



BUYER'S SIDE DUE DILIGENCE CHECKLIST

Hospital Acquisitions of Physician Practices

Hospitals and physicians are continuously seeking ways to strategically align themselves in an effort to be more effective and efficient at providing high-quality patient care.

One such alignment strategy is the “buy and employ” model, whereby hospitals acquire physician practices and employ the physician(s) under productivity-based compensation arrangements. This buy-and-employ strategy often makes good business sense for both the hospital and physician(s) but also includes certain risks. As such, attorneys, certified public accountants, and healthcare consultants are often called upon to provide “**buyer’s side**” due diligence services for purposes of identifying and minimizing these risks.

BUYER’S SIDE DUE DILIGENCE | Buyer’s side due diligence is generally focused on the assets being acquired and liabilities assumed—including those not directly reflected on the balance sheet. Additionally, some level of due diligence regarding practice operations is also helpful for purposes of identifying future operating risks and/or opportunities for improvement.

THE CHECKLIST | The checklist on the following pages will address many of the due diligence issues that should be considered in connection with a physician practice acquisition. However, it is critically important to gain a clear understanding of the proposed transaction, including the intended deal structure (e.g. asset or stock purchase) and identity of excluded assets or liabilities, before beginning any due diligence.

ASSETS AND LIABILITIES TOPICS

1. Cash
2. Accounts Receivable
3. Supplies Inventory
4. Fixed Assets--Owned
5. Fixed Assets--Leased
6. Intangible Assets
7. Accounts Payable and Accrued Expenses
8. Debt Obligations
9. Contingent Liabilities

OPERATIONS TOPICS

1. Revenues
2. Operating Expenses
3. Payor Mix
4. Patient Charts

ADVANTAGES OF BUYER’S SIDE DUE DILIGENCE | Although most physician practice acquisitions are structured as asset purchases with representations and warranties from the seller, appropriate buyer’s side due diligence will assist with identifying and minimizing the risks associated with the transaction. Such risks are not only from a financial “benefit of the bargain” standpoint but also from a regulatory compliance perspective, since paying more than fair market value for the practice could result in penalties or sanctions under the Stark law and/or Anti-Kickback Statute.



DUE DILIGENCE | ASSETS AND LIABILITIES

1. Cash

- Cash is generally not included in acquisitions structured as asset purchases. However, some level of cash due diligence may be appropriate depending upon the circumstances, such as the practice's size and complexity
- Review bank accounts for unusual transactions such as significant checks written to cash or large cash transfers
- Review bank reconciliations and compare to the balance sheet for the same time period
- Investigate unusual reconciling items

2. Accounts Receivable

- Most physician practices utilize the "cash" method of accounting for purposes of preparing their internal financial statements and/or tax returns. Therefore, accounts receivable will generally be omitted from the balance sheet.
- Obtain and review a current aged accounts receivable listing and determine whether such amounts are stated on a "gross" or "net" basis. For this purpose, gross refers to **before** contractual adjustments and net refers to **after** contractual adjustments. Note: It is common for physician groups to initially record accounts receivable on a gross basis and then make the contractual adjustment upon receipt of the third-party payor's payment. The remaining balance will be the net amount due from the patient (i.e. net of the contractual adjustment). In such cases, the accounts receivable listing could include amounts that are stated on both a gross and net basis and appropriate adjustments may be necessary.
- Inquire about accounts receivable balances more than ninety days old and determine whether an allowance for uncollectible accounts is necessary

3. Supplies Inventory

- Most physician practices expense medical supplies when purchased. However, depending upon the type of practice, medical supplies could be a significant asset.
- Inquire about medical supplies inventory on hand and determine whether such amounts are material under the circumstances.
- If a material amount of medical supplies exists, obtain a detailed list of items including quantities and related cost information for purposes of estimating the value.

