

# CONTENTS

<b>Figures and Tables</b>	<b>xvii</b>
<b>Preface</b>	<b>xix</b>
<b>The Author</b>	<b>xxix</b>
<b>ONE: ESSENTIALS OF FULL-COST ACCOUNTING</b>	<b>1</b>
Learning Objectives	1
Organization of the Chapter	2
Uses of Cost Information	2
Pricing Decisions	2
Profitability Assessments	3
Comparative Analyses	3
Issues to Consider in Calculating Full Costs	4
Resource Usage: A Conceptual Framework	5
Land	5
Labor	6
Capital	7
Units of Measure	7
Limitations	7
Cost Drivers	8
The Cost Accounting Methodology	9
Decision 1: Defining the Cost Object	9
Decision 2: Determining Mission and Support Cost Centers	10
Decision 3: Distinguishing Between Direct and Indirect Costs	13
Decision 4: Choosing Allocation Bases for Support Center Costs	14
Decision 5: Selecting an Allocation Method	20
Decision 6: Attaching Costs to Cost Objects	23
Determining the Impact on Customer Prices	25

Summary of Cost Accounting Choices	26
To Bear in Mind	26
Appendix 1.1: The Reciprocal Method of Cost Allocation	27
Practice Case: Mossy Bog Laboratories	29
Case 1.1: Harbor City Community Center	30
Case 1.2: Carroll Hospital	34
Case 1.3: Atherton Medical Education Programs	45
<b>TWO: COST BEHAVIOR</b>	<b>63</b>
Learning Objectives	63
Organization of the Chapter	64
The Nature of Costs	64
Fixed Costs	64
Step-function Costs	64
Variable Costs	65
Semi-variable Costs	66
Separating the Fixed from the Variable	66
Relation of Cost Behavior to Full-cost Accounting	67
Cost Behavior in Organizations	67
Cost-Volume-Profit Analysis	70
Unit Contribution Margin	72
Incorporating Other Variables into CVP Analysis	72
Profit or Surplus Considerations	72
Special Considerations in CVP Analysis	73
CVP Analysis with Semi-variable Costs	73
CVP Analysis with Step-function Costs	73
CVP Analysis with Multiple Products or Services	75
The Impact of Product Mix	76
Contribution	79
Contribution Income Statement	79
To Bear in Mind	82
Practice Case: Huntington Hospital	82
Case 2.1: Carlsbad Home Care	83
Case 2.2: Springfield Visiting Nurse Association	85
Case 2.3: Abbington Health Center	87

<b>THREE: DIFFERENTIAL COST ACCOUNTING</b>	<b>91</b>
Learning Objectives	91
Organization of the Chapter	92
The Differential Cost Concept	92
Principle 1: Full-cost Information Can Be Misleading	94
Principle 2: Differential Costs Can Include Both Fixed and Variable Costs	94
Principle 3: Assumptions Are Needed	94
Principle 4: Causality Is Needed	94
Principle 5: Sensitivity Analysis Can Be Helpful	95
Principle 6: A Contribution Income Statement Can Be Useful	96
Sunk Costs	96
Sunk Costs and Intuition	96
Sunk Costs in Organizational Settings	97
The Strategic Perspective	100
The Outsourcing Situation	100
Keep or Drop a Product Line	103
Sporadic Use of the Strategic Perspective	105
Precision of Depreciation	106
Relationship to Changing Strategic Scenarios	106
Nonquantitative Considerations	106
Allocated Overhead	107
Misleading Allocation Bases	107
Effects of the Step-down Sequence	109
The Analytical Effort	111
To Bear in Mind	111
Practice Case: Narcolarm, Inc.	112
Case 3.1: Lakeside Hospital	114
Case 3.2: Boston University Medical Center Hospital	120
Case 3.3: Huron Joint Company	130
 <b>FOUR: ABSORPTION COSTING</b>	 <b>135</b>
Learning Objectives	135
Organization of the Chapter	136
Health Care's Stage 2 Dilemma	136

## X Contents

The Ratio of Costs to Charges	138
Solving the Problem	140
A Functional Classification of Manufacturing Costs	140
Direct Manufacturing Costs	140
Indirect Manufacturing Costs	140
Applicability to Health Care	142
Some Terminology Cautions	143
Computing Full Cost	143
Process System	143
Job Order System	143
Unit Costs	145
The Overhead Rate	145
The Basis	145
The Computation	146
Predetermined Overhead Rates	146
Overhead Variances	149
Flexible Overhead Budgets	149
Calculation Steps	154
Terminology Issues	158
Accounting Implications of an Overhead Variance	159
Managerial Uses of Overhead Variances	160
To Bear in Mind	160
Practice Case: Crimson Chair Company	161
Case 4.1: Owen Hospital (A)	164
Case 4.2: Neighborhood Servings (A)	166
Case 4.3 South Bristol Hospital	168
<b>FIVE: ACTIVITY-BASED COSTING</b>	<b>177</b>
Learning Objectives	177
Organization of the Chapter	178
Activity-based Costing	178
Conditions for ABC	180
Establishing Multiple Second-stage Cost Drivers	180
A General Approach	184

