Profitability and Cost Management in Healthcare

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Executive Overview

Profitability and cost management is an imperative for healthcare insurance providers. This is being driven by both regulatory requirements and competitive pressures. Effectively addressing the challenges of profitability and cost management involves mastering a methodology, understanding the business drivers, changing business processes, and introducing a system that supports an efficient process. The impact of profitability and cost management ripples through to all management processes and is a key component of an overall enterprise performance management system.

The Need for Profitability and Cost Management in Healthcare

Healthcare is important to everyone. Receiving quality care when needed to ensure a long and healthy life is a basic tenet of life in the United States. Securing the correct solution that balances financing and quality care is now the subject of great debate in the United States. With the Healthcare Reform Legislation of 2009 the US Government has sought to ensure that all Americans have access to affordable quality care and insurance, however the legislation is meeting resistance by some states. Providers struggle to deliver quality care at a reasonable price. Insurers struggle to provide a fair and affordable funding solution. Government officials are trying to balance the needs of all participants to ensure a viable, long term, stable solution.

The traditional model of how employee healthcare benefits are provided is changing. Large employers providing a comprehensive benefits package are shrinking in numbers. These are being replaced by small employers and independent workers seeking healthcare insurance coverage on their own, or looking to join the regional healthcare exchanges defied by the 2009 legislation. This new Individual or Direct Pay model presents new challenges for Healthcare Insurers:

- How do you underwrite a group of one effectively?
- New credit and collection issues.
- Increased scrutiny on member interactions.
- Reshaping the benefit design to meet today’s needs.
These issues are creating new informational challenges. Having accurate, immediate data to analyze is critical to maintaining a consistent, profitable revenue stream and membership.

Healthcare Insurers are operating in a volatile and fluid environment today. Government has enacted new legislation that could alter the way benefits are funded and delivered. Businesses are rethinking the benefit programs that they provide to their employees. There is a new focus on being competitive in a global economy. It is now more important that companies are able to compete on a global basis. This will help to ensure that companies remain competitive and keep jobs and opportunity here in the US. As a result, there are many new pressures on Healthcare Insurers:

- Pressure to lower premiums
- Pressure to increase benefits to address the needs of changing demographics
- New legislative initiatives and increased regulations and oversight
- Financial and tax incentives and burdens
- Shrinking market of large employers
- Trend towards small business and self employed
- Need for more portability and stability of all employee benefits
- Need to reduce fraud and increase claim payment accuracy
- Detailed reporting on Medical Loss Ratios
- Need to have a more current and accurate view of their business performance

Increased competition in the marketplace, combined with increasing health care costs, have forced healthcare insurers to place a premium on managing administrative expenses. With evolving complexity of product offerings, understanding product line and market segment costs become essential information for managing the business. Add to the business information need the complex compliance requirements imposed by government programs such as the Federal Employee Program, Medicare and CHAMPUS, and you have a very complex financial application requirement.

All of these issues are creating challenges and opportunities for the Healthcare Insurers. Increased efficiency will allow insurers to maintain stability in their operations and rates. It will also allow them to react quickly to changes in regulation and in their markets. Receiving accurate information in a timely manner will allow them to make better decisions regarding their operations, markets and ultimately their long term viability and survival.
The Relevance of Profitability and Cost Management Today

The interest in profitability and cost management is re-emerging, and the topic is increasingly being elevated to the board’s agenda. Profitability and cost management is more relevant than ever. There are multiple reasons for this, both on the tactical side—responding to internal and external pressures, and from a strategic point of view—increasing the organization’s competitiveness.

Indirect Costs Are Increasing

Healthcare Insurers are continuously challenged to determine their organizational effectiveness. Despite modern processes and systems indirect costs are increasing. To reduce these costs many organizations are introducing shared service centers, centralizing certain operations either in the front or back-office. The economies of scale outweigh the overhead of such centralized operations, but the overhead and other types of indirect costs still need to be allocated. Profitability and cost management solutions help ensure the business relevance of shared service centers. Profitability and cost management solutions can also help establish whether these shared service centers should be placed within the organization or should be outsourced. In such an exercise, the burden of internal indirect costs can be compared and benchmarked against external services.

Competing on Service, Portfolio and Brand

It may be relatively easy to attribute revenues to the sales of specific products, but individual products alone do not make a competitive difference anymore. It is the service that comes with the product that makes the difference. Whereas Activity Based Costing (ABC) had a strong focus on the back-office as an analytical tool to optimize processes, profitability and cost management solutions can be used for service pricing—where the relationship between resources, activities, and revenues is not always easy to make.

