechanisms.

Lobo & Zhou (2006) found that following the Sarbanes-Oxley Act (hereafter SOX) firms report lower discretionary accruals and incorporate losses more quickly than gains. These results suggest that accounting conservatism increased compared to the period preceding SOX.

Kanagaretnam et. al (2013) studied the Influence of national culture on accounting conservatism and the risk-taking in the banking industry. They found that individualism is negatively related to conservatism and uncertainty avoidance is positively related to conservatism.

There are different consequences of accounting conservatism, for example increase in investment efficiency and less managerial risk-taking.

Lara, Osma, and Penalva (2016) studied the effect of timelier recognition of losses on firm investment efficiency. "An efficient investment policy can be defined as one in which all positive NPV investment projects are identified, funded and implemented, while all negative NPV projects are rejected" (Lara-Osma-Penalva 2016:5). According to the literature managers may be well informed about the existence of profitable investment opportunities, they might not always pursue them. Not pursuing could happen because of moral hazard problems or the lack of available funding derived from high cost of external financing. To avoid these problems accounting information could be an important tool in monitoring senior managers. For example not disclosing geographic segment information has a negative effect on the efficiency of foreign investment. They expected the increasing of firm investment efficiency because of three factors (Lara-Osma-Penalva 2016:7):

- "decreasing the adverse effect of information asymmetries between outside equity holders and managers, facilitating the monitoring of managerial investment decisions;
- increasing managerial incentives to abandon poorly performing projects earlier and to undertake fewer negative net present-value investments; and
- facilitating the access to external financing at lower cost."

Lara, Osma, and Penalva (2016) hypothesized that the timely recognition of economic losses has a significant informational role that results in improvements to firm investment efficiency. To test their assumption they used a large sample which contained financial data for the period between 1975 and 2006. They found a negative association between conditional conservatism and measures of over- and under-investment, and a positive association between conservatism and future profitability. Kravet (2014) used corporate acquisitions to study the association between managerial risk-taking and accounting conservatism. He found that managers make less risky acquisitions under more conservative accounting. This association is driven by the firms with accounting-based debt covenants.

Kuo (2018) results suggest that accounting conservatism reduces default risk.

Li et al. (2018) found that the reduction in personal litigation risk of managers leads to lower investment efficiency.

Our last topic in the literature review is conservatism in the Hungarian accounting regulation.

The Hungarian Law of Accountancy (HLA) contains both principles and detailed rules which are considered as conservative. The basic accounting principles in the HLA are the principle of going concern; the principle of completeness; “true and fair view” principle; the principle of clarity; the principle of consistency; the Principle of continuity; the principle of matching; the principle of prudence; the principle of grossing up; the principle of accruals; the principle of substance over form; the principle of materiality, the principle of individual assessment and the principle of cost-benefit.

The principle of matching and the principle of prudence are conservative. According to the principle of matching “when determining the profit or loss for a certain period of time, the revenues recognized for a given period of activities and the costs (expenditures) directly associated to such revenues shall be taken into account, regardless of financial settlement. The revenues and costs shall relate to the period in which they were incurred for economic purposes”. (HLA, Section 15) According to the principle of prudence “no profits shall be recognized where the financial realization of the revenues and certain items of income are uncertain. When determining the profit or loss for the year, foreseeable liabilities and potential losses shall be taken into account and shall be covered by provisions, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up. Depreciation impairment losses shall be accounted for, regardless of whether the income statement for the year shows a profit or a loss”. (HLA, Section 15)

We show examples related to these conservative principles. The first example is related to the principle of prudence. The valuation of assets is definitively conservative. According to Section 57 of HLA if the market value of an asset is substantially higher than the book value at which they were recognized in the books, such assets may also be recognized at their market value. In this case the difference between the cost or the net value of intangible assets and tangible assets determined by ordinary depreciation, and the market value may be shown as value adjustment for assets or as valuation reserve - in the same amount shown as value adjustment - for liabilities. This treatment is optional. According Section 53 on the Depreciation of Assets: Extraordinary depreciation shall apply in connection with intangible and tangible assets if

