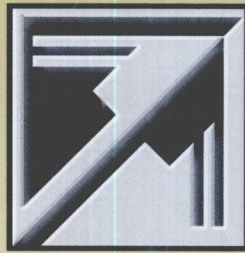


FOURTH EDITION

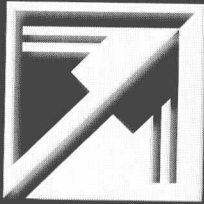
ACCOUNTING



FOR
DECISION MAKING
AND
CONTROL

JEROLD L. ZIMMERMAN

Fourth Edition



Accounting for Decision Making and Control

Jerold L. Zimmerman
University of Rochester



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ACCOUNTING FOR DECISION MAKING AND CONTROL

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This book is printed on acid-free paper.

4 5 6 7 8 9 0 DOW/DOW 0 9 8 7 6 5 4

ISBN 0-07-250179-0

Publisher: Brent Gordon

Sponsoring editor: Steve DeLancey

Developmental editor: Kelly Odom

Marketing manager: Ryan Blankenship

Project manager: Catherine R. Schultz

Lead production supervisor: Heather D. Burbidge

Coordinator freelance design: Mary L. Christianson

Supplement producer: Vicki Laird

Typeface: 11/12 Goudy

Compositor: Cenveo Indianapolis

Printer: R. R. Donnelley & Sons Company

Library of Congress Cataloging-in-Publication Data

Zimmerman, Jerold L., 1947

Accounting for decision making and control / Jerold L. Zimmerman.—4th ed.

p. cm.

Various multi-media instructional materials are available to supplement the text.

Includes index.

ISBN 0-07-250179-0 (alk. paper)—ISBN 0-07-119915-2 (international : alk. paper)

I. Title.

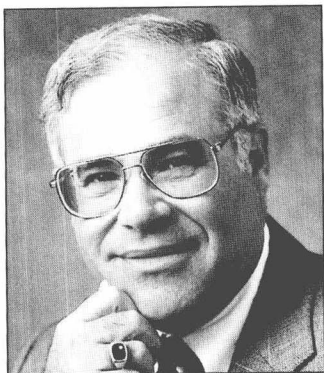
HF5657.4.Z55 2003

658.15'11—dc21

2002024630

To: Miriam and Harry

About the Author



Jerold L. Zimmerman

Jerold Zimmerman is Ronald L. Bittner Professor at the William E. Simon Graduate School of Business, University of Rochester. He holds an undergraduate degree from the University of Colorado, Boulder, and a doctorate from the University of California, Berkeley.

While at Rochester, Dr. Zimmerman has taught a variety of courses spanning accounting, finance, and economics. Accounting courses include non-profit accounting, intermediate accounting, accounting theory, and managerial accounting. A

deeper appreciation of the challenges of managing a complex organization was acquired by spending four years as Deputy Dean of the Simon School.

Professor Zimmerman publishes widely in accounting on topics as diverse as cost allocations, municipal accounting, budgeting, taxes, auditing, financial accounting theory, mergers and acquisitions, trade unions, capital markets, and executive turnover. His paper, "The Costs and Benefits of Cost Allocations," won the American Accounting Association's Competitive Manuscript Contest. He is recognized for developing Positive Accounting Theory. This work, co-authored with colleague Ross Watts, also at the University of Rochester, received the American Institute of Certified Public Accountants' Notable Contribution to the Accounting Literature Award for "Towards a Positive Theory of the Determination of Accounting Standards" and "The Demand for and Supply of Accounting Theories: The Market for Excuses." Both papers appeared in the *Accounting Review*. They are also co-authors of the highly cited textbook, *Positive Accounting Theory* (Prentice Hall, 1986). Professor Zimmerman's textbooks also include: *Managerial Economics and Organizational Architecture* with Clifford Smith and James Brickley, 2nd ed. (McGraw-Hill/Irwin, 2001) and *Management Accounting: Analysis and Interpretation* with Cheryl McWatters and Dale Morse (McGraw-Hill/Irwin, 2001). A founding editor of the *Journal of Accounting and Economics*, published by North-Holland, this scientific journal is one of the most highly referenced accounting publications.

