

THE MEASURE NETWORK

IMPROVING THE QUALITY OF MANAGEMENT INFORMATION

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The quality of cost accounting information depends on more than accuracy. Quality cost accounting information is consistent with the management intuitions of financial and nonfinancial managers alike. The root causes of many problems with cost accounting information quality lie in two methodologies used to determine organization and product performance: transfer pricing and overhead allocation. Market-based transfer pricing and the elimination of cost allocations are two important initial steps for creating higher-quality cost accounting management information.

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Toward the end of Eli Goldratt's *The Goal*, Alex Rogo is having a late-night conversation with his wife Julie about problems with the cost-measurement system at the plant. (Isn't that what we all discuss in the wee hours?). Alex is convinced that the plant's financial performance has improved because production and sales have increased while overhead expense has remained the same. But the cost-measurement system shows that the cost of making parts has gone up. Like any good manager, Alex trusts his intuition and wonders what might be wrong with the accounting system. Julie is a good listener, but she doesn't have any ideas for helping Alex with the problem.

At work the next day, Alex finds an unlikely ally in Lou, the plant controller. To show what they believe to be a more accurate view of financial performance, Alex and Lou conspire to change the basis for determining the cost of parts without informing the financial higher-ups of the change. They rationalize that the risk of getting caught adjusting the system is offset by the greater chance that the right business decision

will follow from the more positive and correct view of the situation.

In the end, the right business decision is made, the plant makes lots of money, and Alex is promoted to head of the division. The conspiracy to alter the financial results is all but lost in the improved performance of the plant, but so much for fiction. The real issues are never addressed. Are the cost accounting systems employed by businesses so inherently flawed that we should expect them to sometimes provide bad managerial information? Is it acceptable behavior to change the assumptions on which cost accounting calculations are based so that the information provided is more consistent with managerial intuition? Is there something that accountants can do about the methodology to provide more appropriate and useful information for managers?

The root causes of the problems with cost accounting information rest in two methodologies used to determine organization and product performance: transfer pricing and overhead allocation. Let's examine each method by understanding what it is, why it is used, what causes the problems,

and how a better outcome might be obtained.

TRANSFER PRICING

Most firms can be viewed as consisting of a series of business activities that support the design, development, production, sales, delivery, and servicing of deliverables provided to customers and other stakeholders. This collection of activities is sometimes called a "value chain," to emphasize the value added by each of the elements of the overall process. The elements of the chain may correspond to business subprocesses, organizational boundaries, or some other useful breakdown of the whole. Analysis of the profit contribution of each element can help managers to determine such things as the allocation of new resources, the need for profit improvement, the desirability of outsourcing, and other important business decisions.

Transfer pricing is the mechanism used to specify the value of inputs to, or outputs from, each element in the value chain. When dealing with an external supplier or customer, the transaction or market price is automatically the basis for transfer price. But, when one internal operation deals with another, alternative methods are often used. This is the case when an internal manufacturing operation transfers goods to a selling business unit at cost, or at cost plus a specified margin. Both of these transfer pricing choices creates a distorted view of the profitability of both the selling and buying units. When actual cost is used, the selling unit nets a profit of zero and the buying unit enjoys profit that is greater than it could achieve as a stand-alone business. When the transfer price is cost

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plus a specified profit margin, the profit of the selling unit is artificially determined at a level that may or may not reflect its true competitiveness, and the buying unit may be forced to pay in excess of the price otherwise available to it.

Although internally determined transfer price is easily determined, the information resulting from this method of transfer pricing often leads to poor or misguided managerial decisions, and ultimately to the destruction of firm value. A better solution is to use market price as the basis for transfer price. Only in this way will the true opportunity cost be considered for both the seller and buyer. If the selling unit is sufficiently profitable when using market price to determine revenue, the activities of the seller are warranted. If the buying unit can pay the market price and still earn sufficient profit to justify investment in it, it, too, has a competitive rationale for existence. Any element of the value chain that cannot earn a profit sufficient to justify the firm's investment in it must be considered a candidate for outsourcing.

