

The Seeds of Accounting Conservatism

David S. Christensen

ABSTRACT

Why does the accounting principle of accounting conservatism persist, despite the criticism of 20th-century deductive accounting theorists? Accounting conservatism's etymology suggests that the traditional connotation of deliberate understatement began in America, circa 1900. Its genealogy, however, reaches much deeper into the past. This research adds to the work of Basu (1997; 2009) who reports evidence of accounting conservatism in medieval Europe and China, and to the work of Bloom (2018) and Watts (2003), who provide modern rationales for accounting conservatism. By using key elements derived from its definition, accounting conservatism's genealogy is traced from ancient times to the 20th century. A review of major works on accounting history and notable articles on accounting conservatism reveals that the seeds of accounting conservatism predate Pacioli, and were sown for largely pragmatic reasons. As long as accounting retains its pragmatic flavor, accounting conservatism will likely survive its critics. It has passed the test of time.

Keywords: Accounting Conservatism, Accounting History, Accounting Principles, Lower of Cost or Market.

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I. THE ETYMOLOGY OF ACCOUNTING CONSERVATISM

The most recent, authoritative accounting definition of accounting conservatism appears in Statement of Financial Accounting Concepts No. 2 (SFAC2), "Qualitative Characteristics of Accounting Information" (FASB, 1980). In the glossary of terms, accounting conservatism is defined as a "prudent reaction to uncertainty." A key word in this definition is "prudent". In fact, in paragraph 92 the FASB implies that prudence and accounting conservatism are synonymous: "There is a place for a convention such as accounting conservatism (meaning prudence) in financial accounting and reporting". According to the Scribner-Bantam English Dictionary, prudence means "to be wise in practical things", (1980, p. 728) or "to be careful or cautious". Thus, accounting conservatism in financial accounting and reporting is intended to connote a feeling of caution and care. Also, if to be practical is to base one's ideas and judgments on experience rather than on theory, then accounting conservatism also connotes a pragmatic approach toward accounting measurement and reporting.

Accounting conservatism has traditionally connoted an intentional penchant for understating net assets and net income. The adage "anticipate no profits but provide for all possible losses" is a fairly concise definition of the convention. In its discussion of accounting conservatism, the FASB laments its inability to discourage this particular bias by recalling that for over forty years it has been unable to change the "deeply ingrained" penchant for pessimism (paragraph 93). At the same time, however, the FASB does suggest that when a choice must be made between two

equally likely estimates of amounts to be received or paid in the future, accounting conservatism dictates using the less optimistic estimate (paragraph 95). It seems, therefore, that the traditional connotation of accounting conservatism still remains, though in a somewhat subtler form--instead of using some compromise between two equally likely estimates, accounting conservatism dictates choosing the less optimistic estimate (Devine, 1963).

The original meaning of accounting conservatism did not imply understatement. Gilman (1939, p. 233) reports that the Oxford English Dictionary (1897) defines the adjective, conservative, as "characterized by a tendency to preserve or keep intact or unchanged". In 1933 the Oxford English Dictionary Supplement included an additional definition: "Characterized by caution or moderation; (esp. of an estimate) purposely or deliberately low or 'on the right side'." The dictionary also states that this particular meaning originated in the United States. Thus, the word's etymology suggests that the "traditional" connotation of understatement began in America during the early 20th century.

Given this rather negative 20th-century connotation, accounting theorists have generally been critical of the convention and have not known quite how to deal with it. For example, it has been variously described as a convention (FASB, 1980), a modifying convention (Accounting Principles Board (APB), 1970), a "fundamental principle of valuation" (Sterling, 1967, p. 524), "the most objectionable and obstructive tradition of accounting" (Paton, 1948, p. 279), the "first virtue of accounting" (May 1943, p. 44), a doctrine or article of faith (Gilman, 1939), a principle of accounting (Sanders *et al.*, 1938), a "brilliant piece of flabby

thinking” (Hatfield, 1927 AIA meeting), and a piece of *time-honored hokum* (Greer, 1925).