He and his wife Dodie have two daughters, Daneille and Amy. Jerry has been known to occasionally engage friends and colleagues in an amicable diversion on the links.

Preface

During their professional careers, managers in all organizations, profit and non-profit, interact with their accounting systems. Sometimes the manager uses the accounting system to acquire information for decision making. At other times, the accounting system measures the performance and thereby influences the behavior of the manager. The accounting system is both a source of information for decision making and part of the organization's control mechanisms—thus, the title of the book, *Accounting for Decision Making and Control*.

The purpose of this book is to provide students and managers with an understanding and appreciation of the strengths and limitations of an organization's accounting system, thereby allowing them to be more intelligent users of these systems. This book provides a framework for thinking about accounting systems and a basis for analyzing proposed changes to these systems. The text demonstrates that managerial accounting is an integral part of the firm's organizational architecture, not just an isolated set of computational topics.

Distinguishing Features

Conceptual Framework

This book differs from other managerial accounting texts in several ways. The most important difference is that it offers a conceptual framework for the study of managerial accounting. This book relies on **opportunity cost** and **organizational architecture theory** as the underlying framework to organize the analysis. Opportunity cost is the conceptual foundation underlying decision making. While accounting-based costs are not opportunity costs, in some circumstances accounting costs provide a starting point to estimate opportunity costs. The theory of organizations provides the conceptual foundation to understand how accounting is employed as part of the organization's control mechanism. These two concepts, opportunity costs and organization theory, provide the framework and illustrate the trade-offs created when accounting systems serve both functions: decision making and control.

Trade-Offs

This text emphasizes that there is no “free lunch”; improving an accounting system's decision-making ability often reduces its effectiveness as a control device. Likewise, using an accounting system as a control mechanism usually comes at the

expense of using the system for decision making. Most texts discuss the importance of deriving different estimates of costs for different purposes. Existing books do a good job illustrating how accounting costs developed for one purpose, such as inventory valuation, cannot be used without adjustment for other purposes, such as a make-or-buy decision. However, these books often leave the impression that one accounting system can be used for multiple purposes as long as the users make the appropriate adjustments in the data.

What existing texts do not emphasize is the trade-off between designing the accounting system for decision making and designing it for control. For example, activity-based costing presumably improves the accounting system's ability for decision making (pricing and product design), but existing texts do not address what activity-based costing gives up in terms of control. *Accounting for Decision Making and Control* emphasizes the trade-offs managers confront in an organization's accounting system.

Economic Darwinism

A central theme throughout this book is **economic Darwinism**, which simply implies that accounting systems that survive in competitive industries must be yielding benefits that are at least as large as their costs. While newer accounting innovations such as activity-based costing are described, the text also indicates through a series of company histories that many elements of today's modern costing systems can be traced back to much earlier times. It is useful to understand that today's managers are struggling with the same accounting issues as their predecessors, because today's students will also be struggling with the same problems. These problems continue to exist because they involve making trade-offs, usually between systems for decision making (e.g., product pricing and make-buy decisions) versus control (e.g., performance evaluation).

Accounting systems differ across firms and change as firms' circumstances change. Today's students will be making these trade-offs in the future. The current rage in managerial accounting texts is to present the latest, most up-to-date accounting system innovations. While recent innovations are important to discuss, they should be placed in their proper perspective. Traditional absorption costing systems have survived the test of time for over one hundred years. Accounting system innovations are new, not necessarily better. We certainly do not know if they will survive.

