



MANAGEMENT ACCOUNTING in Health Care Organizations

Third Edition

David W. Young

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**This book is dedicated to the memory of Andy Pasternack,
a leader in the development of instructional materials for the
health care field, and a professional with quality standards that
the rest of us can only aspire to attain.**

We all miss him.

PREFACE

This book provides introductory-level instruction for students of health care management who are studying management accounting for the first time, or for those who want a refresher as part of a course in advanced management accounting. It offers a user-oriented approach to management accounting concepts and techniques that will help prepare them for work in an environment where an understanding of management accounting is important to their success.

Management accounting is concerned primarily with the information needs of an organization's managers. In general, these needs arise in three areas: full-cost accounting, differential cost accounting, and responsibility accounting. The distinctions among these different types of accounting are discussed later in this preface.

To the Student

The working assumption of this book is that you have no prior knowledge of management accounting. My goal is that, on completing the book, you will be knowledgeable about both the uses and the limitations of management accounting information. To accomplish this, I place minimal emphasis on the technical aspects of preparing accounting information, covering only those technical matters that are essential to understanding the computations that the accounting staff typically makes. Most of the material focuses on the meaning and utility of accounting information for managers and other users.

In general, the learning process consists of developing new skills, which can be acquired only by practice. Learning management accounting is a bit like learning about a new city. If someone takes you on drives around the city, you will probably learn very little about how to get from one place to another. If you drive by yourself, however, you will learn a great deal about the city—acquiring far more knowledge on a single trip than you would in dozens of trips as a passenger.

In this book, you are the driver rather than the passenger. The idea is for you to practice (and learn) accounting while you read each chapter. You

will have opportunities to prepare answers to problems that appear throughout the chapters and to analyze a practice case (sometimes two) at the end of the chapter. There are several features to keep in mind as you engage in this effort.

Minimal Memorization

Throughout each chapter, the important terms are defined in the margins. These terms also are contained in a glossary at the end of the book.

Having the definitions readily available means that you do not need to spend time memorizing them. Indeed, some management accounting terms are not used in a consistent way by everyone, so memorizing definitions may actually be counterproductive.

Rather than memorizing the terms, you should focus instead on mastering the concepts and analytical techniques discussed in each chapter. The book guides you as you work with these concepts and techniques so you can see how they are developed and applied. Please note that the discussion in each chapter assumes that you understand the material covered in the prior chapters, so it is important to work through the chapters in order.

Interactive Learning

A distinctive feature of this book is its interactive approach to the learning process. You are regularly asked to stop reading and work out the solution to a problem. The idea is to shorten the feedback loops in the learning process. Rather than answering questions or analyzing problems only at the end of each chapter, you can apply what you have learned about a topic immediately following the discussion about it. When the discussion of a topic is lengthy, problems may be presented throughout.

You may be tempted to shortcut this process, but please do not succumb to temptation. Shortcutting will compromise your mastery of the material. Indeed, the reasoning in the answer to a problem can be quite seductive: if you look at it before working out your own answer, you may find yourself in agreement with it, saying something like, “That’s how I would have done it, if I had done it.” But you may not have fully internalized the analytical techniques. Actually working through a problem, arriving at a solution, and then comparing it to the answer will give you an understanding of the logic behind the related accounting concept and allow you to apply it to real-life problems. To take full advantage of the interactive feature, you should answer each problem to the best of your ability before looking at the answer provided in the text.

In short, to learn management accounting, you must struggle through the process of arriving at solutions yourself, gaining understanding from both your successes and your mistakes. To prepare for this learning process, you should have a pencil, a calculator, and a supply of paper next to you while you are reading each chapter. A problem begins as follows:

PROBLEM

The problem statement is in a different typeface and is indicated with a question mark, as shown here.



ANSWER

The answer to the problem, also in a different typeface, immediately follows the problem, as shown here.



Use a blank sheet of paper to cover the answer as you work out the solution to each problem. Then compare your solution and associated reasoning with the answer provided. If your comparison shows that your solution is correct, continue reading. If you have an incorrect answer, spend as much time as you need to figure out where you went wrong. This may require rereading the section of the chapter immediately preceding the problem.

Short Chapters

Most of the chapters are relatively short. Reading a chapter and working your way through the problems can take several hours, however, so it's normal to feel that you are working slowly.

You should not try to cram the learning process into a short period of time, because you need to digest the material slowly as you go along. If you believe you already understand the material in a particular section and therefore do not need to read that section, you should prepare solutions to the problems in the section to confirm your understanding.

