

**McKESSON**

**Understanding Your Cost to  
Serve Can Save You Time,  
Money and Worry**



**McKesson Medical-Surgical**



## Understanding Your Cost to Serve Can Save you Time, Money and Worry

In the never-ending mission-critical pursuit to make a business more profitable, DMEs must be diligent in reviewing their business activity and how it affects the bottom-line. But along with keeping track of inventory control, fulfillment costs, complicated billing requirements, returns and the ever-changing needs of customers, DMEs also face increasing paperwork demands, reimbursement cuts, quota caps and competitive bidding. Bottom line: DMEs are within a changing, somewhat frenzied industry, which makes process measurement difficult — yet integral to survival.

Changes to processes, such as the DME supply chain, can result in increased revenue and higher profits without having to increase sales. This can positively affect any DME retailer, whether a major DME with locations across New England or the local independent DME serving a rural community.

### **But where should you begin?**

As an example, ABC (fictitious) is a home medical equipment company that offers myriad DME products to its customers, including a line of incontinence supplies. Along with stocking these items in its chain of retail stores, it also delivers incontinence supplies and other DME products to its customers' homes. ABC orders incontinence supplies from a distributor, and then warehouses these items in a single distribution center until a customer orders a product to be delivered to a home. Once a customer fills out paperwork to begin the purchase, the item is picked, boxed and shipped. This example is a very simple chain of events with many moving parts that may change to meet the dynamic demands of customers. But each of these moving parts has a cost, and savvy DME retailers understand that the cost to serve customers is the sum of all these individual parts. Therefore, each business activity (inventory, storage, delivery, fulfillment, etc.) must be looked at individually to begin the process of eliminating inefficiencies.

DME retailers should first begin to decrease costs by understanding their cost to serve (CTS). For example, if a retailer is storing inventory items, there is a carrying cost involved. There's a cost in: collecting documents, back office processes, claim denials, manual versus automated ordering, transporting products, redundant processes, in how many times you redo something because of and re-work due to errors or miscalculations. There's a cost to all these situations, which really are above and beyond the cost of the product. Understanding your CTS is the starting point of reducing inefficiencies, which can lead to increased profitability.

### **What is your CTS?**

A company's CTS is the accounting of how the cost of business activities and company overhead are consumed in meeting the demands of getting your product or service to your customer. CTS can be segmented to measure how profitable a certain product or customer is. The larger the company, the more complicated it might be to determine CTS. For example, a manufacturing company may have to factor in product assembly lines, product material costs, etc., where a DME retailer wouldn't.

In the DME industry, one of the reasons the CTS is high is because many retailers are performing their business processes the same way they did 20 years ago. At one point, a DME providers' reimbursement income provided twice the revenue doing only half the work and effort. Today, they are making half as much with twice the work. But the internal process hasn't changed much. So with all the caps, cuts and consequences of competitive bidding, DME retailers must look at other ways to lower their CTS.

For example, inventory can have large costs for DME retailers. From purchase and inventory storage costs to warehouse rent and delivery, DME retailers need to look at ways to decrease capital investments and create a smaller footprint in order to lower CTS.

### **What causes an increase to CTS?**

Inventory costs can be a major negative effect to CTS. But there are inventory programs available to DME retailers that help lower CTS. One such program is McKesson's PHD program. It helps decrease an HME provider's need to manage its own inventory and shipping. Providers gain access to McKesson's 40,000-plus SKUs in a network of over 20 distribution centers. Instead of owning this inventory — and paying for staff and warehouses to manage merchandise, freight and repair costs, and capital expenses — DME retailers simply take orders from customers as usual. Those orders are then sent electronically to a McKesson distribution center, where the item is picked, packed and delivered to the end customer's doorstep.

Some questions that may help define the inventory segment of your CTS include:

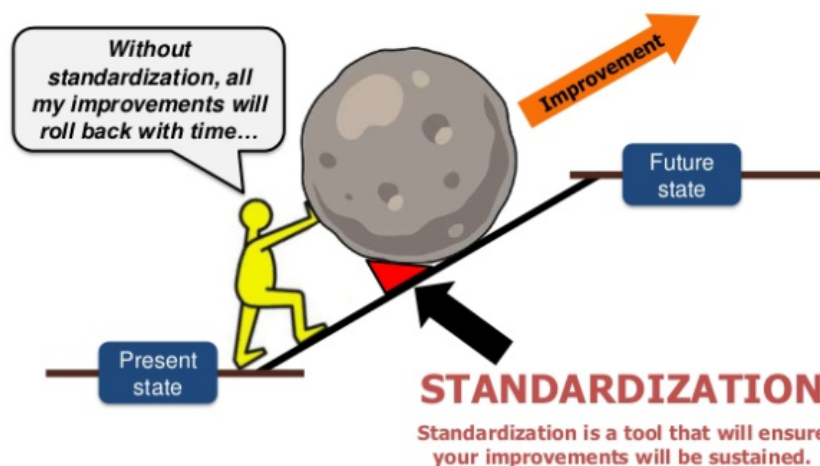
- What are your procurement numbers?
- How many orders per month do you send to distributors?
- What is the average wage of the staff entering new orders?
- How many minutes does it take to calculate inventory fulfillment needs?
- What is your average order amount?
- What is your carrying costs (average value of the inventory)?
- What type of return on the inventory do you expect?
- If the money sitting in inventory was used elsewhere, what would be your return then?
- What is your cost to receive and handle product?
- How many returns, damaged products, expired products do you have?