- the book value of the intangible or tangible asset (not including assets in course of construction) remains permanently and substantially higher than the market value of such asset;
- the value of intellectual property and tangible assets (including assets in course of construction) drops permanently because such intellectual property or tangible assets (including assets in course of construction) have become unnecessary due to a change in the entrepreneurial activities, or cannot be used for the original purpose thereof as a consequence of damage or destruction, or cannot be used at all;
- a concession or similar right can only be exercised to a limited extent or cannot be exercised at all due to the amendment of the contract;
- an activity implemented as a result of a completed experimental development project is limited or terminated, or produces no result;
- the book value of goodwill - in consequence of any change in the circumstances that affect expectations concerning future economic benefits - remains permanently and substantially higher than its market value (the amount of the expected return). Depreciation shall be carried out to an extent that the intangible assets, tangible assets and assets in course of construction are shown in the balance sheet at the known market value corresponding to the utility thereof, in effect on the balance sheet date. If an intangible or tangible asset, or an asset in the course of construction cannot be used for its intended purposes, or if it is unusable, destroyed or is missing, it shall be removed from the list of intangible assets, tangible assets or assets in course of construction after extraordinary depreciation is claimed and deducted. Any extraordinary depreciation on the basis of market value shall be claimed as on the balance sheet date; whereas extraordinary depreciation upon derecognition shall be accounted for as at the date when the asset is derecognized.

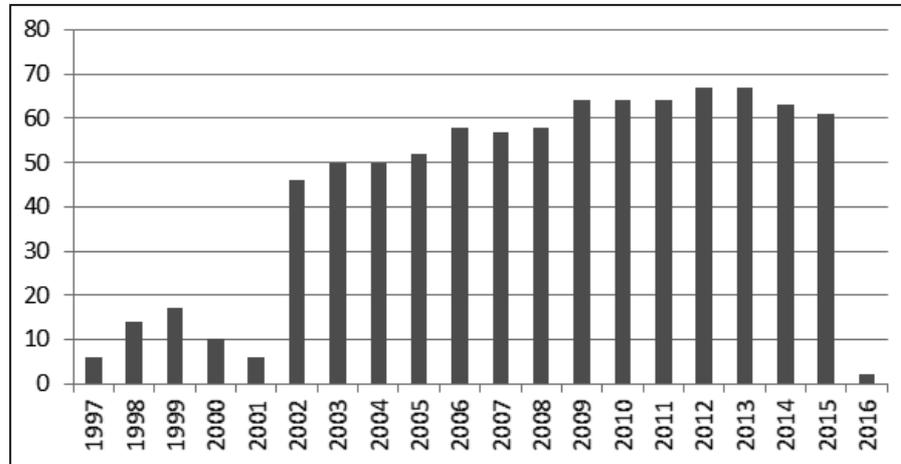
The main difference between the two treatments is that anticipating the loss is obligatory but anticipating the gains is optional.

The next example for conservatism is related to the principle of matching. Section 45 of HLA states that any support, liquid assets received without any further obligation or assets received without consideration shall be cancelled as deferred income as soon as the cost, or a commensurate part thereof, of any asset realized in the course of the development, any asset related to any cancelled liability or that of which has been assumed by a third party, or any asset received without consideration (including any asset received as a gift or bequest or any surplus asset discovered) is recognized as a cost or expenditure. Furthermore, any development grant or subsidy shown under deferred income shall be cancelled at the time such grant or subsidy is repaid. Taken together, regardless to the real obligations, gains are prohibited to recognize till the covered cost or expenditure arises.

With the help of these two principles and detailed rules example we showed that conservatism in accounting regulation still exists in Hungary. In the next chapters we will examine the tendency of the last 20 years.

Methodology

We used a sample which contains 900 financial statements data of 63 companies. The selected companies operated in Hungary and disclosed the studied financial statement about the fiscal years between 1998 and 2016. The sample was designed to examine the differences between the individual financial statements of public listed companies compared to private companies before the IFRS introduction. The present research examines how conservatism has changed over this period.



2. Figure: Financial statements per year

Source: authors' own collection from the database of Opten Kft.

The first figure shows the financial statements per year. The distribution of the statements allows us to study the tendency of change in accounting conservatism.

First we used trend analysis than linear regression to find out which influencing factors drive the timely recognition of large negative incomes.

Prior researches such as Lang-Raedy-Yetman (2003), Christensen et. al (2015), Ball-Shivakumar (2005) used timely loss recognition to measure accounting quality. With the help of LNEG dummy variable the large losses are analyzable.

$$\frac{NI_t}{TAS_t} \leq -0,2 \rightarrow LNEG_t = 1 \quad (1)$$

$$\frac{NI_t}{TAS_t} > -0,2 \rightarrow LNEG_t = 0 \quad (2)$$

Where,

NI_t = Net income in year t.

TAS_t = Total assets in year t.

$LNEG_t$ = Dummy variable.

