

Activity Based Profitability for HME

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HME Clients often ask why their company isn't profitable in spite of the fact that business appears to be constantly increasing. There are no easy answers to this question, since there are a multitude of possibilities as to why companies are not as profitable as they could be. One recommendation that we frequently make to managers or owners is to ascertain whether the products and services they are currently providing are profitable.

It is important to quantify the revenue reimbursement and the "fully loaded" cost of each service and product you provide to assess the profitability of each one. This will assist you in determining your "profit mix" to allow for an increased focus on product lines that are more profitable and to analyze all the services and products that you provide. It is recommended that service and product revenue and cost be reviewed on an ongoing basis due to the frequent changes in HME reimbursement and pricing. In addition, providers should consider profitability prior to adding a new product line or service. However, profitability is only one factor to be considered in adding or continuing a product line. The following are other issues to consider: Does the product complement more profitable services or products? Do you need this product to retain key referral sources? If you are part of a Health System does the product or services contribute to their strategic initiatives?

There are different formulas for calculating your gross profit, but the primary component of any calculation involves determining your cost of product and labor and your reimbursement/allowable revenue. In order to do that, the following steps should be taken:

Determine the "Average Reimbursement/Allowable Revenue" per Product. Establish the reimbursement/allowable revenue and percentage mix of business for each payer: Medicare,

Medicaid, Commercial (includes the average of all commercial payers), and Private Pay/Retail. Then calculate the average gross revenues as follows:

Payer	Allowable	% of Business	Average Gross Revenue Per Payer
Retail	50.00	50	25.00
Medicaid	35.00	10	3.50
Medicare	32.00	25	8.00
Commercial	40.00*	15	6.00
Average Reimbursement/Allowable			42.50

*Average of Commercial Allowable

It is also desirable to subtract the company's historical bad debt % from the average reimbursement. For instance, if your company averages bad debts of 5% of net revenue, that percentage should be deducted from the average reimbursement/allowable revenue.

Group Job Functions by Activity. The first step in determining your cost of providing a service is to group job functions by activity (i.e. Customer Service, Reimbursement, Delivery, etc.) so that you can assign a dollar value for each activity. For instance, customer service may be responsible for taking a referral, verifying benefits, and data entry. There is a cost to the company for each of these tasks and by segregating responsibility, costs can be assigned appropriately.

Determine Labor Cost per Activity. After grouping the company's job functions by activity, you then determine the cost of performing each of these functions. In other words, you need to assign a dollar value for each task. For instance, if you determine that it takes an average of 15 minutes to take a referral, you can compute the cost of that activity by averaging the hourly salaries of your customer service staff and multiplying that figure by 25% (15 min./60 min). An example is as follows:

Average Salary Cost / Time to perform Function = Activity Cost

$$\text{\$24.00} / 25\% = \text{\$6.00}$$

It is also desirable to add the cost of benefits and other fringe expenses to the salary figure to get a more accurate activity cost. The cost of every activity associated with delivering this product or service should be determined.

Determine the Cost of the Product.

Determine the average cost of the product you are analyzing. Be certain to add any shipping or other charges to the cost of the product.

Calculate Your Profit Margin. With the above information, you can calculate a simplified version of your gross profit margin as follows:

Average Reimbursement/Allowable Revenue	\$42.50
Less: Cost of Product	(22.50)
Activity Costs -	
Customer Service	(6.00)
Other Activities (Delivery, Warehouse, etc.)	(8.00)
Total Cost	(36.50)
Gross Profit before Selling, General & Admin.	\$6.00
Percentage (\$6.00/\$42.50)	14.1%

Even though this is a simplified version of how to calculate your gross profit by product, it is a good starting point for determining what services could be added or eliminated from your line of business. Activity Based Costing will also identify areas within your organization that could benefit from reducing your cost through processes improvement. In addition, knowing your specific product profit margin will assist you in developing pricing guidelines.