As indicated by the variety of names given accounting conservatism, accounting theorists have generally not favored accounting conservatism. Why then has it persisted despite the lack of support? It is suggested that accounting conservatism has a genealogy that pre-dates accounting theory. Accounting conservatism has developed pragmatically, independent of theory. As long as factors that fostered accounting conservatism exist, accounting conservatism will persist, despite the theoretical objections.

II. THE GENEALOGY OF ACCOUNTING CONSERVATISM

Elements of accounting conservatism (caution and care) appear in the stewardship accounting system of Zenon. In 256 B.C., Zenon was a manager for a large private estate of the Greek finance minister, Apollonius. Each area of the estate had a supervisor or steward. Each steward was required to keep meticulous records of every transaction affecting his stewardship. In addition, each record was subject to the approval of Zenon or one of his assistants and to a detailed audit.

According to Chatfield (1977), the purpose of such detail in record-keeping and audit was asset protection. There was no report to outsiders, no classifications, no “bottom-line” profit number, and no distinction between capital and revenue expenditures. Thus, the extreme care and caution implicit in such a system reflect an early, pragmatic rationale for accounting conservatism: asset protection.

Another element of accounting conservatism (reluctance to change) is seen in medieval account keeping. In particular, the early association of accounting conservatism with stewardship accounting is seen in the English manorial accounting system. In this case, however, the objective was not only to safeguard the system's assets, but also to maintain the system's status quo or equilibrium via an extensive system of internal reporting and manorial audit. The change was an anathema to the manor. As with the Apollonius estate, the manorial estate was a largely self-sufficient, economically independent entity. As a result, there was no requirement for outside reporting to creditors or tax assessors, there was no profit motive, and there was no distinction between capital and revenue expenditures. According to Chatfield,

The lord's incentive for keeping accounts arose from his need to check on the integrity and reliability of these stewards (...) little of what we call financial accounting was needed (...) Manorial officers thus kept accounts, not for the sake of the business entity (...) but for their own protection (1977, p. 25)

The purpose of the manorial “charge and discharge statement” was thus to show that individual stewardship duties had been performed. Accordingly, each steward would record and report on “just those items for which he was responsible” (1977, p. 25). Surely, in such a vertically integrated, static system, the concept of change was dangerous and the idea of accounting conservatism was likely a tacit mechanism that discouraged change.

In addition to maintaining an equilibrium or status quo, the manorial accounting system fostered accounting conservatism via the annual manorial audit. The audit was a

check on each steward's accountability. According to Chatfield (1977),

The view of account thus became a subtle contest between the auditor and steward. The latter wished to render accounts profitably for himself by estimating losses generously and revenues and natural increase conservatively. In contrast, the auditor's charge was that the lord must suffer no loss from fraud, negligence, or bad judgment (p. 27).

The period between Pacioli and the late 19th century has been called accountancy's “Age of Stagnation” by DeRoover (1955). During this period bookkeeping procedures were refined and disseminated, but accounting concepts did not develop. There was no enforced consistency, and managers-owners relied primarily on the detail in the ledger records. Indeed, the Age of Stagnation might just as well be called the “Age of the Ledger”. There was no general interest in profit-finding or asset valuation. According to Chatfield (1977, p. 60), the balance sheet was not a statement of values, but an inventory of fixed assets. Asset valuation was eclectic. There was no tradition of reporting to outsiders. It is little wonder then that little reference can be found to accounting conservatism. However, there are occasional references to its operational offspring, the lower-of-cost-or-market (LCM) rule.

The genealogy of the LCM rule has been extensively researched by Gilman (1939), Littleton (1941), Vance (1943), and Parker (1965). Littleton argues that the rule was largely the result of expediency and convenience. The first records showing the use of the rule in inventory valuation are found in the accounts of Francisco di Marco, an Italian trader, banker, and cloth-maker in 1404. Littleton claims the policy of write-downs was an early attempt at avoiding a rather heavy Italian tax burden. Thus, tax expediency was the rationale for the rule.

