How to Buy or Sell Your Medical Practice

This makes used car sales look easy!

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There are no scratches or dents to worry about when you're buying a medical practice. Probably no rust spots or valve problems, either. But like buying a used car, there still are plenty of pitfalls and costly traps that can snare the unsuspecting physician. As in buying a car - “caveat emptor” (let the buyer beware). The seller is not free from pitfalls either. Indeed, mistakes may lead to an economic disaster for both parties.

Before engaging in buying or selling a used car, an appraised value should be obtained. No different is the medical practice. Instead of taking the selling physician's offer at face value, the buyer and seller would be wise to commission an independent appraisal or have the seller's offer analyzed by a trusted and experienced financial adviser.

Sports Cars, Luxury Cars, or RUV’s?

Prior to any potential buy/sell transaction, both buyers and sellers need to reflect upon their desires. Questions should include:

“What am I interested in buying? Why am I interested in selling? What am I willing to pay? How will I phase out? Is this the right practice for me? Is this the right buyer for my practice?

Frequently an emotional decision is made based on finance alone, without considering all of the ramifications of the transaction. As an example, a practice that is financially and professionally attractive is unlikely to succeed if the buyer does not wish to live in that particular geography. Additionally, the terms of the transaction should strive to fulfill the needs of both parties. As a buyer, select the potential practice cautiously. As a seller, you should be just as selective in potential buyers.

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Sidebar Insert 1

In an interview with a seller, the individual spoke frankly of how his practice was overvalued and the deal turned out miserably. The seller sold and carried the financing. After two years, the buyer, unable to provide a living, make debt payments, and generate sufficient revenue, collapsed and declared bankruptcy. In turn the seller, left with no incoming cash flow from the sale, also saw his personal property foreclosed and after large legal bills, regained control of his practice. Today, after two years of hard work, the practice and selling physician are recovering. The road back has been all uphill, however. At age 60, it has been a mountain incredibly difficult to climb.

The moral: If the buyer or seller cannot afford to make the payments (or accept less in payments) and make/maintain a living off the income generated by the practice, you shouldn’t do the deal!

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Kicking the Tires

When you are in the market to buy a car, what do you look for? Is it neat and clean? Does it smell good? Does it run well? In the medical practice purchase or sale, many of the same types of questions should be asked. How old is the equipment? When was furniture last purchased? How well does the equipment work? Does the office appear neat, clean, well lighted? As the owner, are you proud to have friends (not patients) visit you at your office? To realize maximum benefit in a sale, these questions should be honestly evaluated.

The value of a medical practice is directly proportional to the amount of business the doctors generated in the previous few years. But some practices assign an arbitrary buy-in amount for buyers and new partners that may not coincide with the practice's true value. For example, a new doctor with an opportunity to buy into a practice may be told that he or she would need to pay $150,000 after three years of employment, or that buy-in could be deferred in the form of a lower salary over those three years. While the system may seem fair, the amount may not be correct.

Instead, a physician may be wise to ask the practice to establish a formula to determine the buy-in amount, but not to establish the dollar amount until an appraisal is conducted near the time of the buy-in.

A Presumption of Honesty

Solid business relationships proceed with the assumption that both buyer and seller will deal fairly and honestly with each other. That assumption is verified by the buyer obtaining documentation that supports the seller’s claims about the practice. The seller is expected to disclose any information about the practice which may affect the buyer’s risk. This information includes:

* Financial statements
* Tax records
* Bank statements
* Leases on properties or equipment
* Debts or other practice liabilities
* Patient payments records
* Patient medical records
* Documentation of any legal action taken by or against the practice
* Documentation of compliance with regulatory agencies
* Physician production reports for the last five years
* Office visit volumes for the past five years
* Accounts receivables
* The current fee schedule by CPT code
* A list of all employees, their work schedule and wages

* A copy of all office policies and procedures
* A list of all equipment and supplies owned by the practice

During this investigatory phase of the transaction, the seller should secure a legal agreement with the buyer which holds all business and financial information confidential.

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Sidebar Insert 2

In an interview with a buyer, the individual spoke of going through the process of due diligence. A request for information was made and granted. Two lengthy on-site visits were performed. Finally, the offer was presented. The offer was countered and finally agreed upon. On one of the most challenging days of his life, he signed on the dotted line for the loan and title to the assets. The practice was now his to operate and manage. In the following year and a half, he grew the business and today has a strong practice providing him with a good income. The practice is successful and doing well because the buyer took his time and did a thorough job in the due diligence process.

The moral: Thorough due diligence, completed in an organized manner, will provide information regarding price and future cash flow expectations. Take your time and be thorough.