End-of-Chapter Tools

Each chapter contains, in addition to the problems for you to solve, three tools to help you verify your understanding of the concepts and techniques that were covered in the text.

To Bear in Mind

This section highlights two of the most significant issues in the chapter, with an emphasis on concepts that can be confusing or techniques that can cause difficulties when used in practice. These are just short “nudges” to make sure you understand.

Test Yourself

This section contains five questions (sometimes compound questions) that allow you to make sure you have grasped the chapter’s major points. A short answer is usually all that is required for each question, although sometimes the answer can be longer. You should try to respond to each question as fully as you can before looking at the answer in appendix A.

Practice Cases

In addition to solving the problems in each chapter and answering the “Test Yourself” questions, you are asked to prepare an analysis of one or more practice cases at the end of each chapter. As with the problems contained in the chapter, you should attempt to analyze each practice case to the best of your ability before looking at the solution in appendix B. Each case covers some of the concepts discussed in the chapter and thus will give you an opportunity to test your knowledge of how the chapter’s content would be applied in a practical setting.

The practice cases usually are rather short; some might even be thought of as extended problems. In some instances, however, the cases are longer and more detailed. Much depends on the chapter’s content. The conventional distinction between an extended problem and a case is that a case usually presents a situation for which there is no single right answer. For many of the practice cases, there are right answers, although as you will see, there is sometimes more room for judgment than you might imagine initially.

Several practice cases are good candidates for relatively simple spreadsheet analysis, and you should use spreadsheet software in preparing your analyses of these cases. This approach not only will help you improve your spreadsheet skills but also will allow you to test alternative solutions more easily than if you had only written out the answer.

User Orientation

The book has a user orientation, focusing mainly on line managers and senior managers, and orienting the discussion to the decisions they make on a regular basis. Accounting details are discussed to the extent necessary for you to understand the concepts and techniques used in most

organizations, but the text does not cover exceptions to the rules or some of the possible variations on each traditional theme.

Organizational Focus

Many texts use manufacturing examples to illustrate accounting concepts and principles. This book uses manufacturing examples, where appropriate, but these examples—as well as all the problems and practice cases—are set in the context of organizations that are in some way associated with the health care sector. Nevertheless, most of the examples, problems, and practice cases are about service organizations.

Although most management accounting concepts are universal, meaning that the type of organization used to illustrate a point is relatively unimportant, the learning process is much easier when the examples are related to your area of interest. The examples, problems, and practice cases have been chosen with the hope that they will resonate with you because they deal with organizations with which you may be somewhat familiar.

To the Instructor

This book has been written principally for use in a one-semester, user-oriented course in management accounting in health care. Each chapter is designed to be covered in a week, ideally over two classes of 1.5 to 2 hours each. Clearly a great deal depends on the depth you wish to pursue and how quickly or slowly you wish to move through the course. (The material in this book has also been used in a half-semester course on management accounting for MBA students. In this instance, each chapter was covered in a single 2-hour class meeting.)

Students' preparation for the first class session associated with a given chapter should include reading the chapter, engaging in the chapter's interactive activities, answering the "Test Yourself" questions, and analyzing the chapter's practice case or cases. Due to the interactivity, students will need considerably more time to read these chapters than they would if they were using a more traditional text. Moreover, they will need to spend time analyzing the practice cases.

It is sometimes useful to have an open class discussion after students have read a chapter and prepared the practice case or cases. This discussion can serve to clarify the chapter's concepts and address any difficulties the students are having in using them.

After this class session, each remaining class for a given chapter can focus on a case or cases that you select that will require students to use

the chapter's concepts and techniques. This way, the concepts are first clarified and then applied in the analysis of case situations. At the end of each chapter is a list of suggested cases for that chapter.

If you would like assistance in selecting cases for your course, you may contact The Crimson Press Curriculum Center (www.thecrimsonpress.org) and review its online catalogue of materials. In addition, the Harvard Business School Press has a catalogue and a Web site (www.hbsp.harvard.edu) that can help you in selecting cases to supplement each chapter. An instructor who adopts the book for his or her course may obtain a course packet of cases from The Crimson Press Curriculum Center at no charge.

Case Method of Instruction

Educators increasingly are recognizing the power of the case method in teaching management accounting. The value of the case method lies in its ability to put students in the middle of the action, requiring them to be analytical—to apply principles rather than just memorize or reiterate them. In this way, it prepares students for work in an environment where analysis, judgment, and attention to nuance increasingly are required for success.