The result of this kind of thinking may well be a value chain consisting of a mixture of internally performed activities and elements provided by external sources, but each element will be competitive in its own right, and the overall value chain should be

capable of dealing with any competitive threat.

OVERHEAD ALLOCATION

Shared services represent a potentially efficient and effective way of providing required assistance to business activities. Examples of such activities include engineering, information services, human-resource management, and corporate services. The service used by a particular part of the business can often be clearly identified and a cost for those services assessed. According to the earlier discussion of transfer pricing, this should ideally be an opportunity cost determined by the market price. Sometimes, however, the activities of a shared service do not clearly attach to a particular element of the existing value chain and are not easily assigned. Such activities might include engineering experimentation on a new technology, infrastructure capability development for information services, benchmarking the company pay structure to assess competitiveness for human resources, or maintaining a legal department to prevent litigation.

Most firms view such activities as necessary for the common good and assess all activities for their cost by assigning an appropriate share to various organizational entities. The rationale is that allocation will provide a discipline for control of the common costs, and that all costs must be considered for an evaluation of unit profitability to be considered fair. The methods used to make such allocations are difficult, if not impossible to justify, however, and the resulting charges to business units are often resented and disputable. The ensuing arguments among managers about the "fairest" way

to allocate costs are often driven by considerations of personal compensation, not of the corporate good. Such allocation discussions should be seen as a costly distraction from the important tasks of beating competitors in creating value for customers.

In an ideal system, there are no cost allocations. All elements of the value chain including shared services are profit centers. All spending must be justified on the willingness of internal departments or external customers to pay for the output from those expenditures either right now or sometime in the future. The engineering department will be judged on whether the user organizations find their output attractive and are willing to pay a market price for it. If not, engineering will lose money, and a decision will have to be made as to whether having such a department is worthwhile.

CRITICISM OF THESE IDEAS

The ideas stated above are straightforward. First, all transfer pricing is based on market prices. Second, there are no cost allocations allowed. Let the criticism begin.

Market Prices are Difficult and Sometimes Impossible to Obtain. You have to try. This will be difficult because apples-to-apples comparisons must be obtained. The conditions of the sale

must be the same. In many industries, market prices are readily available. Make them part of your internal performance evaluation system. If they are completely unavailable, you may have to devise the logic for making them up! The process is to think through what an ideal competitor would have to charge to make a reasonable profit. The task is difficult, but time spent by managers analyzing and debating their competitiveness in the market is surely more valuable than time spent arguing over the fairness of cost allocations.

Market Prices are Always Changing. Welcome to the real world. The most nimble and well-informed companies can and will take advantage of the rapid pace of change affecting business today.

Time Spent Managing These Internal Issues is Wasted. Not if the outcome of the work is a more efficient and effective set of business processes. This should be viewed as encouraging entrepreneurial behavior. The underlying assumption is that the whole will be most efficient when all the underlying parts are as effective as possible. Cooperation is encouraged, but only when it makes economic sense.

If We Don't Allocate Common Costs, We Won't Know Our True Costs to Produce Products and Services. Yes, you will. Every business activity that uses goods or services pro-

vided by another unit must pay for them at the market price. To the extent that a shared service spends money to support future capabilities, users of the future service will pay for them at the time they want to use them (or not). In the meantime, such expenditures must be thought of as investments by the shared service, that are funded with the expectation that someday future "profits" will be realized. No part of the business should subsidize another part by providing below market prices unless it is part of a deliberate strategy to encourage volume growth that leads to a better future for the seller.

CONCLUSION

Alex Rogo had it right when he focused the organization on the goal of making enough money to satisfy the return requirements of the owners while simultaneously serving the needs of customers and other stakeholders. The cost measurement systems used in support of these goals should help managers make better business decisions. Market-based transfer pricing and the elimination of cost allocations go a long way toward providing the right kind of management information. ■