

Cost allocation

Does it affect you?

The accounting profession focuses much attention on how to allocate costs. A quick analysis shows a myriad of procedures and practices as the profession seeks to answer the age old question of cost allocation. To the uninitiated, the subject can become a bewildering mass of theories, hype and jargon.

But is the subject really the sole domain of academics, or can it become an effective tool in control of your practice?

Cost allocation is relevant to any organisation that has more than one group incurring expenses. In essence it seeks to answer who has incurred costs and who should be responsible for paying them?

Whilst this may seem especially relevant to larger multi departmentalised organisations, the reality is that each medical practice will have a number of partners who are each incurring costs. **The method used to pass these costs onto its partners will have a large impact on the income the partners receive.**

Methods of allocation

Gross Revenue Allocation

Medical Practitioners generally allocate revenue on a percentage of fees received basis. The rationale behind this is that each medical practitioner should receive the fees they have personally generated. On the other hand some practices choose to allocate revenue on the basis of patient numbers.

Direct Expense Allocation

Direct expenses are those that are directly attributable to specific members of the practice. These are commonly allocated on a direct cost for cost basis, as a percentage of fees or as a percentage of patients.

Overhead Expenses

The remaining expenses are generally left to allocation on a fairly arbitrary basis. Commonly these again are the percentage of fees or the percentage of patients basis. More advanced allocation techniques are available for those who wish to divide expenses more accurately.

The allocation techniques mentioned above are all based on sound rationale, but the final results can be markedly different. The following scenarios illustrate just how major the changes can be:

ASSUMPTIONS

	TOTAL	Partner A	Partner B	Partner C
Net Fees	<u>\$530,000</u>	<u>\$200,000</u>	<u>\$150,000</u>	<u>\$180,000</u>
Directly Attributable Expenses				
Locums	72,200	24,500	15,500	\$32,200
Conferences	1,390	540	50	800
Motor Vehicle	4,200	1,460	430	2,310
	<u>\$77,790</u>	<u>\$26,500</u>	<u>\$15,980</u>	<u>\$35,310</u>
Overhead Expenses Allocation				
Percentage of Number of Patient Visits	100%	34%	24%	42%
Percentage of Fees	100%	37.74%	28.30%	33.96%
Total Overhead Expenses Allocated By:				
Number of Patient Visits	\$152,000	\$51,680	\$36,480	\$63,840
Percentage of Fees	\$152,000	\$57,358	\$43,019	\$51,623

PROFIT CALCULATIONS

	TOTAL	Partner A	Partner B	Partner C
Scenario One – Percentage of Fees				
Fees: On % basis	\$530,000	\$200,000	\$150,000	\$180,000
Direct expenses – To Incurring Partner	77,790	26,500	15,980	35,310
Overhead Expenses - % of Fees	<u>152,000</u>	<u>57,358</u>	<u>43,019</u>	<u>51,623</u>
Net Profit	<u>\$300,210</u>	<u>\$116,142</u>	<u>\$91,001</u>	<u>\$93,067</u>
Scenario Two – Equal Share				
Net Profit	<u>\$300,210</u>	<u>\$116,142</u>	<u>\$91,001</u>	<u>\$93,067</u>
Scenario Three – Number of Patients				
Net Fees – Number of Patients	530,000	180,200	127,200	222,600
Direct Expenses – Number of Patients	77,790	26,449	18,670	32,672
Overheads – Number of Patients	<u>152,000</u>	<u>51,680</u>	<u>36,480</u>	<u>63,840</u>
Net Profit	<u>\$300,210</u>	<u>\$102,071</u>	<u>\$72,050</u>	<u>\$126,088</u>

These figures highlight the changes that can result from different allocation methods. Several of the partners in these scenarios have had net income changes of over 30%, which has potential to cause problems in partner relationships.

The solution

Unfortunately there is no clear cut solution to the problem. Generally cost allocation is detailed in a partnership or cost sharing agreement document. If your agreement does not deal with these issues and no other legally binding document details the allocations, we suggest you should move to rectify the situation.

For those of you who may be looking at entering an agreement, look very closely at the way the costs are allocated. Remember the method of allocation you agree to, will very likely stay the same throughout the time you are in the partnership. The way to achieve a happy solution to the cost allocation problem is to **agree from the start** of your venture together.

Additional benefits

In addition to avoiding potential problems, the attention to cost allocation can result in significant efficiency gains within your practice. In focusing on what expenses can be directly attributed to individual partners the practice is looking at what causes its costs. Often this will highlight expenses that are being incurred inefficiently.

Having decided on the method of cost allocation to use, the practice should then ensure that an adequate accounting system is in place to provide the information required. Improved control over the accounting system can again lead to more efficient control of expenses.

Help

The correct allocation of costs is important to Medical Practitioners. If this article has raised concerns, we would recommend you seek legal advice on how to rectify any problems.

This article was written by KPMG Peat Marwick – 14 July 1999

Need more help?

Contact the NZMA:

Phone | 0800 65 61 61

Email | Robyn Fell: robyn@nzma.org.nz