Cost Drivers in Other Health Care Settings	187
To Bear in Mind	189
Practice Case: Lincoln Dietary Department	190
Case 5.1: Owen Hospital (B)	192
Case 5.2: Neighborhood Servings (B)	196
Case 5.3: Cortland Manufacturing, Inc.	201
Case 5.4: Massachusetts Eye and Ear Infirmary	203
<b>SIX: RESPONSIBILITY ACCOUNTING: AN OVERVIEW</b>	<b>219</b>
Learning Objectives	219
Organization of the Chapter	220
Cost Accounting and Responsibility Accounting	220
Responsibility Accounting Systems Defined	221
The Responsibility Accounting Structure	223
Types of Responsibility Centers	224
Role of Senior Management	226
The Design Process	227
Aligning Responsibility and Control: The Fairness Criterion	228
A Working Example	229
The Responsibility Accounting Framework	232
Strategic Planning	232
Task Control	232
Management Control	233
Formal Management Control Activities	233
Programming	234
Budgeting	235
Operating and Measuring	237
Reporting	239
To Bear in Mind	240
Practice Case: Akron Public Health Department	241
Case 6.1: LaSalle Hospital	244
Case 6.2: Franklin Health Associates (A)	252
Case 6.3: Southern Seattle University Health System (A)	262

<b>SEVEN: DESIGNING THE RESPONSIBILITY ACCOUNTING STRUCTURE</b>	<b>273</b>
Learning Objectives	273
Organization of the Chapter	274
Making Profit Centers Work	274
Issue #1: The Fairness Criterion	274
Issue #2: The Goal Congruence Criterion	275
Issue #3: The Transfer Pricing System	275
Issue #4: The Cross-subsidization Policy	276
Design Complications	277
Matrix Organizations	277
Responsibility Centers and Motivation	280
The Role of Contingent Compensation	281
Overarching Themes	281
Link to the Responsibility Accounting System	282
Transfer Pricing Problems	282
Issues to Consider in Setting Transfer Prices	284
Relation to Informal Authority and Influence	286
To Bear in Mind	287
Practice Case: Valley Hospital	289
Case 7.1: White Hills Medical Center	291
Case 7.2: Converse Health System	293
Case 7.3: Apogee Health Care	303
<b>EIGHT: PROGRAMMING</b>	<b>317</b>
Learning Objectives	317
Organization of the Chapter	318
Programming: An Overview	318
Capital Budgeting Techniques	319
Capital Investment Decision Making	319
Effect of Taxes	323
Effect of Accelerated Depreciation	325
Choosing the Discount Rate	327
Weighted Cost of Capital	327
Current versus Projected Weighted Cost of Capital	328
Incorporating Risk into the Analysis	328

Nonquantitative Considerations	329
Link to Strategy	330
Link to Culture	330
Link to Conflict Management	330
To Bear in Mind	331
Appendix 8.1: The Concept of Present Value	332
Appendix 8.2: Special Programming Issues in Governmental Organizations	336
Practice Case: Erie Hospital	343
Case 8.1: Yoland Research Institute	345
Case 8.2: Green Valley Medical Center	348
Case 8.3: Disease Control Programs	357
<b>NINE: OPERATIONAL BUDGETING</b>	<b>367</b>
Learning Objectives	367
Organization of the Chapter	368
The Context for Operational Budgeting	368
Organizational Context	369
Budgeting Context	371
Formulating the Budget: Behavioral Aspects	373
Formulating the Budget: Mechanical Aspects	374
Budgeting Misfits	378
1. Between the Cost Structure and the Budget Structure	378
2. Between the Cost Structure and Budget Monitoring Reports	378
3. Between Strategic Success Factors and the Budgeting Phase	378
4. Between the Organizational Structure and the Budget	379
5. Between Strategic Objectives and the Budget Process	379
6. Between Motivation Systems and the Responsibility Accounting System	380
7. Between the Budget Formulating and Budget Monitoring Phases	381
Toward More Effective Budgeting	381
To Bear in Mind	382
Practice Case: Los Reyes Hospital (A)	382
Case 9.1: Bandon Medical Associates (A)	385
Case 9.2: Sonsonala (A)	388

Case 9.3: North Lake Medical Center	390
Case 9.4: Southern Seattle University Health System (B)	403
Case 9.5: Rush-Presbyterian-St Luke's Medical Center	407
<b>TEN: CASH BUDGETING</b>	<b>425</b>
Learning Objectives	425
Organization of the Chapter	426
Link to the Dual-aspect Concept	426
Cash-Related Cycles	427
The Operating Cycle	427
The Financing Cycle	429
Financial Accounting versus Financial Management	431
Key Cash Management Concepts	431
Debt Structure	431
Leverage	434
The Role of Profit	436
Making the Forecasts	439
Business Growth	439
Product Line Changes	439
The Statement of Cash Flows	440
Operating Activities	440
Investing Activities	440
Financing Activities	442
To Bear in Mind	444
Practice Case: Gotham Meals on Wheels	445
Case 10.1: Sonsonala (B)	447
Case 10.2: Brookstone Ob-Gyn Associates	449
Case 10.3: Menotomy Home Health Services	458
Case 10.4: Boise Park Health Care Foundation	464
<b>ELEVEN: MEASURING AND REPORTING</b>	<b>471</b>
Learning Objectives	471
Organization of the Chapter	472
The Measuring Phase	472

