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From the Desk of R. Lewis Dark...

THE DARK REPORT

RELIABLE INTELLIGENCE, EXCLUSIVELY FOR MEDICAL LAB CEOs / COOs / CFOs

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R. Lewis Dark

Founder & Publisher

Introducing The "Three Blood Brothers"

How many of you remember the "Seven Sisters" or the "Big Six?" These were terms used by the business press and media to describe the seven major oil companies (**Standard Oil**, **Gulf**, **Atlantic Richfield**, **Union Oil**, **Exxon**, **Shell** and **Mobil**). The "Big Six" were the large certified public accounting companies, such as **Arthur Anderson**, **Coopers & Lybrand**, etc.

Around our offices, we have taken to calling the three national laboratories the "Three Blood Brothers." For us, it is a simple way to refer to **Laboratory Corporation of America**, **Quest Diagnostics Incorporated** and **SmithKline Beecham Clinical Laboratories**. Jokesters among our staff like the humor implied by the title as well.

Apparently we are not alone in our appreciation of that nickname. At THE DARK REPORT's *Executive War College* in New Orleans recently, our Editor referred to the national laboratories as the "Three Blood Brothers." As the audience chuckled, he explained how the LabCorp-Quest-SmithKline triumvirate earned that title. It seemed the audience appreciated the obvious humor of this nickname.

That being the case, I considered it an opportunity to have some fun with this column. I figured you might also be amused. After all, having "Three Blood Brothers" as the industry giants in our profession is fitting, given the amount of real blood which passes through laboratories every day.

It is also fitting, given that the three national laboratories struggled mightily during the last three years to achieve financial stability. At least two of the Three Blood Brothers required financial transfusions to remain alive. Each of the Three Blood Brothers endeavors today to restore financial balance to their company.

In fact, as you read this issue of THE DARK REPORT, you will learn that the Three Blood Brothers are finally reaching such desperate straits that they are now willing to drop unprofitable client accounts. That still begs the question as to whether they continue to price new business at loss-leader levels. But it is a sign that they can no longer afford to ignore obvious areas of major savings.

In the process of restructuring these unprofitable client accounts, the Three Blood Brothers will help laboratories throughout the United States restore profitable levels of pricing for tests and related services... but only if competitors exercise similar pricing discipline. Otherwise, the financial bloodbath will continue for all laboratories in the industry. TDR

National Labs Cut Costs Using Radical Strategies

Big three use proven management techniques to control costs and maintain service levels

CEO SUMMARY: All three national laboratories are dumping unprofitable accounts and unprofitable lines of testing. It ends the era when commercial labs "gave away" testing to any client willing to open an account. The three national laboratories are enacting stiffer requirements for new accounts. This significant trend will radically alter sales and pricing strategies for all competitors throughout the United States.

EACH OF THE three national chain labs is currently dropping unprofitable clients or unprofitable lines of testing. This important marketplace change will alter sales and pricing strategies among competing laboratories throughout the United States.

Within the commercial laboratory segment, this is the most significant trend since the consolidation wave ended in early 1995. It will force changes upon the sales programs of independent commercial laboratories and hospital laboratory outreach programs everywhere.

Each national laboratory seems to have a different strategy, but the market impact will be similar. **Quest Diagnostics Incorporated** is repricing physician accounts which generate small volumes of tests. **SmithKline Beecham Clinical Laboratories** is releasing long term care accounts in selected markets around the United States. **Laboratory Corporation of America** is sending specimens from regions with high production costs to be processed at regional laboratories with lower costs.

A common theme links the individual strategies of the three national laboratories: profit per account. If the individual client account does not generate sufficient income to cover direct costs and administrative overhead, then the laboratory pursues one of two strategies. It either declines to provide service or it alters the terms of service with the client.

"This is the first evidence I have seen of rational business decisions concerning money-losing client accounts," said Mark Smythe, Principal of **Management Mentors** in Wilsonville,

THE DARK REPORT Intelligence Briefings for Laboratory CEOs, COOs, and CFOs are sent 17 times per year by The Dark Group, Inc., 1731 Woodland Terrace Center, Lake Oswego, Oregon 97034, Voice 1.800.560.6363, Fax 503.699.0969.

R. Lewis Dark, Founder & Publisher. Robert L. Michel, Editor.

SUBSCRIPTION TO THE DARK REPORT INTELLIGENCE SERVICE, which includes THE DARK REPORT plus timely briefings and private teleconferences, is $10.80 per week in the US, $11.40 per week in Canada, $12.45 per week elsewhere (billed semi-annually).

Oregon. "I am encouraged to learn that the national laboratories finally want to look at profitability per individual account. The laboratory industry must learn that it is good business to offer testing only at prices that fully cover costs and generate a profit."

Fear of Competitors

Since the early 1990s, laboratory executives feared giving competitors an advantage if they priced small-volume physician clients differently than large-volume accounts. Also, with fat operating profit margins of 15% to 30% for the total laboratory, lab executives felt no pressure to change the way unprofitable accounts were serviced.

Today the picture is different. With laboratories struggling to maintain financial stability, any source of cost savings is undergoing scrutiny.

Probably the most rigorous effort to evaluate and reprice individual client accounts is now under way at Quest Diagnostics. Quest retained **Booz-Allen & Hamilton**, a national consulting firm, to study the profitability of client accounts.

THE DARK REPORT learned that Quest is using parameters developed by Booz-Allen to revamp pricing and service policies for individual client accounts. Quest quietly sent letters early in May to physicians whose small volume accounts fail to cover costs. These letters put the clients on notice that, after a specific date, service terms will change.

Clients serviced by Quest's central laboratory in Teterboro, New Jersey were among the first to receive registered letters dated May 7. The letters announced changes to the terms of service. *(See sidebar on page 4.)* Similar letters were mailed to clients in Ohio and Pennsylvania. In the coming months it is expected that Quest will send these letters to clients in every regional market. One criteria used to identify money-losing accounts is the monthly net revenue generated by those accounts. Apparently Quest is restructuring service arrangements for accounts generating less than $500 per month in average net revenues.