4. Fixed Assets—Owned

- Obtain a detailed list of fixed assets owned and compare the total cost to the amount reflected on the balance sheet. Inquire about any material differences.
- Group the fixed assets by major type such as: office furnishings, computer equipment, medical equipment, and leasehold improvements and determine whether all assets are still being utilized.
- If applicable, compare the personal property assets to the most recent personal property tax report and the real property assets to the most recent real estate tax report.
- Identify and inspect all major medical equipment assets and determine whether such assets are under third-party service contracts.
- Determine if any of the major medical equipment assets have undergone significant upgrades or are in need of significant upgrades.
- Determine if any fixed assets are pledged as security for third-party loans or other debt obligations.



5. Fixed Assets - Leased

- Obtain a list of all leased assets including: medical equipment, office equipment, and facilities.
- Obtain copies of all lease agreements and summarize relevant terms.
- Determine whether such leases are capital leases or operating leases. If capital leases, such assets should be reflected on the balance sheet.
- Verify that leases can be assigned to the buyer, if that is the intention.

6. Intangible Assets

- Determine whether the practice has significant intangible assets such as purchased goodwill, trademarks, trade names, licenses, certificates of need, etc.
- If such intangible assets exist, obtain copies of relevant documentation and information regarding their value.
- Determine whether the practice has non-competition or similar agreements with prior employees or owners. If such agreements exist, determine whether they are transferable to the buyer.

7. Accounts Payable and Accrued Expenses

- If the practice financial statements are prepared on the cash basis of accounting, accounts payable and accrued expenses will generally be omitted. Therefore, additional inquiries will be necessary to identify and quantify such liabilities.
- Obtain a list of all incurred but unpaid accounts payable and accrued expenses as of the appropriate balance sheet date.
- Verify that all payroll taxes due have been paid.

8. Debt Obligations

- Identify all outstanding loans and/or other third-party debt obligations.
- Obtain copies of all outstanding debt agreements and summarize relevant terms such as covenants, assets pledged as security, repayment terms, and personal guarantees if applicable.
- Verify that loans are not in default.

9. Contingent Liabilities

- Determine if the practice has contingent liabilities such as: potential malpractice claims, lawsuits with former employees or owners, and claims from third-party payors.
- Review invoices and correspondence from law firms for purposes of identifying potential lawsuits or other claims.



DUE DILIGENCE | OPERATIONS

1. Revenues

- Risk factors generally include: overstated revenues due to inaccurate or inappropriate coding (e.g. over-charging or up-coding practices), high dependence on a limited number of referral sources, high dependence on a small number of providers, capacity constraints, and declining reimbursement rates.
- Analyze practice revenue over a relevant period of time and compare to appropriate benchmark data for reasonableness. Depending upon the type of practice, such revenue metrics may include:
 - Net revenue per physician/provider
 - Net revenue per procedure/encounter
- Obtain a listing of total procedure volume by CPT code over a relevant period of time and compare the distribution of procedure codes to appropriate benchmark data for reasonableness.
- Analyze revenue by specific provider to determine whether a disproportionate amount is being generated by a relatively small number of physicians.
- Determine age and expected future work life of each physician.
- Consider capacity constraints that could limit the practice's ability to grow. Examples of capacity constraints include: space limitations, equipment being utilized near capacity, and the number of providers in the practice.
- Determine if the practice has significant ancillary revenue.
 - If such ancillary revenue exists, obtain details by type of service over a relevant period of time.
 - Determine certificate of need and licensure requirements, if any, in connection with ancillary revenue sources.

2. Operating Expenses

- Compare operating expenses, in total and by major category, over time and against appropriate benchmark data. Substantial variances and/or unusual trends should be investigated.
- Review employment agreements with physicians and summarize relevant terms including compensation arrangements.
- Analyze physician compensation and compare to relevant benchmark data based on productivity metrics such as: net collections per physician and/or work relative value units (wRVUs) per physician. Significant variances should be explained.

3. Payor Mix

- Determine the practice's payor mix over a relevant period of time and evaluate for reasonableness under the circumstances.
- The payor mix should be determined based on the relative percentage of gross charges attributable to each type of payor such as: Medicare, Medicaid, commercial insurance carriers, and self-pay patients.

4. Patient Charts

- Some physician practices (such as family medicine) will have recurring patients; whereas others (such as general surgery) may not.
- If applicable, determine the number of active patients currently and over a relevant period of time. *Note: The definition of an active patient will vary by specialty.*

