

RFHHA MANAGEMENT TIP OF THE DAY FOR HOSPITAL ADMINISTRATORS 1305

What is Activity-Based Costing in healthcare Part 3?

Difference between traditional vs Activity based costing:

In traditional costing, the overhead cost was allocated based on single predetermined rates. If the overhead expense is attributable to other service providers then apportionment is used to distribute the overheads. This works fine in manufacturing process where direct labor is major chunk of the costs. However, the direct labor costs have come down and customized products have increased in the last three decades; and this methodology will not suffice for accurate costing. Moreover, there is some intuition and arbitrary decisions that are taken during re-apportionment. On the contrary, in ABC, the overhead costs are allocated to activities (also called cost pools) and then to products using cost drivers. Cost pools are similar to departments but you will have more number of cost pools than equivalent departments in traditional approach. The one big difference between traditional absorption costing and ABC is that, ABC uses multiple absorption rates and traditional uses just one.

One of the challenges

The number of activities performed in Hospital are vast; the collecting, counting, classifying of the data is going to be time consuming and expensive. Hence, a phased approach will help in a win –win situation. Here we are looking to analyze the cost to serve a patient who has come for emergency surgery; hence this can be considered as a phased approach. As you complete this phase successfully, you will accumulate some lessons learned; mitigating the risks arising out of this effort will help in moving swiftly with next phases such as line of service costing.

One of the important milestones in ABC implementation

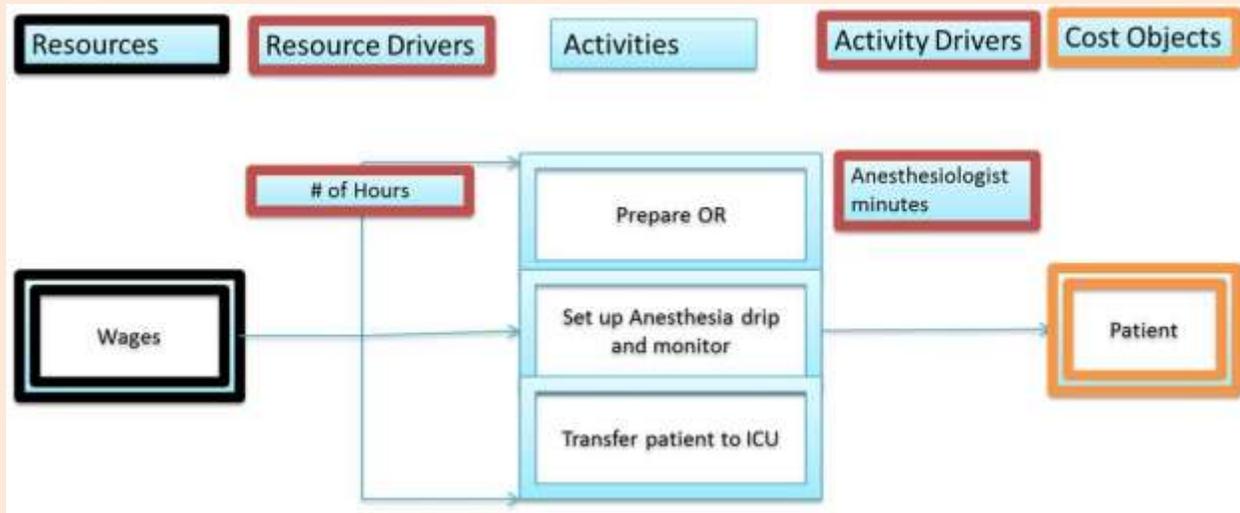
An important milestone in this implementation is to make sure the Managers of the cost centers are on board with – cost policies/allocation methodologies and the data. The Managers need to have input in the policies and should be able to trust the data that is being used. The discussions surrounding the allocation methodologies is going to be based on several factors – culture of the organization, ability of the project sponsor to address or drive the behavior change, data availability and the ability to make informed decisions based on the reports. There will be contentious issues that need to be handled especially as to how the overhead be allocated.

Line of Service – Emergency Room

In this study we will consider an Emergency department visit by the patient who will have an emergency surgery. The article will show how to calculate the cost to serve a patient. You may also encounter situations where more than one service line is involved in treating the patient. The challenge here is have appropriate allocation methodology in place to handle these scenarios since the dominant department (Emergency department) will get the income but the other service line may just go unnoticed. Ideally, the income and cost need to be allocated

between the service lines so that there is fair amount of representation based on activities. These need to be finalized during allocation policies meetings.

The picture below shows how resources, activities, drivers' line up with cost objects.



Terminology use in ABC

Direct Costs: Direct costs are expenses directly related to the delivery of the activity to patients such as medication, procedure specific equipment and specialist's salaries.

Indirect Costs: Indirect costs are expenses not directly related to delivery of activity such as administration, corporate overheads, housekeeping and buildings.

Cost Driver/Allocation Base: It is the activity/item that causes a cost to be incurred.

Allocation: Involves spreading costs from one to many based on predetermined methodology.

Activity: Activity can be defined as work performed by people, equipment, technologies or facilities.

Cost Object: Any product, service, customer or other work unit for which a separate cost measurement is desired.

Cost Pool: A logical grouping of Resources or Activities aggregated to simplify the assignment of resources to activities or activities to cost objects.

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