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Quantifying Risk and Identifying Signs of Stress in Your Organization

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Amidst the many challenges in the current healthcare industry, health system leaders frequently neglect to regularly monitor their strategic risk profile.

Often, key indicators are reviewed only in comparison to the current budget or prior year's performance, leaving the impact of longer-term trends unquantified and unaddressed. Failing to assess trends over time can allow operational and strategic issues to grow, gradually hobbling an organization's viability. A depleted balance sheet, significant deferred investment, an obsolete physical plant, or a compromised market position can threaten the prospects of a health system. Strategic drift and operational underperformance, even if modest year over year, will adversely affect the health system's ability to attract and retain staff, reinvest and renew its asset base, and respond to competitive threats or regulatory requirements.

Early recognition of the signs of a stressed or distressed organization is crucial, providing leadership with the opportunity to take proactive and less disruptive action to address the situation. Moreover, this understanding allows board members to engage in meaningful discussions with hospital management before operational fixes and strategic options become limited.

Key Sources of Risk

In assessing strategic risk, it is essential to consider four key sources of risk:

1. **Financial risk:** Critical trends to monitor within the financial risk domain include top-line revenue, cash flow and margins, leverage (debt to total capitalization), and liquidity (days

cash on hand). An additional indicator is the degree to which the asset base has not been renewed, measured by average age of plant. A backlog of deferred investment can constrain an organization's prospects.

2. **Operating risk:** Operating risk is characterized by key trends in patient volumes, payer mix, and cost efficiency.
3. **Value risk:** The value risk domain focuses on essential metrics of quality such as readmission rates and HCAHPS scores in addition to the organization's cost position.
4. **Market risk:** Market risk examines trends in market position, demographic shifts, consumer preferences, and the economic vibrancy of the market.

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It is crucial to recognize that poor performance or elevated risk in one domain can trigger collateral or "spillover" effects that impact one or more of the other risk domains. A comprehensive and integrated approach to monitoring these domains is vital for effective risk management and overall organizational resilience. For example, the departure of a key employer can be expected to depress local incomes and perhaps lead to population loss. With time, these changes can spill into health system volumes, payer mix, and financial health as measured by top-line revenue, cash flow, and margins. Systems will often defer investment and be forced to spend reserves to address losses, resulting in a depleted balance sheet on top of the backlog of investments.

Monitoring key trends within each risk domain annually is vital for informed decision making. Health system leaders must quantify long-term trends and analyze a minimum of five years of historical data to gain a comprehensive understanding of the risk landscape. Comparing current performance against budgeted performance, past performance, and objective benchmarks such as rating agency medians will provide valuable perspective to the data trends. Additionally, if the rate of change in several metrics is increasing and moving in the same direction, this acceleration bears additional exploration. This comprehensive approach ensures a thorough evaluation of the evolving risk environment and supports strategic planning and risk management initiatives.

Risk Profiles

The culmination of trends within the four risk domains shapes an organization's risk profile and serves as a strategic framework that systematically organizes the analyzed data from within each domain. This structured presentation empowers leadership to effectively monitor performance and identify potential gaps in the organization. Organizations commonly categorize their risk profiles as either stable, stressed, or distressed.

Stable organizations reflect satisfactory performance where an organization can reinvest in its asset base and sustain or improve its market position. These organizations avoid presuming automatic organizational growth and recognize the importance of cautious and deliberate investment and expansion to meet changing market and consumer needs. Additionally, stable organizations tend to have positive quality attributes and HCAHPS scores and sustained growth of top-line revenue, which leads to an expansion of resources and services. Leading market share in the service area is also common with stable organizations. Fundamentally, stable organizations not only reinvest wisely but exhibit a comprehensive approach to performance, growth, and market leadership.

