

# Cost Transparency: The Healthcare Imperative

Whatever direction reform takes over the next several years, healthcare organizations will remain under intense pressure to reduce costs and overhaul inefficiencies. Financial pressures are coming from every area of healthcare: payers, the government and healthcare organizations competing for market share and doctors. The only way to sustain an organization in this financially charged environment is to tightly manage profitability, which cannot occur without understanding true costs and profit sources. Organizations that fail to recognize and meet this imperative will find it increasingly difficult to compete and may eventually have to close their doors.

## THE ROOT PROBLEM: UNDERSTANDING COSTS

Although healthcare organizations have streamlined their processes in recent years, many hospitals and provider groups have yet to rigorously deploy methodologies like Six Sigma and Lean. Nor have they adopted tools like process analysis and activity-based costing. With the demand for financial results increasing, it is time for cost and performance measurement to move to the very top of management’s agenda.

To obtain a clearer picture of costs, you must be able to answer key questions:

- Which activities and processes produce value and enhance quality?
- What drives profitability—by case, service line, etc.?
- How do contractual payer prices compare to costs?
- How much capacity is being used?
- Are equipment investments justified?
- What areas should be kept in-house?
- What improvement initiatives would improve results?

## EVALUATING PROCESS AND RESOURCES

To stay competitive in today’s environment, healthcare organizations need to streamline inefficient processes and understand the types and amounts of resources they need. This can only be achieved through cost transparency.

Amazingly, most healthcare entities still use primitive standard costing tools that date back to an assembly line model - tools long abandoned by the manufacturing industry that created them. The result is rudimentary cost allocation that fails to match resources and related costs to their services. This makes it impossible to arrive at informed decisions that will improve financial results.

Consider, for example the common practice by hospitals of allocating the cost of equipment to surgical procedures that don’t use it. Allocations by their nature are arbitrary and produce distorted results. The cost of internal support services such as registration and materials management (without which patient services couldn’t be delivered) is typically excluded from any current cost accounting systems except as an allocation to a charge on the Charge Description Master (CDM). Many costs that are in fact triggered by the requirements of customers or payers are allocated instead to services.

## ACTIVITY-BASED METHODOLOGY VS. TRADITIONAL METHODS

TRADITIONAL: WHAT IS SPENT	
Labor	\$525,000
Benefits/payroll taxes	\$90,000
Supplies	\$60,000
Depreciation	\$60,000
Other Costs	\$40,000
	<b>\$775,000</b>



ACTIVITY-BASED: WHAT IS DONE	
Delivery Care	\$225,000
Document Care	\$115,000
Process Patient Orders	\$110,000
Transport Patients	\$75,000
Obtain Test Results	\$70,000
Admit Patients	\$50,000
Process Transfers/Discharges	\$30,000
Develop Care Plan	\$25,000
Perform General Administration	\$75,000
	<b>\$775,000</b>

## EFFICIENT OPERATIONS REQUIRE SOPHISTICATED ANALYSIS

One reason that operational managers don't have good cost data: their cost systems fail to reflect the variety of inputs and outputs (processes, sub-processes, utilization of resources) that make up the true cost of any single department or service.

There is no higher priority for healthcare organizations than cost systems that will:

- Provide accurate financial, operational and strategic information
- Compare budgeted to actual performance, at each level of the organization where cost drivers are controllable
- Track operational metrics — and their financial ramifications

## STRUCTURED COST METHODOLOGIES

Activity-Based Management (ABM) and Activity-Based Costing (ABC) are well established methodologies that have had a positive impact on many industries. But their adoption in healthcare has been hindered by lack of understanding of their benefits and a misperception that they are more complex and expensive to deploy. Clearly, the value of being able to manage financial results far outweighs the effort of deployment.

## UNCOVERING HIDDEN COSTS WITH ACTIVITY-BASED COSTING

A well defined organization-wide program to build cost transparency uses ABC to identify areas where costs are not well understood or are unproductive or excessive. This will pinpoint areas where ABM can improve financial results through analysis and restructuring.

