Governance and Management of Not-for-Profit Healthcare Organizations: A Key Driver of Ratings

Summary Opinion

Effective governance and strong management are both necessary for the continued viability and competitive positioning of not-for-profit hospitals as they make critical capital decisions, restructure operations for healthcare reform and compete for patients, physicians and other skilled professionals. Governance and management have long played a large role in Moody’s rating approach for U.S. not-for-profit hospitals given the operating complexity of managing a hospital or health system enterprise, particularly as compared to other not-for-profit organizations including many colleges and universities. Hospitals will require stronger leadership and operating excellence to meet growing compliance requirements for patient safety, cost and clinical outcomes. This report conveys the general framework for our analysis of governance and management, but is not an exhaustive list of best practices. We recognize that governance and management practices will vary significantly depending on the particular credit characteristics and strategy of individual hospitals. Furthermore, our analysis of key indicators of governance and management will evolve with changing regulatory and market conditions facing hospitals.

Effective governance and strong management enable an organization to reach its full potential while avoiding financial stress. Strategy, financial health, and credit position are all fundamentally driven by decisions made by a hospital’s board members and leadership team. This report identifies numerous indicators that are well correlated with effective governance and management, providing an analytical complement to traditional quantitative ratios that remain core components of Moody’s credit analysis. Over the longer-term, non-quantitative indicators of governance and management are likely to provide increasing insights into credit quality given the uncertainty around healthcare reform and the changing healthcare environment. The weight of governance and management assessment in our analysis is particularly important when a hospital is facing strategic change, including: embarking on a major capital expansion program, initiating a significant new borrowing, undergoing financial stress or facing a weakening market position, or experiencing high turnover in senior management.
The five broad factors we consider in our rating assessments are:

1. Board and Senior Management Team Leadership Capability in Stable and Stressful Times
2. Oversight and Disclosure Processes that Reduce Risk and Enhance Operational Effectiveness
3. Execution of Integrated Short- and Long-Term Plans to Optimize Resource Utilization
4. Commitment to Self-Assessment and Benchmarking to Promote Ongoing Improvement
5. Effective Management of Government Relations in Efforts to Influence Local, State and Federal Healthcare Policy

Moody’s weighs the effectiveness of governance and management partly through comparative assessments across the healthcare industry. Our industry insights are derived from our extensive market coverage of healthcare in the United States. Moody’s rates nearly 500 not-for-profit hospitals and health systems, which account for around one-third of hospitals in the U.S. In our published rating reports, we may provide discussion of our assessment of governance and management to explain our rating opinions. The depth of the discussion and points of emphasis will vary based on the particular credit issues facing the hospital or health system.

1) Board and Senior Management Team Leadership Capability in Stable and Stressful Times

Hospital board members and senior managers face the complex challenge of executing the hospital’s not-for-profit mission while generating positive cash flow and safeguarding and growing its financial resources such that the organization’s viability is maintained over the long-term. Moody’s believes that the composition of a hospital’s leadership is the foundation for organizational effectiveness.

The board of a not-for-profit hospital or health system retains the ultimate authority in setting the strategic direction, unlike a for-profit corporation whose board derives its authority from the clear goals of equity holders. Not-for-profit boards are affected by multiple goals of key stakeholders, notably patients, physicians, nurses, management, and government regulators, but especially the physicians who practice at the hospital and drive the volumes that generate a hospital’s revenues. In addition, whereas corporate board members are often well compensated for their service, not-for-profit hospital board members are not.

We examine a number of critical factors when assessing the board composition and senior management of a hospital, including:

» Mix of tenured and new members with knowledge of institutional history as well as external best practices and strategies—thereby ensuring continuity as well as adoption of new perspectives
» Board members who provide expertise in the areas of risk and compliance management, financial statements, multi-year financial and capital plans, and investment strategies
» Chief executive officer who demonstrates clear understanding and leadership on financial and capital matters as well as the hospital’s mission and vision
» Strong chief financial officer and other vice presidents who demonstrate independent expertise and mastery of multi-year financial plans, budgets, and financial statements
Leadership with diverse experience both inside and outside the hospital, including some experience from business, health insurance, physician relations, and government in addition to the healthcare industry.

