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Key Issues that Affect Hospital Laboratory Profitability

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With the majority of hospitals in the U.S. involved in outreach today, assessing and improving laboratory profitability has become more important than ever. However, many organizations do not have a clear understanding of the operational aspects of outreach that impact financial performance. By first casting a critical eye on these areas, laboratory leaders can then employ strategies and tools to improve their programs' financial health.

Major issues affecting laboratory profitability fall into two broad categories: those related to revenue and those involving expenses (Figure 1).

Figure 1: Key Issues Affecting Profitability

- **Revenue**
  - Pricing/payor mix/business ventures
  - Billing/collections (rate, A/R management, referral testing)
  - Sales management (new sales and control of attrition)
  - Market segment(s)
- **Expenses**
  - Staffing and productivity
  - Variable cost of laboratory operations
    - Supplies and referral testing
  - Outreach-specific expenses
    - Geographic coverage
    - PSCs
    - Phlebotomists
  - Overhead

Influence of Revenue-related Aspects on Profitability

A variety of factors, such as pricing, have an impact on outreach program revenue and, thus, profitability. Pricing challenges are threefold. First, hospitals may resist the creation of multiple fee schedules, hampering laboratories' ability to set competitive outreach fees. Laboratory leaders must take the initiative in convincing their organizations of the viability of this approach. Industry resources are available to allay compliance concerns and clarify what is allowed from state to state. Second, facilities may not know how to determine outreach client pricing; often, they mistakenly believe they must match or undercut the competition to succeed, and profitability suffers as a result. Lastly, net revenue, a key component of profitability, is complicated by hospital fee schedules that are frequently based on high multiples of the Medicare schedule and can result in exorbitant allowance rates.

With regards to payer mix, the question centers mainly around whether the outreach program is securing *easy-to-get* versus *valued* business. The former requires less effort to capture but tends to comprise a poor payer mix. Examples include low-paying managed care business or testing from physicians that do not desire connectivity, which in some instances may indicate a practice that is not run very well and thus lacks payer diversity. Valued business, on the other hand, may be defined as a practice with a good payer and test mix and that sends a high percentage of its testing to the program. A high proportion of client bill business can also negatively impact profitability.

Outreach business ventures that involve revenue sharing or low reimbursement also play a role in profitability. While participation in a multiple-entity coalition or consortium may have its benefits, particularly for a service like imaging with significant capital requirements, an organization must ensure that its revenue accrual under these types of arrangements does not negatively impact its margin.

Profitability is profoundly influenced by billing and collection practices. For this reason, it is imperative to determine whether the entity handling outreach billing has a proven track record in laboratory billing. The vast majority of laboratories rely on the hospital billing department to perform this service. Since the net outreach revenue per requisition usually falls below the billing department's write-off threshold, this revenue frequently goes uncollected. While exceptions do exist, for the most part, hospital billing departments do not have the necessary attention to detail for maximizing outreach profitability.

Laboratories must also arm themselves with appropriate information to gauge the effectiveness of their billing processes. Questions to answer include:

- Does the laboratory know its outreach net revenue and cash detail?
- Is all revenue or only the easy-to-bill revenue being pursued?
- Does the laboratory know the efficiency of its billing process in terms of days sales outstanding (DSO)?
- Is it known whether all clients/patients are paying?

Shortcuts and lack of information in this area can have drastic consequences. To assure both a focus on capturing all revenue and provision of essential data to monitor and improve financial performance, laboratories that are truly serious about outreach should consider outsourcing their billing functions, provided they have the net revenue (minimum of $2.0 million to $2.5 million) to financially justify the expenditure.

Table 1: Billing Information

	Yes	**No**	**Uncertain**
Access to net revenue information?	52.3%	38.7%	9.0%
	Hospital	**Outside**	
Billing performed by hospital or outside service?	82.7%	17.3%	
	Yes	**No**	**Uncertain**
Ability to obtain billing information by: ▪ Client ▪ Sales Representative ▪ Courier Route ▪ Market Segment **If you can get to client data, you should be able to get to the rest!**	 74.0% 18.8% 10.3% 33.3%	 21.9% 76.8% 86.8% 55.6%	 4.1% 4.3% 2.9% 11.1%
Do you use the hospital's provider number for outreach billing?	78.6%	21.4%	
Do you receive reports trending Medicare denials?	51.4%	48.6%	
Do you have a process for reviewing claims that have been denied for medical necessity?	73.4%	26.6%	
Are you confident that you are collecting everything you can?	29.7%	70.3%	

Source: Chi Solutions, *Eighth Comprehensive National Laboratory Outreach Survey*, 2009.

Results from Chi's recent outreach surveys reveal some notable trends in the availability of billing information (Table 1). Nearly half of respondents indicated that they either did not have or were uncertain if they had access to net revenue information. As mentioned previously, the hospital handles billing for most laboratories (83 percent). When asked about their ability to obtain billing information by various metrics, two-thirds responded they could get the information by client, but the majority reported that information by sales representative, courier route, or market segment was not available. Interestingly, however, the data by client can be manipulated to provide the other information; respondents are either not aware of that or unable to invest the time to do the necessary calculations. Perhaps most telling is the response to the question, "Are you confident that you are collecting everything you can?" Seventy percent of respondents said they were not.

With regards to bad debt and DSO, the survey uncovered a startling statistic: 76 percent of respondents do not know their laboratory's bad debt rate and 80 percent are unaware of the DSO. The difficulty in tracking these metrics stems in part from the practice of hospitals billing laboratory testing as part of a much larger outpatient services bundle. When payment comes in, it may be difficult to determine what percentage applies to laboratory.