Logical Sequence

Another meaningful distinction between this text and other books in the field is that the chapters in this text build on one another. The first four chapters develop the opportunity cost and organization theory foundation for the course. The remaining chapters apply the foundation to analyzing specific topics such as budgets and standard costs. Most of the controversy in product costing involves apportioning overhead. Before absorption, variable, and activity-based costing are described, an earlier chapter provides a general analysis of cost allocation. This analysis is applied in later chapters as the analytic framework for choosing among the various product costing schemes. Other books emphasize a modular, flexible approach that allows instructors to devise their own sequence to the material, with the result that these courses often appear as a series of unrelated, disjointed topics without any underlying cohesive framework. This book has 14 chapters, compared with the usual 18–25. Instead of dividing a topic such as cost allocation into three small, disjointed chapters, most topics are covered in one or at most two unified chapters.

End-of-Chapter Material

The end-of-chapter problem material is an integral part of any text, and especially important in *Accounting for Decision Making and Control*. The problems and cases are drawn from actual company applications described by former students based on their work experience. Many problems require students to develop critical thinking skills and to write short essays after preparing their numerical analyses. Good problems get students excited about the material and generate lively class discussions. Some problems do not have a single correct answer. Rather, they contain multiple dimensions demanding a broad managerial perspective. Marketing, finance, and human resource aspects of the situation are frequently posed. Few problems focus exclusively on computations.

Changes in the Fourth Edition

Based on extensive feedback from instructors using the first three editions and from my own teaching experience, the fourth edition focuses on improving the book's readability and accessibility. In particular, the following changes were made:

- Each chapter was revised based on student and instructor feedback. More intuitive, easier-to-understand numerical examples were added.
- A pricing appendix was added to Chapter 2.
- Additional actual company practices were integrated into the text.
- Additional problem material, study questions, and cases supplement the existing problems. Users were uniform in their praise of the problem material. They found it challenged their students to critically analyze multidimensional issues while still requiring numerical problem-solving skills. Further problems and cases to complement this selection were added.
- More emphasis is placed on EVA[®] (Chapter 5) and the balanced scorecard (Chapter 14).

Overview of Content

Chapter 1 presents the book's conceptual framework by using a simple decision context regarding accepting an incremental order from a current customer. Unlike the first chapters of other books, Chapter 1 of *Accounting for Decision Making and Control* describes why firms use a single accounting system and the concept of economic Darwinism, among other important topics. This chapter is an integral part of the text.

Chapters 2, 4, and 5 present the underlying conceptual framework. The importance of opportunity costs in decision making, cost-volume-profit analysis, and the difference between accounting costs and opportunity costs are discussed in Chapter 2. Chapter 4 summarizes recent advances in the theory of organizations and Chapter 5 describes the crucial role of accounting as part of the firm's organizational architecture. Chapter 3 on capital budgeting extends opportunity costs to a multiperiod setting. This chapter can be skipped without affecting the flow of later material. Alternatively, Chapter 3 can be assigned at the end of the course.

Chapter 6 applies the conceptual framework and illustrates the trade-off managers often must make between decision making and control in a budgeting system. Budgets are a decision-making tool to coordinate activities within the firm and are a device to control behavior. This chapter provides an in-depth illustration