For Quest's Teterboro clients, service changes will become effective on June 9, 1997. Quest's affected client accounts will see several important differences. First, courier services to the client's office will cease. Patients can continue to be drawn at Quest patient service centers. Quest also noted to the physician that "any transportation and/or shipping costs to our facilities will be the responsibility of your office."

Second, Quest will limit the collection supplies it provides to "a select list of non-blood work testing." Further, Quest will monitor the specimen volume referred by that client and only ship sufficient supplies to maintain the customary volume of specimens.

No Office Teleprinters

Third, results will be reported by fax or by mail. This means that Quest will not offer teleprinters or computers for test requisition/reporting to physicians receiving this letter.

Fourth, all client and patient bill work for tests referred by the physician will be priced at the current Client Fee Schedule and current Patient Fee Schedule, respectively. All special discounts or prices will be discontinued.

Fifth, custom test profiles designed for that physician will be discontinued. Testing will be limited to those assays published in Quest's Reference Manual.

Laboratory executives should recognize that Quest's five key service changes directly reduce the cost of servicing the accounts categorized as unprofitable. In fact, should Quest successfully implement these policies, it will be doing the entire laboratory industry a service. By stopping wasteful

Quest Diagnostics Acts To Reprice Money-Losing Accounts

Here is a key part of Quest's campaign to eliminate unprofitable client accounts. This is the actual letter sent on May 9, 1997 to clients of the Teterboro laboratory.

Quest's letter announces how specific changes will be made to the way a physician's account will be serviced and how tests will be priced. For recipients of this letter, the effective date for changes will be June 9, 1997.

Within the clinical laboratory industry, the move to evaluate the profitability of individual accounts is long overdue. Those laboratories which implement a management project to boost account profitability will be surprised at the positive revenue impact which results.

Look for competing laboratories across the country to follow Quest's lead on this important issue.

Quest Diagnostics Incorporated

One Malcolm Avenue
Teterboro, New Jersey 07608-1679
201.393.5000
201.736.8610

May 7, 1997

CERTIFIED MAIL R.R.R.

SUBJECT: TIME-SENSITIVE INFORMATION ABOUT YOUR LABORATORY TESTING SERVICES

Dear Physician:

All healthcare providers face increasing challenges due to ongoing changing in market dynamics and healthcare policies. Each day it gets harder for each of us to overcome these obstacles and still provide the high quality of care and service expected.

These ever-changing conditions have led Quest Diagnostics(formerly Corning Clinical Laboratories) to analyze the cost effectiveness of how we deliver services associated with laboratory testing. As a result of our analysis, we have determined there is a need to adjust the level of service to your practice, while continuing to maintain the high quality testing you have come to expect from Quest Diagnostics.

An Explanation of your new Service Plan is attached for your review. Areas impacted include use of patient service centers, courier service, specimen collection supplies, report delivery, fees and customized test offerings. Please take a few minutes to review these changes and understand what impact they will have on your practice.

The revised Service Plan will become effective June 9, 1997. If you have questions or additional testing needs, please contact your account representative. Hassan Sherif, by calling 1-800-222-1426 ext. 5782.

We hope you understand our need to make these adjustments. We thank you for trusting us with your laboratory testing needs and look forward to continuing to provide your practice with high quality testing going forward.

Sincerely,

Jae Graves
District Business Manager

The following Services Plan will be provided to your account. Be assured there will be no change to the high quality of testing you have to expect from Quest Diagnostics

EFFECTIVE DATE	June 9, 1997
PATIENT SERVICE CENTERS	• Specimens will be collected at any Quest Diagnostics Patient Service Center. Please see attached list for the facilities closest to your practice.
COURIER SERVICE	• Courier Service will no longer be provided to your office. Your patients may go to one of Quest Diagnostics Patient Service Centers, or you may deliver specimens to one of our Patient Service Centers or laboratory facilities during normal business hours. Please note, all transportation and/or shipping costs to our facilities will be the responsibilities of your office.
SPECIMEN COLLECTION SUPPLIES	• Quest Diagnostics will provide specimen collection supplies for a select list of non-blood work testing. Please call to verify specific supplies. • Any supply orders that exceed the customary number of specimens submitted to Quest Diagnostics for testing will be modified appropriately. • Please allow 3-5 business days for supplies to be shipped to your office
RESULTS REPORTING	• Reports will be delivered by fax or mailed to your office.
FEE SCHEDULE	• For direct client billing to your office, the price per test and service will be the List Price indicated in Quest Diagnostics, Teterboro, NJ facilities most current published Client Fee Schedule. For direct patient billing, the price per test and service will be the list price indicated in our current published Patient Fee Schedule. Any special discounts or prices will be discontinued.
TEST OFFERING	• Custom testing profiles will no longer be available. • You may, however, order any test or service listed in Quest Diagnostics Teterboro, NJ facilities most current published Reference Manual. This broad menu of tests and services reflects one of the most extensive offerings of quality laboratory capabilities available today.

and money-losing practices, Quest aids all laboratories which would like to similarly improve the cost/revenue performance of marginal client accounts.

In Quest's case, it directly targeted courier and transportation costs, clients who abuse "free" collection supplies, office printer/computer costs and discounted pricing to clients whose volume does not justify it.

THE DARK REPORT believes that Quest will successfully implement these new policies, with two outcomes. First, Quest will see a significant, even substantial, gain in overall operating profit at any laboratory site where these new policies are implemented. Second, Quest will see no competitive disadvantage or loss from changing service terms.

Physicians are undergoing the same reimbursement and financial pressures as clinical laboratories. So long as Quest communicates effectively what it is doing and why, THE DARK REPORT predicts most physicians will understand and accept the changes.

