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Due diligence critical for hospitals acquiring small practices

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More than ever before, hospitals are very aggressively pursuing the acquisition of medical practices. The activity is so intense that several attorneys and consultants that we know equate the activity to that of a "feeding frenzy."

Once a hospital has targeted a practice for acquisition, it must analyze that practice to determine if, in fact, the practice is as desirable as the hospital initially believed, and if so, at what price. This process of analyzing a practice is called due diligence.

When hospitals perform their due diligence in anticipation of acquiring a large practice, the process is actually easier than doing it for a smaller practice. This is because larger practices tend to have better technology and more sophisticated personnel, which enables the hospital to access the information they need more easily.

Once a hospital and a small practice have completed preliminary discussions, and a decision to pursue a transaction has been made, the due diligence process begins. The hospital will need to analyze several different aspects of the practice before it can determine if a deal should be made, and if a deal is to be made, how it should be structured. The methodology of the transaction could, in part, be dependent on the results of the due diligence performed.

Step by step

The first step in the process is to review the historical financial data of the practice. Most small practices report their operations for tax purposes on a cash basis of accounting, and most do not have formal financial statements prepared by a CPA firm. The hospital must review the numbers provided and analyze the true overhead of the practice by adjusting for the discretionary and extraordinary items that must be eliminated in order to see what the operations would look like under their control.

In addition to the tax returns, the hospital, as part of the document request, should assess payroll records, employee census data, and copies of all leases, insurance policies, and fixed asset and depreciation schedules. They should also request details of any outstanding indebtedness, accounts payable and any other liabilities, as well as shareholder agreements, employment agreements, and if there are any affiliated entities or related party transactions included in the financial numbers. Once all of the above is received and analyzed, a good financial picture of the practice can be determined.

Perhaps more important to the hospital than the pure overhead and expenses of the practice are the productivity numbers, payer mix, reimbursement rates, ancillary revenues, and referral patterns of the physicians in the group. The hospital will need to review the charges, payments and adjustments of the practice. They will want to see all of this information by physician, by payer, and by CPT code. They will then convert this data to work Relative Value Units ("wRVU's") in order to get productivity, on a level basis. In the past, productivity was measured by collections. This method does not take into account that different providers can accept different insurances, and have a different payer mix. The conversion towRVU's puts everyone on a level playing field, and is a much better basis for comparison and benchmarking a practice.

The hospital will also need to see the details of the accounts receivable of the group. They will want this on an aged basis, by payer. The hospital will want to review a sample of the denials and EOBs over the past year. They will also want to examine all contracts and fee schedules to determine the revenue stream based on their contracts versus the groups contracts.

The hospital will want to review all significant leases and loan documents. They will want to see the medical liability insurance and history of the physicians, as well as the group members CVs. The hospital will also want to assess any buy-sell agreements, and valuations of the practice that might have been done. They will also want details of any employee benefit plans, including pension or profit sharing plans. Once all of the above information is digested, and the financial and operational structure of the group is understood, the hospital will have a picture of what the group would look like under the ownership or affiliation with the hospital. They will then have a basis for formulating a methodology of a transaction, and the financial structure of that transaction.