

Strategizing for Successful Turnarounds

Alan D. Townsend, Principal, Financial Resource Group, LLC, Dallas

In today's healthcare environment, hospitals face mounting pressures at every turn. The responsibility for addressing these challenges falls squarely on hospital management and boards—requiring tough decisions to ensure that a hospital can survive. These challenges result from a number of issues: reduced payment; higher numbers of uninsured; increasing demands from physicians; higher salaries for nurses, pharmacists, and other key positions; high cost of technology; and increasing demand for services resulting in the need for more capital.

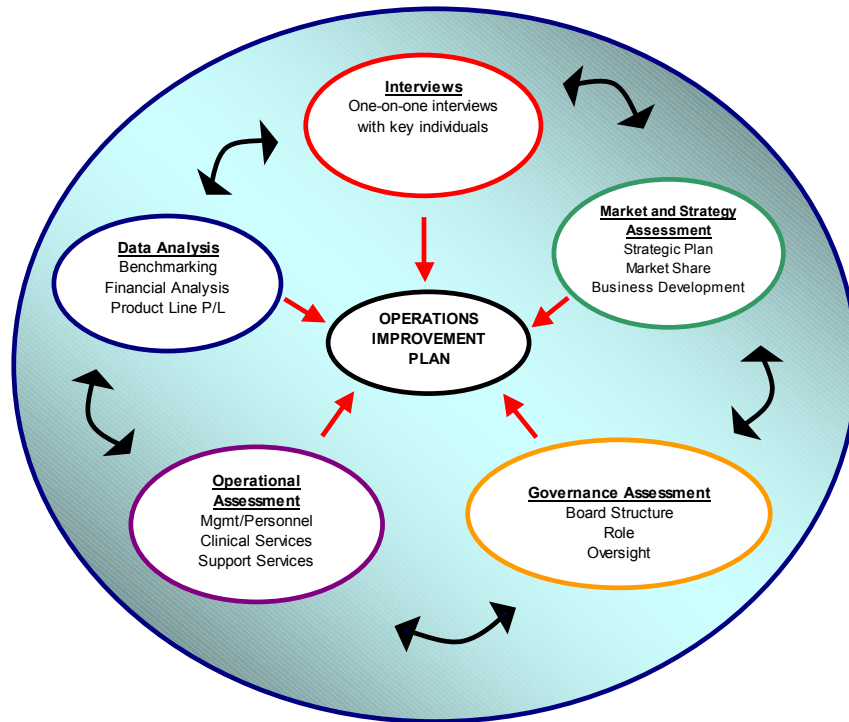
Some hospitals are able to overcome these issues by using cash reserves, creating new sources of revenue, or tightening controls on operating expenses. However, many other hospitals have great difficulty dealing with these financial pressures because volumes are not sufficient or management is unable or unwilling to make changes fast enough to adjust to lower volume and lower payment levels. The manner in which hospitals operated in the past no longer produces the financial outcomes that boards, rating agencies, bond investors, and others require. When a hospital is not able to address these issues, it will find itself in a “turnaround” situation.

The Key: Be Proactive!

Unfortunately, many times a hospital waits until it is too late to improve operating results without outside help. An organization may reach the point where the board decides to replace members of senior management, or bond insurers and bondholders require outside “turnaround specialists” to fix the problem due to a bond covenant violation. These circumstances are not positive for the board or management.

A proactive approach is required to avoid these situations. When senior management sees that the hospital is struggling and financial trends are heading in the wrong direction, it must take fast action. The first step is recognizing that problems need to be addressed. But it takes great effort and energy to break the organizational inertia that seems to grip hospitals in a giant case of denial at times like these.

The ultimate goal of a turnaround project is to develop a performance improvement plan that will result in sufficient cash flow to meet operational and capital needs. Exhibit 1 identifies the various components of a comprehensive turnaround project.



Typical Turnaround Processes

Key board members, management, and physicians should always be involved in the turnaround process: presenting the current financial situation, explaining why it is imperative to improve financial performance, and defining their respective roles. Buy-in from key participants is crucial for success.

Brainstorming helps to generate ideas for evaluation and implementation. Many brainstorming ideas will evolve into revenue enhancement opportunities, by identifying ways to generate more revenue by providing new paying services, improving the payment levels through improved coding, or improving collection procedures on existing business.

Operating improvements offer further opportunities such as increased staffing efficiency, better negotiations and contracting with vendors, better inventory control, and standardization of high-dollar items.

Benchmark Data

As the operating expenses are reviewed, the question is often asked, “How do we know if there are opportunities for savings?” The best way to judge the potential for savings is to use benchmark data to see how the hospital compares with comparable hospitals.