Unlike Quest and SBCL, however, LabCorp does not yet appear to be releasing existing client accounts which are considered unprofitable...

Contrasting Quest's strategy of directly attacking unprofitable accounts through changes to discounting, supplies and service, SmithKline Beecham Clinical Laboratories (SBCL) chose another course of action.

SBCL is simply terminating service to accounts it considers unprofitable. Apparently SBCL decided to exit the long term care market in selected regions. Florida and California seem to be the first states where such efforts are under way, but others are involved.

SmithKline's decision to withdraw from the nursing home business reflects several strategic decisions. First, profitability per individual account is probably marginal at best. This is directly attributable to the high cost of providing phlebotomy, infection control programs and the other numerous features that competition made standard in the nursing home segment.

The second reason is probably SBCL's experience with increased federal regulation and scrutiny of testing for Medicare patients. Add to that the coming Medicare DRGs for skilled nursing facilities, and SmithKline probably sees long term care as a distraction from their core business.

Sources indicate that SmithKline negotiated with regional laboratories to take over nursing home accounts in San Diego, California and Jacksonville, Florida. Similar activity seems to be unfolding in Tampa, Florida and southern Louisiana. In these markets SBCL simply gave the clients notice and stopped service on a specific date.

At Laboratory Corporation of America, profit per account is being addressed in different ways. For new business commitments, LabCorp is pricing contract RFPs and new accounts to more accurately recover full costs.

Unlike Quest and SBCL, however, LabCorp does not yet appear to be releasing existing client accounts which are considered unprofitable. Instead, it is pursuing a policy of moving testing to laboratories within its system which have low costs.

One example of this strategy is LabCorp's cost-cutting moves in New York City. During March and April, LabCorp's Mitchell Field lab facility, their anchor laboratory in New York state, laid off 12 customer service representatives. This was followed by layoffs of eight cytotechnologists.

$1 Million Savings

In salaries, LabCorp saved a minimum of $25,000 per year per customer service rep, along with $65,000 per year per cytotechnologist. With benefits, this represents payroll savings of $1 million per year.

But that is not the whole story. LabCorp will be sending Pap smears to locations outside New York City, where costs are up to 40% cheaper. Assuming that quality and turnaround time can be maintained, LabCorp will reap significant savings by moving work outside the Mitchell Field lab site. It reduces LabCorp's losses on Pap smears originated in that market. As discussed earlier in THE DARK REPORT, all three national labs lose significant money on Pap smear testing. *(See TDR, April 8, 1996.)*

LabCorp's initial strategy is to leverage low cost locations to perform tests which are unprofitable at current reimbursement levels. For this strategy to succeed, LabCorp's service implementation must be flawless so clients perceive no change in how their Pap smears are handled.

Industry Consequences

The fact that all three national laboratories now emphasize the profitability of individual accounts creates consequences soon to be felt throughout the clinical laboratory industry. There will be changes to the way diagnostic testing is priced. There will also be changes to the package of services offered physician clients. For example, not only will Quest cease courier service to small accounts, but Quest will no longer install a printer and dedicated phone line in such accounts. Multiplied by hundreds of accounts, these savings are considerable.

Further, the importance of this new trend is that it is based on a cost management strategy which uses principles established in manufacturing and distribution. In particular, it utilizes two management principles: profit/cost per account and the 80/20 Rule, also called Pareto's Law. *(See pages 10-14.)*

Competition Must React

Laboratory competitors will need to learn these management principles and apply them in their own laboratory if they are to maintain their competitive position in the marketplace. Laboratories will also need to revamp sales compensation plans to emphasize operating profit, not net revenue, as the basis for sales commissions.

As predicted earlier by THE DARK REPORT, it is becoming increasingly important for laboratories to manage profit, not process. That alone represents radical change for many lab executives. TDR

(For further information, contact THE DARK REPORT at 800-560-6363.)

Ken Freeman Fulfilling Innovator Prediction

As CEO of Quest Diagnostics Incorporated, Ken Freeman is taking a decidedly un-laboratory view of the industry. It is no coincidence that Quest is first in the marketplace with a major management project to address the profitability of individual accounts.

As you will read on pages 10-14 of this issue, Mark Smythe explains that successful businesses outside healthcare pay close attention to the profitability of individual accounts. Management principles and techniques are well-established and easy to use. Freeman, drawing on his earlier experience with **Corning Incorporated's** industrial businesses, is importing these successful principles into Quest.

THE DARK REPORT picked Freeman as one of 1997's Laboratory Innovators To Watch. He has not disappointed. We believe Quest will continue to emphasize quality management principles. Compared to its two national competitors, Quest should move to the head of the pack.

Clients of THE DARK REPORT will also be interested to know that Quest is engaged in some very atypical behavior. Laboratorians tend to hire only laboratorians. We believe that one source of problems for the lab industry is that the major commercial labs simply reshuffle executives from one company to another. Old practices and bad habits simply perpetuate themselves at the major laboratories because new executive blood is not infused.

Sources tell THE DARK REPORT that Quest directs its headhunters to recruit executive candidates from outside the laboratory industry. If this is true, it is more evidence that Quest may become a good laboratory model to observe and emulate. Outside executive blood will bring new ideas and new energy to a tired lab industry.

National Lab Strategies Will Impact Competitors

Major changes predicted to marketing and sales practices of laboratory competitors

CEO SUMMARY: Not since the era of commercial lab consolidation ended has such a significant trend emerged. As the three national labs eliminate service to unprofitable accounts, profound changes will occur to the market for laboratory and pathology services. How quickly this leads to improved pricing for lab testing has yet to be determined.

