

## Reader's Forum: The Value of a Cost Accounting System

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The question has been raised as to the value of a cost accounting system to a hospital. It has been asserted that management of a hospital is unlike the management of any other business and that hospital management cannot make decisions regarding a particular disease entity due to the interrelationship of hospital activities that support all disease entities. The cost/benefit of cost accounting information has been challenged due to the uniqueness of the hospital operation and the perceived inability of managers to demonstrate how the costs of implementation and maintaining a cost accounting system are offset by new revenues or cost reductions.

In order to address the broad issue of the value of a cost accounting system when managing a hospital, it is important to review the perceived uses of cost accounting information in a thoughtful and pragmatic manner. We can then make an assessment as to whether we, as health care managers, can use this information to achieve the goal of managing the hospital in a more effective and efficient manner—in decision making, planning and control, and profitability.

Until the advent of the prospective payment system (PPS) in 1983, hospitals were paid for their services based on their cost; therefore, a hospital manager did not have to behave in the same way as a manager of a traditional business. Since 1983 the health care industry has evolved from being a regulated industry to one that is very competitive. The dominant theme has changed from one of growth for all hospitals to one of decline for inpatient hospital services. This has led to an emphasis on increased market share and to the reduction of operating costs.

The emphasis on controlling and understanding costs led to the development of cost accounting systems by numerous vendors and hospitals. These cost accounting systems accommodate detailed clinical and financial information collected at a procedural level. The clinical and financial data base can provide information which can be used for a variety of purposes:

- cost management at a departmental level
- pricing decisions with HMOs and PPOs
- strategic planning
- physician management
- profitability analysis

## **COST MANAGEMENT AT A DEPARTMENTAL LEVEL**

The development of a cost accounting system requires the development of standards at a procedural level. The development of these standards, in turn, contribute to the development of flexible budgeting and productivity monitoring. These budgeting and monitoring tools help to manage operations in the context of declining inpatient services and payers who are adopting capitation systems similar to Medicare. The ability to adjust staffing and spending patterns based on volume and case-mix will become even more important as state regulators (Medicaid and Blue Cross) and HMOs/PPOs adopt case-mix payment systems similar to Medicare. Therefore, the departmental standards that are created by the development of the cost accounting system serve as valuable managerial tools.

## **PRICING DECISIONS WITH HMOs AND PPOs**

Although most HMOs and PPOs have negotiated with hospitals on the basis of per diems or a percentage of charges, many are now beginning to adopt the case basis of payment. In addition, many payers are looking for specialized pricing for specific types of services (for example, children's hospitals and open heart surgery programs). In negotiations with HMOs and PPOs, as well as with other payers, it will be important to have the cost per case broken down between fixed and variable components for product-specific pricing analyses. In a cost accounting system the procedure cost information is broken down into a number of components of cost such as fixed and variable, salary and non-salary, and overhead.

## **STRATEGIC PLANNING IN TODAY'S COMPETITIVE ENVIRONMENT**

Hospital managers need to know how much it costs to deliver a specific service and/or product line. A hospital would not want to embark on an expansion of a service or product line that was losing a substantial amount of money. In fact, for the first time hospitals are beginning to close both services and entire facilities where volume is not sufficient to cover the costs of delivering the service.

Strategic financial planning is the theme of today's hospital planners. Financially driven strategic planning is based on the assumption that the planning efforts should improve the health care system's financial position. Strategic financial planning recognized that health care systems are generally nonprofit and are often affiliated with a religious organization where financial performance is not the primary indicator of success; however, a health care system cannot achieve the organization's statement of purpose or mission unless financial viability is achieved.

## **PHYSICIAN MANAGEMENT**

A cost accounting system will be of little value if physician input is not obtained. Assuming that physicians have been part of the process that developed the utilization standards for the case-mix measure employed by the cost accounting system, management has a powerful tool to control physician behavior. A cost accounting system will provide information to review physician efficiency through a comparison of individual physician treatment protocols for varying types of patients with protocols of other physicians at the same hospital or through other acceptable standards. Additionally, if the system can provide profitability analysis about a physician's clinical practice patterns, management can alter physician behavior based upon what the system has determined it can afford to pay. Managing average length of stay does not mean that the physician will release a patient before it is clinically appropriate; it does, however, make the physician aware of the financial realities management must deal with in order to maintain hospital viability.

## **PROFITABILITY ANALYSIS**

A goal of the cost accounting system is to establish the costs of providing service by:

- case type or DRG
- department
- specialty or product line
- physician
- patient

In addition, the cost accounting system would provide management with payer and net revenue information by the same categories mentioned above. This will allow hospital management to identify profit margins by payer, by physician, by service, or by product line and make the appropriate decisions about resource allocation based upon the goal of maintaining the financial viability of the hospital. This does not mean that because a specific procedure or case type is losing money that the procedure will no longer be provided or the case type no longer can be treated.

This information has to be used in the context of how the hospital operates all of its services. Cost accounting information does not replace management; rather, it provides a tool that allows management to understand how its hospital provides health care services. In a competitive environment it is critical for hospital managers to understand the hospital production function and to work with physicians to improve the quality of provided services while at the same time providing those services in a more effective and efficient manner. Cost accounting information provides hospital managers with the necessary

knowledge to do this. In conclusion, there are several points which are important to mention:

- In today's competitive environment, hospitals that can control their costs will be the survivors. Market share is very important, but the realities of today's environment indicate that many hospitals will be downsizing, with financial performance as the most important variable. The only exception might be the large teaching hospitals, which have a different purpose and also have development capabilities that can raise substantial amounts of money.
- The cost of implementing a cost accounting system is declining every year. Hardware and software are available on mini-computers, microcomputers, or on in-house mainframe computers. Hospital management has now had the opportunity to work with this type of information over the last several years and it is beginning to utilize the information more effectively to make decisions and control hospital operations.
- Information is a very important strategic tool and cost accounting information provides management with information that will allow it to understand the actual costs of delivering services. If management does not understand the hospital production function, how can it make decisions that will reduce the cost of providing a service without having a negative impact on the quality of that service?