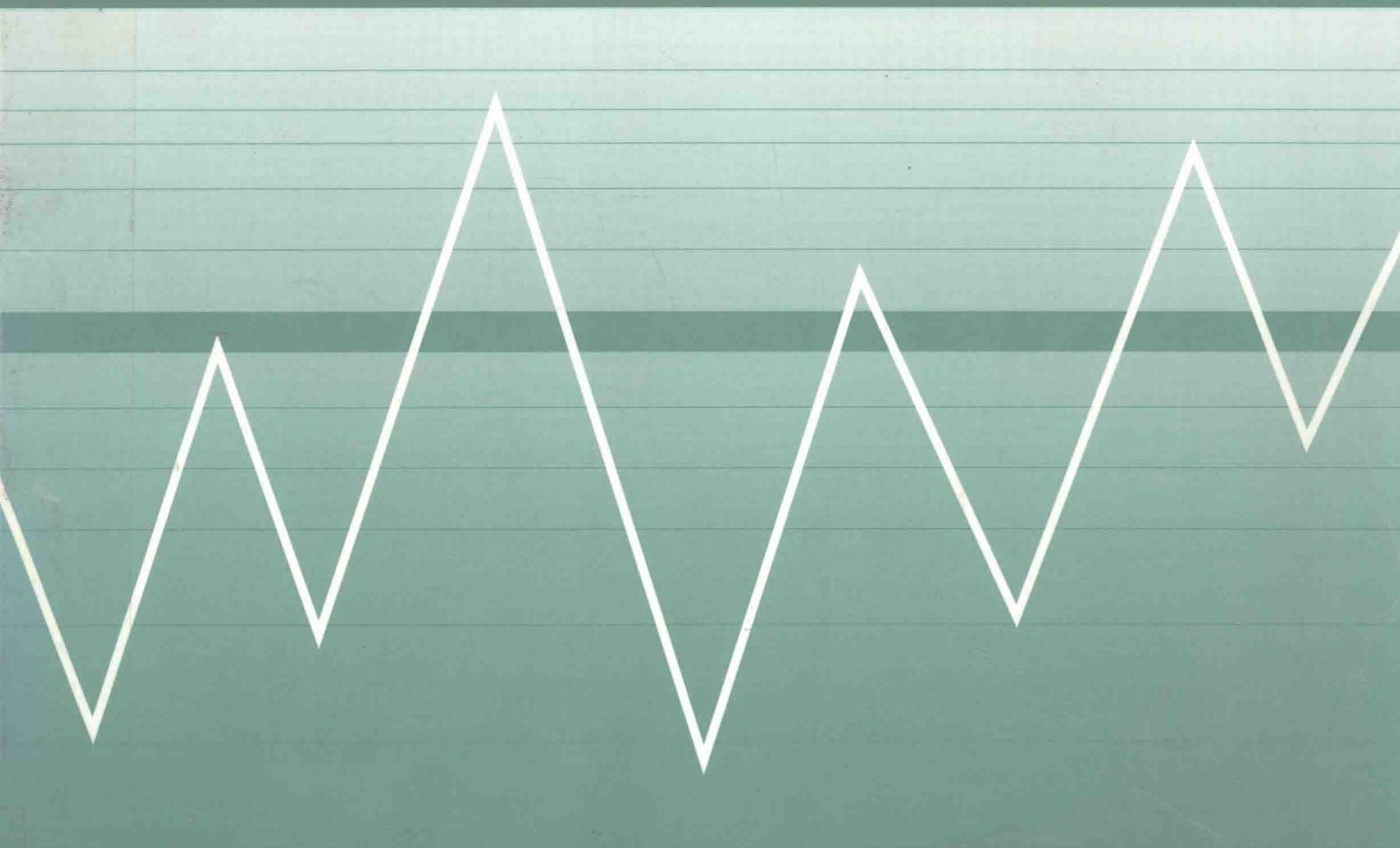


Predicting and Preventing Hospital Decline

by
James J. Unland



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Valuation of Hospitals and Medical Centers

Understanding the Valuation of Medical Practices

A Trustee's Guide to Understanding Hospital Business Fundamentals

Preface

This is a book about management.