Moody’s discusses the composition and structure of the board and its committees, the procedures for selection of new board members as well as the chief executive officer, and the division of responsibilities. When warranted, we request a conversation with key board members.

2) Oversight and Disclosure Processes that Reduce Risk and Enhance Operational Effectiveness

Clearly articulated policies and division of responsibilities provide evidence of transparency, accountability, and oversight. Effective internal controls can alert management to potential problems and help to minimize any negative impact on the hospital’s financial health. Effective internal controls are necessary for maintaining accreditation and adhering to complex patient safety guidelines, compliance with increasing governmental regulations, contracts with Medicare and Medicaid and commercial payer contracts, and donor confidence. Moody’s believes that a board should review internal controls to ensure they remain both supportive of the hospital’s mission and relevant to the financial operations of the hospital.

Effective internal controls and timely external disclosure about quality outcomes, research productivity, financial performance, and organizational efficiency will become the hallmark of effective hospital leadership and will become increasingly critical in mitigating new risks to individual hospitals and the sector overall.

We examine a number of critical factors when assessing the internal controls and external disclosure of a hospital, including:

- Board approved policies on investments, debt, liquidity, and conflicts of interest
- Detailed disclosure and transparency for internal decision makers and external stakeholders
- Appropriate staffing for effective implementation of policies
- Frequent board oversight of the chief executive officer, including annual performance assessment by multiple board members who rotate over time
- Use of internal audit function that reports to the board
- Detailed disclosure on hospital website or publicly available websites regarding quality initiatives, patient safety, financial statements, compliance with bond covenants and other regulatory requirements, and other material issues
- Filing of financial statements within 90-120 days of the fiscal year end, including detailed management discussion and analysis where appropriate for government hospitals, and where volunteered by others
- Availability of quarterly statements or interim information
- Clearly defined board committee structure and responsibilities
- Term limits for board members
Moody’s reviews a hospital’s written policies, assesses presentations made by management to the board, and discusses staffing and processes for risk management with members of senior leadership. We look for the board to develop and routinely review key policies overseeing the hospital’s investments, debt, operations, and compliance-related issues. We also examine information made available to external stakeholders through web sites, financial statements, and official statements associated with debt issuances.

3) Execution of Integrated Short- and Long-Term Plans to Optimize Resource Utilization

Effective utilization of a hospital’s resources requires a long-term strategic plan, a mid-term flexible financial plan, prudent short-term budgeting, and the continuous alignment of all three. In an ever-changing healthcare industry, hospitals can be challenged to provide long-term strategic and financial planning. We believe, however, that a detailed extension of a hospital’s mission and a broad understanding of the level of financial performance needed to fulfill the mission are possible and necessary. An effective board and management team will be willing and able to modify its short- to mid-term planning to meet its long-term goals. Planning is critical given the institutional imperative to fulfill a stated mission in an environment of changing regulation and modes of care, coupled with increasing external stakeholder scrutiny (tax-exempt status, accreditation, community relations).

Moody’s believes that short- to mid-term plans should incorporate detailed conservative, but realistic assumptions. Budgets and plans that are overly conservative or optimistic provide limited value in indicating the organization’s real potential and management’s ability to achieve its goals without causing financial stress.

We look for a number of critical factors and use of best practices when assessing the plans and planning process of a hospital, including:

» Integrated strategic, capital, and financial plans
» Use of detailed multi-year financial plans and budgets that tie to audited financial statements
» Conservative budgeting, producing consistent operating surpluses
» Financial and capital scenario evaluation and stress testing
» Prudent endowment management and sustainable endowment spending policies that are regularly reviewed in context of overall hospital risk assessment and multi-year financial plan (most applicable to children’s hospitals and some academic medical centers)
» History of meeting or exceeding internal forecasts for budget performance, volume trends, and quality measures
» Recognition of key risks in multi-year plans and development of contingencies for addressing them