Another major application of the rule appears in Jacques Savary's book, *The Perfect Merchant* (1676). Because Savary (1622-1690) is also the author of the French Code of 1673, requiring biennial inventories by merchants and bankers, Littleton suggests that the courts used the rule as a convenient mechanism to narrow the opportunity for fraud. According to Littleton, Savary's rationale for the rule was not tax avoidance but to prevent falsification. The accounting records were used as evidence to settle issues of business failure, succession rights, and partnership dissolutions. The fear of fraudulent bankruptcy was particularly poignant to the merchant who could be beheaded if found guilty! Littleton also references the German Commercial Code of 1897, which required the LCM rule in inventory pricing, as additional evidence of the use of accounting conservatism as a legal instrument. To Littleton, then, convenience and expediency were the reasons for the early appearances of the LCM rule (and indirectly for accounting conservatism). In France and Germany, the rule was used to narrow the opportunity for fraud; in Italy, the rule was for tax avoidance.

Vance disputes Littleton's conclusions and argues instead that the LCM rule was a response to the growing needs of businessmen. With respect to tax expediency, Vance argues that the Italian tax was not based on accounting records and that there were other, more effective tax-avoidance strategies. With respect to convenience, Vance argues that the French

code simply did not require the LCM rule, and the German code included the rule in response to the 1873 panic involving listing balance sheet assets at probable sales prices.

Vance's rationale for the LCM rule generally involves the growing needs of businessmen to deal with inventory valuation problems created by an increasing volume of transactions. In venture accounting, inventories were small, accounts were closed irregularly and the profit-motive was weak. Evidence of the LCM rule is therefore rather sparse in early accounting literature. When some organizations did grow large, as with Francisco di Marco, the volume of transactions was larger and more regular, and the profit motive was more apparent to the merchant. Thus, "the cost-or-market rule is an effort to give effect in the profit computation of one period to the forces operating in that period which will not be reflected in the sales or cash accounts until a subsequent period" (Vance, p. 227).

Parker (1965) traced the genealogy of the LCM rule in Britain and the United States. Up to the 19th century, inventory valuation was eclectic. Parker is in full agreement with Vance (1943) and DeRoover (1963) that venture accounting generally eliminated the need for inventory valuation. Early textbooks describe inventory valuations at cost (Peele, 1569), LCM (Savary, 1676), market or cost (Hayes, 1741), market (Hamilton, 1788), prime cost (Jones, 1797), and prime cost or market (Morrison, 1813).

It was not until the middle to late 19th century that the LCM rule appeared to have gained general acceptance as "traditional". In examples cited by Parker (1956, p. 158), the rule was described by Sawyer as a "recognized principle" in his textbook, *Bookkeeping for the Tanning Trade* (1862), and May (1954) claims that the rule was well-established when he entered the profession in England in 1892. In another example, Gilman (1939, p. 439) relates an incident in which a member of the Manchester Accountants Students' Society (1885) claimed the LCM rule was "thoroughly orthodox".

There is some question about whether other forms of accounting conservatism actually existed in the 19th century. Brief (1965) maintains that there is little evidence supporting any policy of deliberate understatement:

The evidence suggests that capital consumption costs were neglected in many cases. This means that assets and profits were overstated (...) The only conclusion that is consistent with the evidence is that the accounting practices and the nature of the accounting error in the 19th century were not stable (p. 30).

Accounting conservatism is often cited as the rationale for the LCM rule. George May (1954), for example, suggested the rule became generally accepted because of "natural accounting conservatism and falling prices" (p. 16). It is interesting to note that May spent his early professional years involved almost entirely in bankruptcy work (Grady, 1962). Accounting conservatism was natural to May and other British accountants because the English environment had conditioned it. Parker (1965) thus develops a plausible thesis that this late 19th-century manifestation of accounting conservatism resulted from years of conditioning in which failures, frauds, and falling prices made accounting conservatism a fetish. The profession was "born through bankruptcies, fed on failures and frauds, grew on liquidations, and graduated through audits" (Robinson, 1964, p. 30). In

short, it filled the profession with "a vivid sense of disaster" (Sampson, 1965, p. 525).