The basic steps of an ABC effort are:

- Identify the products and services the organization produces that directly or ultimately serve customers or sustain the organization
- Associate services with entities like patients and payers
- Identify the range of activities that are inputs to each product or service. They are often a range of activities performed by disparate organizational units
- Match resources (labor, supplies, equipment usage etc.) with the activities that consume them. This needs to be done at a level where the relationship between activity and cost can be established, i.e. where cost is controlled.
- Identify the less obvious but significant drivers of cost such as:

- » Organizational policies
- » Employee turnover and inadequate training
- » Facility location and layout
- » Process complexity
- » Inefficient links between process and technology
- » Unmet needs for automation
- Compute and (as necessary) estimate the cost of activities, taking into account less obvious factors impacting cost, such as facility location and layout
- Compare costs to prices the organization is paid for its services, factoring in non-financial measures including clinical outcomes, patient functional status, cycle time, and customer satisfaction
- Identify “suspect” areas where costs aren't well understood or activities don't appear to contribute to service delivery or other objectives

## UNDERSTAND CASE AND DEPARTMENT COSTS

An immediate benefit of an ABC effort is creation of accurate costs for major processes, especially end-to-end cases. For example, the cost of a surgery extends well beyond the cost of direct supplies and the time physicians and nurses take to perform the procedure. Its true cost includes: the registration process, pre-operative testing (x-rays, blood work, etc.), assistance in recovery, patient transportation, patient counseling, patient accounting, discharge planning and post-operative activities.

Understanding these costs is essential to identifying the inefficiencies and points of vulnerability in patient service or quality of care.

## GREATER ACCOUNTABILITY FOR COSTS

The healthcare reform debate has produced consensus (at least in principle) that there must be a shift away from piece-rate “fee for service” — a system that is said to “pay generously when you do something to a patient, but is stingy when you do something for a patient.” Expect healthcare organizations to face greater accountability for costs and performance.

**REDESIGNING PROCESSES WITH ACTIVITY-BASED MANAGEMENT**

Once possible problem areas are identified an Activity-based Management approach can begin following these steps:

- Analyze activities in relation to their capacity usage and productive outputs (whether intermediate or patient services) to identify inefficiency and waste such as:
  - » Idle capacity
  - » Time associated with set-up or variability of internal operations
  - » Unnecessary handoffs, too many sign offs
- Identify areas where staff is spending too much time on low value-add processes outside its area of responsibility and competency or where staff skills are misaligned with the activity actually being performed, e.g., an RN performing a housekeeping activity.
- Target areas where multiple functions or units are performing the same activities on a sub-scale basis without adequate communication
  - » such as, gathering demographics and preparing and managing documentation
- Consider what could be done by lower cost resources or by sourcing processes internally or externally

**BEST PRACTICE: MAINTAIN MATERIALITY**

Avoid “analysis paralysis” by using rules of thumb such as ignoring activities that use less than 5% of an individual’s time or a resource’s capacity. Keep total number of activities considered in the range of about 10-20.

**COST TRANSPARENCY: THE ROAD TO SUSTAINABILITY**

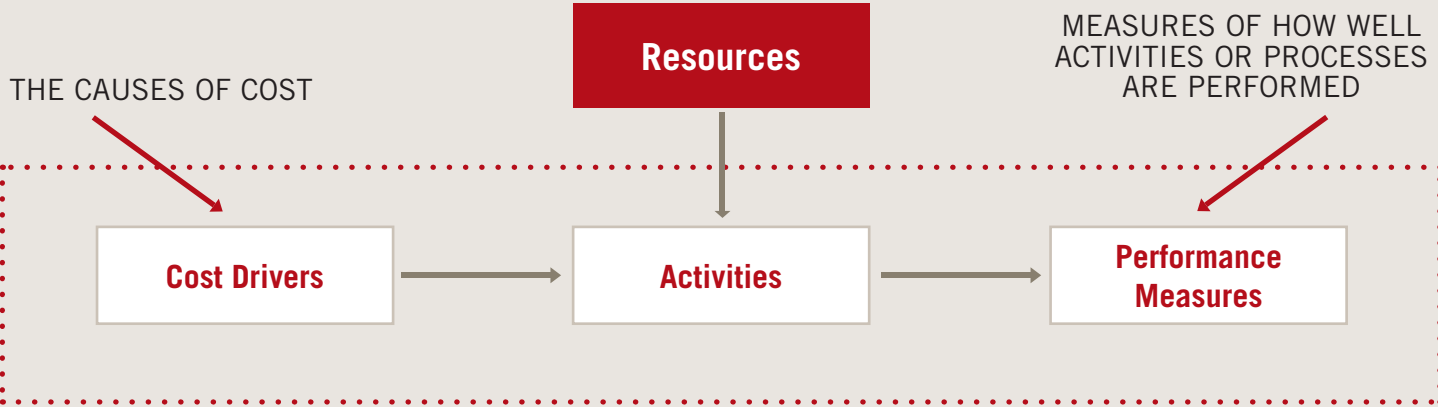
Building cost transparency is challenging, but organizations that move from a rudimentary to a sophisticated approach to cost analysis will reap the rewards. They will be more nimble in the era of healthcare reform, making better resource allocation decisions that lead to better financial results. They will be less likely to encounter negative financial surprises than other organizations.

