

Chapter 4

Step 2: Allocate Indirect Costs

4.1 Allocation of Indirect Costs vs. Distribution of Direct Costs

As described in Chapter 2, cost allocation involves allocating the costs of transient cost centres (TCCs) to the absorbing cost centres (ACCs) to establish the full costs of operating patient care functional centres. Generally, ACCs are associated with the patient care functional centres, whereas TCCs are associated with the administrative and support, or overhead, functional centres. Later in the costing process, the functional centre's relative value units will be used to calculate a cost per unit of service. This cost can then be multiplied by the number of relative value units received by a patient to calculate the case cost.

For case costing, refer to direct costs as those costs that were directly assigned to the ACCs according to the rules discussed in the previous chapter. Establish the full operating costs of the ACC through cost allocation, the process by which the costs of the TCCs are assigned to the ACCs. These allocated costs are referred to as indirect costs. A formula is used to allocate these TCC costs to the ACCs as indirect costs, based on an estimate of costs incurred by the ACC to provide particular services.

4.2 Indirect Cost Allocation Using SEAM

The Simultaneous Equation Allocation Method (SEAM) must be used to compute the indirect cost allocation. This algorithm allows us to determine the relative use of administrative and support services by each patient care functional centre.

SEAM is a set of linear equations that can be solved using a spreadsheet program on a PC or with specifically designed management information system software currently available to hospitals. Many case costing systems have a cost allocation function with their General Ledger or cost accounting software.

In essence, SEAM allocates a portion of the TCC costs as indirect costs to other TCCs as well as ACCs, then simultaneously allocates out all the TCC direct and indirect costs to all the ACCs as indirect costs. Further details and an example of SEAM are found in Appendix J.

4.3 Indirect Cost Allocation Bases

Each TCC is associated with a specific measure, termed the "allocation base," that is used by SEAM to allocate the TCC costs to other functional centres. The allocation base provides a means of estimating the amount of TCC costs consumed by the ACCs in providing patient care. To ensure comparability of results, standard cost allocation bases are used by OCCI hospitals for case cost reporting.

The allocation bases should be measured for the entire fiscal year and the bases should be updated annually. For example, if proportion of department cost is the basis for cost allocation, the cost figures should be the totals for the entire fiscal year. Cost allocation may be done at any MIS account level (3, 4 or 5), depending on the functional centre.

Many of these cost allocation bases are listed in Appendix K Specific explanations which have been developed to clarify the intent of the cost allocation bases are included in the Glossary at the end of the Guide.

Actual Year-End Costs are used for the Cost Allocation Calculation

Actual costs are the most appropriate calculation for Ontario case cost development. Hospitals that allocate and report indirect costs as part of their monthly management reporting typically use budget costs to establish the proportion of actual costs to allocate. OCCI hospitals recalculate the allocation at year-end to produce case costs based on actual costs for the period.

4.4 What TCC Costs are to be Allocated as Indirect Costs?

The costs of those functional centres that are traditionally classified as hospital support and administration or overhead are considered to be indirect costs. For example, Finance, Health Records and Information Systems are departments that do not provide direct patient care, but are necessary in order for the ACC to provide services to patients. Hospital departments and managed support functions have been organized in many different ways. As a result, different hospitals documenting and accounting for operations correctly could produce similar total case costs but with quite different ratios of direct and indirect costs.

In addition, the hospital may not be costing some patient care functional centres, such as Allied Health. These functional centres should receive the appropriate indirect costs, but the costs of the Allied Health functional centres should remain undistributed.

The OCCI standards on the types of expenses or functional centre costs that should be allocated as indirect costs or distributed as direct costs are as follows:

Laundry

Hospitals with a Laundry and Linen Department or using contract laundry services have moved to charge departments for their usage of laundry services.

OCCI hospitals should ensure that all laundry and linen costs are assigned to ACCs as direct costs. Note that hospitals with their own laundry and linen service may choose to use the Laundry and Linen functional centre throughout the year and then at year-end distribute the costs to the absorbing cost centre using a distribution base.

