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Understanding and evaluating transaction considerations in the physician practice management sector

An update for private equity investors

This issue explores certain financial and tax issues that private equity investors should consider when making investments in physician practice management businesses.

Financial and tax considerations

Physician compensation—The largest cost of any physician practice is the compensation and benefits provided to physicians. Depending on the structure of the physician practices, a significant portion of physician compensation may not be reported in the income statement, but rather as equity transactions. In order to properly value the earnings from these practices, financial investors should understand the compensation and benefit structure for these physicians on a post-transaction basis. As post-transaction compensation is a key component of a buyer's negotiation with the selling shareholders, financial investors should consider how the negotiated compensation structure compares to regional and national benchmarks. Additionally, consideration should be given to whether the prospective compensation structure includes sufficient performance incentives, in order to mitigate the risk of decline in physician utilization trends post-transaction.

Revenue cycle—Physician practices are typically reimbursed on a fee-for-service basis from commercial and governmental payors. Understanding the historical billing and collection practices as well

as the historical revenue recognition policies are key focuses of any provider due diligence process. An analysis of the historical revenue cycle practices is not only needed to understand the quality of earnings and working capital of a business, but also to understand whether these practices may have created historical repayment exposures, for which a financial investor may wish to seek a purchase price adjustment or an indemnification in the purchase agreement.

Risk sharing arrangements—As the healthcare industry continues to transform and focus on population health, more and more physician practices are exploring different reimbursement models including receiving capitated payment streams. These models put more of a focus on physicians managing the care of their patients and increases the overall "risk" assumed by the physician practice. Depending on the type of arrangement, the physicians may be responsible for the cost of care provided to the patient outside of the medical practice or by other physicians, requiring the physician practice to record a liability for incurred but not reported (IBNR) claims. Often these arrangements also include incentives related to the quality of the care provided, which may be subject to contractual settlement provisions. Financial investors should consider the impact of these arrangements when analyzing the historical earnings and cash flows of a target entity.

Subsidized revenue streams—Many specialty physician practices contract directly with hospitals and surgery centers to provide physician services within a hospital setting. Often these contracts include administrative subsidies or guaranteed levels of revenue or profit which are paid by the hospital to the physician practice. The amount of these subsidies are largely determined on the overall payor mix and historical profitability at the hospital. These arrangements may include settlement and/or claw-back provisions, which may require the physician practice to reimburse the hospital for certain previous payments. These contracts may also put limitations on the physicians negotiating powers, specifically with commercial insurers. A detailed analysis of these arrangements is necessary to understand the historical cash flows and earnings of the physician practice. Financial investors should also consider the sustainability of any subsidized revenue streams when evaluating the future cash flows of a target entity.

Professional liability insurance—Physicians practices are often insured for professional liability risk (medical malpractice risk) on a "claims-made" basis. While this coverage provides for lower annual cash premiums, it provides coverage for only the claims-made or reported during the current accident year. Physician practices that are insured under claims-made policies should also account for the exposure related to IBNR claims. Financial investors should consider the impact of the changes in the estimated IBNR claim liability on the historical quality of earnings, as such estimates are often determined based on a complex actuarial analysis which utilizes sensitive assumptions. Buyers often require the selling shareholders to acquire, at the selling shareholders' expense, a "tail-policy" to mitigate the historical insurance exposure.

Cash basis reporting—Many physician practices maintain their financial records on a cash-basis of accounting and are not subject to a financial statement audit. Financial investors should utilize historical information on an accrual-basis for their valuation model, as there could be significant timing issues in the receipt and payment of cash, which could distort historical earnings. Buyers should tailor due diligence procedures to understand key cash-to-accrual adjustments. Financial investors should also consider the impact that the lack of audited accrual-basis financials may have on their financing and exit strategies.

Depending on the tax structure that financial investors pursue, physician practices may be required to report taxable income using the accrual-basis of accounting during post-closing tax periods. The conversion from the cash-basis of accounting to the accrual-basis of accounting may trigger taxable income, creating adverse tax implications for buyers and/or sellers. As such, we recommend that these tax implications be addressed in the letter of intent so that the parties clearly understand who is responsible for the taxable income that may have been deferred as a result of the cash-basis of accounting. Additionally, if required to use the accrual-basis of accounting for tax purposes, the physician practice will need procedures in place to substantiate its revenue recognition generally based on contractual reimbursement rates at the time of services and billings. If the physician practice has not historically implemented such procedures, additional post-acquisition system implementation costs would be required.

Tax structuring considerations—Certain states require physician practices to be owned by medical professionals who are duly licensed or otherwise legally authorized to render professional medical services. This requirement is often referred to as the corporate practice of medicine doctrine. To comply with the corporate practice of medicine doctrine, financial investors may need to form legal entity/ownership structures, whereby a private equity-owned management company and the existing medical practice operate under the governance of various agreements. The formation of these structures, the ongoing operations, and the exit from these structures can have adverse tax implications for both buyers and sellers if not carefully structured and reported.

Independent contractors—Many physician practices treat certain medical professionals as independent contractors. The proper classification of an individual as an independent contractor vs. an employee is highly dependent on the facts and circumstances. A company that misclassifies certain individuals as independent contractors may be subject to income tax withholding exposure and payroll tax exposure, which could be sizeable depending on the number of independent contractors and the lengthy statutes of limitations. Underpayment of payroll taxes could also impact a target company's quality of earnings.

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