WITHIN THE LAB INDUSTRY, a fundamental marketplace shift is under way. As described on pages 2-6 of this issue of THE DARK REPORT, the "Three Blood Brothers," **Quest Diagnostics Inc.**, **Laboratory Corporation of America** and **SmithKline Beecham Clinical Laboratories** (SBCL) are taking first steps to purge unprofitable accounts or restructure test pricing.

Each of the three national laboratories is evaluating individual accounts and individual assays for profitability. Their common goal is to eliminate accounts which lose money and restructure lines of testing which fail to recover costs.

In taking this action, the three national laboratories are opening a door to improved profit margins. All commercial and hospital laboratories serving the outreach market will benefit from this situation. The reason is simple.

For ten years it was the national laboratories and their predecessors which dictated pricing levels in virtually every metropolitan market. Armed with huge test volumes and ample war chests, they offered low test prices as a way to further increase specimen volume.

During the last seven years, the national labs played a dominant role in the markets they serve. Thus, changes to their pricing practices will greatly influence local markets. As the national laboratories get serious about improving the profitability of individual accounts, then radical changes to current laboratory pricing practices will result.

> ***"I believe that efforts by the national labs to improve profitability will help stabilize and even increase the price of lab tests in different cities around the United States."***
>
> ***-Mark H. Smythe***

This could be good news for independent regional laboratories and hospital laboratory outreach programs. As the national laboratories seek to improve profit margins on individual accounts, it can be expected that general price levels for diagnostic testing will begin to rise. Increased pricing will benefit all laboratories. However, there is a caveat. Whatever increases occur to test prices will be neither large nor quick.

Managed care also makes the job of the national laboratories tougher. In markets with high managed care penetration, most physicians offices will be using from two to five separate laboratories. Determining service levels and pricing for physician accounts which refer a limited number of specimens becomes more complicated because of these managed care relationships.

Price Stabilization

Despite such challenges, the three national laboratories will continue their attempts to increase the profit margins of individual accounts. Price stabilization will take several years to work its way through the marketplace. Recent events in California illustrate this. During the previous 18 months, both **Unilab** and **Physicians Clinical Laboratories** (PCL) declared their commitment to maintaining adequate pricing. Despite these public pronouncements, competitors tell THE DARK REPORT that both labs recently inked managed care contracts at cap rates under 50¢ PMPM.

As the Unilab and PCL examples demonstrate, commercial laboratory executives must unlearn their habit of marginal cost pricing for new business before price stabilization occurs. It is important for competitors to understand how deeply entrenched such habits are.

During the last ten years, it was the major commercial laboratories which pursued specimen and revenue growth through highly discounted pricing. Whether offering sizable discounts from client bill and patient bill fee schedules, or contracting services at capitated rates, the national laboratories cut test prices to rock bottom levels.

"The popular wisdom among commercial lab executives was that their large regional labs produced testing at such a low cost that they could still earn profits at cutthroat price levels," stated Bernie Ness, of **B.J. Ness Consulting Group** in Toledo, Ohio. Ness served as national sales or marketing director for several large laboratories. He currently provides contract sales and marketing management services for hospital laboratory outreach programs.

"The other popular misconception was the impact of incremental specimens on the fixed cost/marginal cost structure of the laboratory," continued Ness. "These same commercial laboratory executives believed that incremental test volume, priced at marginal cost, would use up excess capacity and drive the average cost per test down."

Cytology, Anatomic Pathology Undergoing Profit Scrutiny

*Further changes to marketplace pricing will be visible in the areas of cytology and anatomic pathology. As reported last year in **THE DARK REPORT** (See April 8, 1996), the national laboratories know that cytology is a money-loser.*

Pap smears illustrate the problem perfectly. Years ago, commercial labs priced Pap smears at marginal cost in order to get the OB/GYN's other testing. Today the labs calculate their full cost at about $15, but they average only $7 in reimbursement. With each of the major labs doing 5 million Pap Smears per year, that works out to annual losses of $40 million just on Pap testing. For that reason, the national labs want to either reprice Pap Smears or exit this segment of the business.

The story is similar with anatomic pathology. The national laboratories consider AP specimens as outside their core competency. Much of their existing AP work will be released to other providers in the immediate future. Of the three, SmithKline Beecham Clinical Laboratories seems to be the most aggressive at restructuring their anatomic pathology arrangements.

"We all bought into that," said Ness. "As a result, laboratories permitted their sales reps to solicit business at any price necessary to bring tests through the door. Most of the time, the profitability of the individual account was ignored."

Destructive Test Pricing

Mark H. Smythe, Principal of **Management Mentors** in Wilsonville, Oregon, pointed out another factor which contributed to destructive test pricing. "You had a situation where management was willing to fill excess capacity with specimens priced at marginal cost. That was tied into a sales compensation plan which paid the sales reps a commission calculated against net revenue. Therefore, sales reps were paid bonuses to bring in new accounts which lost money for the laboratory! No one in the system had an incentive to monitor the profitability of individual accounts.

"As a result, laboratories ended up with lots of new accounts which actually lost money from day one of service," explained Smythe. "In those days laboratories showed overall profits of 20% to 35%, so no one cared. That's changed in the last three years as reimbursement for diagnostic tests decreased."

Good For Lab Industry

"I think it is a good thing for the laboratory industry that the national labs finally want to emphasize profit per individual account, not the net revenues," he continued. "This is the first evidence I've seen of rational business decisions concerning money-losing client accounts. Every laboratory should want to look at profitability per individual account. The laboratory industry must learn that it is an acceptable business practice to offer testing only at prices that fully cover costs and result in a profit to the laboratory."

Smythe's comments are on target. Competitors of the major laboratories will need to adopt similar management programs. The potential gains in operating profit are too great to ignore. In addition, the national laboratories will gain a competitive advantage with this effort if competing laboratories do not respond.

THE DARK REPORT recommends that both independent laboratories and hospital laboratory outreach programs begin with three management initiatives. First, each laboratory should develop accurate "cost per account" and "operating profit per account" measures. This provides the information baseline necessary to evaluate individual accounts.