Recognize that Activity-Based Management will require focus and commitment. It must be undertaken as an enterprise-wide program that is seen as essential to communicating and achieving the organization’s strategy. Only an enterprise approach can achieve true transparency and address systemic issues. Improving only one step in a 10 step process doesn’t reduce cost and time for the 10 steps as a whole.

The benefits of ABM are substantial. As wider coverage drives up revenues, organizations that can muster the mechanisms and incentives to reduce costs will see their margins grow and their competitive position improve. They will be able to invest intelligently in the organization’s future at a time when others will face financial difficulty. ABM is an essential step toward world class cost management and meeting your financial, strategic and patient outcome goals.

To learn more about Tatum’s Activity-Based Management methodology, contact Tatum at 888.TATUM11.

**ACTIVITY BASED MANAGEMENT: METHODS THAT DRAW RESULTS**



## CASE STUDY:

### Tatum Uses Activity Based Cost to Drive Change at a Major Physician Group

**Situation:** A 400-physician medical school faculty practice was faced with a major performance improvement effort. The CFO was concerned that the practice's cost allocation processes were creating a distorted view of which service lines were making and losing money. She engaged Tatum to analyze activities and costs related to the administrative side of the practice. Like most provider organizations, this group performed a complex chain of tasks, producing a varied mix of services. Accurately aligning costs with services was critical.

**Process:** Tatum Cost Analysis identified almost 1,000 separate and unique activities carried out by the practice, honing in on 10-20 major activities responsible for a significant portion of total costs. The team first systematically identified resources consumed by the major activities within each area. It then analyzed the accounting system and other source systems to identify costs related to resources, assigning them to departments based on their activities usage. The next step was to identify significant drivers of cost and pinpoint the causes of inefficiencies and rework.

*It was essential that ABC data be high quality and fully defensible. Employees were surveyed regarding the time they spent on activities and (for non-personnel resources) measured or estimated the percentage of the resource used by each activity. Even managers inclined to doubt the findings were impressed by the rigor of the methodology, neutralizing their resistance to change.*

**Results:** The study found that the practice had been using arbitrary formulas to allocate costs. Service lines that looked profitable really were not and vice versa. The P&Ls for each of the 14 departments were revamped to reflect results accurately. The study also provided a detailed view of costs by patient which in turn could be summarized by payer. This gave the practice the ability to understand its profitability by payer. The practice was also able to determine the high cost of not fully utilizing facilities. This resulted in a significant change in management practices to incent higher utilization.

After identifying problem areas and restructuring processes, the practice was able to reduce days in A/R from 50 to 38 and increase average cash collections by almost \$1 million per month. In addition to the financial results, staff morale improved significantly because productivity is now monitored via a set of actionable, outcome focused measures, including cash collected and patient satisfaction. The results were so unexpected by the organization that Tatum's Activity-Based Consultants have since been retained to apply the Activity-Based methodology in other areas identified in the original assessment including clinical practice operations.



## ABOUT THIS SERIES

Whatever reform legislation ultimately comes out of Washington, the challenges that put the healthcare industry at a significant inflection point are likely to intensify.

Wrenching change is coming as powerful trends transform how healthcare is financed and delivered. All industry players must be open to adjusting their strategies, processes and mindsets. This Special Report is part of a series developed by Tatum Healthcare to explore issues from the perspective of an operating executive.

## ABOUT TATUM

We are operating executives who serve a wide variety of healthcare organizations as interim and permanent CEOs, COOs and CFOs. Our advisors and consultants assist healthcare management with financial, technology, operations and compliance issues. Our services range from leading turnaround of financially troubled hospitals to advising private equity firms on new healthcare business models.

## WHAT WE BELIEVE

Tatum healthcare professionals believe that well run healthcare organizations have the opportunity to fulfill their missions and prosper through:

- Sound yet relentlessly innovative management practices
- Readiness to embrace the shift from fee-for-service to accountability for performance relative to cost
- Deployment of best practices, including those proven effective in other industries

For more information call 888.TATUM11 or visit [www.TatumLLC.com](http://www.TatumLLC.com).