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Rural Focus

Proactively Assessing Your Organization's Strategic Risk Profile

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A crucial responsibility of a not-for-profit board member is to understand the strategic risk position of their organization and how that risk position has changed over time.

This obligation falls within the broader category of a board member's duty of care. An organization's strategic risk profile is dynamic and constantly evolving. Changes may be subtle from year to year, but the cumulative effects can be profound and pose significant constraints to the organization's future viability.

We often use the terms "stable," "stressed," and "distressed" to describe an organization's strategic risk profile. The greater the risk, the more stressed or distressed an organization is:

- A *stable* organization is performing well and has a modest strategic risk profile.
- A *stressed* organization may be experiencing challenges that require attention and modification to its trajectory.
- A *distressed* organization has been experiencing significant challenges for some time and has significantly constrained the path to sustainability; a significant change in trajectory is needed urgently.

This article provides not-for-profit hospital and health system boards with a framework for evaluating strategic risk and making decisions when the organization is distressed.

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Are We a Distressed Organization?

Many organizations do a poor job of putting their operating results and financial and market position into any type of strategic framework or risk analysis. The result can be years of strategic drift characterized by a deteriorating balance sheet and erosion of the organization's market position and strategic vitality. These adverse trends can compromise the ability to attract and retain staff and constrain the ability to make needed investments in biomedical equipment, computer systems, and facility renewal.

To address poor operating and financial results, organizations often defer investments and use short-term fixes to mitigate further damage. These Band-Aid fixes can take place over years and without meaningful discussion of strategic and long-term implications and often have significant adverse implications if they continue for more than a year or two. Understanding the key signs of a stressed and distressed organization can give leadership advanced warning and time to make stronger and less destructive decisions. In addition, recognizing key signs can allow board members to engage in meaningful discussions with hospital management before financial options and fixes become limited.

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A prerequisite for any discussion of strategic risk is to examine long-term trends. A minimum of five years of historical data on key operating, financial, clinical, value, and market trends should be analyzed, and trends highlighted. In addition, organizations should examine current year-to-date performance and budget numbers on these metrics to understand how recent and budgeted performance compares with past performance. It can also be helpful to compare organizational performance to objective benchmarks, such as rating agency financial medians by credit category or state, national, or cohort operational benchmarks.

Once the data has been gathered, it is critical to put organizational performance into a strategic framework that enables leadership to assess the organization's risk profile. The severity of the performance gap, the trendline in performance (is performance stable or are poor results accelerating?), and the baseline strength of the organization will define how well an organization can tolerate adverse forces. These components of the organization's risk profile will determine how quickly an organization moves from stable to stressed and then distressed, with a final stop at insolvency.

The organization's performance on the following factors and their trajectory define an organization's strategic risk profile:

- **Signs of a stressed organization** (not all need be present):
  - Two years of flat top-line revenue growth
  - Two years of deterioration in market position as measured by market share and payer mix

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    - Stagnant volumes in key services
    - Declining performance on key quality metrics and scorecards compared to competitors and state and national benchmarks
    - Key operating and financial indicators are trending negative and compare unfavorably to competitors
    - Increasing reliance on non-operating income to offset operating losses
    - Material deterioration in cash flow for two years (EBIDA and debt service coverage)
    - Capital reinvestment is below depreciation expense for two years
    - The capacity to make needed investments in the future is uncertain based on current trends
- **Signs of a distressed organization** (not all need be present):
    - Declining top-line revenue from the prior year or flat top-line revenue growth for three or more years
    - Significant deterioration in market position for two or more years
    - Declining volumes in several key services
    - Three or more years of declining margins; two years of negative margins
    - Material deterioration in key balance sheet measures of liquidity (days cash on hand) and leverage (debt to total capitalization)
    - Material deterioration in cash flow for two or more years (EBIDA and debt service coverage)
    - Capital reinvestment is below depreciation expense for three or more years
    - Cost-cutting measures impact core programs and functions
    - The capacity to make needed investments in the future is uncertain based on current trends

The above-referenced metrics provide an overview of how a board can assess the strategic risk profile of the organization. Because the risk profile of most organizations is dynamic, it is best practice to evaluate the organization's strategic risk profile at least every two years and more frequently for organizations that are stressed or distressed.