Learn To Rank Accounts

Second, each laboratory should learn how to rank their client accounts by revenue, operating profit and service costs. As explained on pages 10-14 of this issue, such rankings highlight money-losing accounts and help management make easy decisions about the proper course of action.

Third, each laboratory needs to proactively use the information developed in the first two steps. Like Quest, they should act decisively to restructure money-losing accounts. Although most laboratory managers do not like to give clients "bad" news, implementation is the essential step in this process.

Managing with the goal of increasing operating profit is a new development for the clinical laboratory industry. As it becomes widespread, it will be a major factor in helping clinical laboratories achieve financial stability. TDR

(For further information, contact Bernie Ness at 419-843-6400 and Mark Smythe at 503-694-2473.)

Management Techniques

Smythe Teaches Methods To Lift Operating Profits

All laboratories should be developing similar "profit per account" strategies

CEO SUMMARY: Efforts by national laboratories to improve profit margins will affect all laboratories. Consequences of this initiative will actually benefit competitors. It provides all laboratories with the opportunity to increase profits. Mark Smythe demonstrates how this can be accomplished.

STRATEGIES USED by the three national laboratories to improve "profit per account" will change the competitive marketplace. These changes will be to the benefit of all laboratories.

It is essential that competing laboratories respond in three ways. First, they must understand what the national laboratories are doing *(see pages 2-5)*. Second, they must understand how these new changes will alter the competitive marketplace for laboratory services *(see pages 6-8)*.

Third, competing laboratories must respond with their own "profit-building" strategies if they are to take advantage of the market opportunity now unfolding. That is the purpose of this story. Mark Smythe, Principal of **Management Mentors** in Wilsonville, Oregon, describes two simple techniques which boost profits.

"As I study the actions of the three national laboratories, I can see the first applications in the clinical laboratory industry of two management principles consistently used by well-managed companies. First is 'profit per account' analysis. Second is proper use of the 80/20 Rule.

"Both management principles can greatly increase the operating profits of your laboratory," continued Smythe. "This is just as true for a hospital laboratory as for a commercial laboratory.

Easy To Learn

"The wonderful thing about these management principles is that they are easy to learn and easy to apply. As I explain how to use them, I want laboratory executives to recognize that they gain an advantage over competing laboratories when they are first to introduce these profit-building techniques into their own lab organization.

"First, let's look at 'profit per account.' I am heartened to see that the national laboratories finally want to pay attention to profit per account," stated Smythe. "The fastest way to lose money is to accept business which costs you more to service than the revenue it generates. Although this common sense precept is widely understood among manufacturers and distributors, for some reason the clinical laboratory industry ignored this truth.

"The concept is simple: each individual client account of the laboratory should generate enough revenue to cover the *full cost* of providing the service," he explained. "It sounds easy, but two things generally prevent this from happening. First, few labs accurately know what it costs them to service individual accounts. Thus, they don't know how much money they lose on specific accounts. Second, lab managers allow sales reps to pressure them to accept money-losing terms as a way to acquire or retain individual accounts."

> ***"It is unfortunate that the clinical laboratory industry has long neglected to copy successful management techniques used outside the healthcare industry."***
> ***-Mark H. Smythe***

"To evaluate profit per account, the first step is to develop a cost figure for each element of an account. Besides the cost of performing the tests themselves, this typically includes the cost of providing courier and logistics services, the cost of placing and maintaining a remote printer or test-ordering computer system in the physicians office, requisitions, supplies, catalogs, etc.

"However, the cost analysis should not overlook expenses incurred by the laboratory to maintain the account internally" stated Smythe. "For example, it costs something to track billing and reimbursement activity for the account. Client services may communicate daily with the account. Service reps may make weekly or monthly calls to the account. These items should be costed and added to the expenses necessary to maintain the account.

"This information is required to develop a reasonable figure for expenses. On the revenue side, the laboratory needs to develop a basic formula for calculating operating profit," noted Smythe. "Regardless of how the numbers are calculated, operating profit should be a measure of how much income is generated by the account over the allocated direct and administrative costs."

Calculate Operating Profit

"Once these two sets of numbers are determined, it is necessary for management to evaluate the existing cost/operating profit performance of the account. Obviously, every account which incurs more costs than the revenue it generates is a target for management action."

Smythe believes that the letter sent by **Quest Diagnostics Incorporated** to clients in the East and Midwest *(see letter on page 4)* represents good execution of the "profit per account" principle. "A careful reading of that letter indicates that Quest has done their management homework. Quest apparently did a rigorous cost analysis of servicing specific accounts. They matched those costs against actual revenues and decided on strategies to eliminate money-losing accounts."

Quest Changing Services

"Look at the specific service terms Quest is changing. For low volume accounts, they are dropping regular courier service and encouraging the physician to send patients to the Quest's phlebotomy sites for collection. Not only does this eliminate courier costs, but specimens collected by Quest are more likely to have complete patient and billing information. Specimens collected this way can also be preaccessioned before arriving at Quest's regional laboratory.

"Just changing courier arrangements can trigger a cascade of cost savings beyond simple courier expenses," declared Smythe. "Results reporting is another big money-saver. Quest will fax or mail reports to the affected accounts. This eliminates three expense items: the dedicated telephone line, the line printer and possibly a test-ordering computer. Balance these monthly costs against the *operating profit* generated by an account referring less than $500 per month of tests. Quest will harvest significant savings from these changes.

"Savings from collection supply policies and client/patient list fee discounting is probably not equal to the changes I've already mentioned. However, spread across thousands of client accounts in Quest's system, even these savings are considerable."

Quest Did Basic Math

"Remember that Quest had to do the basic math on the cost to service an account versus the operating profit and revenue generated by that account before they could intelligently decide which accounts would be affected," said Smythe. "Once that was done, it was obvious where the cut-off levels were and which accounts would receive Quest's letter changing terms of service.