Looking at CTS means looking at the entire value-stream and mapping these procedures to identify processes that are not adding any value to your customer. There are many types of waste in your process to look for. Below are some of the more common types that have been found in the DME industry.

- Transporting materials — How often are your warehouse employees moving stock? Each touch of the inventory adds cost to your process. Receiving, stocking, picking and shipping all move the material. Is your warehouse set up to minimize these movement efforts?
- Motion — Is equipment used in the everyday functions of the company situated optimally? This affects employees who are part of the back-end, office-related functions of the company. If an employee has to fax or print many pages per day, is the fax machine or printer close by?

Similar to transporting materials, motion looks at the best strategies for keeping people close to their work.

- **Waiting** — Do employees have to wait for something before they can start a particular task? Think about your revenue cycle. Before you can send a bill to Medicare, you need to have all the correct paperwork, physicians' orders, prescriptions, diagnoses, ICD 10 codes, etc. How long are people waiting for the items? What can you do to ensure your employees have the right tools or information when they need it in order to complete their job?
- **Over-processing and over-production** — Are employees asking for more information than they need or performing tasks that aren't necessary? Your goal should be to provide the exact amount of information that your customer needs in order to pay you for your services. Anything more than that is adding to your CTS. Are too many products being ordered and stored? Excess inventory can be a CTS killer for a DME. The capital tied up in that is a waste and can be better used somewhere else in your business.
- **No standard work** — Standard work is the known best and most reliable method and sequence for each process and employee. The standard work is developed by the employees who are doing the work on a daily basis or their leaders. With each new improvement, the standard work should be updated. Standard work will encourage creativity, clarify processes and expedite new hire training. Standard work provides a baseline measurement for all continuous improvement activities. Without standard work, you cannot know if you are improving or backtracking from previous improvements.



The reality is you have to look for a lot of little improvements that, when all is said and done, make a difference. It's rare when you audit a DME retailer and find one thing that makes a dramatic difference in CTS. You don't usually tell a DME retailer, "I can cut 10 hours out of your week with this one improvement." More likely, you might find 10 things that cut an hour out, or 20 things that cut 30 minutes out. You actually get the same result, but it's through recognizing smaller inefficiencies that you eliminate. And that diligence can make a significant difference.

How information flows through your process will also impact your CTS. There was a client in which the time it took to take an order and ship it out would take 28 minutes. But by improving some of the processes and putting part of the inventory in the hands of a distributor so it didn't sit in a warehouse,

the time to take and ship an order was reduced to eight minutes, which positively affects CTS. Whether it's lowering inventory commitments, adding new technology or changing how the order is collected, these CTS techniques work for both large and smaller DME companies.

There is no magic bullet for every DME retailer, not one CTS formula that fits all. We do see a lower CTS in companies that measure and track some processes versus those who fly blind. Companies that measure are aware of their key performance indicators (KPI) and are making progress in lowering costs by continual measurement. Simply put, companies that are measuring something, anything, tend to perform better than companies that aren't. Higher initial CTS measurements typically are attributed to companies that haven't changed. They are still using antiquated inventory and computer systems and might not have the capital to upgrade to more efficient machinery.

### **Why DME retailers need to know their CST**

DME retailers should care about CTS in order to understand what percentage of their service portfolio provides little to no contribution to gross profit margin. At McKesson, we have seen many DME retailers boasting about a product they claimed made them a lot of revenue. But after looking at the cost of the processes to get to that revenue, we uncovered a different story. The good news is there are product lines that with just a few changes can possibly become much more profitable than the cash cow DME retailers think they might have.

Do a CTS evaluation for the same reasons gardeners prune trees and bushes. Sometimes you have to clip things off so that the other branches can grow.

Another reason to know a company's CTS: DME providers will likely have a good accounting of customer and product segmentation. This can give you a closer look at your own company, segmented by diagnosis, product categories, customer types, SKUs, etc. This way you more clearly see which parts of your company are providing growth and which need to be pruned.

By segmenting, you find that not all customers are good customers, but now you know the group you should focus on. For example, by segmenting your home-delivery costs out of the overall company picture, you may find that paying for a driver, truck maintenance, insurance and gas incurs costs that could help grow a more profitable side of the company.