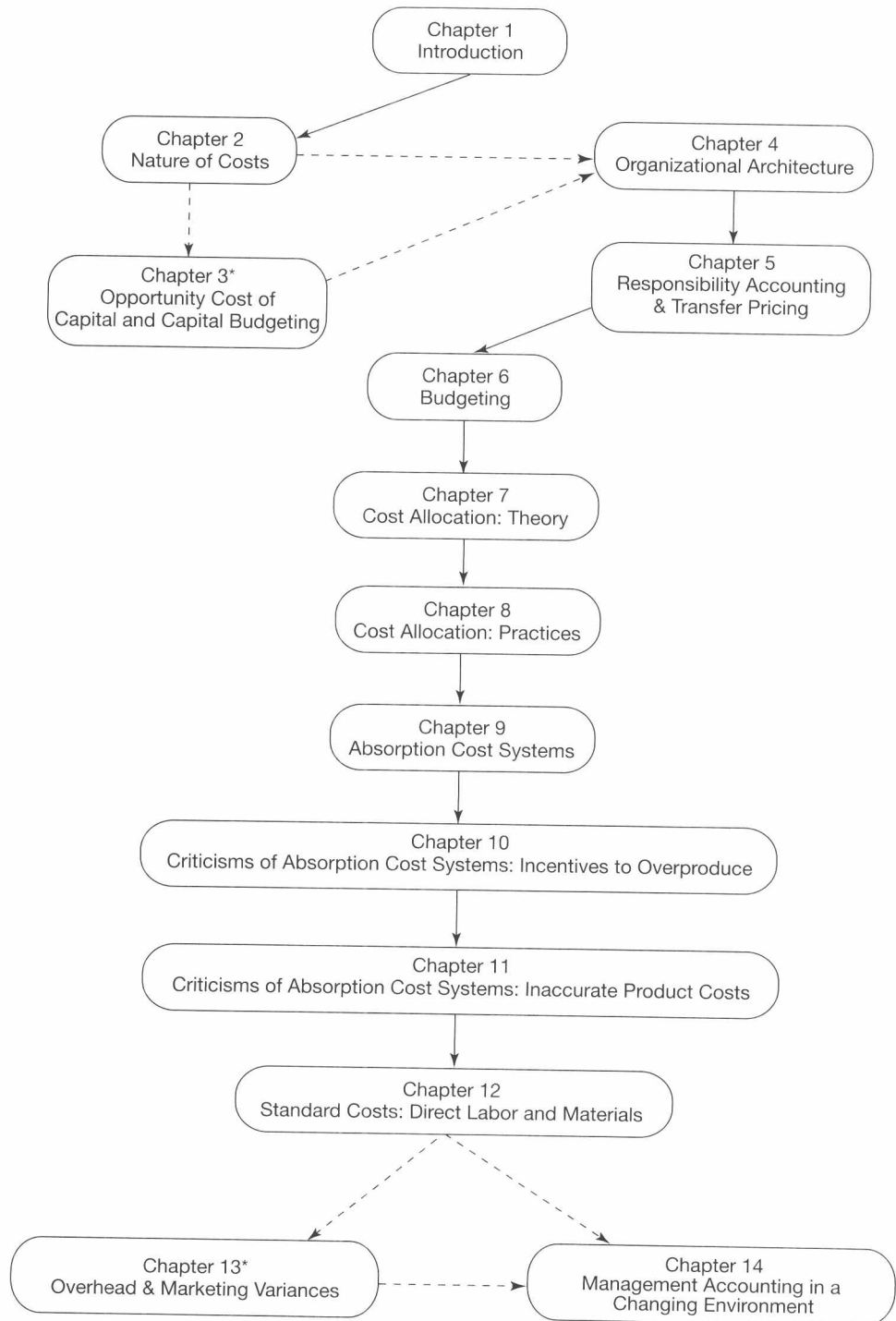
of how budgets are a significant part of an organization's decision-making and control apparatus.

Chapter 7 presents a general analysis of why managers allocate certain costs and the behavioral implications of these allocations. Cost allocations affect both decision making and incentives. Thus, there is again the trade-off between decision making and control. Several specific cost allocation methods such as service department costs and joint costs are described in Chapter 8.

Chapter 9 applies the general analysis of overhead allocation in Chapter 7 to the specific case of absorption costing in a manufacturing setting. The managerial implications of traditional absorption costing are provided in Chapters 10 and 11. Chapter 10 analyzes variable costing, and activity-based costing is the topic of Chapter 11. Variable costing is an interesting example of economic Darwinism. Proponents of variable costing argue that it does not distort decision making and therefore should be adopted. Nonetheless it is not widely practiced, probably because of tax, financial reporting, and control considerations.

