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Caution Required when Using Managerial Accounting Data in Court

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Managerial accounting data is typically collected and configured for corporate strategy purposes, so that company executives can evaluate various cost and pricing scenarios and make rational decisions about their business practices. Often, however, this data can end up as a central input into expert analyses conducted in at least two types of antitrust litigation: predatory pricing and price fixing.

A central allegation in predatory pricing cases, for example, is that a company is pricing its products below what is profitable in order to drive competition out of the market and create a monopoly. That was the claim in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.* (1993), in which cigarette manufacturer Brooke Group alleged that its competitor was selling generic cigarettes at a loss by setting its retail prices below its production costs. Profitability is typically measured by looking at price in excess of variable cost, so a factual question that often must be answered in cases such as this is whether the defendant priced its products below a measure of its variable cost. Managerial cost data can be used to calculate that variable cost.

Meanwhile, the central allegations in price-fixing cases are that a cartel has colluded to raise prices and that purchasers were damaged because they were charged a higher price than would have been set in a competitive market. In some states, indirect purchasers, or those who have bought products at one or more steps removed from the alleged cartel, can also claim damages, as in the case of *In re Dynamic Random Access Memory (DRAM) Antitrust Litigation*, a multidistrict matter involving a number of North American makers of computer memory chips.

A key economic question in indirect-purchaser cases is how much of the overcharge — the difference between the market and the cartel price — was passed through the direct purchaser(s) to the indirect purchaser(s). Managerial accounting data may be used to measure prices at different points in the distribution chain and to study the relationship between these prices, thereby revealing the extent to which the overcharge has been passed through.

In both types of cases, the use of managerial accounting data is not as straightforward as it might appear. Because the information generally will have been gathered and managed for non-litigation purposes, the quality and appropriateness of the data may come into question when it is being considered for introduction into court. The effective use of such information at trial requires careful quantitative and qualitative analyses by managerial accounting experts. Otherwise, counsel may risk introducing analyses with inaccurate conclusions.

PREDATORY PRICING CASES

Managerial accounting data is at the core of many of these matters, where a key question often is: Did the company price its products below its variable cost?

Higher-level cost data, such as that found on financial statements, often reflects a mix of fixed and variable costs and therefore may overstate a company's variable cost. The cost of goods sold, for example, which typically measures those costs that are directly attributable to the production of the goods the company sells, could include labor, parts, depreciation and overhead — only some of which may be fixed costs.

Granular data from managerial accounting systems is therefore required to obtain a more precise estimate of variable cost. But not all managerial accounting data measure whether a cost is fixed or variable. For example, the depreciation reported on a piece of manufacturing equipment may not be an accurate measure of the direct usage of the machinery. Depreciation is determined by standard schedules that are associated with the "useful life" of a piece of equipment, and

that may be influenced by tax considerations. Therefore, depreciation may not accurately measure the actual variable cost incurred when a piece of machinery is used to make a product.

In all cases, it is best for experts to validate results by speaking with company managers, who can have important insights into whether a cost is variable or fixed. For example, company managers can provide additional information about how frequently a piece of machinery is replaced or repaired and whether this is influenced by the rate of machine usage or by other environmental factors unrelated to direct usage. (Consider that the depreciation of a car may be affected as much by the car's exposure to weather as by the number of miles it has been driven.)

Company managers can also be a good sounding board for evaluating the results of the analyses that experts perform on all the individual cost items. Statistically speaking, it is important to have this extra validation because of the large number of separate analyses conducted on the different cost items in a typical assessment of variable cost. The more cost items that are analyzed statistically, the more possible it becomes that the managerial accounting expert could find spurious correlations. Company managers can help identify such problems by indicating cost items which they are relatively certain are fixed or variable. These interviews can help the managerial accounting expert ascertain whether managers have accurately categorized fixed versus variable costs and thus can help the expert develop credible testimony.

A managerial accounting expert's prior experience working with managerial accounting data can also be a useful reference point for interpreting statistical results that are not clear cut. For example, if the expert is assessing data from multiple factories, and some results indicate that a cost item varies with output and some results do not, the expert's prior experience with the typical behavior of this type of cost item may lend additional insight into whether the cost is fixed or variable.

PRICE-FIXING CASES

In price-fixing cases, managerial accounting data may be used to measure pass-through of overcharges from a cartel to indirect purchasers. Pass-through analyses measure the extent to which changes in prices charged by the alleged cartel are reflected in changes in prices paid by indirect purchasers. Therefore it is important in such analyses that the data used reflect actual prices paid.

Here, however, the use of managerial accounting data may be problematic. A 2002 survey found that 76 percent of U.S. companies use the "standard costing" method of accounting, as opposed to the "actual costing" method. In the former, the costs of material, labor, and overhead are derived from managerial estimates. In the latter, the costs are derived from actual transactions.

Standard costs are predetermined estimates of how much an input will cost and thus do not reflect actual transaction prices. If such costs are used to estimate pass-through, then accurate measures will not be obtained. The managerial accounting data being used also may not fully reflect all the discounts or rebates that a company received or paid. Additionally, some transactions between affiliated parties may involve administratively determined transfer prices, which are set to conform to tax regulations but might not reflect a "true" transaction.

Further complicating matters, in some cases, the alleged overcharge may pass through numerous levels of a distribution chain – for example from the producer, to the direct purchaser, to a distributor, to a wholesaler, to the final customer. This means that different companies in the pass-through analysis may be using different managerial accounting methods.

THE DEPRECIATION REPORTED ON A PIECE OF MANUFACTURING EQUIPMENT MAY NOT BE AN ACCURATE MEASURE OF THE DIRECT USAGE OF THE MACHINERY.

Taking these potential data limitations into account, a managerial accounting expert may, when feasible, directly ask the company that produced the data whether any of the previously mentioned issues are present. The expert will then examine the data. If there is data produced by the buyer and seller in the same transaction, the expert can compare the price recorded by each. If they are a close match, the expert can be relatively comfortable that the transaction price has been captured accurately. The expert can also compare purchases or sales of the same product by different companies and, where there is a similar data pattern for each company, can be comfortable that the actual prices or costs are accurately reflected.

The use of managerial accounting data in litigation is generally not a matter of "one size fits all," given the types of data collected and the differences among companies' managerial accounting systems and approaches. Managerial accounting expertise, methodical analysis, and clear communication with the company managers involved can enhance the accuracy and credibility of analyses based on such data. ■

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