Horizontal Alignment

Reporting structures tend to be hierarchical in nature. New plans and strategies are cascaded top-down into the organization’s hierarchy. Conversely, most geographic or functional domains self-report to their management, and at the top all information about all costs and revenues come together. However, cost and value drivers seldom report ‘upwards’ in a meaningful manner. Drivers tend to impact the organization ‘sideways’, through the organization’s value chain. Profitability and cost management solutions introduce ‘horizontal alignment’, which is a crucial extension to the vertical alignment most organizations have.

For instance, the most important cost driver for a claims department within an insurance company is the risk profile that the underwriting department is using. Too many accepted bad risks lead to an increase of claims, both in quantity of claims and in size per claim. The claims department actually has little means to influence total claim size, which can be up to two-thirds of the cost structure of an insurance company.
Transparency
The cliché that business experiences higher cost and regulatory pressures will come as no surprise in the Healthcare market. Patients, suppliers, shareholders, and regulators, all demand more transparency. Executives cannot allow surprises regarding their profitability. They need to ensure that both cost and revenue are managed in alignment throughout the organization. A solid set of processes, a comprehensive methodology, and a robust system are needed to meet these requirements. In fact, if executives do not ensure such a level of control in a transparent and regulated world, it will cost them dearly.

How is Profitability and Cost Management Different Today?
Profitability and cost management traditionally has been an operational function because of the prevalence of ERP systems. These systems have a Chart of Accounts, ledger, sub-ledger, operating statements etc. This is a necessary structure to accurately reflect and record the financial activities of an organization. However, it has very little relevance to the products and services offered by the business. As a result, the majority of the profitability and cost management solutions in the business were relegated to a series of reports which were pulled together from disparate sources. Organizations often spent more time in reconciling the variances in reports than in actually understanding the data on the reports. As a result, Management had very little faith in these profitability reports.

Profitability and cost management today is a strategic function. It has management attention and visibility. Today’s profitability and cost management solutions are driving a key performance metric – the overall profitability of the business. It is not only reported upon but it is used as a strategic tool to driver change throughout the organization. It involves mastering a methodology, understanding the business drivers, changing business processes, and introducing a system. The impact of profitability and cost management ripples through to all management processes. The following is an overview of the stages most organizations experience as they mature in their approach to profitability and cost management.

Stage 0: So What?
At the macro or company level, profitability is simple and easy to measure and evaluate: revenue – cost (expenses) = profit. For organizations that have experienced unbridled growth, and perhaps have a straightforward set of products and services, this may be enough for a long time. However, when economic circumstances change or if the product and services portfolio grows, a better grip on the cost and contribution of processes, products, and customers is needed.
Stage 1: Know What

Profitability in the micro environment of the organization, for example at the customer or product level, can easily become complex, difficult to measure, and often leads to multiple interpretations of the data. The first stage—the “know what” stage—in the profitability maturity lifecycle of an organization begins with profitability reporting. In this stage, the organization simply measures the profitability via key performance indicators (KPIs) that drive their business. For example, if an organization wants to determine customer/product profitability, profitability reporting would focus on questions such as:

- What is the profitability of each customer/product?
- Who are the most profitable customers/products?
- Which products have the highest margins?
- How much does it cost to serve customers?
- What is the total cost of producing the products?
- What are the ongoing service and support costs?
- What is the direct support cost for each customer?

Most organizations would be happy if they could accurately measure their profitability KPIs. This reporting is often the trigger point in examining the profitability data for accuracy. Thus begins a cycle of analysis to ensure the validity and accuracy of the data.

Stage 2: Know How

The second stage—the “know how” stage—begins with an understanding of the meaning behind the numbers in an organization’s KPIs, in other words profitability analysis. Most businesses try to manage price, sales volume, variable costs, and overhead to drive their financial performance. Price and sales volume are often not debated. They are pretty straightforward. The variable costs and overhead, however, are not well understood. Why are some customers profitable and others not? Why is there a difference in the profitability of like customers? Why is a particular customer consuming more support resources than another? Comparing the variable costs against all customers in a segment can help provide answers to the variances in profitability of customers in a segment. These variances are not only the key to understanding and developing the core drivers of profitability, but are necessary to developing a plan of action to improve profitability.

Stage 3: Now What?

The third stage—the “now what” stage—begins by developing a plan of action for improving the profitability of an organization’s underperforming assets, i.e. those customers and products that fall below the line. Profitability optimization and profitability planning are introduced, after profitability reporting and profitability analysis. The key drivers of profitability (in the second stage) provide the baseline for the desired profitability performance of the assets.
Improving profitability requires more than just identifying the delta between the plan and the actual results. It requires creating and comparing multiple scenarios to achieve optimal performance. Once a scenario is selected, budgets and plans need to be updated to execute upon the selected scenario. Organizations in this stage often benchmark profitability internally, asking questions such as: What is the profitability today versus a time-period ago? How does the profitability with the new organizational structure compare to the old organization structure? Many organizations in this stage bring in external data to establish benchmarks in order to compare themselves to their competition.