Chapter 12 discusses the decision-making and control implications of standard labor and material costs. Chapter 13 extends the discussion to overhead and marketing variances. Chapter 13 can be omitted without interrupting the flow of later material. Finally, Chapter 14 synthesizes the course by reviewing the conceptual framework and applying it to three recent organizational innovations: Total Quality Management, just-in-time (JIT) production, and the balanced scorecard. All three provide an opportunity to apply the analytic framework underlying the text.

Overview of Table of Contents



*Chapter can be omitted without interrupting the flow of material

Using the Text

This book assumes that the student is familiar with introductory financial accounting. *Accounting for Decision Making and Control* can be used in advanced undergraduate, graduate, or executive programs. It is being used widely outside the United States. While the book relies on opportunity costs and concepts concerning organizations, much of the discussion is at an intuitive level. To focus on the managerial implications of the material, journal entries are deliberately de-emphasized.

The text is concise, which allows the instructor to supplement the course with additional outside readings or heavy problem assignments. The text has been used in a ten-week quarter course with few outside readings and two to three hours of homework assignments for every class period. MBA students find this challenging and rewarding. They report a better understanding of how to use accounting numbers, are more comfortable at preparing financial analyses, and are better able to take a set of facts and communicate a cogent analysis. Alternatively, the text can support a semester-length course.

Some of the more challenging material is presented in appendixes following the chapters. The two appendixes to Chapter 2 describe the pricing decision and some of the difficulties encountered trying to estimate fixed and variable costs using regression analysis. Chapter 6 appendix contains a comprehensive master budget. Cost allocations as a tax system is presented in Chapter 7's appendix. The reciprocal method for allocating service department costs is described in the appendix to Chapter 8. The appendixes to Chapter 9 describe process costing and demand shifts, fixed costs, and pricing. Appendixes can be deleted without affecting future chapter discussions.

Supplements

Several important supplements accompany *Accounting for Decision Making and Control*. The Instructor's Resource Guide CD-ROM provides chapter-by-chapter teaching strategies, suggested problem assignments, recommended outside cases, lecture notes, sample syllabi, Chapter PowerPoint presentations, and, of course, complete solutions to all problem and case material within the text.

McGraw-Hill has also created a website to accompany the text, which can be found at <http://www.mhhe.com/business/accounting/zimmerman4e>. The website offers several useful features for students and instructors, including downloadable supplements, Chapter PowerPoint presentations, and website links. Professor Ronald S. Barden of Georgia State University has created the PowerPoint presentations for the professor and student, which add an important visual dimension to your lectures.

Acknowledgments

William Vatter at the University of California, Berkeley, and George Benston at Emory University, motivated my interest in managerial accounting. The genesis for this book and its approach reflect the oral tradition of my colleagues, past and present, at the University of Rochester. William Meckling and Michael Jensen stimulated my thinking and provided much of the theoretical structure underlying the book, as anyone familiar with their work will attest. My long and productive collaboration with Ross Watts sharpened my analytical skills and further refined the approach. He also furnished most of the intellectual capital for Chapter 3, in-

cluding the problem material. Ray Ball has been a constant source of ideas and has contributed to my understanding of managerial accounting. Clifford Smith and James Brickley continue to enhance my economic education. Three colleagues, Andrew Christie, Dan Gode, and Scott Keating, supplied particularly insightful comments that enriched the analysis at critical junctions. Valuable comments from Ron Dye, Kenneth Gartrell, K. Ramesh, Shyam Sunder, and Joseph Wein-
trop are gratefully acknowledged.

This project benefited greatly from the honest and intelligent feedback of numerous instructors. I wish to thank Mahendra Gupta, Susan Hamlen, Badr Ismail, Charles Kile, Leslie Kren, Don May, William Mister, Mohamed Onsi, Ramachandran Ramanan, Stephen Ryan, Michael Sandretto, Richard Sansing, Deniz Saral, Gary Schneider, Joe Weber, and William Yancey. This book also benefited from two other projects with which I have been involved. Writing *Managerial Economics and Organizational Architecture* (McGraw-Hill/Irwin, 2001) with James Brickley and Clifford Smith and *Management Accounting: Analysis and Interpretation* (McGraw-Hill/Irwin, 2001) with Cheryl McWatters and Dale Morse, helped me to better understand how to present certain topics.

