Healthcare's Dilemma: How to Manage Patient Costs
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Until recently, healthcare has been a predominantly revenue-driven industry, where hospital and health system leaders focus on increasing the money coming into their facilities rather than curbing costs. However, as organizations shift away from fee-for-service and embrace more value-driven payment models, they are realizing they can no longer afford to prioritize revenue over spending to drive profitability. They must instead take a balanced approach that looks at both revenue and costs. To support this new perspective, organizations should strive to obtain a true appreciation of their costs down to the patient level, so they can make more informed budgeting decisions and effectively maintain and even strengthen margins.

Why traditional methods won't work anymore
Although organizations may acknowledge the need to be more cost-conscious, getting a handle on costs in the healthcare space is challenging. In part, because there hasn't been a credible cost accounting option. Outdated methods, such as ratio cost of charges (RCCs) and relative value units (RVUs), are not overly effective at determining costs because they involve broad averages that do not take into consideration the actual consumption of resources. As such, they are not an accurate reflection of what is really happening in the organization.

Looking to manufacturing for ideas
Healthcare can learn a lot from manufacturing—especially the automotive industry—because of its use of activity-based costing (ABC) to gain a clearer picture of the total cost per unit. ABC is a managerial accounting method that assigns indirect costs like support staff salaries and utilities to the products or services incurring the bulk of those costs. It is less arbitrary than other costing methods and results in a more comprehensive cost figure that takes into account the complete costs of creating a product or delivering a service. As healthcare organizations begin to embrace this methodology, they will start to see better progress toward quantifying and responding to cost information.

Integrating operational, clinical and financial analytics
The manufacturing sector has been using activity-based costing for a while, however healthcare organizations have been slow to adopt the concept—largely because this approach requires technology that can access clinical, financial and operational systems to completely capture what's happening in an organization and tie it back to costs. Historically, the clinical and financial worlds have functioned independently, with the technology systems that support them operating separately. For healthcare, an effective costing system must break down these barriers and easily connect to a range of data sources, including electronic medical records, operating room systems, Cath lab tools and radiology systems as well as general ledger, asset ledger, payroll, supply chain and revenue cycle solutions. As next-generation costing technologies enter the healthcare marketplace, organizations will be better equipped to

understand their costs and use that information to make smarter decisions around value and profitability.

Two key areas in which to apply the technology

While there are many ways for healthcare organizations to leverage a comprehensive costing solution, there are two use cases that stand out as especially important and relatively straightforward to pursue:

Use Case 1: Uncovering physician variability

Since physicians are tasked with making decisions about the type and degree of care a patient requires, a lot of healthcare costs tie back to physician decisions. Given that, it's easy to see how a slight variation in care approach can have a significant financial impact. Consider the example of a hospital that had two groups of physicians who were using two different surgical glues. One glue cost nearly double that of another brand. When the organization discovered the variance using an ABC-enabled costing system, it reached out to physicians to ask whether the more expensive glue was any better than the other one. The doctors didn't have an objective reason. Once the physicians were made aware of the differences and weighed the pros and cons, they decided as a group to use the less costly glue. Sometimes just pointing out the variance can prompt change, which can save money and resources.

Although spotting variations is not a new concept, a robust costing tool can take this activity to the next level. Take the story of two physicians who regularly performed heart valve replacements. Their profitability was nearly equal, and a traditional costing tool may not have identified substantial differences between the two. However, an ABC solution was able to figure out that even though these two physicians had similar profitability, they were utilizing resources in different ways. Physician A was using an average of 26 hours more ICU time per patient than the other physician on each valve replacement. The other physician was using less ICU time but more expensive drugs. The organization looked at this information and decided which of the two approaches better fit its clinical, usage, resource and cost goals and worked to implement the preferable process.

Most of the time physicians follow workflows based on habit or because they were trained to do things a certain way. What a comprehensive costing tool can do is provide clear information to the physicians that shows the variations between them and their peers. In some cases, there are medical reasons why they are following specific processes, but in others, an organization may be able to refine workflows and supply decisions to save costs while still preserving outcomes.

Use Case 2: Informing payer negotiations

As organizations more fully embrace value-based care, they are starting to negotiate bundled payment arrangements. A basic arrangement will offer a single payment for a defined procedure, such as for total knee replacement, and cover the hospital and physician costs. A more sophisticated bundle, which will probably be the more common model for the future, provides payment for the entire medical condition. In these arrangements, the bundle would cover follow-up visits with various providers, rehabilitation costs, skilled nursing care and any other costs involved in bringing the patient back to wellness. With both types of bundled payment arrangements, an organization must have a full appreciation of the treatment costs to make sure that the amount of reimbursement will cover the expenses. As such, having access to data that can provide a clear indication of what the true costs are is essential to better prepare for and participate in negotiations. Unfortunately, many hospitals enter bundled payment negotiations blind, or they use a proxy for cost data because they don't have a tool that gives them the full picture. The more specificity an organization can get around its costs, the more informed it will be as it enters bundled payment arrangements, ensuring greater profitability and reducing risk.

It's time to leave the old ways behind

For healthcare organizations to successfully navigate the move to value-based payment methodologies, they must welcome a new approach to determining costs that mirrors the one used in manufacturing. By leveraging technology tools that seamlessly integrate clinical and financial systems to enable activity-based costing, organizations can see tremendous benefits, implementing a well-considered pricing strategy, better controlling supply chain and more effectively managing their margins.

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