CHAPTER 1

Predicting a Crisis: Early Warning Signs

THE LEAD-UP

Hospital turnarounds traditionally have been viewed as institutions gradually lapsing into financial decline. Eventually, the decline takes an aggregate financial toll on the organization and reaches a trigger point. This situation still happens regularly.

But today, environments can change rapidly. Even historically well-run institutions' financial fortunes can go sour because of changes and shifts in the market. Any institution can be subject to financial decline if its leadership is not vigilant. However, few healthcare institutions drift into financial distress without having telegraphed some early warning signs.

Other than in hospitals struggling visibly with their bottom lines, identifying circumstances where a hospital is trending toward serious financial distress is not easy, but it is possible. Sometimes the signs are unmistakable. An example of distress could be the leadership's concern about the organization's ability to pay its bills. Another sign might be a decision to cut back on the level and type of services offered to the community. More common are the institutions in the middle of the road experiencing fluctuating cash flow streams simply from earning less money than they are spending.

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For the vast majority of hospitals, discovering signs of distress requires a thorough vetting of many factors both financial and nonfinancial. A primary objective of the CEO and senior leadership should be to make a distinction between what is a short-term hiccup—one or two quarters of losses in a fiscal year, but a positive financial outlook beyond that point—and what is a more deep-seated downturn—such as losses for more than two quarters with a continued negative financial outlook. Another example is the organization that moves back and forth between being profitable and losing money over a 12-month period. This yo-yo effect signals instability in the management system and should be treated as one potentially requiring a turnaround.

Leaders should make every effort to get a handle on the situation quickly. With each passing day, the situation is less likely to get better on its own.

Performance Analytics

When answers are needed right away, hospital leadership should gather and use performance analytics. Three basic methods exist for gathering performance analytics and getting a quick read on the organization's financial performance: the acid test, the quick test, and the comprehensive test, as shown in Exhibit 1.1. All three tests help you gather and analyze information rapidly. However, each test has a specific formula and purpose. Selecting which test to use depends on how much detail the leadership wants to delve into and how fast the information is needed.

All three tests can be developed by the chief financial officer (CFO) without spending much time or energy. Each test combines a section of key performance indicators into a snapshot of how the organization is doing. Most of information and data should already be available internally. In addition, other benchmarking data can be obtained free of charge from public agencies. Benchmarking information can also be purchased from

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Exhibit 1.1: Checklist for Rapid Assessments of Hospital Financial Health

Performance Indicators (within range?)	Acid Test	Quick Test	Comprehensive Test	Purpose of Measurement
Operating margin (EBITDA) (declining or negative)	✓	✓	✓	Ability to pay short-term bills
Days cash on hand (below industry standards)	✓	✓	✓	Ability to pay short-term bills
Debt service coverage (declining ability to pay)	✓	✓	✓	Ability to pay short-term bills
Average days in accounts receivable (above industry standards)		✓	✓	Cash flow management
Average days in accounts payable (above industry standards)		✓	✓	Cash flow management
Admissions trend (up/down)		✓	✓	Physician loyalty
Emergency room volume (up/down)		✓	✓	Physician loyalty
Surgical volume (up/down)		✓	✓	Physician loyalty
Labor cost (as a percent of net revenues)			✓	Cost management
Supply and purchased services cost (as a % of net revenues)			✓	Cost management
Productivity (FTEs/adjusted occupied bed)			✓	Operational efficiency
Market share trend (up/down)			✓	Competitive position

proprietary companies. The number of vendors selling health and hospital benchmarking data has exploded in the past decade.

The Acid Test

The acid test is the quickest to perform. It zooms in on the profitability and answers the question, "Do we have enough money coming in to pay our short-term bills, including meeting payroll?"

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The formula for the acid test contains indicators for operating margin, days cash on hand, and debt service coverage. Each of these indicators is a standalone performance indicator that can have a significant impact on paying short-term bills. The number of days cash on hand will be the most critical indicator of short-term financial health.

The Quick Test

The quick test uses the acid test results as a baseline and then builds cash flow and physician loyalty measures on top of it. In the quick test, you want to know if you are properly balancing cash coming in with cash going out. Leadership's ability to manage this balance is critical to a successful turnaround. The goal in cash flow management is to pull in as much cash as possible from generated business and other sources, such as the sale of noncore assets. On the other side of the ledger, you have accounts payable, where your goal will be to pace your payment process (cash outflow) to vendors to reflect the money you are bringing in (cash inflows).