Throughout our educations and our professional careers, we are incessantly hearing the word "management." Young people in business schools are taught that becoming a "manager" is a worthwhile career goal. People with titles like Vice President, Chief Financial Officer, Chief Executive Officer, Chief Operating Officer, and so on are considered important both in business organizations and in hospital organizations because they "manage" people and resources.

Management—or the activity of managing means different things to different people. To some, management is the activity of getting people to direct their efforts in specific tasks. To others, management is the ability to build teams to achieve a common objective. Management and leadership are often thought of as activities that go hand in hand; one can not manage without being a leader. Still others look at management as the ability to allocate human efforts and other types of resources such as materials, capital, and space—all toward defined objectives.

All of these views about management are legitimate. As I continue to spend more years in the health care industry, however, I have come to appreciate what one of my early college professors said about management. Although at that time I thought this professor had a rather odd view of management, his view seems to have a legitimate application to what is happening in the health care industry—especially the hospital industry—today.

This professor said that management can involve many different kinds of activities but that fundamentally it involves the ability to anticipate changes affecting an organization, to cope with changes affecting an organization, and to steer an organization in a particular strategic direction while continually adapting to change. In other words, this view holds that management means anticipating, coping with, and making changes in an organization. The professor went on to say that the most effective managers have the dual ability to deal with today's tasks and problems while, at the same time, always looking ahead to anticipate and deliberately plan for change.

Mentioning this professor's view about management is not intended to diminish the many other legitimate definitions of what management is or what managers are suppose to do. On the other hand as the hospital industry moves into the 1990s, the abilities to look ahead and anticipate change, to cope with change, and to make an organization change are all abilities which, I believe, will differentiate the managers of successful hospitals from the managers of hospitals that are not as successful.

By using the term "managers," we do not mean just the hospital's paid management. The management of hospitals necessarily involves more people than just those called managers who have titles within the hospital organizations. The management of hospitals also involves board members and members of the medical staffs, all of whom need to work together.

Still, the burden of primary leadership responsibility must fall upon the top line managers and strategic planners within any hospital organization, for these are the people who bring expertise and focus to the goal of maintaining and enhancing a hospital's viability. The ultimate responsibility to anticipate and deal with change and to create a working coalition of management, board members, and key physicians—this responsibility lies with the top management of a hospital.

Anticipating change, coping with change, and making change—all of these are important activities, but the first and most important of these is anticipating change.

From a strategic standpoint, the most painful and yet the most essential recognition is the fact that the hospital industry will continue to occupy a lower and lower percentage of the health care industry in terms of the provision of patient care and in terms of economic impact. Hospitals which are able to make the transformation away from being so heavily oriented toward monolithic institutional facilities and toward decentralized, vertically integrated, market-driven, diversified, high-quality health care providers will inevitably be better able to cope with change because they themselves are changing organizationally in anticipation of fundamental new trends in the delivery of health care.

It is this author's opinion that the changes which will occur in the hospital industry in the 1990's will be so significant that by the year 2000 hospitals will not resemble what we now think of as hospitals. Many hospitals which continue to cling to more traditional views of hospital organizations and missions will simply no longer exist by the turn of the century.

Although the word "hospital" may still be in use at the year 2000, most of the evolved organizations that survive will be diversified health care providers, probably called health service corporations or something similar.

To provide the kind of management able to cope with, survive, and evolve through the changes of the past few years and the even more dramatic anticipated changes of the 1990's in health care delivery, those managers who are now with hospital organizations or medical centers are encouraged to think carefully about leading their organizations through some fairly dramatic changes—changes necessary because of the changes in the overall health care delivery system during this decade.

As I indicated above, anticipating change may be the most important step in coping with change. This book attempts to give the reader a flavor for some of the more important elements involved in anticipating and coping with change. From the managerial standpoint, the prejudice in this book is definitely toward the professor's definition of management—the ability to anticipate change, cope with change, and make change in such a way as to strategically redirect an entire organization. The book does not focus upon every conceivable way of anticipating change or upon every conceivable change that should be anticipated, but, rather, focuses upon what the author considers to be the most important areas to be looked at. Likewise, the discussion of preventing hospital decline in the second portion of the book does not elaborate every conceivable step but, rather, outlines the major areas that should be looked at and addressed in one way or another.

The reader is definitely encouraged to think carefully about ideas that may not be in this text but that could be helpful in either anticipating change, predicting decline, or preventing decline.

