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**Title:** *Activity-Based Costing: The New Management Tool.*

**Subject(s):** [ACTIVITY-based costing](#); [COST accounting](#)

**Source:** [Behavioral Health Management, Mar/Apr2001, Vol. 21 Issue 2, p48, 4p](#)

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**Abstract:** Provides information on the **activity-based cost management** (ABCM) process. Difference of ABCM with the traditional **costing** process; Problems associated with the application of ABCM; Steps in implementing ABCM; How **behavioral health** and social service organizations can benefit from ABCM.

**AN:** 4393396

**ISSN:** 1075-6701

**Full Text Word Count:** 1836

**Database:** Academic Search Elite

**Print:**  Click here to mark for print.

**View Item:** [Full Page Image](#)

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Section: FEATURE ARTICLE

## **ACTIVITY-BASED COSTING: THE NEW MANAGEMENT TOOL**

### **It's useful to strategic planning and quality improvement**

Businesses are constantly under pressure to cut costs and improve performance. Historically, armed only with traditional **management** accounting information, managers were forced to achieve their efficiency goals by engaging in "slash-and-burn" or "cut-and-cope" approaches to cost cutting. Success for **behavioral health** and social service providers is no different, as the pressure to provide quality services at the lowest possible cost is demanded by payers and consumers.

To accomplish this, though, organizations must develop mechanisms for accurately reporting the cost of services, and the information must be in a form

that allows managers to make changes to reduce these costs.

Traditional cost accounting methodologies have proven to be of little use to organizations in managing unit cost, because they do not provide timely and accurate information on what changes are necessary to reduce cost. For example, knowing that it costs \$95 for an agency to render an hour of outpatient psychotherapy is helpful when benchmarking with other providers, but it gives little information about how the clinic site can change its processes and procedures to reduce this cost.

This is where **Activity-Based Cost Management** (ABCM) can be helpful. In a previous issue of this magazine, Henry Yennie described the cost-reduction benefits of this **new** approach ("ABC: The **New** Cost-Cutting **Tool**," September/October 1999, p. 26). Once that is addressed, ABCM goes even further. Rather than simply helping an organization calculate unit cost, ABCM provides managers with information about the processes that make up the unit cost.

ABCM is itself a process that aligns revenues and costs to business processes. Its fundamental principle is that cost **management** should be focused on what you do, rather than on managing the cost of your inputs. ABCM focuses on your outputs and the **activities** required to produce them. Knowing these processes (or **activities**, as they are known in ABCM circles) allows an organization to re-engineer its operations to reduce and manage the cost of service delivery.

This is, for the **behavioral health** field, a **new** and vital concept and, not surprisingly, it has raised its share of questions. For example:

### **What's the difference between traditional costing and ABCM methodologies?**

When attempting to analyze cost, the challenge lies in calculating "indirect" costs (often known as overhead, administrative or support costs) and how they relate to the services being offered. Traditional systems use simple formulas to allocate these costs and have really been designed to control expenditures. These expenses are usually divided into categories, such as salaries, fringe benefits, supplies and depreciation. These do not provide information on why costs occur.

ABCM, however, traces costs to the products that cause them, providing a much more accurate picture. Indirect costs are driven first to the **activities** and processes that occur in an organization, and then to the actual services themselves. ABCM thus allocates these indirect costs more accurately and allows staff to manage **activities** rather than to just manage dollars.

### **Why haven't more organizations adopted ABCM?**

**Activity-based costing** was first introduced as an improved way to calculate

cost by H. Thomas Johnson and Robert S. Kaplan in their 1987 book entitled *Relevance Lost: The Rise and Fall of **Management** Accounting*. Initially, their methodologies were adopted in manufacturing industries to reduce production costs, and only later did the service industry begin to consider ABCM as an alternative to traditional cost accounting methodologies. However, **behavioral health** and social service providers have often encountered two major obstacles when they began to use ABCM: staff resistance and insufficient implementation time.

The first obstacle is the most pervasive. Staff members are often resistant and overwhelmed by the language of ABCM and see it as a more expensive and time-consuming way to do a "useless" accounting exercise. Terms such as "cost objects" and "resource drivers" (see "Definition of Terms," p. 52) have little meaning to them and are perceived to be of no value in improving operations. Successful implementation of ABCM requires that the concepts and terms be "translated" to match the organization's culture and staff needs.

This obstacle can be overcome by ensuring that there is sufficient training for all staff about what ABCM is and how to use it. The training should be customized for human services providers, and senior managers (rather than just "fiscal staff") should be involved in all aspects.

ABCM is a multidisciplinary process requiring the key participation of persons in all the disciplines within the organization. They must be involved so that they will accept the credibility of the information and be committed to the need to develop innovative strategic initiatives to improve performance.

The second major obstacle to implementing ABCM arises when an organization underestimates the amount of time it takes to develop its initial ABCM model. Typically, it takes three to five months to train staff and gather the data to prepare the initial model for a single service line or clinical program. Rolling out ABCM to other service lines usually occurs more quickly once staff are familiar with identifying key processes and developing measures to track them.