Changes for the Third Edition

This edition of the text contains several changes from the second edition:

- The chapter on absorption costing has been eliminated. Its important techniques and concepts have been included in the chapter on activity-based costing (chapter 5).
- A new chapter (chapter 1) has been prepared that sets the stage for the rest of the book. It discusses the many challenges health care organizations will face in the next five to ten years, such as the aging of the population and the presence of many more individuals with chronic conditions. Management accounting concepts and techniques have therefore become even more important than they were in the past.
- The cases without solutions have been eliminated. Only practice cases remain. As mentioned earlier, instructors who adopt the book for a course may select as many cases as they wish from The Crimson Press Curriculum Center without a need to pay the normal copyright clearance fees. This results in a shorter book as well as increased flexibility for professors to choose cases that meet their pedagogical needs.

- Five “Test Yourself” questions have been included at the end of each chapter. These questions help students to reflect on the concepts and techniques contained in the chapter.
- Several new appendices have been added that allow students to pursue material that was not discussed directly in the chapter, such as pricing in nonprofit organizations or undertaking benefit-cost analysis in public-sector capital budgeting.

Organization of the Book

Exhibit P.1 contains the book’s learning objectives for each of its three major areas: full-cost accounting, differential cost accounting, and responsibility accounting. The book’s chapters move from the design of good cost measurement systems to the design of good cost control systems. Cost measurement can take place without cost control, but controlling costs requires an ability to measure them. Therefore, the chapters need to be read in the sequence presented. The overall theme for each chapter is discussed briefly in this section.

Chapter 1: Management Accounting and Health Care’s Impending Fiscal Crisis

Health care systems throughout the industrialized world are in trouble. As the population ages, and as people live longer, they will require increasing amounts of health care services, especially for the treatment of chronic conditions. In addition, individuals born shortly after the end of World War II (between 1945 and 1955) have now reached the age at which they will demand more services. Even nonelderly individuals who do not practice good health habits require greater care. This chapter discusses the details of this demographic and health behavior scenario. The inevitable conclusion is that if health care costs in industrialized countries are not better managed, there will be a fiscal crisis: either spending will skyrocket, or people will be denied needed care. Neither needs to happen if policymakers, managers, and physicians learn to understand their costs and manage them more appropriately. This chapter is, in effect, a call to action.

Chapter 2: Essentials of Full-Cost Accounting

“What did it cost?” is one of the trickiest accounting questions for all organizations, including those in health care. This chapter discusses the kinds of managerial decisions that are made in answering this question, as well

EXHIBIT P.1 Management Accounting Learning Objectives

Full-Cost Accounting

- The meaning of such terms as *cost object*, *cost center*, *direct costs*, *indirect costs*, *overhead*, *cost allocation methods*, and *cost systems*
- The way costs can be allocated to help determine the cost of a particular product or service
- The distinction between mission (or revenue) centers and support centers
- The nature of the managerial choices inherent in a full-cost accounting system
- The concept of an overhead rate, for attaching a mission center's costs to its cost objects
- The concepts of activity-based costing and cost drivers, including the use of multiple second-stage cost drivers

Differential Cost Accounting

- The rationale for the statement, "Different costs are used for different purposes"
- The distinction between full costs and differential costs, and when each should be used
- The nature of the factors that influence changes in cost, including the distinctions among fixed, variable, step-function, and semivariable costs
- The nature of alternative choice decision making, and the three major types of alternative choice decisions that most organizations make
- The concepts of unit contribution margin and total contribution, and their roles in alternative choice decision making
- The technique of cost-volume-profit analysis, how to prepare such an analysis, and its uses and limitations

Responsibility Accounting

- The definition of a responsibility center, the different responsibility center options, and the basis for choosing the most appropriate type of center
- The definition of a transfer price, and the role of transfer prices in a responsibility accounting system
- The phases of the management control process, and the characteristics of each phase
- The key elements in the budgeting phase of the management control process, and the relationship between budgeting and responsibility centers
- The meaning of the term *flexible budget*, and how it can be used in a responsibility accounting system
- The technique of variance analysis, and the different types of variances that can occur
- The uses and limitations of variance analysis, and the relationship between variance analysis and the reporting phase of the management control process
- Some of the difficulties involved in measuring nonfinancial (or programmatic) performance, and how to overcome them