Hospital Library, Audiovisual, Medical Illustration and In-Service Education

For case costing, the provision of Hospital Library, Audiovisual, Medical Illustration and In-service Education should be allocated as *indirect costs* to functional centres receiving these services as noted in Appendix K. (Costs associated with receiving in-service education are allocated to the receiving employee's cost centre.) Note that OCCI standards are not consistent with the MIS Standards, which specify that Hospital Library and Medical Illustration are to remain undistributed.

OCCI hospitals should also ensure that the expenses of "Special Functional Centres" are *excluded* from the cost allocation process and left undistributed. These Special Functional Centres are the Level 2 Framework Sections of Research (7), Education – Formal (8) and Undistributed Functional Centres (9). It was reasoned that the services of these functional

centres are not associated with specific patients or programs and are outside the scope of a hospital's patient care business.

Maintenance (General and Biomedical)

The MIS Standards recommend the use of a work order system and the posting of maintenance activities as *direct costs* to each functional centre receiving service. Any residual maintenance cost not covered by the work order charges should be allocated as an *indirect cost* using net square metres or department total costs. Hospitals that do not have a work order system in place may allocate general maintenance costs. Biomedical maintenance must be distributed as direct costs through a work order system. Note that maintenance covered by maintenance contracts is charged as a *direct expense* to the functional centres receiving the service.

Patient Care Administration and Support Functional Centres

The costs of separate support and administration functional centres should be assigned as a *direct cost* to the patient care centres they support. More detail about patient care departmental support and administration cost distribution can be found in section 3.1.2.

Nursing Administration

All Nursing Administration costs should be distributed as *direct costs* to nursing functional centres based on each nursing functional centre's total costs as a proportion of total nursing costs. Where suitable patient-specific workload measurement systems are in place, clinical resources' functional centre costs are to be distributed to patients based on workload.

There are several functional centres for Nursing Administration (see also 3.1.2). These provide general management for both the Department of Nursing and Nursing Clinical Resources. Nursing Administration is included with General Administration and Support Services in the MIS Chart of Accounts as per the OHS *only* if the person, in a non-program management setting, is responsible for functional centres in addition to Nursing. Only nursing costs in this administration functional centre (71110) are to be allocated as *indirect costs*. All other Nursing Administration costs are to be distributed as *direct costs*. These functional centres are then to be cleared to zero by charging the costs to the nursing patient care functional centres. The use of the other Nursing Administration functional centres listed will depend on the organizational structure of the facility.

71110 - General Administration (if person is responsible for other functional centres as well as Nursing)

71205 - Inpatient Nursing Administration (non-program management setting)

10 - Nursing Administration

20 - Clinical Resources (centralized)

2020 - IV Therapy

2040 - Enterostomal Therapy

2092 - Transplant Coordination/Organ Procurement

2094 - Palliative Care Team

71206 - Program Management Administration (program management setting)

71305 - Ambulatory Care Administration

71306 - Program Management Administration

If a manager is responsible for both Inpatient Nursing functional centres and Ambulatory Care functional centres, then compensation for this individual should be split appropriately between 71205 and 71305.

Patient Transport

How patient transport services are organized can impact the direct/indirect cost ratio. The labour costs of a porter who works in a specific absorbing cost centre are *direct costs* if that porter's hours are posted as part of the functional centre's hours. It is common in many hospitals to have porters assigned to Radiology or the Operating Room, for example. In many other hospitals, portering is provided by a central porter service established as a support functional centre. In this case the porter hours are charged directly to the portering functional centre, and the costs of portering are allocated to user ACCs as *indirect costs* based on the total costs of the using departments.

Materials Management

Typically, Materials Management is responsible for providing hospital departments with timely supplies at the best possible cost. Because of varying system capabilities, the choices made can move costs between direct and indirect. For example, disposable supplies are most likely charged through the inventory system as direct expenses, whereas reprocessing costs associated with reusable supplies are allocated as indirect costs. Shifting from disposables to reusables (or back) can affect the direct/indirect cost ratio.

Printing Services

Internal printing may not be charged directly to a department, but outside printing and forms from stock are generally charged directly to the using departments.

It is accepted that these cost categorization differences will arise and that they cannot be totally eliminated without extensive effort. Be mindful of these issues when conducting any detailed analysis and comparisons of hospitals' case costs.