Signs of a stressed organization (not all need to be present):

- Two years of flat top-line revenue
- Two years of deterioration in market position as measured by market share
- Two years deterioration in payer mix
- 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 (EBITDA 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
- Budgeted performance is frequently not achieved

Identifying signs of a ***stressed organization*** is imperative for effective risk management and strategic decision making. These indicators serve as red flags that warrant careful attention and intervention. A stressed organization may exhibit various warning signs, including two consecutive years of flat top-line revenue growth, deterioration in market position measured by market share and payer mix, stagnant volumes in key services, and declining performance on crucial quality metrics compared to competitors and benchmarks. Additionally, negative trends in key operating and financial indicators, coupled with an increasing reliance on non-operating income to offset operating losses, can signal a concerning situation. Material deterioration in cash flow over two years, reflected in metrics like EBITDA and debt service coverage, and capital reinvestment falling below depreciation expense for two consecutive years are also significant indicators. Ultimately, a lack of clear capacity to make essential investments based on current trends underscores the dire importance of recognizing and addressing these warning signs promptly.

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 three or more years
- Declining volumes in several key services for several years
- 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)
- Compare unfavorably to competitors and state averages on key quality metrics and scorecards
- Material deterioration in cash flow for two or more years (EBITDA and debt service coverage)
- Non-operating income is insufficient to offset operating losses for two or more years
- Capital reinvestment is below depreciation expense for three or more years or cumulatively over the prior five-year period
- Material degradation of the balance sheet for liquidity (days cash on hand) and reinvestment (average age of plant)
- Cost-cutting measures impact core programs and functions
- The capacity to make needed investments in the future is uncertain based on current trends
- Inability to recruit and retain needed providers such that the medical staff is materially aging overall and key needs go unmet
- Budgeted performance is frequently not achieved—and the variances are large and growing

Identifying and understanding the signs of a ***distressed organization*** is paramount for proactive management and strategic planning. Distressed organizations may exhibit a range of concerning indicators, including declining top-line revenue from the previous year or flat growth persisting for five years. Additionally, significant deterioration in market position over two or more years, declining volumes in key services, and a sustained decline in margins, with two years of negative margins, are warning signs. Material decline in key balance sheet indicators such as days cash on hand, volume of accounts payable, and debt service coverage can further highlight the severity of the situation. Often, distressed organizations both spend down their reserves and curtail investment, resulting in a material decrease in days cash on hand, increased accounts payable, a low capital investment ratio, and an elevated average age of plant. A material decrease in cash flow over more than two years should be cause for concern. If cost-cutting measures begin to impact core programs and functions, and the ability to make essential investments in the future becomes uncertain based on current trends, urgent and strategic interventions are imperative to mitigate further distress and facilitate organizational recovery.

The importance of monitoring an organization's strategic risk position cannot be overstated. Through the strategic framework of the four risk domains, organizations can recognize signs of stress or distress. Organization's risk profiles are dynamic and reflect the current state. It is considered best practice to assess an organization's or system's risk profile at least every two years. For organizations experiencing stress or distress, a more frequent evaluation may be necessary. This proactive approach can provide senior leadership and boards with appropriate time to make informed decisions and implement interventions to safeguard their organization's stability.

Key Board Takeaways

- Monitor your organization's strategic risk profile on an annual basis.
- Use a balanced, easily understood methodology. The methodology should only be modified occasionally—refrain from constant changes that make assessing long-term trends more difficult.
- Understand the key sources of risk for your organization across the four critical risk domains.
- Evaluate, based on risk domains, if your organization is stable, stressed, or distressed.
- Use the strategic risk profile of your organization to engage with leadership in meaningful discussions around strategic options.

This article is part two in a series on the importance of hospitals and health systems assessing their strategic risk profile. Part one provided a framework for evaluating risk.[1] *The next articles in this series will explore the responsibilities of boards whose organizations are potentially distressed and options to consider as a distressed organization.*

The Governance Institute thanks Jeff Sommer, Managing Director, and Clare Kelley, Senior Consultant, Stroudwater Associates, for contributing this article. They can be reached at ckelley@stroudwater.com and jsommer@stroudwater.com.

1 See Jeff Sommer, Jennifer B. Lyday, and Clare Kelley, "Proactively Assessing Your Organization's Strategic Risk Profile," The Governance Institute, *Rural Focus*, December 2023.