The quick test will also help you determine if the level of business flowing through the organization is stable enough to generate the level of financial strength necessary to keep the organization on track and moving forward. Here, examining volume statistics comes into play. One pointed question to answer is how well your organization is doing with admissions, surgical cases, and emergency department visits. Look for swings and patterns in these areas, which could dramatically affect organizational revenues. Within each service line, start the process by reviewing the admitting patterns of major admitters. Do any patterns here suggest a significant change in loyalty to the organization?

The Comprehensive Test

The comprehensive test uses the results of the acid and quick tests as a baseline and integrates discussions about cost management, operational efficiency, and the organization's competitive position in the market. Labor, supply, and purchased services expenses will

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constitute between 80 and 90 percent of total operating expenses. Getting a handle on where you stand on these important indicators is a must. While many hospital and organizational productivity indicators exist, one of the more commonly used indicators for comparative purposes measures full-time equivalent employees (FTEs) and adjusted occupied beds. This number can provide an immediate snapshot of how the organization is performing in personnel staffing.

Analyzing Leading and Lagging Indicators

One of the more common mistakes hospital leaders make when delving into the diagnostic aspects of a turnaround is to focus solely on lagging indicators and not pay attention to the leading indicators. The terms *leading* and *lagging indicators* describe the qualitative and quantitative performance of an organization within a financial context. Leading indicators precede the visibility of lagging indicators and the deterioration process. Leading indicators are the causes of financial distress, while lagging indicators are the symptoms. Examples of some leading and lagging indicators can be found in Exhibit 1.2.

Lagging indicators include routinely reported statistics and ratios found in most institutions' financial statements. These indicators must be reviewed, but experience suggests going further upstream to look at situations, events, and decisions that may be the root causes of performance deficits. The lagging indicators tell you where you are but not how you got there. The "how" question can be answered by looking at the leading indicators. Leading indicators are the bellwether for an organization in financial distress—they can predict what is to come in the lagging indicators, but they often go ignored or unnoticed until the financial deterioration has reached a threatening or critical stage. Once the lagging indicators are on the books, you may already be in damage-control mode. Do not take leading indicators for granted.

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Exhibit 1.2: Leading and Lagging Performance Indicators

Leading indicators (causes)	Volume	Increasing, decreasing, or neutral? Especially for inpatient admissions, OR cases, ED visits, outpatient visits.
	Market share	Increasing, decreasing, or neutral? Overall rank and service line rank in the competitive market?
	Physician loyalty	Profile each physician. Are their admissions increasing, decreasing, or neutral?
	Patient satisfaction	Rising, falling, or neutral? How do patients answer the question "Would you recommend this hospital?"
	Quality and clinical outcomes	Performance on quality core measures and patient safety? Performance compared to regulatory requirements and benchmarked best practices?
	Image and reputation	Improving or declining? Internally and externally?
	Management and employee turnover	Benchmarking against local competitors? Against industry standards? Trending (monthly and annually)?
	Information and data	Is available, accurate, credible, and used in the decision-making process?
	Reimbursement and payer mix	Is there erosion? Are there collection issues?
Lagging indicators (symptoms)	Operating margins	Increasing, decreasing, or neutral? Benchmarking against industry standards? Trending (monthly and annually)?
	Days in accounts receivable	Increasing, decreasing, or neutral? Benchmarking against industry standards? Trending (monthly and annually)?
	Days in accounts payables	Increasing, decreasing, or neutral? Benchmarking against industry standards? Trending (monthly and annually)?
	Days cash on hand	Increasing, decreasing, or neutral? Benchmarking against industry standards? Trending (monthly and annually)?
	Liquidity (beyond days cash on hand)	The availability of short-term assets for conversion, if needed?
	Debt service ratio	Is net income sufficient to cover annual debt service?

(continued)

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Exhibit 1.2: Leading and Lagging Performance Indicators (continued)

	Bond rating	Investment grade? Increasing or declining?
	Capital investments in core business and infrastructure	Increasing, decreasing, or neutral? Higher than average age of physical plant? Deferment of mission-critical projects? Deferment of life safety projects? Higher than average age physical plant?
	Pension liability and payroll taxes	Increasing liabilities? Delayed payments?

If you view and address them appropriately, you have time to fix the issues and have a significant impact on the performance of the lagging indicators. Locating and analyzing leading indicators can help enhance a leadership team's decision-making process and accelerate the necessary course corrections.

To ensure effective financial performance, management should develop a process in which the indicators are normally part of the management reporting and oversight process, such as at weekly or biweekly executive team meetings and monthly board of directors and medical staff meetings. One of the better ways to achieve this oversight is to place the indicators in an organization's balanced scorecard performance measurement system (see Chapter 5).