Moody’s reviews a hospital or health system’s written strategic plan, master facilities or capital plan, as well as short-range and mid-range budget projections (one to five years). Moody’s analyzes budget-to-actual results for volumes, operational performance, fundraising and investment returns. We examine management’s assumptions used in projections as well as use of stress testing scenarios.
4) Commitment to Self-Assessment and Benchmarking to Promote Ongoing Improvement

Self-assessment provides governing boards and management teams with the tools to identify challenges early on and develop strategies to address those challenges in the interest of maximizing efficiency. External benchmarking is of particular importance in light of increasing competition for patients and physicians. Moody’s believes that the most successful organizations follow best practices in self-assessment, including use of a short list or “dashboard” of key metrics that are closely monitored on a regular basis to identify adverse trends quickly and development of contingency plans to make mid-year adjustments when necessary.

We examine a number of critical factors when assessing the self-assessment and benchmarking process of a hospital, including:

» Benchmarking relative to best practices and strategies across healthcare sector
» Existence of key performance indicators that are regularly monitored
» Development of well considered contingency plans
» Regular performance reviews and assessment of the chief executive officer and top management
» In-depth institutional research and evaluation of competitive landscape

Moody’s reviews the metrics and set of peer organizations by which a hospital chooses to measure itself. Well managed organizations compare themselves against a carefully selected set of peers rather than only to an ‘aspirant’ peer group that is likely to reflect hope and image over substance. We discuss with management the frequency and depth with which the information is reviewed by senior leadership and board members. We also inquire about examples of leadership actions based on a hospital’s performance relative to key indicators to understand its willingness and ability to react to developing situations.

5) Effective Management of Government Relations in Efforts to Influence Local, State and Federal Healthcare Policy

Hospitals are affected by the regulations that govern them. These regulations can be instituted by local, state, or federal bodies of government. Policies and regulations that affect hospitals include but are not limited to: patient safety issues and accreditation requirements; certificate of need regulations; healthcare taxing programs; required staffing levels instituted by state governments; reimbursement rates and supplemental payment programs under the Medicaid and Medicare programs managed by the state and federal governments, national healthcare reform and for certain governmental hospitals: tax rates that drive tax revenues (including county-owned, district-owned, and authority hospitals). These policies and regulations drive strategic decisions by management and the board as to where to invest capital as well as which services to provide, along with affecting the ability of the hospital to generate adequate cash flow to meet ongoing operating needs, build reserves and pay debt service.

We examine a number of critical factors when assessing the relationship of a hospital to various governmental bodies, including:
» Understanding of certificate of need regulation to ensure accurate and timely filing of requests for capital projects

» Ties to the state and national hospital associations for access to potential impact to operational and financial performance given proposed state or federal changes in regulation

» Representation in local and national lobbying efforts to influence regulatory developments to the healthcare industry, including: rate setting; reporting of and required levels of charity care provision; supplemental payment programs such as disproportionate share and upper payment limit

Moody’s evaluates the political and regulatory environment in which a hospital operates and looks for examples of the limitations or flexibility in navigating particularly challenging situations. Moody’s reviews legislative and statutory changes as well as the political discourse that could affect hospitals. In addition to monitoring news coverage and leveraging the research of Moody’s state and local government analysts, we discuss the political landscape with hospital management teams.
Moody's Related Research

Special Comments:
» Long-Term Credit Challenges of Healthcare Reform Outweigh Benefits for Not-for-Profit Hospitals, April 2010 (124233)
» Top 10 Factors Driving Not-For-Profit Hospital Upgrades and Downgrades: Swift and Effective Decision-Making Crucial As Credit Pressures Continue, November 2010 (128435)
» Governance of Not-for-Profit Healthcare Organizations, June 2005 (92815)
» Annual Sector Outlook for Not-for-Profit Healthcare, January 2010 (122650)
» Indicators of Successful Management for Not-for-Profit Hospitals, August 2005 (93898)

Rating Methodology:
» Moody’s Not-for-Profit Hospitals and Health Systems, January 2008 (105813)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
SPECIAL COMMENT: GOVERNANCE AND MANAGEMENT OF NOT-FOR-PROFIT HEALTHCARE ORGANIZATIONS: A KEY DRIVER OF RATINGS

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