To the numerous students who endured the development process, I owe an enormous debt of gratitude. I hope they learned as much from the material as I learned teaching them. Some were even kind enough to provide critiques and suggestions, in particular Jan Dick Eijkelboom. Others supplied, either directly or indirectly, the problem material in the text. The able research assistance of P. K. Madappa, Eamon Molloy, Dag Ozay, Jodi Parker, Steve Sanders, Richard Sloan, and especially Gary Hurst, contributed amply to the manuscript and problem material. Permission has been received from the Institute of Certified Management Accountants of the Institute of Management Accountants to use questions and/or unofficial answers from past CMA examinations. Financial support was received from the John M. Olin Foundation.

I learned how much a world-class publisher can enhance a textbook. Publishing textbooks requires a publisher with insight, dedication to detail, and patience. My colleagues at McGraw-Hill/Irwin have these qualities and made this book a reality. Janice Willett and Barbara Schnathorst did a superb job of editing the manuscript and problem material.

Besides providing editorial and production assistance, the publisher manages the outside review process. The very useful comments and suggestions from the following reviewers are greatly appreciated:

Urton Anderson
Howard M. Armitage
Ron Barden
Kashi Balachandran
Da-Hsien Bao
David Borst
Eric Bostwick
Marvin L. Bouillon
Wayne Bremser
David Bukovinsky
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S. Mark Young

Kathy Jones, my very able assistant, had the difficult and often impossible task of managing and editing the manuscript and instructor manual. She did a superb job. To my wife Dodie and daughters Daneille and Amy, thank you for setting the right priorities and for giving me the encouragement and environment to be productive. Finally, I wish to thank my parents for all their support.

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Brief Contents

1	Introduction	1
2	The Nature of Costs	27
3	Opportunity Cost of Capital and Capital Budgeting	103
4	Organizational Architecture	155
5	Responsibility Accounting and Transfer Pricing	193
6	Budgeting	255
7	Cost Allocation: Theory	333
8	Cost Allocation: Practices	387
9	Absorption Cost Systems	441
10	Criticisms of Absorption Cost Systems: Incentive to Overproduce	509
11	Criticisms of Absorption Cost Systems: Inaccurate Product Costs	541
12	Standard Costs: Direct Labor and Materials	597
13	Overhead and Marketing Variances	639
14	Management Accounting in a Changing Environment	681
	Solutions to Concept Questions	737
	Glossary	747
	Index	757

Contents

1	Introduction	1
	A. Managerial Accounting: Decision Making and Control	3
	B. Design and Use of Cost Systems	6
	C. Marmots and Grizzly Bears	11
	D. Management Accountant's Role in the Organization	14
	E. Evaluation of Management Accounting: A Framework for Change	17
	F. Vortec Medical Probe Example	19
	G. Outline of the Text	22
	H. Summary	23
2	The Nature of Costs	27
	A. Opportunity Costs	29
	1. Characteristics of Opportunity Costs	30
	2. Examples of Decisions Based on Opportunity Costs	30
	B. Cost Variation	34
	1. Fixed, Marginal, and Average Costs	34
	2. Linear Approximations	37
	3. Other Cost Behavior Patterns	38
	4. Activity Measures	39
	C. Cost–Volume–Profit Analysis	42
	1. Copier Example	42
	2. Calculating Break-Even and Target Profits	43
	3. Limitations of Cost-Volume-Profit Analysis	47
	4. Multiple Products	47
	5. Operating Leverage	49
	D. Opportunity Costs versus Accounting Costs	52
	1. Period versus Product Costs	53
	2. Direct Costs, Overheads, and Opportunity Costs	53
	E. Cost Estimation	56
	1. Account Classification	56
	2. Motion and Time Studies	57
	F. Summary	58
	Appendix A: Costs and the Pricing Decision	58
	Appendix B: Estimating Fixed and Variable Costs	64