"For those laboratory executives who are interested in doing this same 'profit per account' analysis," I want to add some advice. Don't let the naysayers in your laboratory tell you that it can't be done. There are two common objections I hear when I am brought in to help implement this project.

"The first objection is 'we can't get accurate numbers to properly cost these items.' That is a bogus objection. Even a ballpark estimate of costs is better than no estimate at all. If your laboratory is like most others, no one has ever tried to collect this information. You will be surprised at how easy it is to develop a relatively precise measure of individual account cost and operating profit... *once management decides it has to happen!*"

"The second objection is the same one that originally contributed to the problem. 'If we do this, the physicians will become upset, our competitors will take the account from us and people will say we have financial problems.' My response is 'hogwash.' When you make a sound business decision for the right reason and communicate your decision effectively to your clients, they understand and support your efforts. Besides, under existing terms of business, these are precisely the accounts which suck money out of your laboratory. You are better off without them.

"I can prove that both these objections are straw men," continued Smythe, "by predicting that Quest Diagnostics will successfully implement this project on a national scale and it will result in a significant percentage increase to their operating profits within two quarters. If Quest can do it, why can't your laboratory?

"Now it is time to look at the other management principle, the 80/20 Rule. Also known as Pareto's Law, the 80/20 Rule simply says that in any distribution or population, a small number of items have a disproportionate impact."

Abundant Examples

"The examples are abundant," said Smythe. "In your laboratory, 20% of the assays in your catalog generate 80% of the billable tests. 20% of your revenues come from 80% of your clients. 20% of your sales reps generate 80% of the new business. In the hospital, 20% of the physicians order 80% of the tests.

"The 80/20 Rule is your management secret weapon, if you will use it. It is simple to learn and quick to apply. You start by looking at information in a different way. Typically, when you ask accounting or systems for a study or report on client revenues, test volumes or expenses, they provide a lengthy report which is sorted by account num-

80/20 Ranking: Scientific and Technical Suppliers

Ranked in Descending Order of Annual Purchases

Rank	Supplier	Annual $ Purchases	Cumulative Purchases	Percent	Cumulative Percent
1	Abbott	$234,219	$234,219	8.9%	8.9%
2	Scientific Products	$180,193	$414,412	6.8%	15.7%
3	BMC	$155,677	$570,089	5.9%	21.6%
4	Hybritech	$145,604	$715,693	5.5%	27.1%
5	Formanalysis	$142,507	$858,200	5.4%	32.5%
6	Curtin Matheson	$138,292	$996,492	5.2%	37.7%
7	VWR	$100,931	$1,097,423	3.8%	41.5%
8	Responsive Termnl Sys	$76,954	$1,174,377	2.9%	44.4%
9	Nichols Institute	$70,948	$1,245,325	2.7%	47.1%
10	Bio Rad labs	$53,580	$1,298,905	2.0%	49.1%
11	Amersham	$48,787	$1,347,692	1.8%	50.9%
12	Kallestad	$46,477	$1,394,169	1.8%	52.7%
13	Diagnostic Products	$40,405	$1,434,574	1.5%	54.2%
14	Syva	$39,467	$1,474,041	1.5%	55.7%
15	Vitek	$35,598	$1,509,639	1.3%	57.0%
16	Fisher Scientific	$34,870	$1,544,509	1.3%	58.3%
17	Ortho Diagnostics	$33,575	$1,578,084	1.3%	59.6%
18	Boise Cascade	$33,004	$1,611,088	1.2%	60.8%
19	Technicon	$32,220	$1,643,308	1.2%	62.0%
20	Scientific Supply	$30,923	$1,674,231	1.2%	63.2%
21	Bartels Immuno	$30,707	$1,704,938	1.1%	64.3%
22	Wampole	$29,087	$1,734,025	1.1%	65.4%
23	Sarstedt	$28,553	$1,762,578	1.1%	66.5%
24	Mailwell Envelope	$26,669	$1,789,247	1.0%	67.5%
25	High Purity Chem	$23,584	$1,812,831	0.9%	68.4%
	Total Top 25	**$1,812,831**	**$1,812,831**	**68.6%**	**68.4%**
	175 Total Suppliers	***$2,640,991***	***$2,640,991***	***100.0%***	***100.0%***

Mark Smythe Explains The 80/20 Ranking:

The above chart is taken from a real laboratory. Notice that the top 25 suppliers represent only 14.3% of the vendors, but represent 68.4% of total purchases!

Even more compelling, the top 10 vendors provide 50% of the purchases. As a manager, I use this 80/20 ranking of technical suppliers to set my priorities. Better contract terms and arrangements with the top 25 vendors will save my laboratory more money than if I try and divide my time to negotiate price and service with all 175 vendors.

This 80/20 report format will highlight the critical items when used to rank client revenues, client costs, client operating profit, test types, billable tests and similar parameters.

Try it and see what a difference in makes in helping your management team see trends, set priorities and implement cost-saving programs.

ber or alphabetically.

"For serious managers, these formats are completely useless," declared Smythe. "Insist that your reports henceforth be submitted in an 80/20 format. You want to sort the information in descending order of the financial or volume variables. For example, a study of revenue by client would rank the largest volume client at the top, the second largest, then third largest and so forth.

"It would be the same for test volumes. Rank your highest volume test at the top and then descend to lowest," he continued. "If you can get columns to represent cumulative volume, percent and cumulative percent, then you can quickly identify the 20% of your accounts, tests, expenses, etc. which affect 80% of your total volume.

"The chart on page 13 is an example of an 80/20 Report. If you use this format, you will discover several benefits. First, it is easier and quicker to make decisions. Second, you have confidence that these decisions are correct. Third, you find it easy to establish priorities for you and your staff, because you focus work on the 20% of the accounts/tests/expenses which generate 80% of the results."