Another plausible rationale for the development of 19th-century accounting conservatism is developed by MacNeal. In *Truth in Accounting* (1939) MacNeal describes three phases in the development of asset valuation. During the first phase (roughly equivalent to DeRoover's Age of Stagnation), the owner-manager dominated asset valuation. The valuation was eclectic because the manager-owner was the accountant's only employer, and this employer knew his business well enough to value it himself. During the second phase (roughly beginning with the Industrial Revolution), the need for outside financing allowed creditors to insist on independently-prepared financial statements. The accountant now had two groups to serve: the creditor and the owner-manager. In the third phase (roughly beginning with the 20th century), the owner was replaced by thousands of generally uninformed stockholders, and there were three groups for the accountant to serve: managers, creditors, and investors.

According to MacNeal, it was during the second phase that accounting conservatism received a major impetus. The creditors were "only interested in knowing that earnings and net worth were at least as great as represented" (p. 73). Any understatement of earnings and net worth meant additional security to the creditor. Businessmen came to see that credit came easily when it was known that they had understated net worth and earnings. Understatement meant they were "better than their word" (p. 74), and became a mark of success and stability. Given this peculiar demand for undervaluation, accountants naturally came to view the prevention of overstatement as their sole duty. It was thought that understatement harmed no one and provided creditors with a margin of safety. Thus, the LCM rule became orthodox, and "the consensus on asset valuation which emerged from the 19th century was that historical cost should normally be the maximum asset value" (Chatfield, p. 97).

When Parker's thesis of pessimism and MacNeal's thesis of creditor pressure are combined, there is little wonder why the English public accountant was not considered a valuer. In 1906 an English court concluded:

The purpose of the balance sheet is primarily to show that the financial condition of the company is at least as good as there stated, not to show that it is not or may not be better (Newton versus Birmingham Small Arms, as cited in Parker, 1965, p. 24).

Conditions in America were different than in England, but by 1900 accounting conservatism was "the dominant accounting principle" and "even more strongly entrenched" (Chatfield, p. 233). Consistent with MacNeal's thesis, 19th-century American corporations were usually small and received most of their early financing from short-term bank loans. Consequently, there was an emphasis on liquidity rather than on earnings. It was not until 1920-21 during the "inventory depression" that debt financing fell into disfavor and equity financing became a popular alternative. But as long as short-term financing was the rule, the balance sheet and the pragmatic feeling that accounting conservatism was a safe policy dominated all the theoretical criticisms of accounting authorities (Chatfield, p. 72).

Early 20th-century accounting authorities generally agree that accounting conservatism is illogical but concede to it on

the grounds of pragmatism. According to Previts and Merino (1979), English-born or English-influenced accountants, such as May and Montgomery, tended to maintain the most favorable views of accounting conservatism. American writers, such as Littleton, Paton, and Hatfield, are more critical, but also concede to it. In 1913, for example, Hatfield writes that though the policy of understating a firm's assets may be "the lesser of two evils, (it) nevertheless falls short of the ideal standard of accounting" (p. 85). Later, in a rather colorful example, Hatfield laments:

The accountant transcends the accounting conservatism of the proverb, "Do not count your chickens before they are hatched," saying "Here are a lot of chickens already safely hatched, but for the love of Mike, use discretion and don't count them all for perhaps some will die (1927, p. 256).

In another somewhat revealing anecdote, DR Scott (1926, p. 18) delivered an "obituary notice" to accounting conservatism in general and to the LCM rule in particular before a group of accounting educators. In the discussion that followed, Filbey claimed that "the reports of the death of this rule have been greatly exaggerated" (p. 24) and that practitioners were not willing to abandon it.