### **What are the basic steps in implementing ABCM?**

There are four: (n1)

Step 1: Map **activities** and processes. By interviewing the staff members who do the work, an organization can develop a list of the primary **activities** that are part of the process of running an organization and providing a service. This "bottom-up" approach has the added benefit of involving staff in the development of the ABCM model, thus building consensus and ensuring that it reflects the reality of the organization's workflow. The rule of thumb is to only attempt to identify **activities** that take more than 5% of an individual's time. Too much detail makes the ABCM model more complicated and difficult to maintain, and the cost of measuring the additional detail will exceed the benefit derived from any

process improvement. Inherent in this step is a productivity or "capacity" analysis.

Step 2: Determine the costs of these **activities**. By developing a measurement to link the financial resources used with the **activities** performed, an organization can then translate the expenses recorded in its financial system into the cost of the identified **activities**. (In ABCM terminology, these measurements are known as "resource drivers.") For example, the measurement most commonly used to link salary expenses to **activities** and processes is the amount of time an employee spends performing the **activity**. Completing this step, an organization knows, usually for the first time, the expenses for the various **activities** that staff are engaged in.

Step 3: Identify the services being provided by your organization. This step is straightforward, but it allows an organization to link its processes and **activities** to the services it provides. It also encourages managers to think about how much they are being paid for services and whether they are profitable. ABCM experts refer to the services being provided as "cost objects."

Step 4: Select quantitative measures for each **activity**. An organization must next determine how to best count the "output" of the various **activities** that comprise delivering a service. Usually gathering this information is the most costly part of implementing ABCM. Service providers customarily measure processes and **activities** by counting the number of times an **activity** is performed (e.g., the number of patients registered by the Front Desk in an outpatient clinic), or by the amount of time spent doing the **activity** (e.g., six hours for patient record keeping). The former is known as a "transaction-**based** cost driver" and the latter is "duration-**based**."

Once these four steps have been completed, the organization has the data that it needs to conduct the initial analysis. **Activity-based costing** software applications are then used to calculate the costs of the services provided and the various **activities** that compose them.

### **How can *behavioral health* and social service organizations best use ABCM?**

While ABCM is an excellent onetime operational analysis **tool** for analyzing cost and studying profitability, it can also be used as a strategic **management tool** for organizational change. Let's start with its primary rationale:

**Determine and manage the cost of services.** This allows managers to answer the following questions:

- How much does it cost to render a particular service or clinical program, and how does this compare to the revenue stream associated with it?

- What are the primary **activities** that make up the cost of a service?
- What are the inefficient or unnecessary **activities** that can be reduced or eliminated to reduce cost?
- What changes in staff time and other resources would be necessary if the processes and procedures were changed?

**Evaluate outsourcing options.** Once an organization has developed more accurate information about the cost of service, it can then better evaluate "buy versus build" options.

**Develop "what if" scenarios for service expansion or reduction.** For example, if a provider is expanding the number of available beds in its day treatment unit, ABCM can help determine at what census levels additional staffing or other resources are needed.

**Assist marketing staff in product design and service pricing.** ABCM provides an organization with the information it needs to determine the unit cost of adding quality or "value-added" attributes to a service. This is essential when developing or enhancing service lines and when responding to proposals that require quality or performance measures not currently in place. Additionally, ABCM information allows marketing staff to identify the services that operate more profitably, so that they can develop marketing plans to shift customer demand in that direction.

**Develop budgets.** It is easier for an organization to develop accurate budgets, particularly when assumptions are made about increases or decreases in the amount of service delivery.

**Measure performance.** ABCM data can be incorporated into an organization's key indicators or other performance measures as a mechanism for monitoring and continually improving operations. Unit cost information can be benchmarked with other provider organizations. Employee incentives can be tied to ABCM measures to further stimulate process improvement and profitability.

**Evaluate the cost benefits of provider alliances or mergers.** This is an expanded use of the "what if" scenario capabilities of the ABCM software applications.

With such extensive potential uses, it is clear that **activity-based cost management** systems can produce significant results in re-engineering an organization's operations and its culture. However, for most **behavioral health** and social service providers, successful implementation will require that ABCM be demystified and translated into a **tool** that has meaning for organization program managers and staff.

## DEFINITION OF TERMS

Legend for Chart:

A - ABCM Term  
B - Translation

A  
B

Cost Objects

The services provided by an organization.

### **Activities**

The work **activities** or processes within the organization.

Resource Drivers

The measurements used to link expenses to the work **activities** performed by staff (e.g., the amount of time spent on an **activity** can be used to link salary expenses to it).

Cost Drivers

The measurements of the "output" of an **activity** of process (e.g., the number of **new** patients registered at the Front Desk).

## Reference

(n1.) Kaplan RS, Cooper R. Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance. Harvard Business School Press, 1998.

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