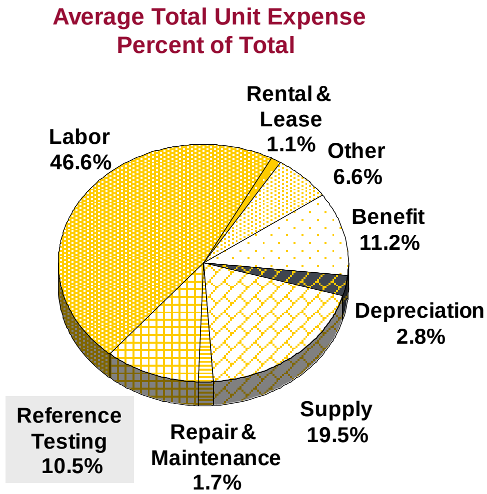
From a revenue standpoint, sales management practices also play a significant role in outreach profitability. Representatives should have a strong laboratory sales background. Those from other fields may possess considerable general sales knowledge, but the particular challenges of marketing laboratory services call for individuals with industry-specific expertise to secure profitable business. Additionally, successful outreach programs require sound territory management practices. Most laboratories can readily identify their target markets, but many do not have the appropriate mechanism to assign responsibilities for and track sales activities within those markets. Competitive compensation is another important component of effective sales management. Recruitment and retention of exceptional talent requires attractive compensation; studies of sales force effectiveness point to compensation as a key driver of representative performance on multiple levels. Some in the industry believe that compensation should be based on client profitability; however, to employ this approach, a laboratory must be sophisticated enough to routinely track profitability. Lastly, performance management can be enhanced by ensuring the sales department reports to a sales professional.

Impact of Expenses on Profitability

Monitoring and controlling expenses can also help boost financial performance. A prime target for action in this area is supply cost. As a first step, laboratories should make sure all high-volume supplies are covered by contracts. Surprisingly, many organizations—even large, successful regional outreach programs—lack these types of agreements and thus forgo an important cost control opportunity. Once contracts are in place, the laboratory must audit invoices to verify that the agreed-upon pricing is being honored. Standardization of both contracts and technology also provides substantial cost benefits. Many times, health systems elect not to pursue this strategy due to political or priority issues, but overcoming these obstacles to unify supply contracts and technology platforms system-wide can result in significant savings. Existing contracts should not be a roadblock to standardization; vendors are often willing to renegotiate contracts to acquire more business from and/or prevent loss of a client.

Referral testing represents another area of opportunity for profitability enhancement. As Figure 2 shows, referral testing comprises 10 percent of an outreach program's average total unit expense. For this reason, bringing this cost in line can have a profound impact.

Figure 2: Referral Testing as a Percentage of Total Unit Expense



Referred testing is ~10.5% of cost of an outreach program, but only 2-4% of the volume!

Note: Average of past several years

Source: Chi Solutions, Inc., database.

Laboratories should undertake a thorough analysis of referral testing practices and utilization to uncover savings opportunities. An evaluation of process flow and management is critical for determining potential efficiencies. Utilization should be monitored to ensure that excessive patterns of referral test ordering are identified and addressed. Reimbursement can be managed via coding or referral laboratory billing of esoteric testing. Laboratories should also check their referral laboratory “hot lists”—which are most often prepared by the reference laboratory’s sales staff rather than the clients—to assure they include high-volume tests and negotiate the lists with their vendors if they do not. Conducting a simple top twenty analysis by payer of actual reimbursement will help identify problem areas. In addition, significant financial improvement in this area is feasible through repatriation of referral testing as outreach volumes grow.

Infrastructure poses a challenge on two fronts. First, many laboratories’ rate of infrastructure expansion far exceeds the growth of their outreach volume and revenue. While it may be tempting to develop numerous patient service centers and wide-ranging courier routes in the hopes that the business will follow, the reality is if you build it, they do not always come. If sales do not materialize, the fixed cost of excessive infrastructure also makes it difficult to improve performance by eliminating unprofitable clients, since the relative percent of overhead increases as the number of clients decreases. On the other hand, ineffective infrastructure can also damage profitability. As mentioned previously, the two biggest problem areas reported by outreach programs today are billing and physician connectivity. Inadequate sales infrastructure also plagues many programs. Laboratories must strike a balance between making sure vital elements are in place and anticipating what infrastructure growth their programs can reasonably bear.

The way that overhead is allocated to an outreach program impacts its profitability. Great variation exists in the methods used to apportion overhead expenses. It can be based on an arbitrary approach, in which for instance the Medicare Cost Report may be utilized to decide what percentage of all hospital overhead—whether related to the outreach program or not—is allocated to the program. An affinity methodology, however, takes into account the overhead costs actually incurred in support of the program. Whether or not overhead is assigned to an outreach program and the manner in which it is determined will affect contribution margin. Forty percent of respondents to Chi’s outreach survey indicated that hospital overhead is allocated to their programs; therefore, their contribution margins appear lower in comparison to others whose margins do not include overhead. In some cases, allocation of hospital overhead can make an outreach program with an otherwise positive contribution margin look like a significant financial loser. For this reason, to properly identify profitability enhancement opportunities, it may be necessary to first remove overhead from the equation to discover whether the program is recouping its direct cost.

Conclusion

An important initial step in laboratory financial performance analysis and enhancement is to examine revenue- and expense-related outreach components. A thorough investigation of these areas and how they influence program profitability will often reveal opportunities for improvement that may augment the organization's bottom line.