If this book encourages the reader to think more carefully about the future and to open his or her mind more broadly to change, then the book will have accomplished its goal.

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CHAPTER 1

The Importance of Understanding Hospital Business Fundamentals

Achieving a Broad Base of Understanding

Although we are clearly in the age of specialization, it is important that all key hospital managers, board members, and members of the medical staff have a broad-based understanding of the basic hospital business fundamentals, even though their particular jobs or roles (in the case of board members) may focus upon a relatively narrow aspect of the hospital's business. Despite the necessity of individuals to specialize and focus upon particular aspects of the organization's business, all of the key people who impact various aspects of the hospital's business should understand the importance and status of the various fundamental key areas of the hospital's business.

There are certain very basic conditions underlying the viability of hospitals. Several conditions, in particular, would seem to be essential, and the absence of any one of these could cause a hospital to be financially troubled. These conditions for hospital viability are:

- Acquiring patients
- Providing services *effectively* and *efficiently*
- Maintaining *adequate* and *competitive* facilities and equipment
- Receiving *timely* and *adequate* payments

The purpose of evaluating hospital business fundamentals is to identify those elements which affect hospital viability. Factors which enhance the ability to accomplish the above objectives also enhance overall hospital viability. In order to gain insight into a hospital's business fundamentals and their effect upon institutional viability, we can identify five key areas of business performance which should be understood and continually examined in any hospital:

- *Market Position*

A hospital's relative market status, the quality and depth of its medical staff, the hospital's scope of services delivered to its defined market, and its past and projected inpatient and outpatient utilization.

- *Regulatory Position*

The degree of regulation of facilities and operations, the regulatory history of the organization, its accreditation status, quality of care indicators, and relations with third party payors.

- *Hospital Operations*

The effectiveness and efficiency of operations, the quality of care, the quality and adequacy of clinical operations, the quality and adequacy of staffing, and the quality of management.

- *Physical Facilities*

The quality, capacity, and condition of physical facilities and equipment, the relative competitiveness of such facilities, and the requirements for future facilities/equipment.

- *Financial Management*

The adequacy of financial systems and procedures, the quality of financial staff, the management of assets and liabilities (including long term debt), and the management of expenses and revenues, including accounts receivable management.

Although it is impossible for every manager and board member to become immersed in the details of each of these areas, it is vital that they understand where their institution is positioned in each of these areas and where it is headed. In this way, they will be able to better relate how their efforts impact the institution as a whole and how the contribution of their specific area moves the institution forward, helps to meet challenges, or solves problems.

Each of the above areas of hospital business fundamentals is discussed briefly in the following pages. By understanding these fundamental areas and how the specific hospital is performing in these areas, each manager, board member, and physician is in a better position to identify with the goals of the institution and to relate problems in his or her specific area to the problems and challenges of the overall organization. When trouble does arise, it is then much easier to obtain a consensus approach to solving problems, and it is easier to address specific problems themselves by having the benefit of the understanding of all of the major areas of the organization's business fundamentals.

Involving Managers, Board Members, and Physicians

One of the more important efforts in monitoring a hospital's viability and in anticipating problems is to involve a wide variety of managers, board members, and physicians in understanding and examining the various key business areas. Each of these groups has points of view that will be useful to the others, and if there are problems with the institution's viability, the active efforts of all three groups will be vital to addressing those problems.

Therefore, it is suggested here that every hospital have a "strategic planning task force" consisting of key members of top management, key board members, and key members of the medical staff. There are a number of advantages to having such a task force.

A well-conceived strategic planning task force will have members whose expertise covers various areas of a hospital's business and who can educate one another as well as listening to one another about problems and challenges. This kind of "cross-fertilization" of areas of expertise is extremely important in predicting hospital decline, because the elements contributing to decline are highly interrelated, usually involving linkages among many different areas of business fundamentals, not just one particular problem.

It is important, for example, that those managing the finances of the hospital understand its marketing strategy and its market position. It is important that those interested in expanding the hospital's market share through physician joint ventures and alliances understand regulatory limitations and financial constraints upon such efforts. It is important that the medical staff understand the strengths and weaknesses of the organization as a whole, as well as specific financial issues such as the availability of capital. The medical staff should be involved in examining market position and in developing strategies to improve market position or to solve problems in this area. Key physicians should also be involved in planning for the replacement or expansion of facilities, equipment, and clinical programs.