3	Opportunity Cost of Capital and Capital Budgeting	103
A.	Opportunity Cost of Capital	106
B.	Interest Rate Fundamentals	108
1.	Future Values	108
2.	Present Values	109
3.	Present Value of a Cash Flow Stream	110
4.	Perpetuities	111
5.	Annuities	112
6.	Multiple Cash Flows per Year	113
C.	Capital Budgeting: The Basics	115
1.	Decision to Acquire an MBA	115
2.	Decision to Open a Video Rental Store	116
3.	Essential Points about Capital Budgeting	118
D.	Capital Budgeting: Some Complexities	119
1.	Risk	119
2.	Inflation	120
3.	Taxes and Depreciation Tax Shields	122
E.	Alternative Investment Criteria	124
1.	Payback	124
2.	Accounting Rate of Return	125
3.	Internal Rate of Return (IRR)	126
4.	Methods Used in Practice	130
F.	Summary	131
4	Organizational Architecture	155
A.	Basic Building Blocks	157
1.	Self-Interested Behavior, Team Production, and Agency Costs	157
2.	Decision Rights and Rights Systems	163
3.	Role of Knowledge and Decision Making	164
4.	Markets versus Firms	165
5.	Influence Costs	167
B.	Organizational Architecture	168
1.	Three-Legged Stool	169
2.	Decision Management versus Decision Control	173
C.	Accounting's Role in the Organization's Architecture	175
D.	Example of Accounting's Role: Executive Compensation Contracts	178
E.	Summary	180
5	Responsibility Accounting and Transfer Pricing	193
A.	Responsibility Accounting	195
1.	Cost Centers	196
2.	Profit Centers	198
3.	Investment Centers	200
4.	Economic Value Added (EVA®)	204
5.	Controllability Principle	208
B.	Transfer Pricing	211
1.	International Taxation	211

	2. Economics of Transfer Pricing	213
	3. Common Transfer Pricing Methods	218
	4. Reorganization: The Solution If All Else Fails	222
	5. Recap	223
	C. Summary	225
6	Budgeting	255
	A. Generic Budgeting Systems	259
	1. Country Club	259
	2. Private University	263
	3. Large Corporation	265
	B. Trade-Off between Decision Management and Decision Control	269
	1. Communicating Specialized Knowledge versus Performance Evaluation	269
	2. Budget Ratcheting	270
	3. Participative Budgeting	272
	4. Managing the Trade-Off	273
	C. Resolving Organizational Problems	275
	1. Short-Run versus Long-Run Budgets	275
	2. Line-Item Budgets	277
	3. Budget Lapsing	278
	4. Static versus Flexible Budgets	279
	5. Incremental versus Zero-Based Budgets	280
	D. Summary	282
	Appendix: Comprehensive Master Budget Illustration	284
7	Cost Allocation: Theory	333
	A. Pervasiveness of Cost Allocations	336
	1. Manufacturing Organizations	338
	2. Hospitals	339
	3. Universities	339
	B. Reasons to Allocate Costs	341
	1. External Reporting/Taxes	341
	2. Third-Party Reimbursement	342
	3. Decision Making and Control	342
	C. Incentive/Organizational Reasons for Cost Allocations	343
	1. Cost Allocations Are a Tax System	343
	2. Factor Price Understates Total Cost	346
	3. Insulating versus Noninsulating Cost Allocations	352
	D. Summary	355
	Appendix: Cost Allocations as Taxes	356
8	Cost Allocation: Practices	387
	A. Death Spiral	389
	B. Allocating Capacity Costs: Depreciation	390
	C. Allocating Service Department Costs	391
	1. Direct Allocation Method	392