COMMON CAUSES OF FINANCIAL DISTRESS

As you embark on the diagnostic journey of a turnaround, one of the first issues to address is what happened, and more important, how it happened. If your first response is that our industry is unique, stop talking! You are about to stroll down the road of excuses, and you should be on the road to finding solutions. Of course healthcare—hospitals in particular—is unique. But so are banking, airlines,

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automotive, and so on. The real question is, within this field, why do some organizations succeed and others fail?

The American Hospital Association (AHA) produces an annual financial trend publication on how well hospitals in all sectors are performing in aggregate with respect to operating margins. In the 2013 *Trendwatch Chartbook*, the AHA reported on hospital industry performance from 1995 to 2011. The percentage of hospitals reporting negative operating margins ranged from approximately 28 percent in 2011 to 42 percent in 2000. A regression line drawn through this chart shows approximately 30 percent of hospitals are experiencing annual operating losses.

The flip side is that about 70 percent of the hospitals had positive operating margins.

How can an industry have a consistently high level of losses that is so common that losses appear to be structurally woven into the management practices and reporting process? The usual suspects for operating losses are

- reimbursement,
- mission,
- location,
- age of facilities,
- market saturation,
- access to capital,
- recruitment, and
- culture.

Some of the structural questions can be answered in how the industry operates. Healthcare is highly competitive, but it is also a "me too" industry. This approach can be particularly true of hospitals. Being left behind is not an option, so expediency has crept into some leaders' decision-making processes. In other words, leaders veer off the road of sound decision making and start to substitute copycat strategies, copycat investments, and copycat decisions, all for the sake of expediency. A follow-

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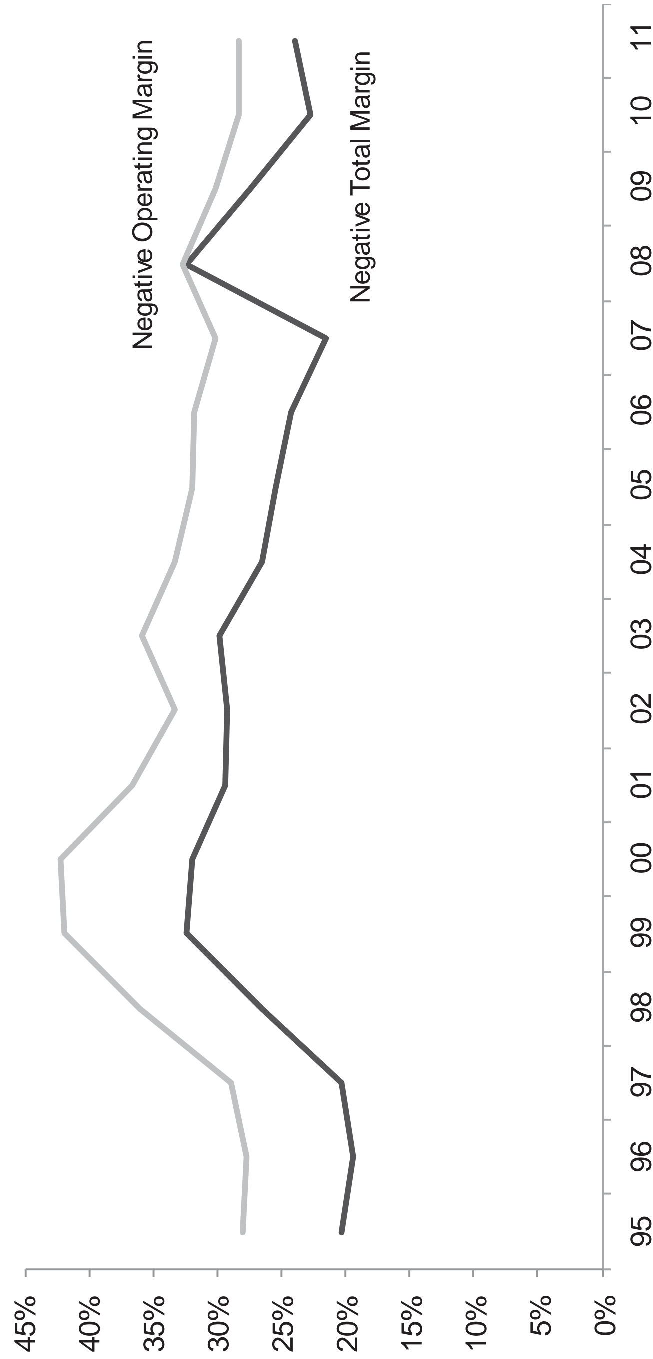
Exhibit 1.3: Percentage of Hospitals with Negative Total and Operating Margins, 1995–2011