There are many sources for this type of data: Ingenix, Solucient, VHA, Premier, and many others. Some of the high-level measures include cost per adjusted patient day or cost per adjusted discharge. For example, a not-for-profit, 200-bed urban hospital is compared with the category for urban hospitals with 175 – 250 beds. The hospital being reviewed has operating-expense-per-case-mix-adjusted discharge of \$5,794. The rate is \$5,532 for hospitals at the 50th percentile level, which does not appear to be much of a difference. But considering the volume of cases, there is a savings opportunity of \$4.6 million if the hospital can simply achieve “average” performance. And if the hospital could drive expenses to the 25th percentile level, it could save \$16.5 million.

This calculation doesn’t indicate where to reduce expenses; however, it does provide a range of potential savings and would be very useful in achieving buy-in to the “target” savings. The difficult part is finding those specific opportunities that can drive costs

down to achieve the target. These opportunities typically are the result of a myriad of small changes—fine-tuning *all* of the organization's processes.

Product-Line Evaluation

Identifying revenue enhancement opportunities or expense savings by department is an important step in the turnaround process, but these improvements may not be substantial enough if a significant turnaround is needed to avoid violating bond covenants or some other financial catastrophe. When a hospital reaches this point, it must make drastic changes in the way it operates.

Product-line analysis will identify money-makers and losers. Winners need to be maintained or improved. Services that are losers need to be turned into winners (or at least break even), or these services may need to be eliminated.

In evaluating product lines, it is important to take into account variables such as payment, direct costs, and indirect costs. All operating costs must be included to accurately depict each product line. An effort must be made to identify fixed versus variable costs as well as direct versus indirect (overhead) costs. Lack of this information can result in poor decision-making. Eliminating a product line or service because it is losing money overall could be the wrong decision if the payment is covering the direct costs and offsetting some of the indirect costs. When eliminating a service, most of the indirect costs will remain, leaving the other product lines to cover the remaining costs. Of course, indirect costs must also be examined to reduce these expenses.

Many hospitals use cost-accounting systems to evaluate product-line profitability. These systems normally account for fixed/variable and direct/indirect factors. Even without a formalized cost-accounting system, the same analysis is possible using cost-to-charge ratios from the Medicare cost report and information from the patient-accounting system. The important thing is to make sure all revenues and expenses are included and that the totals tie back to the hospital's bottom line. Exhibit 3 shows a sample product-line report.

**SAMPLE GENERAL HOSPITAL
2002 IP Product Line Report**

Description	Cases	Days	ALOS	Net Revenue	Variable Cost	Contribution Margin	Fixed Cost	Net Income/(Loss)
NEUROLOGY	1,004	5,000	5.3	4,719,318	5,355,908	-636,590	891,500	-1,528,090
PULMONARY	1,792	12,309	6.8	10,939,845	10,806,503	133,342	1,809,112	-1,675,770
OPEN HEART	558	4,806	8.7	15,619,181	9,190,939	6,428,242	1,396,724	5,031,518
CARDIOLOGY	4,264	17,731	4.2	28,500,970	22,602,741	5,898,229	3,226,273	2,671,956
GENERAL SURGERY	1,605	13,428	9.4	20,667,117	15,414,351	5,252,766	2,100,663	3,152,103
GASTROENTEROLOGY	1,796	8,122	5.2	8,206,729	6,839,692	1,367,037	990,642	376,395
ORTHOPEDECS	2,114	9,831	4.8	15,450,644	12,965,110	2,485,534	1,999,716	485,818
GENERAL MEDICINE	584	3,226	6.3	3,539,397	3,074,772	464,625	441,985	22,640
GYNECOLOGY	1,041	2,728	2.8	5,113,515	3,063,341	2,050,174	475,154	1,575,020
OB/DELIVERY	2,515	7,044	2.5	8,878,714	6,878,715	1,999,999	828,559	1,171,440
NEONATOLOGY	2,562	10,847	3.7	9,652,919	9,623,031	29,888	755,845	-725,957
PSYCH/DRUG ABUSE	1,444	9,029	7.2	2,758,905	5,275,891	-2,516,986	744,062	-3,261,048
Totals	21,279	104,101	4.89	134,047,254	111,090,994	22,956,260	15,660,235	7,296,025

Determining product-line winners and losers is often the easy part of the equation. The difficult part is making decisions to eliminate services so the hospital can survive.

Hospitals have a very difficult time eliminating services they have traditionally provided.

In the current environment, hospitals cannot depend on contributions or investment

income (as they may have in years past) so programs have to stand on their own unless a conscious decision is made to subsidize the shortfall.

Looking Ahead

The hospital Board and Senior Management must reevaluate the hospital's mission in today's healthcare environment. Can the hospital's mission be as broad and as comprehensive as it has been in the past? Today's healthcare reality requires that, for the good of the community, some services might be better provided elsewhere, so the majority of the community receives the fundamental necessary health care.

Many hospital CFOs today are struggling to meet budgets, answer cash flow needs, and fulfill mission. The key to a successful turnaround is developing the necessary information to do exceptional analysis so that senior management can make intelligent decisions. Finally, executives need to be proactive in implementing these decisions in a timely manner.

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