Aligning Responsibility with Control	472
Measuring and Reporting Techniques	472
Flexible Budgeting	473
Variance Analysis	474
A Graphic Illustration	475
Calculating Variances	477
Managerial Uses of Variances	483
Limitations of Variance Analysis	483
The Reporting Process	484
Timeliness	484
Hierarchy of Information	484
Relevance and Accuracy	487
Behavioral Factors	489
Measuring and Reporting Nonfinancial Information	489
Criteria for Good Nonfinancial Reports	493
Linking Nonfinancial to Financial Performance	494
To Bear in Mind	495
Practice Case: Oak Street Nursing Home	496
Case 11.1: Bandon Medical Associates (B)	496
Case 11.2: Los Reyes Hospital (B)	503
Case 11.3: Spruce Street Shelter	508
Case 11.4: Franklin Health Associates (B)	510
Case 11.5: Union Medical Center	514
<b>TWELVE: IMPLEMENTING A NEW RESPONSIBILITY ACCOUNTING SYSTEM</b>	<b>523</b>
Learning Objectives	523
Organization of the Chapter	524
Criteria for a Good Responsibility Accounting System	524
Structural Criteria	524
Process Criteria	524
Behavioral Criteria	525
Key Characteristics of a Good Responsibility Accounting System	525
The Responsibility Accounting Context	526

## **xvi** Contents

Managing the Change Effort	528
Resistance to the Change Effort	531
Dealing with Resistance	532
Short-term Wins	533
Consolidating and Moving Forward	533
To Bear in Mind	535
Case 12.1: The Robert Wood Johnson Medical School	535
Case 12.2: Hillside Hospital	554
Case 12.3: Omega Research Institute	564
Case 12.4: Fletcher Allen Health Care	576
<b>Appendix: Solutions to Practice Cases</b>	<b>601</b>
<b>Glossary of Selected Terms and Concepts</b>	<b>635</b>
<b>Index</b>	<b>641</b>

# FIGURES AND TABLES

## FIGURES

1.1	Resource Usage: A Conceptual Framework	6
1.2	The Step-down Method	22
2.1	Types of Cost Behavior	65
2.2	Fixed and Variable Costs Versus Mission and Service Center Costs	67
2.3	The Fundamental Profit Equation	71
3.1	Outsourcing Risk	107
4.1	Job Ticket for Buzzard Glen Hospital	144
4.2	Summary of MOH Variances	153
4.3	Manufacturing Overhead Variances for Silverado, March and April	158
6.1	Management Accounting Information: A Summary	222
6.2	Types of Responsibility Centers and Financial Objectives of Each	224
6.3	Organizational Structure of Richardson Health Institute	230
6.4	The Management Control Process	234
7.1	A Typical Matrix Structure	278
7.2	Matrix Structure in a Large State Agency	279
9.1	The Context for Budgeting	370
10.1	The Operating Cycle	428
10.2	The Financing Cycle	430
10.3	Business Risk Versus Financial Risk	435
10.4	Cash Needs Associated with Growth	437
10.5	Using Income to Finance Growth-related Cash Needs	438
11.1	Types of Variances and Controlling Agents	483
11.2	Reporting Hierarchy for an Integrated Delivery System	486
11.3	Reporting Hierarchy for a Department of Mental Health: Program Analysis	488
11.4	Reporting Hierarchy for Spenser Rehabilitation Hospital, First and sixth levels	490
11.5	Measures of Nonfinancial Performance	491
11.6	Program Performance Report Framework: Commonwealth Medical School	492
11.7	Example of a Spidergram	494

12.1	Cross-functional Processes in an Organization	528
12.2	Questions Concerning Cross-functional Processes	529
12.3	Eight Steps to Change	531
12.4	Commitment to Change	531
12.5	Methods of Dealing with Resistance to Change	532
12.6	Impact Versus Difficulty	533
12.7	Players, Status, and Action Plan Worksheet	534

**TABLES**

1.1	Examples of Cost Drivers in a Hospital	8
A1.1	Basic Information for a Reciprocal Cost Allocation	27
A1.2	Allocation of Support Center Costs to Mission Centers	29
4.1	Manufacturing Cost Terminology	141
4.2	Overapplied and Underapplied Overhead	159
A8.1	Present Value of \$1 Received One Time	334
A8.2	Present Value of \$1 Received Annually for <i>N</i> Years	335
9.1	Variable Budget, by Product (or Service) Line	376
10.1	Balance Sheet for Homecare, Inc.	427
10.2	Examples of Leverage	434
10.3	Two SCF Formats	441