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the-leader mentality can lead you over a cliff. Attempting to duplicate what others have done, without proper vetting and forethought, likely will not yield the same outcomes. Deploying the same or similar strategy in a different environment with different circumstances can lead to a different result. A classic example is the acquisition of physician practices by hospitals. Many hospitals were acquiring practices but did not know how to manage them. Another example is the acquisition of health plans. Losses mounted quickly, and hospital leadership soon realized they did not possess the expertise to manage health plans. Instead of jumping on trends, do your due diligence and follow your own path.

The Health Care Advisory Board (2000) conducted a study of hospital and health system financial turnarounds. The study methodically peeled the onion of hospitals' performance layer by layer, identifying numerous common mistakes leaders made that pushed their organizations into financial decline. The Advisory Board grouped the mistakes into four categories:

1. Strategic missteps
   a. Mergers and acquisitions
   b. Diversifying beyond the core business
2. Leadership shortfalls
   a. Board of directors
      – Dissention or confusion about priorities and process
      – Critical information necessary to make decisions not reaching the board
   b. Management
      – Lack of clear direction for organization
      – Lack of technical and managerial knowledge necessary to execute successfully
      – Lots of data, no information
      – Fear of making difficult decisions
3. Organizational culture and structure
   a. Culture of compliance with the status quo

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   b. Culture where relationships take precedence over sound business practices
   c. Organizational structure that is bloated and bureaucratic
4. Performance management and track record
   a. Downward trend in key performance indicators
   b. Unrealistic performance targets given the environment
   c. Expectations and performance set too low
   d. Cumulative track record of not achieving agreed-on targets

These same mistakes continue today. Strategic missteps have a profoundly negative impact on the well-being of an organization. Nowhere is this impact seen more clearly than on the balance sheets of financially distressed organizations. Strategic decisions can require large sums of capital. If an executed strategy does not pay off, it can become a financial drain in the form of declining liquidity, declining net worth, and rising debt. All of these problems surface on the balance sheet long before you see them on an income statement. The Advisory Board (2000) discovered two main contributors to strategic missteps—mergers and acquisitions, and diversification beyond an organization's core business. For example, acquiring competing hospitals that have historically had losing bottom lines or merging with another struggling hospital to reduce competition or seek economies of scale, which rarely materialize. From a diversification standpoint, some organizations make conscious decisions to purchase and manage physician practices or to own and operate health plans. Many of these strategies are recycled through the industry. But financially successful organizations rarely lose sight of their core business: managing the hospital.

Second, leadership shortfalls were detected at multiple levels within financially distressed organizations, on the board of directors and within the senior management ranks. These leadership shortfalls can be painfully obvious. Figuring out this part of the diagnostic process does not take long. Review financial statements and strategic plans, assess productivity, review board minutes,

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and interview key stakeholders. This information should give you a quick sense of whether the organization has leadership issues. There is no substitute for effective leadership; without it, the organization will suffer.

The third category, organizational culture, is frequently overlooked in the turnaround process because it is considered a soft area (intangible) and cannot be turned around on a dime. Also, people get downright offended if you tell them there may be a problem with their system of beliefs and practices. Organizations in turnaround tend to have affection for the status quo. In financially distressed institutions, relationships can trump sound business practices. To improve the organization's performance, leadership has to sidestep the old saying that "you have to go along to get along." To create a culture of accountability, the mold may have to be broken and the culture reshaped.

Setting and monitoring performance is the fourth and final category. Financially distressed institutions often lack a comprehensive, documented, and enforced performance management system that serves as a compass for accountability. Some of the more basic questions to ask when developing a sound performance management system include the following:

- What is the team or organization trying to accomplish?
- Who is trying to accomplish it?
- When will it be accomplished?
- Are the performance expectations measurable and set in advance?
- How is accountability handled if targets are not met?

One example of performance measurements affecting a turnaround would be having a goal of moving the hospital's cost per adjusted admission from the twenty-fifth percentile up to the seventy-fifth percentile in your peer group. Another example would be moving the FTEs/adjusted occupied bed productivity

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performance indicator from the twenty-fifth percentile to the seventy-fifth percentile in your peer group.