80/20 Rule Is Secret Tool

"Does it sound too simple? It is. But the 80/20 Rule is the secret used by management experts skilled in turnarounds and accelerated growth situations. They use the 80/20 Rule to focus their time and energy on only those elements which promise huge benefits.

"If it is this easy and this effective, why wouldn't you want to begin using this management tool?" asked Smythe. "Quest Diagnostics certainly has. After analyzing their account costs and operating profits, they probably ranked clients by three parameters: net revenue, monthly service costs and operating profit generated by the account."

Determine Breakeven

"From these three rankings, they determined where their break-even points were for making money versus losing money. It was a simple matter to identify accounts below break-even, then develop a strategy to either reprice or release the account.

"Having explained these two management principles," added Smythe, "I want to make it clear that these tools are guides to management decision-making. Someone still has to make choices that affect how the laboratory services individual client accounts.

"Someone within your laboratory must make the executive decision to address the problem of unprofitable accounts. Further, once specific accounts are determined to be unprofitable, management must make decisions about how to fix that situation, taking into account marketplace quirks, political relationships and competing lab activities.

"Until recently, no laboratory seemed willing to take the lead in emphasizing profit per account. Now that Quest, **SmithKline** and **LabCorp** are taking the initiative, laboratory competitors who lag behind will find their profits negatively affected.

"By contrast, any laboratory which takes the initiative to utilize these principles will find a big boost to their profits. In my 35 years of management experience, I find rigorous application of account profitability, the 80/20 Rule and deliberate methods change techniques cause operating profit to increase by upwards of 30%. The same can happen to your laboratory."

Challenge And Opportunity

"You face a challenge and an opportunity. The challenge is that your three national competitors are finally using proven management principles to boost operating profits. If your laboratory does not respond in a timely manner, you may find yourself losing market share.

"The opportunity is for you and your laboratory to rapidly incorporate these management principles into your organization," recommended Smythe. "By moving faster than the competition, your laboratory can increase operating profits and market share. Plus, your laboratory may just implement these management principles with more skill than your three national competitors. If so, it is a great chance to turn the tables on them for a change!" **TDR**

(For further information, contact Mark Smythe at 503-694-2473.)

Technology Report

Lab Info Systems Meeting Highlights Innovation, Ideas

CEO SUMMARY: Managed care's pressure to create clinically integrated healthcare delivery systems changes the way laboratories report, use and warehouse clinical data. Dr. Bruce Friedman's annual laboratory information systems conference in Ann Arbor provided graphic evidence that technology and LIS products are evolving at distressingly rapid rates. This complicates any decision to upgrade LIS.

CUTTING EDGE would be an apt description of the 15th annual symposium on clinical laboratory information systems held last week in Ann Arbor, Michigan.

Sponsored by the Department of Pathology at the **University of Michigan Medical School**, this year's program, titled *Automated Information Management In The Clinical Laboratory*, was a hotbed of progressive and innovative technology affecting laboratory information systems.

Succinctly highlighting the direction of the industry was Robert De Crese, M.D., Director of Clinical Laboratories at **Rush-Presbyterian-St. Luke's Medical Center** in Chicago. He defined the healthcare trends now influencing the design and operation of laboratory information systems.

Clinical Integration Impeded

In particular, Dr. De Crese noted that, although managed care is pushing integration of clinical delivery systems, a contrary trend is impeding it. Scattered contracting of services by managed care plans contributes to a "fractured" healthcare system. Year-to-year churning of employees between health plans complicates the picture. Because clinical data is inaccessible between providers, money and time is spent on duplicate testing and unnecessary studies.

"For this reason," stated Dr. De Crese, "both clinical and economic pressure will encourage integrated clinical information systems. Regionalization of service is required for true integration of clinical data to succeed."

Regionalization Of Services

De Crese noted that radiology is leading this regionalization. Digital transmission of images and data is growing. Other candidates to help lead this trend are anatomic pathology and the clinical laboratory. Commercial laboratories already demonstrate the capability of regional laboratory networks. Technology of laboratory information systems must evolve to support the needs of regional pathology, laboratory networks and the clinicians they serve.

Dennis Winston, President of **Dennis Winston and Associates,** echoed De Crese's theme, noting that no software product exists today which can properly support the demands of those regional laboratory networks which are now operating.

"I will use the term LNIS, or laboratory Network Information System, to describe the type of software which is required by regional laboratory networks," stated Winston. "Unfortunately, no such LNIS exists today. Existing laboratory networks are forced to take a 'shake and bake' approach to solving their problems."

Need For Network Software

Winston pointed out that any LIS vendor which gave serious effort to developing a product to meet this market need would be actually taking the first steps to develop end-stage integrated clinical information systems. Winston's consulting firm wants to support the design of an LNIS product.

For pathology, fascinating developments are under way at the **University of Pittsburgh Medical Center** (UPMC). In conjunction with a hospital in eastern Pennsylvania, UPMC is developing a working model of a "virtual pathology practice."

> ***"Virtual pathology departments will emerge due to pressures for increased specialization, higher productivity and diminished teaching budgets."***
> ***-Bruce A. Friedman, M.D.***

"We have the capability to offer electronic pathology reporting. We are already moving text and images within UPMC and with our 'virtual' pathology partner," noted Michael J. Becich, M.D., Ph.D., Director of Genitourinary Pathology at the **University of Pittsburgh Medical School**. "To make this a practical system, however, we must continue to refine the capture of pathology images, how this information is warehoused and how information is retrieved and transmitted. Another problem we are working to solve is how a pathologist properly certifies electronic pathology reports."

Using a laptop, Becich demonstrated the report formats, data retrieval capabilities and ease of access for the systems already in operation at UPMC. In front of the audience, he used the internet to access text and graphics of anatomic pathology reports in real time.