In too many situations of hospital decline or failure, the magnitude of the problems is not fully appreciated until it is too late, and often very few people in the organization really understand the various problems and challenges of the organization as a whole. This is why we often hear from so many medical staffs, managers, and employees of hospitals how surprised they are when it is announced that the organization is in serious trouble. Frequently, even board members are stunned when the magnitude of the hospital's problems becomes known. Too frequently, even those at the upper management levels of hospitals sometimes do not realize the magnitude of problems until a destructive cycle of decline has been unleashed and has gotten out of hand.

Hospitals are tremendously complex organizations requiring the expertise of many types of individuals. All of these areas of expertise need to be represented in strategic planning and management if an organization is to predict problems and address them before they become too serious.

Exhibit 1-1

The Trustees' Responsibility for Hospital Management

Below are some of the major duties and responsibilities of hospital trustees with respect to general hospital management and financial management:

- Develop hospital mission
- Actively participate in development of strategy
- Participate in joint board/management/physician task force
- Hire and review top management
- Participate in physician strategic plan
- Approve physician contracts
- Set policy regarding charity care
- Review market position and set marketing strategies
- Participate in new product development
- Prioritize major projects
- Set capital expenditures policies/initiatives
- Oversee fund-raising, foundation, and special funds
- Set policy on retained earnings and investments
- Participate in annual capital budgeting process
- Participate in annual operating budgeting process
- Monitor monthly budget vs. actual performance
- Monitor all key business fundamentals
- Monitor utilization, pricing, accounts receivable, return on equity, return on assets, operating margin, managed care contracts, cash flow, and other financial indicators

Understanding Hospital Market Position

Of the numerous changing forces which can effect the viability of the hospital, changes in a hospital's market position can have the most far-reaching implications and can be the most difficult to reverse.

The term "market position" used here refers to the ability of a hospital to attract patients within its service area, to provide appropriate services to its defined markets, and to attract and retain a qualified, active medical staff. The market position of a hospital is reflected by both the absolute occupancy and patient utilization of its various departments—including outpatient services—and is also reflected by the relative market share of the hospital compared with other health care providers within what can reasonably be defined as the hospital's service area.

Every hospital executive knows that hospitals are now competing with other hospitals and with other types of health care providers and that hospitals have had to adapt to dramatically changing market conditions in recent years in order to remain viable and competitive. Part of the erosion of the traditional market position of most hospitals is the result of emerging technologies which permit medical delivery in non-hospital settings. Another part of the deterioration of relative market share can be attributed to competition from other hospitals and other health care providers, especially in metropolitan areas.

Metropolitan hospitals are competing with other metropolitan hospitals, physician clinics, surgi-centers, specialty clinics, and even individual physicians. Hospitals in rural settings may theoretically have a solo position in a given market but, in fact, may be losing patients who travel to metropolitan areas because of the limited medical programs in the specific rural area or because of outmoded hospital facilities.

If one examines the reasons for hospital closings, the inability or unwillingness to adapt to changing market conditions is nearly always a leading factor in the unfortunate chain reaction which results in the institution's financial demise. It is important for the top management of the hospital, the board, and the physicians to have a thorough understanding of the hospital's existing market position and to develop an ongoing consensus strategy to maintain and/or improve the institution's market position. This includes knowing what types of patients are served by the business, the type of payments represented by those patients, the trends of patient utilization, the relative trend of inpatient versus outpatient services, the services that the hospital should be providing for its defined markets, and the existing and desired positioning of the medical staff.

A hospital's market position is determined in large part by the nature and composition of its medical staff. The medical staff is important not only in terms of its numbers and geographic positioning but also in terms of the relative degree of loyalty of the individual physicians.

Any hospital that does not have a medical staff plan and that does not take an aggressive posture in recruiting and positioning medical staff is automatically vulnerable to losing market position and to setting off a chain reaction leading to decline. In addition, it is this author's strong opinion that key medical staff members need to be involved in formulating hospital market strategies, in defining facilities and programs, and in understanding management issues.

Exhibit 1-2

Is a Hospital Measuring its Market Position?

Does the strategic planning task force routinely monitor the utilization of all major programs and services?