Don't forget to evaluate the following company expenses when evaluating CTS:

- Promotions and discounts
- Efficient order terms
- Sales organization costs
- Marketing costs
- Ordering and cash collection
- Storage
- Picking and packing
- Outbound transportation
- Customer-specific services

- Returns management

Look for ways to reduce items in this list, and measure to find out which ones are really helping your company.

## Evaluating Your CTS

When it comes to CTS, the farther you drill down into the company's processes, the more information you can gather to help you fix inefficiencies. There's no set formula for evaluating CTS — just the will and determination to mine as much data as the company wants to come up with solutions to cut inefficiencies and increase profitability.

CTS can be as simple or as complex as you want it to be. One way to start is just by doing. Take a look at your procurement, customer order and revenue cycle value streams. List all the activities under those categories and then do a basic cost analysis of those activities. A company has to decide how far it wants to go and whether they want a consultant to help or try to measure on their own. Finding a benchmark before you start is very difficult, as each company will calculate cost differently, such as adding in warehouse costs where you have none.

But you can develop a baseline for your company by finding out where you are today. Then ask how you can drive out some of the inefficiencies you've found. Next, set a goal for six months to reduce your CTS by 10 percent.

If looking for help in evaluating and ultimately lowering your CTS, consider a company that can offer you the following:

- An inventory fulfillment and delivery system, such as McKesson's PHD, which helps decrease a DME provider's need to manage its own inventory and shipping, thus lowering CTS.
- A barcoding system that helps streamline inventory management and consistently enters correct information.
- Relationships with partners that make the CTS evaluation even easier. McKesson has a relationship with Brightree, which allows the free-flow of information between McKesson DME clients and McKesson's supply manager. Or use a program like PunchOut, a technology solution that lets McKesson DME retailers exchange information with the McKesson supply manager regardless of the software system the DME is using.

If you want to learn more about CTS and discuss how it can be a beneficial process for your company, call your McKesson sales account manager for more information. They can get you started in self-evaluating your company's CTS by providing some advice and resources, including on-site consultation.

## SIDEBAR:

The 5S Organization System

Your journey to lower your CTS can unveil many inefficiencies in your organization. That is great news, but only the first step. Many companies have found that discovery is the easiest part of the CTS project. Once the initial bottlenecks have been found, there is a natural euphoria that will lead to some short-term improvements. The key to success though is to make these changes a long-term solution. The energy and excitement level can wane as another project starts to take priority. Implementing a 5S system can help you make your changes permanent. For more information on implementing your own 5S program, contact your Account Manager to see how McKesson can help you.

Pillar	What it means	Why it is important	Problems avoided
Sort	<ul style="list-style-type: none"> <li>• Remove all items not necessary for supply operations</li> <li>• Leave only the bare essentials for your work</li> </ul>	<ul style="list-style-type: none"> <li>• Reduces problems and annoyances in workflow</li> <li>• Improves communication</li> <li>• Improves productivity</li> </ul>	<ul style="list-style-type: none"> <li>• Storage of unneeded items can get in the way of communication and create crowded workspaces</li> <li>• Unneeded inventory is costly</li> <li>• Excess items make it difficult to improve process flow</li> </ul>
Set in Order	<ul style="list-style-type: none"> <li>• Arrange items so they are easy to use</li> <li>• Label items so anyone can find them or put them away</li> </ul>	<ul style="list-style-type: none"> <li>• Eliminates searching waste in finding things or putting away things</li> </ul>	<ul style="list-style-type: none"> <li>• Motion waste</li> <li>• Excess inventory waste</li> <li>• Unsafe conditions</li> <li>• Searching waste</li> </ul>
Shine	<ul style="list-style-type: none"> <li>• Keep everything swept and clean</li> </ul>	<ul style="list-style-type: none"> <li>• Turn workplace into a source of pride where people enjoy working</li> <li>• Keep things in good condition so they are ready to use</li> </ul>	<ul style="list-style-type: none"> <li>• Defects are less obvious in dirty conditions</li> <li>• Unorganized workspace can lead to low morale</li> </ul>

<p>Standardize</p>	<ul style="list-style-type: none"> <li>• Integrates first three pillars into a whole</li> </ul>	<ul style="list-style-type: none"> <li>• Ensures conditions do not deteriorate into previous state</li> </ul>	<ul style="list-style-type: none"> <li>• Conditions go back to previous state</li> <li>• Work areas are dirty and cluttered</li> </ul>
<p>Sustain</p>	<ul style="list-style-type: none"> <li>• Making a habit of the procedures</li> <li>• Instill the discipline to avoid backsliding</li> </ul>	<ul style="list-style-type: none"> <li>• Consequences of not keeping up with the process is greater than the consequences of keeping up</li> </ul>	<ul style="list-style-type: none"> <li>• Unneeded items piling up</li> <li>• Dirty, disorganized workplaces leading to lower morale</li> </ul>



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