To analyze the drivers of timely loss recognition we used the following equation:

$$\text{LNEG}_{ti} = \alpha_0 + \beta_1 \text{SIZE}_{ti} + \beta_2 \text{LEV}_{ti} + \beta_3 \text{TURN}_{ti} + \beta_4 \text{LIST}_{ti} + \beta_5 \text{ZSCORE}_{ti} + \beta_6 \text{EU}_{ti} + \beta_7 \Delta \text{GDP}_{ti} + \varepsilon_{ti} \quad (3)$$

Where

SIZE_{ti} = The natural logarithm of total assets of company i at fiscal year-end t ;

LEV_{ti} = Total liabilities divided by equity book value of company i at fiscal year-end t ;

TURN_{ti} = Revenues of company i at fiscal year t divided by total assets of company i at fiscal year-end t ;

LIST_{ti} = Indicator variable that equals one if the firm is listed on Budapest Stock Exchange;

ZSCORE_{ti} = The Z score of Altman (1968) of company i at fiscal year-end t ;

EU_{ti} = Indicator variable that equals one if the financial statement disclosed after 2004;

ΔGDP_{ti} = Percentage change in the Hungarian gross domestic product in year t .

We calculated the Z score using the equation 4.

$$Z = 0,012x_1 + 0,014x_2 + 0,033x_3 + 0,006x_4 + 0,999x_5 \quad (4)$$

Where

x_1 : (current assets-current liabilities)/total assets,

x_2 :(equity-subscribed capital)/ total assets,

x_3 : profit before taxes/ total assets,

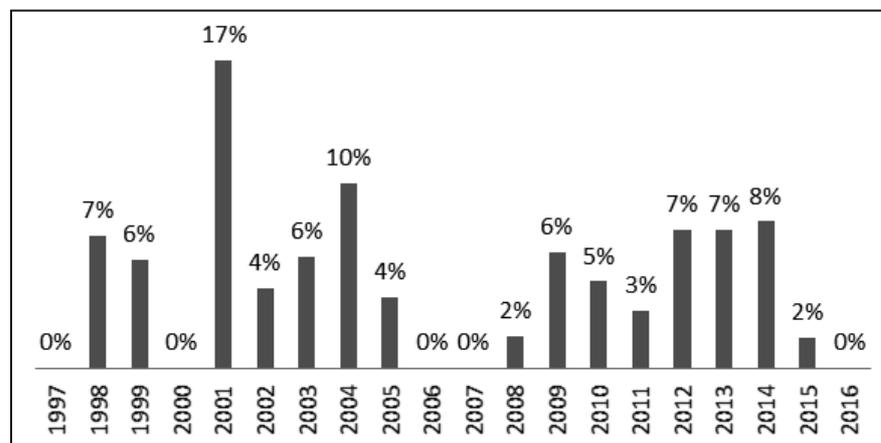
x_4 : equity/total liabilities,

x_5 : revenues/ total assets,

Change in gross domestic product may explain the change in net income, to quantify the effect of economic growth we use change in GDP as an explanatory variable.

Results

After eliminating the missing values, our sample contained 877 financial statements data. Fifty-one percent of these firms are public forty-nine percent are private company. Forty-seven percent of the statements were disclosed by public, fifty-three percent were disclosed by private companies. In accordance with the regulation every financial statement prepared by public listed firm is audited. Due to the sample matching process ninety-nine percent of the financial statements prepared by private company are audited, as well. Seventy-seven percent of the financial statements were disclosed after Hungary became an EU member state.



3. Figure - Percentage of LNEG per year

Source: authors' own collection from the database of Opten Kft.

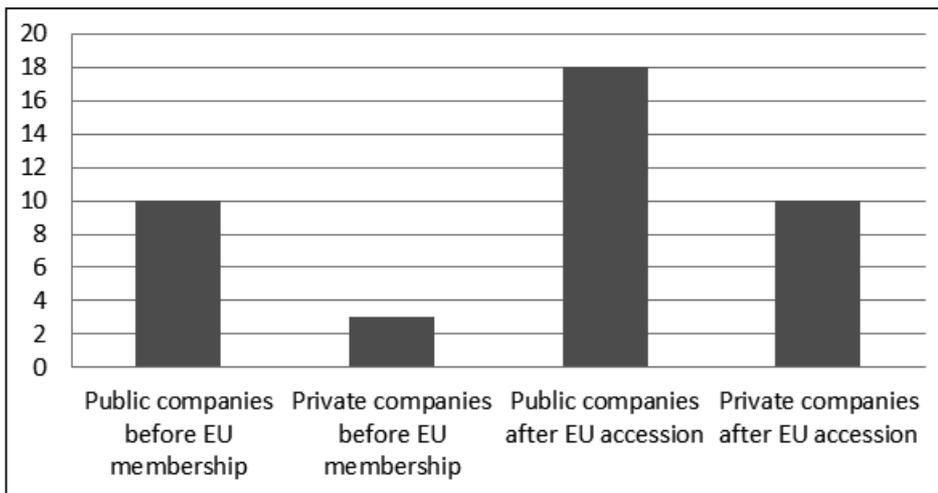
Figure 2 shows the ratio of large losses to the analyzed financial statement in a given year. The results are wavering.