Stage 4: Know Why

Organizations that have fully matured have built in profitability management in their core business processes. They do not only know where they are profitable, but also why they are profitable. Profitability management is not an after-the-fact analysis, or a top-down plan. Instead, it is incorporated into every single transaction. Indirect functions know their impact and contribution on the core processes. Operational managers have the information to assess the efficiency and effectiveness of their decisions. The planning process doesn’t just focus on financial results, but rather dynamically incorporates resources and activities. Any change in these leads to a new financial forecast.

Organizations that have reached this level have extended their ‘operational excellence’ strategies to include ‘management excellence’. Oracle believes there are three pillars to achieving management excellence.

**Smart:** There is no shortage of data and every organization has access to the same data, both internally and externally. The difference is continuous insight in how small internal and external changes can be leveraged to increase profitability.

**Agile:** Being smart is useless if you can’t turn insights into action. Organizations are constantly changing through global expansion, product lines, and acquisition. New opportunities to increase profitability need to be implemented immediately and dynamically plug into the evolving enterprise information architecture.

**Aligned:** The third pillar of management excellence is about aligning insights across the value chain and to all the stakeholders of the enterprise. Many of an organization’s profit drivers are located outside the organization’s firewall. Organizations must evolve from a command and control approach to a collaborative model incorporating contributions from all stakeholders. Profitability and cost management is at the core of management excellence.

Where does Profitability and Cost Management Fit in the Organization?

Profitability and cost management is integral to many areas of a healthcare insurer’s operations. Visibility is important to assist in making strategic and competitive decisions for:

- Executive Management Team
- Product Management
• Underwriting and Actuarial
• Customer Service
• Sales and Marketing
• Treasury and Asset Management

Choosing the Right Tool for the Job

The journey of profitability and cost management begins with creating a profitability model that can allocate costs and revenues. A flexible allocation engine that can be easily used by the business users is, therefore, a must. A flexible allocation engine provides the basis for more granular allocations, leading to more accurate profitability data. In most organizations, allocations are a rather arbitrary process.

While the granularity of allocations is the precursor for accuracy, the confidence in the accuracy of the allocations can still be suspect. Therefore, being able to visually trace the path that an allocation takes can quickly turn doubt into confidence, thus empowering users to make effective decisions. In addition, many healthcare insurance providers contract with the federal government and are reimbursed for administrative costs. These costs include overhead allocations and as such, allocations are subject to specific guidelines / rules that must be followed to maximize their reimbursement. Contractors perform audits of the payers systems to insure costs are allocated within the guidelines of their contract making the audit trail a vital feature of any system.

While allocations are necessary for accuracy, analyzing profitability data to discover the key drivers of cost and profitability is at the heart of a profitability and cost management solution. Therefore, having a robust analytic foundation is also a necessity. The analytic foundation needs to provide an intuitive user interface for “speed of thought” analysis. Business users must be able to manipulate large profitability data sets to monitor complex scenarios, forecast outcomes, and perform what-if analysis to identify customer/product profitability trends.

Profitability and cost management solutions have traditionally focused on reporting and analyzing profitability—generally as an accounting, analysis or operational process. The users could report and analyze the data but there was no integrated or systemic process to execute the decisions stemming from the analysis. With profitability as part of performance management, profitability is not merely reported—it is planned, measured, and interpreted.

Profitability and cost management solutions today must provide a systemic process to execute upon and implement best practices discovered as a result of profitability analysis. There must be a closed-loop system between the profitability and cost management system and the budgeting and planning system so that resources can be strategically allocated as a result of the profitability data. Planning ensures that efforts are directed toward the achievement of corporate objectives. Measurement checks and adjusts progress against plans by matching revenue against costs incurred, making adjustments by tweaking processes to align with profitability metrics. Interpretation of profitability data helps identify developing trends that alert management to ask the right questions and take action.
Oracle's Profitability and Cost Management Solution

Oracle Hyperion Profitability and Cost Management (HPCM) is a performance management application that is part of Oracle's enterprise performance management (EPM) system and provides actionable insights into costs and profitability. This solution drives business performance by discovering drivers of cost and profitability, empowering users with visibility and flexibility, and improving resource alignment. HPCM provides the ability to accurately allocate revenues and costs with detailed documentation and audit trails. Built around a flexible allocation engine, HPCM's powerful analytic foundation helps organizations determine which plans and group policy customers to invest in (or to divest from), and how to strategically allocate resources. The following features differentiate HPCM from other solutions on the market.