With the advent of the corporation in the 20th century came additional reasons for accounting conservatism. MacNeal (1939) and Sterling (1967) suggest that the accountant was unprepared for the change in ownership. The accountant was suddenly faced with an overwhelming responsibility when the relatively well-informed user group, consisting of powerful bankers and owner-managers, was overshadowed by "thousands or hundreds of thousands of uninformed stockholders" (MacNeal, p. 71). Without the creditor's demand for understatement, management's natural tendency for optimism and overstatement required a moderating influence. Thus, the time-honored tradition of accounting conservatism was seen as an offsetting force necessary to "strike a balance" (Sterling, 1967, p. 521) to protect the shareholder from management bias. In a somewhat related vein, Devine (1963) has suggested that accounting conservatism also serves the needs of auditors who wish to avoid legal liability.

Other significant factors affecting accounting conservatism in the 20th century include the income tax laws, the 1929 Depression, and the codification efforts. According to Chatfield, the income tax laws "gave businessmen a vested interest in financial understatement" and "strengthened the conservative view of asset valuation" (p. 238). Tax deferring techniques such as LIFO and accelerated depreciation also tended to reinforce accounting conservatism. The 1929 Depression further entrenched historical cost valuation and prompted additional regulation and codification efforts. According to Chatfield (p. 279), the Securities Exchange Commission encouraged understatement and concealment by discouraging price-level-adjusted data, financial forecasts, and appraisals.

It is difficult to assess the impact of codification on accounting conservatism. Generally, if the codification effort was largely descriptive of existing practices, then accounting conservatism was included as a principle; deductive efforts either completely ignored accounting conservatism or criticized it as illogical and inconsistent. In the 1932 AIA-NYSE letter (reprinted in May 1943), accounting

conservatism is not referenced in a listing of five principles, but the LCM rule was recognized as the most commonly accepted inventory method. In Byrne's 1937 essay, accounting conservatism is included in a listing of eight principles, which are defined as "fundamental truths." In "A Statement of Accounting Principles" (Sanders *et al.*, 1938), accounting conservatism is referenced as the sixth "general principle". Paton and Littleton's *An Introduction to Corporate Accounting Standards* (1940) was the first deductive codification effort (Chatfield, p. 292), and accounting conservatism is not supported (pp. 80-81, 126-129). Similarly, the deductive efforts of the American Accounting Association (1936; 1941; 1948; 1957; 1966) have not supported accounting conservatism. The APB has attempted both inductive (Grady, 1965) and deductive (Sprouse & Moonitz, 1962) approaches, in which accounting conservatism was respectively listed as a principle or ignored.

III. CONCLUSION

The seeds of accounting conservatism are ancient. Accounting conservatism's roots can be traced to the detailed stewardship system of Zenon, reflecting extreme caution and care, and to the medieval account-keeping system, where (1) the manorial need for constancy and stability is apparent in the "charge and discharge statement" and (2) the steward's need for protection is elicited by the manorial audit. The "balancing contest" between the auditor and steward is particularly reminiscent of the 20th-century rationale for accounting conservatism offered by Gilman, MacNeal, and Devine.

Accounting conservatism's flower, the LCM rule, has been traced to ancient times, but its general acceptance apparently did not occur until the middle to late 19th century. Littleton's rationale for its ancient appearance, tax expediency, and legal convenience, have also been offered as rationale for 20th-century accounting conservatism.

In the middle to late 19th century, accounting conservatism received a major impetus when creditors' dominant influence over business made the balance sheet supreme (MacNeal). It has also been suggested that during this time period, a conservative attitude was conditioned by decades of fraud and failures (Parker 1965). Parker's thesis of pessimism and MacNeal's thesis of creditor pressure are persuasive explanations for accounting conservatism's dominating position by 1900.

Deductive accounting theorists since 1900 have not been able to completely dislodge accounting conservatism's influence, probably because its roots reach deep into history and its seeds were sown for largely pragmatic reasons. As a kind of vindication of the enduring influence of accounting conservatism, in 2018 the International Accounting Standards Board (IASB) revised its conceptual framework to include "prudence", defined as "the exercise of caution under conditions of uncertainty".

CONFLICT OF INTEREST

Authors declare that they do not have any conflict of interest.

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