"As you can see, we already have a workable system," commented Becich. "Our challenges in creating telepathology systems are the speed with which new imaging and computer technology is introduced and how to continually adapt such technology to our system."

Dynamic Telepathology

"The other impediment is cost. A dynamic telepathology station starts at a minimum of $150,000. Until prices come down further, I don't believe that pathologists will use this technology on a widespread basis."

Pathologists will be interested to know that Dr. Friedman predicts increased employment for pathologists and laboratory managers who take an interest in clinical information management. "Healthcare is recognizing that information is the key to improving clinical services. I see every segment of the healthcare industry defining their product as information.

"For example, in-vitro diagnostic manufacturers now view themselves as in the information business," explained Dr. Friedman. "For them to develop and execute this business strategy, they need pathologists and laboratorians who understand clinical practices as well as the information technology used to manage this data.

"I believe that the creation of virtual laboratories will fuel demand for pathologists with the ability to manage new technology and outsourcing relationships. Pathologists with such skills will find themselves in high demand." **TDR**

(For further information, contact Bruce Friedman, M.D. at 313-764-8333.)

The Dark Index

Roche Holdings, Ltd. Acquires Boehringer Mannheim In Merger

CEO SUMMARY: Roche will pay $11 billion to buy Corange Ltd., parent company of Boehringer Mannheim, the world's number two diagnostics company. Wall Street expects this deal to quicken the pace of consolidation in the healthcare industry. The surprise move will impact clinical laboratories.

WALL STREET and the clinical laboratory industry were both caught off guard by the announcement last Monday that **Roche Holdings. Ltd.** would pay $11 billion to acquire **Corange Ltd.**

Because **Boehringer Mannheim GmBh** is a division of Corange, Roche will now own and operate Boehringer. It is too early to understand what Roche intends to do with Boehringer. Because Boehringer is a major player in the diagnostics marketplace, clinical laboratories will eventually see changes to how Beohringer markets its products.

Roche's first foray into diagnostics started slowly, but rapid growth in earnings and profits in the diagnostics division apparently encouraged the company to expand diagnostics. Boehringer's acquisition should quadruple Roche's annual diagnostics sales.

With the acquisition, Roche now eclipses **Abbot Laboratories Inc.** as the world's largest diagnostics company. The Corange acquisition is still subject to regulatory approval, but there are no indications that such approval would be withheld.

For laboratory executives, this acquisition is a reminder that the same type of consolidation that transformed the commercial laboratory industry is hitting other segments of healthcare. Wall Street analysts expect this deal to trigger others in the diagnostics industry, possibly involving **Johnson & Johnson**, Abbott and **Bayer AG**.What will cause such transactions is the fact that developing diagnostic technology requires huge amounts of capital and resources which smaller companies do not possess.

THE DARK REPORT believes that Roche may want to enter the marketplace with a combined diagnostic-therapeutic package. This would pair diagnostic tests with appropriate pharmaceuticals. Were this to occur and catch on in the marketplace, it might impact the type of services commercial laboratories provide.

Imagine the sales force of a clinical laboratory offering both the diagnostic test and the related prescription drugs for the indicated treatment. THE DARK REPORT sees this trend already occurring with certain boutique laboratories.

In the press stories about the Roche-Corange merger, there was no mention of **Laboratory Corporation of America**, in which Roche holds a 49% stake. The Corange acquisition may lead Roche to reassess what strategic value LabCorp can contribute to the combined parent company. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

With commercial laboratories pressing hospital laboratories for joint ventures, a unique selling proposition helps. **MDS-AutoLab, Inc.** of Canada has a different twist. They will not sell you their automated laboratory equipment. Instead, they offer it on a profit-sharing type of arrangement.

MORE ON:
MDS-AutoLab...
This profit-sharing arrangement is already part of the regional laboratory venture between **Columbia/HCA** and MDS-AutoLab Atlanta. After AutoLab's experience with its automation equipment at **Mayo Medical Laboratories'** central site, the company wants to insure perfect performance of its laboratory automation technology. A profit/loss sharing arrangement is certainly one way to incentivize AutoLab to design a laboratory automation installation which functions effectively and generates an acceptable return on investment.

INDICTMENT DIFFICULTIES

THE DARK REPORT has learned that criminal investigation continues in the **Damon Laboratories** case in Boston. However, the prosecutor is having difficulty building a case and the statute of limitations is running out. Like the Whitewater case, the Damon prosecutor has invested years of effort, but no indictments have resulted.

MORE ON:
Laboratory Indictments...
Knowledgeable sources tell THE DARK REPORT that employees of **SmithKline Beecham Clinical Laboratories** (SBCL) have nothing to fear from further federal criminal investigation. Apparently there was a tacit agreement as part of the $325 million settlement between SBCL and the feds that the allegations involved were totally resolved with the public settlement and payment of the fine. Thus, no criminal indictments of individuals involved in that case are expected.

The **American Pathology Foundation** (APF), a progressive group of business-minded pathologists, will deal with the Pap smear dilemma at its July 16-20 meeting in Napa, California. Also scheduled are presentations on pathology networking and information technology which supports regional pathology activities. Information on the meeting can be obtained through the APF's offices in Mundelein, Illinois.

Last month's *EXECUTIVE WAR COLLEGE* in New Orleans confirmed that laboratory regionalization is the trend of the future. Attendees agreed that healthcare trends were going to continue to force laboratories to partner with competitors in forming regional systems. However, the jury is still out as to whether regional laboratory networks will be the dominant organizational form. More on this topic in future issues of THE DARK REPORT.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, June 23, 1997

UPCOMING...

- ***Why Hospital Laboratories Face Continuing Federal Medicare/Medicaid Investigations.***
- ***More Proven Management Techniques To Slash Costs, Boost Service.***
- ***Exclusive Interview With Major Pathology Business Innovator.***
- ***The Second Executive War College: Surprise Lessons About Lab Networks.***