On a final note, decision making deserves a deeper discussion even though it has been mentioned before. Decision making is at the nexus of each of the four common mistakes. If an organization finds itself in a financial hole, its leaders should take the time to honestly reflect on their decisions and the decision-making process.

- Did specific thought processes or patterns lead up to the decisions that made for good judgment or not-so-good judgment?
- How was information gathered and vetted?
- Was critical information overlooked or unavailable?
- Did key individuals participate (or not participate) in the decisions?
- Were checks and balances in place?
- Were previous mistakes used as teachable moments for the current processes?
- How were the final decisions made?
- Who made the final decisions?
- What could have been done differently to have a better outcome?

BEWARE OF LEADERSHIP TIPPING POINTS

Malcolm Gladwell (2002) defines a tipping point as the "moment of critical mass, the threshold, the boiling point." Others have described a tipping point as a point at which a slow, reversible change becomes irreversible, often with dramatic consequences.

Hospital turnarounds have recognizable tipping points, especially for leaders. Triggering these tipping points can have dire consequences on you as the leader of a turnaround. Your ability to recover and seriously lead a turnaround will be difficult if people question your leadership on the basis of a lapse in judgment or other negative event. Some tipping points have fatal consequences, others are critical and lead to being fatal, and others can start out

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as serious and become critical if they are not addressed. Examples of serious, critical, and fatal leadership tipping points are listed in Exhibit 1.4.

Many times the tipping points and the actions leading up to them can become intertwined, creating a domino effect when one critical mass point or change can cause the deterioration of another situation. This can accelerate a downward spiral. Stay mindful of the interconnectedness of your decisions and the events that may result. For example, a no-confidence vote by the medical staff could trigger a loss of board support. If the image and reputation of the organization falls below expectations, it can trigger a lack of confidence in the leadership. A sentinel event could cause the image and reputation of the organization to fall below expectations. A no-confidence vote by the medical staff could trigger a precipitous decline in volume. A downward change in credit worthiness could restrict access to capital and cause concerns about financial viability.

Exhibit 1.4: Categories of Leadership Tipping Points

	Occurrences
Serious	• Performance falls below expectations of board or corporate leadership • A major failed decision • A sentinel event (quality or nonquality) • Bond ratings declining below investment grade
Critical	• Performance below expectation of board and corporate leadership which has not been corrected after mutual agreement to do. • No plan developed for course correction of organization • Change in political direction of internal or external supporters • Being seen as lacking competence for the job • Volume falling off the cliff • Image and reputation of the organization falling below expectations
Fatal	• Loss of confidence by the board • Loss of support from the board • A no-confidence vote by the medical staff • Continued financial losses with or without a financial turnaround plan

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The best way to handle these types of tipping points is to be aware of them, and develop and execute your turnaround plan in a manner that does not allow reversible situations and events to become irreversible. For example:

- Have an open and direct line of communication with the board of directors and board chair. Ensure the turnaround plan has been presented and approved by the board. Schedule routine meetings for update and progress.
- Ensure the turnaround plan has been discussed in broad terms with medical staff leadership. You may not be able to get full agreement on a specific plan because of the diversity of opinions, but you should be able to gain support for a specific direction for the organization. Keep the medical staff engaged in the process through routine updates and progress reports.
- Work to ensure no surprises. If difficult messages need to be delivered or decisions made, deliver the messages and acknowledge the difficult decisions required.
- Vet major decisions prior to implementation. Decisions should not be made in a vacuum or in isolation.
- Do not underestimate the element of time. If an organization is in the red, remaining there is detrimental to leadership and the organization. Move through the process with a calm and rapid sense of purpose.
- Be mindful of an organization's image and reputation. Any decisions affecting this area should be discussed with the board and other organizational leadership.

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Critical Success Factors Checklist		
CSF 1.1	Distinguish between a short-term financial hiccup and a more deep-seated financial downturn.	☐
CSF 1.2	Get a quick read on your financial situation—perform an acid test or quick test to gauge the organization's financial health.	☐
CSF 1.3	Identify both leading and lagging performance indicators. Cash flow and days cash on hand should be the first measures assessed.	☐
CSF 1.4	As early as possible, diagnose causes of organizational financial distress and any missteps. Separate symptoms from causes. (Fixing symptoms does not solve the problems.)	☐
CSF 1.5	Assess whether the organization's decision-making process is sound. Is it effective?	☐
CSF 1.6	Avoid leadership tipping points.	☐
CSF 1.7	Chart the potential domino effects of the tipping points and the actions that lead up to them. Gauge your proximity.	☐

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