

## 55.2 An exercise on the significance of overheads in costing

The authorities in Gotham are concerned to increase the efficiency of their health service. Each hospital in the city has been required to calculate its total cost per operation performed in the year to date. Money will be saved as more patients are directed to hospitals with the lowest cost per operation.

Comment on the Gotham policy

### Response

The Gotham policy shows the danger of using average costs for decision-making where fixed costs are involved. In such circumstances, average cost per unit will depend on volume of usage as much as it does on efficiency. Consider the data below. Hospital A is clearly more efficient than Hospital B – it has a lower fixed cost per unit of capacity, and a lower direct cost per operation.

HOSPITAL	A	B
capacity(operations per week)	100	200
fixed cost per week	£1 000	£2 400
fixed cost per unit of capacity	$\frac{£1\,000}{100} = £10$	$\frac{£2\,400}{200} = £12$
direct cost per operation	£4	£6

However, if we imagine that Hospital B is used more intensively at, say 75% capacity, as against only 50% capacity in Hospital A, it may well generate a lower actual cost per operation than Hospital A, as shown in the table below:

HOSPITAL	A	B
actual usage (operations per week)	50	150
total cost per week	£1 200	£3 300
average cost per operation	£24	£22

If followed through, the Gotham policy could involve closing efficient hospitals like Hospital A, and transferring their patients to other less efficient hospitals like Hospital B.