Does management routinely monitor patient origin information for its own hospital and other competing hospitals in the general geographic service area(s)?

Does the marketing department continually monitor the services offered by competitors (including physicians, HMOs, home health agencies, and other types of providers)?

Does management monitor the financial performance and business fundamentals of competing hospitals?

Is the strategic planning task force aware of the hospital's relative market position with respect to overall utilization and with respect to key programs and services?

Is the strategic planning task force monitoring medical staff shifts and other medical staff characteristics, and is this activity tied in with a medical staff strategy?

Does the hospital conduct customer satisfaction surveys?

Does the hospital conduct consumer-oriented research into consumers' needs, preferences, and opinions?

Does the hospital understand its image in the service area and in the community at large?

The preservation and enhancement of a hospital's market position requires a cooperative effort among the institution's management and its physicians. Too many stories of hospital decline include antagonism between the medical staff and the board, the medical staff and the hospital administrators, the medical staff and the nursing staff, and other related problems. Other instances of hospital decline include a failure of the hospital's administrators and board to actively work to anticipate the replacement of retiring physicians or to work with physicians to assist them in building their practices.

No single group of people is more important to a hospital's market position than its medical staff. Involving key members of the medical staff in important strategic and management decisions and working with members of the medical staff to attempt to blend their best interests with the hospital's best interests is an important approach in maintaining and expanding hospital market position.

The Impact of Regulatory Position

Hospitals are among the more highly regulated industries in the United States. They are regulated by local, state, and federal regulatory bodies, and they are regulated by health care industry organizations as well. The regulatory position of a hospital involves both its relationship with licensing and certification bodies as well as its relationship with third party payors, who are an important force in regulating prices. Hospitals and their various departments and subsidiaries are regulated from several points of view:

- Their physical facilities must meet certain standards and conform to certain codes.
- Their operations require certain minimum licensed staff, and the individual types of staff are regulated in the areas of licensing, certification, and continuing education.
- The materials hospitals use—especially drugs, nuclear medicine materials, and complicated items of equipment—are tightly regulated and periodically inspected.
- Hospitals must maintain significant amounts of insurance coverage, both for their facilities and also for malpractice, workmen's compensation, and employee benefits.
- Payments to hospitals by government third party payors are regulated, and payments to hospitals by commercial insurers and managed care programs are also regulated to one degree or another.

All of these major categories of regulations have an impact upon hospital viability by impacting expenses, liabilities, capital expenditures, and revenues. Negative regulatory events can have a significant impact on income and cash flow, and regulatory problems which persist can precipitate or add to a cycle of decline.

It is important that all key management personnel, board members, and physicians understand the major categories of regulation and where the specific hospital fits in with regulatory authorities. Individual department and unit managers need to have an in-depth understanding of the specific regulations affecting their respective areas.

In recent years, federal regulators have focused on the relationship between hospitals and physicians, the outcomes of patient care, and the tax-exempt status of community hospitals. The Joint Commission on Accreditation of Healthcare Organizations, which is a voluntary, self-regulatory body, has also begun to focus upon issues such as quality of care, patient outcomes, financial viability, and medical staff credentialing in reviewing hospitals for accreditation.

Maintaining compliance with regulations in the areas of monitoring patient outcomes and examining the appropriateness of hospital utilization often require enormous amounts of work and significant staff resources. Greater, not lesser, resources will be required in the future as the amount of regulation continues to expand. It is critical that a hospital have the proper management information systems, quality improvement systems, and other decision-making processes in place to cope with regulatory authorities of various kinds.

Since regulatory activity crosses all of the departmental and disciplinary lines of a hospital, it is important that the board, the managers, and the medical staff all be aware of the challenges and problems with respect to a hospital's regulatory position, because chances are that they will all become involved in one or another aspect of maintaining a healthy regulatory position or confronting a problem with respect to the institution's regulatory position.

Understanding Hospital Operations

By "hospital operations" we mean all of those elements relating to the management, staffing, clinical programs, and day-to-day operations of the institution. We are referring both to business operations and clinical operations.

As with other fundamental areas of a hospital's business, it is important that the various key players understand the basics of each other's activities. This means, for example, that physicians should—to the extent practical—understand hospital business operations, facilities planning and management, and other non-clinical matters. Likewise, hospital administrators and key financial personnel should have an understanding and appreciation of clinical operations.