Business User Driven Profitability Modeling
With an open, flexible, and easy-to-visualize modeling environment, business users can follow a suggested path—or create their own process—to create, maintain, and deploy their cost and profitability models. This offers a huge advantage over traditional “black box” cost and profitability solutions, which required specialist analysts and intensive use of IT resources to develop models.

Flexible Allocation Platform
Accurately measuring and allocating both cost and revenue is the key to calculating profitability. HPCM’s allocation engine supports your cost and revenue modeling approach whether it uses cascading allocations, custom calculations, ABC, time estimation, or industry-specific revenue adjustments. Multiple allocation methodologies can be combined to form your own custom allocation methodology.

Business Rules Engine
The business rules engine in HPCM allows line-of-business personnel to drive application design and rapid iterations. Its intuitive interface makes it easy to build dimensions, hierarchies, metrics, and scenarios.

Traceability Maps
Traceability maps—graphical depictions of allocations—provide a new level of transparency into cost and revenue allocations through multiple steps. Using traceability maps, users can verify that business rules have correctly applied the allocations. Traceability maps can serve as documentation so that independent reviewers are able to comprehend and, if desired, duplicate the allocation algorithm to validate the profitability model.
Model Validation Reporting

HPCM provides users with stage-by-stage cost and revenue assignment validation reports for testing the completeness of their cost and profitability models and reduces the time required for troubleshooting. In addition to the allocation calculations, HPCM includes a process to create genealogy data. The genealogy data creation process calculates the allocation detail for source and destination intersections that do not have a direct assignment but instead have an indirect relationship. These calculation processes, together with the embedded traceability maps and validation reports, support complex analysis and reporting of causes and effects within the model.

Hierarchy and Dimension Management

The dimension and hierarchy management capabilities synchronize metadata across Hyperion Performance Management applications. Users can graphically design their profitability application using existing artifacts from the common performance management library in the EPM Architect module of Hyperion Performance Management applications. Dimensions and attributes defined for one model can be used in multiple models.

Multidimensional Calculations

HPCM is the only packaged profitability application that leverages Oracle Essbase for faster, easier, powerful multidimensional analysis. One point of maintenance makes it easy for an administrator to manage business rules.

Powerful Analysis and Reporting

The data generated by HPCM delivers powerful insights for decision-making. Business users can visualize multi-dimensional information in a highly intuitive manner through user-directed query and analytic capabilities.
Integration with Other Hyperion Performance Management Applications

Oracle Hyperion Performance Management applications are an integrated suite of performance management applications that provide common security, user workspace, and metadata management that enables a single point of maintenance. This means a reduced cost of administration and ownership over non-integrated point solutions. Integrated within the EPM processes, Oracle Hyperion Profitability and Cost Management enables faster, better decision making and allows organizations to allocate resources more strategically.

![Diagram](image)

Figure 3 – Oracle's Hyperion Performance Management Applications

Supporting the Needs of the Health Insurance Industry

Oracle Hyperion Profitability and Cost Management supports the core requirements of the Healthcare Insurance industry and provides value for a broad range of use cases. For core profitability management, HPCM helps managers gain visibility and understanding of the cost to service different healthcare plans, group business and members. It helps provide an accurate understanding of profitability by member segment, healthcare plan and distribution channel. Based on this new insight, managers can improve marketing programs through better member segmentation and make more confident operational decisions about plan design and services. In addition, HPCM helps Finance and Operating Staff provide more complete documentation and audit trails for regulatory reporting and to visually justify Medical Loss Ratio results.

HPCM can support a number of different stakeholders and user groups. This includes Financial Executives who need to understand what drives costs and profitability; which plans and member groups are truly adding value to the business; and how to strategically allocate resources. HPCM can also be used by Line Managers, Operations Managers, and Marketing Managers to better understand causal business relationships and make better decisions about which plans and channels to support, which member groups to invest in, and which campaigns to undertake.

And finally, HPCM can benefit Information Technology Executives by providing a self-service environment where business-users control and manage costing and profitability models. This will free up IT resources allowing them to focus on supporting other critical business functions and initiatives.
Conclusion

Profitability and cost management is a business imperative. Organizations should start by assessing their ‘as is’ situation, by identifying their position in the maturity life cycle. Then they should define their particular business case. This can be either tactical, by focusing on cost management, or strategic, by using it to enhance the business model and enabling portfolio management, customer self-service and value chain integration through horizontal alignment.

In evaluating solutions, organizations should not focus on profitability and cost management as a single discipline; it should be seen as a foundational part of an overall EPM system.