BKD Case Study

BKD Helps Evaluate Aggressive Projection Model

BKD NATIONAL HEALTH CARE GROUP

A client was considering a transaction with "hockey stick" projections before bringing us in to help assess the target hospital's financial projection model.

THE TRANSACTION

The client was considering acquiring an acute-care hospital with approximately $200 million in total operating revenues. The hospital's profitability had significantly declined for several years because of relatively flat top-line revenues and increasing costs. However, hospital management developed a three-year turnaround plan to return the hospital to profitability.

THE CHALLENGE

The initial turnaround plan summary didn't include supporting calculations. The hospital's projections included adjustments for nonrecurring expenses incurred historically, potential future improvements and myriad assumptions about changes to operations.

THE SOLUTION

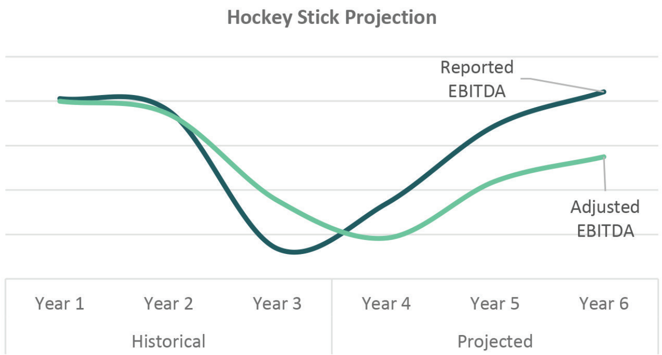
We received a copy of the financial models supporting the projected operating results, clerically tested the models for errors and evaluated the methodologies used by management. Due to several historical and projected clinic acquisitions, we presented a "same-store" analysis of net revenues to separate organic growth from acquisition growth.

THE RESULT

We identified several potential issues with the projected results, including clerical errors in the model, aggressive assumptions and accounting policy changes that affected both historical and projected results. We proposed adjustments to earnings before interest, taxes, depreciation and amortization (EBITDA) to estimate the potential effect of these issues. Ultimately, our client decided to withdraw from the potential transaction.

"HOCKEY STICK" PROJECTION EVALUATION

It's tough for a buyer to walk away from a deal—especially after investing significant time and resources. However, that's what our client did after considering our findings and other diligence work streams. The chart below illustrates the difference in the hospital's projected EBITDA after our proposed due diligence adjustments.



The hospital had projected its turnaround plan in the typical "hockey stick" model, which can be seen by the aggressive and immediate projected recovery of profitability. However, adjusted EBITDA had a much smaller level of improvement after we incorporated a number of adjustments for clerical issues and what appeared to be aggressive assumptions.

What were the key findings affecting the result?

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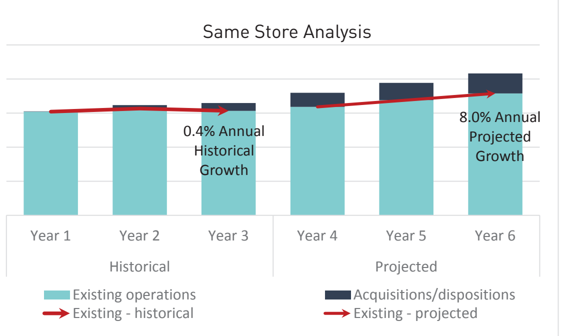
KEY FINDINGS

Finding	Description
Disconnect Between Actual & Interim Results	In several instances, we found that projected amounts were based on interim information for the most recent historical year that was not consistent with audited full-year results. Consequently, applying a particular assumption to the misstated historical results caused a misstatement of projected earnings. This mistake affected several areas, the largest of which were average reimbursement rates and operating expenses.
Same-Store Analysis Results	Both historical and projected revenue growth were masked by acquisitions and dispositions of clinics and service lines. When these were removed, projected revenue growth from existing service lines was 5.3 percent annually compared to 0.4 percent historically.



Finding	Description
Inconsistent Historical Accounting Practices	In our analysis of the historical financial statements, we discovered the hospital had begun accruing unbilled revenue for particular services in the middle of the historical period, which caused an artificial increase in accounts receivable and net revenues. We included an adjustment to remove the effect of these changes from adjusted EBITDA.
Top-Down Model Build	The projection model prepared by management was built using a “top-down” approach, meaning the summary income statement was projected first and then various assumptions and metrics were computed to “back into” the summary projections. Instead of testing how the income statement amounts were projected, we relied on statistics provided separately to analyze the validity of the assumptions and reconstruct an adjusted view of EBITDA using a “bottom-up” approach.

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