Coefficients (lneg)	Beta	Std.err.	St.Beta	t	sig
<i>size</i>	-0,013	0,009	-0,051	-1,514	0,130
<i>lev</i>	0,001	0,000	0,143	4,290	0,000
<i>turn</i>	-0,005	0,005	-0,036	-1,077	0,282
<i>list</i>	0,036	0,014	0,086	2,555	0,011
<i>zscore</i>	-3,98E-05	0,000	-0,017	-0,494	0,621
<i>eu</i>	-0,035	0,019	-0,069	-1,862	0,063
<i>gdp</i>	-0,230	0,266	-0,032	-0,868	0,386

Table 1 – The coefficients of LNEG;

Source: authors' own collection

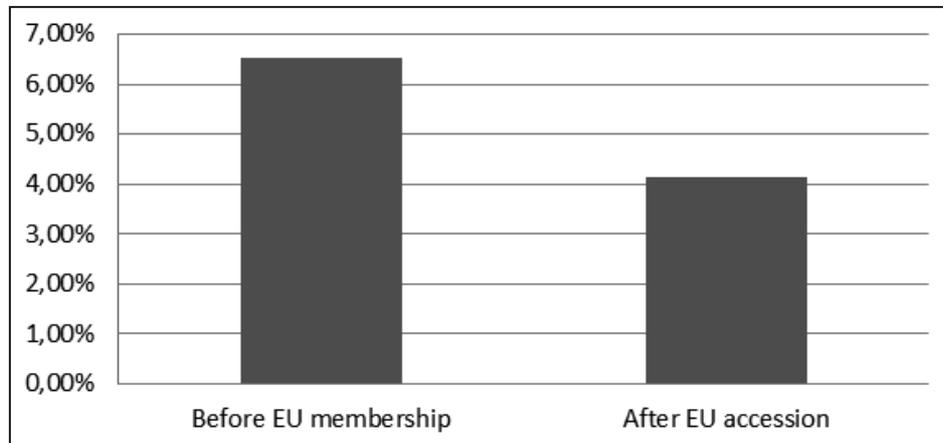
Timely loss recognition does not show a clear increase or decrease in the period under review. What determines timely loss recognition? To study this we used linear regression like for example Christensen et. al (2015). Looking at the coefficients, indebtedness, stock market presence and the EU membership can be correlated with timely loss recognition. The following figure shows the recognition of large losses for both binary groups.



4. Figure - Timely loss recognition before/after EU accession, for public and private companies

Source: authors' own collection

Figure 4 shows positive association in both groups. Both stock market presence and EU membership means more frequent disclosure of large negative incomes. The sample contains fifty-one percent of public and forty-nine percent of private companies, but the sample is asymmetric in connection with EU membership. We can get a different result if we analyze the ratios instead of the number of pieces.



5. Figure – Percentage of timely loss recognition before/after EU accession

Source: authors' own collection

Examining ratios, timely loss recognition have not increased but decreased after the EU accession.

Conclusions

Conservatism is still a living accounting principle. Recent researchers like Basu (1997) and Watts (2003) suggest that it seems not only to have survived but also increased in the last three decades. There are different explanations for accounting conservatism. Watts (2003), for example, collected the contractual explanation, the increase in shareholder litigation, the tax system's influence on financial reporting accounting methods, a regulatory explanation. The most common explanation is the contractual explanation. Contracts mean the formal contracts between the parties to the firm extended with the firm's organizational arrangements such as managerial accounting, control system and taxation. The literature suggests that these contracts require conservative accounting practice to mitigate the agency problems. To test the trend of accounting conservatism, we examined timely loss recognition in Hungary for the last 20 years. Our sample contained the data of 877 financial statements. The distribution of the statements allows us to study the tendency of the change in accounting conservatism. Based on the sample of this research, we couldn't establish a clear trend in the development of accounting conservatism. Accounting conservatism still exists in the regulation, but this has not led to an increase in timely loss recognition. I recommend this area and the the factors that make the financial statements conservative for the attention of future researchers.

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