What Are Our Responsibilities as Board Members of a Potentially Distressed Organization?

Often, agreeing to be a board member of a small community hospital is motivated by an appointee's desire to serve the community. Regardless of one's benevolent intent, a board member owes significant duties to the organization that he or she serves. It is expected that board members are curious, reasonable, loyal, and always refrain from self-dealing. Regardless of a board member's altruistic intent, he or she needs a full understanding of a board member's duties.

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In many states, the governing body of a municipality may establish, by resolution, officer positions and a board to maintain and operate municipal hospitals. The specific duties of board members and officers are often described by the appointing authority (such as a county board) or by state statute. For example, in North Carolina, board members of a municipal hospital board have a statutory duty of loyalty.[1] Generally, the duty of loyalty is defined as acting in the best interest of the entity served.[2] This typically means that no member of the board, employee, or spouse of a member of the board or employee has any interest in the hospital facility, property, contracts, or proposed contracts.[3] There are similar restrictions in other states.

Further, other duties might not be specifically mandated by statute or the appointing authority. We rely on a full body of laws governing non-profit organizations to inform board members of their obligations. For example, board members and officers should adhere to the duty of care and duty of obedience. The duty of care requires board members and officers to act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[4] This duty includes a duty of oversight. The duty of obedience requires board members to ensure that the organization is acting in furtherance of its defined purpose and mission as outlined in the organization's charter and bylaws.

Key Board Takeaways

- Analyze your organization's risk profile annually with an emphasis on financial, operational, market, and value (quality and cost) indicators.
- Examine five years of historical trends plus current YTD and budget performance to understand how the organization's risk profile is evolving.
- Assess trends to understand if change in the strategic risk profile is accelerating or slowing.
- Develop a cash run rate projection to determine how long until available cash is depleted.
- Create a performance improvement plan to extend the time available before cash is depleted.
- Do not wait until it is too late to improve operating performance and/or explore strategic options. If available cash can support less than one year of operating losses, you need to act immediately to improve operating results to extend the available runway.

1 N.C. Gen. Stat. § 131E-14.2 (a).

2 See N.C. Gen. Stat. § 55A-8-30(a)(3); N.C. Gen. Stat. § 55A-8-42(a)(3).

3 See N.C. Gen. Stat. § 131E-14.2 (a) (1)-(2).

4 N.C. Gen. Stat. § 55A-8-30(a)(2); N.C. Gen. Stat. § 55A-8-42(a)(2).

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What Are Our Options as a Distressed Organization?

Distressed healthcare organizations have many options at their disposal. First, they should focus on whether operational improvements can be implemented to increase the organization's revenue and/or decrease the organization's costs. In some cases, outside consultants can assist the organization. If implementing such operational improvements is not feasible, then the organization should consider partnering with a larger healthcare organization. Partnering with a larger healthcare organization can lead to many positive outcomes, including increased cost reduction and higher reimbursement rates. However, finding a partner while in a distressed state can severely limit options and the ability to negotiate favorable terms. Often, a distressed hospital must implement operational changes to improve cash flow or stem cash losses to find a partner. But what can a distressed healthcare organization do if operational improvements are inadequate to create a path to viability or to attract a potential partner?

A distressed healthcare organization that cannot make adequate operational improvements (or lacks the time to do so) or one that is unable to find a partner should certainly consider seeking bankruptcy protection to support its rehabilitation. Under the right circumstances, bankruptcy can help a distressed healthcare organization reorganize by restructuring payments to secured creditors, discharging debt to unsecured creditors, rejecting burdensome executory contracts and unexpired leases, and even terminating pension plans. Bankruptcy courts are also able to approve sales free and clear of liens and other encumbrances, making distressed healthcare organizations in bankruptcy often more attractive to potential partners than their counterparts outside of bankruptcy. Reorganization is certainly better than ceasing to operate. Professionals can assist board members in identifying and understanding the options.

Evaluating risk is important to support the longevity of an organization.

Evaluating risk is important to support the longevity of an organization. For distressed organizations, action is of the essence and critical to survival. As a board member, it is essential that you have the tools to assess if your organization is distressed and a comprehensive understanding of your responsibilities as a board member of a distressed organization. A solid foundation of this understanding will empower you to support your organization and explore potential solutions.

For more information, please watch for future articles on these topics to be released in early 2024.

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