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The Test Drive

Once a potential practice is identified, the following are factors to consider:

* Are the billing and coding practices conservative or aggressive?
* Are the books and records current and maintained consistently?
* Are the clinical charts neat, readable, and well organized?
* Are the patients happy with the care they receive or just happy they received care?
* Does the practice receive referrals from patients, other physicians, or by advertising?
* Does the practice generate excess cash flow?
* How easy would it be to replicate the patient volume and revenue?

These factors should be considered when developing the “picture” for the practice sale. As Rod Stewart said, “Every picture tells a story.” An objective evaluation of these factors will yield a result which will allow for a fair and reasonable price expectation to be developed.

The Sticker Price

Three common methods of appraising the value of a medical practice are:

1. Asset–Based valuation

In general, a practice has two sets of assets, tangible and intangible. The tangible assets are those items that can be touched. Equipment, supplies, furniture, cash, accounts receivable, and real estate are all tangible assets.   The major intangible asset of a medical practice is goodwill.

Tangible Assets

Determining the value of the tangible assets includes estimating the fair market value or replacement value of all equipment, furniture, and other “hard assets.” In most transactions, the cash is excluded from the valuation process on the assumption that the sellers will distribute excess cash among themselves prior to the transaction.

Accounts receivable may or may not be included in the calculation. Purchasing receivables requires knowledge of the approximate amount that is truly collectable. Their purchase indeed helps the buyer maintain an even cash flow in the initial stage of ownership, and allows for a complete break from the business for the seller. The buyer needs to use caution, however, as collecting receivables owed by patients of the former practitioner may not be easy. Once the former practitioner is no longer involved, patients may lose their sense of loyalty and obligation to pay. If the seller retains the receivables, he or she may wish to collect them independently, or ask the buyer to collect them while retaining a service fee.

Intangible Assets

The intangible assets of a practice include all the characteristics that contribute to its success. These “factors of production” include such things as reputation, practice location, management system, payer mix, and patient visit volume.

Many physicians spend years practicing with the assumption that their hard work and dedication will build a substantial goodwill asset. They expect that this goodwill will serve a significant contribution to their retirement package. Unfortunately, buyers and sellers often place different values to this asset and hence, goodwill is frequently responsible for a certain amount of “transaction tension.”

At the onset of a goodwill valuation, distinction should be made between corporate goodwill and personal goodwill. Corporate goodwill is associated with the non-human factors of production indigenous to the practice infrastructure and its operation. Conversely, personal goodwill is associated with charisma, relationships, and work ethic of the seller. A clear distinction is warranted since only corporate goodwill is easily transferred in the transaction. Personal goodwill is often harder to transfer however, it may be facilitated by retaining the seller and having him or her endorse the buyer to patients.

There are numerous accounting methods designed to attempt to quantify goodwill. A rather new approach to determining the value of the goodwill, which may then be added to the tangible asset value, is known as the method of excess earnings. In this method, the practice’s historical earning patterns are analyzed and compared to other practices of the same specialty in the same geographical area. The portion of a physician’s income that is above the average is attributable to goodwill. This method should serve as a guidepost only, as it does not seek to separate out corporate from personal goodwill (and the ability of the new owner to replicate that revenue) and therefore should be used in conjunction with other methods generally employed by experienced accountants.

2. Income-Based Valuation

This is a popular approach taken by appraisers to value businesses in general. An appraiser will examine the historical revenue stream as well as project future revenue streams in order to come to an understanding of value on the basis of future benefits. The net present value of those future benefits can become the basis for an understanding of the fair market value of both tangible and intangible assets.

This method is of greatest relevance when it is clear that the “new entity” has an opportunity to gain improved revenues due to an increase of productivity by the new owner, decreasing costs, or other major value-adding features. The analytical process for determining value through a review of the revenue stream is similar to that which a banker might undertake to ensure that a borrower is credit-worthy. Just as the revenue stream must be sufficient to repay the loan tendered by the bank, so must the revenue stream of a medical practice be sufficient to provide a return on investment to the purchaser of the medical practice being valued.

3. Market Valuation

This third classification builds on the previous two approaches but asks the question: "What’s it worth in the market?" Much like real estate, the more often such transactions occur in the market, the easier it is to ascertain an approximate figure for the value of the medical practice.

Other Than Death, it is Life’s Only Guarantee

Tax laws may impact the net result of a practice buy/sell agreement in significant ways. The details of each transaction will require input from qualified accountants and attorneys.

The primary goal for sellers should be to structure the transaction in such a way that it shifts as much of the proceeds as possible to capital gains rather than ordinary income. Each dollar that can be shifted to capital gains will be taxed at the lower rate of 20% rather than the higher normal income tax bracket of the seller. Conversely, the buyer needs to assure that the transaction will not create an audit risk with the IRS. A prudent buyer will strive to balance the needs of both parties while minimizing their risks as well as minimizing the seller’s tax consequences.

Payments to the seller for accounts receivable will be treated as ordinary income. Tax liability may be reduced by having the accounts receivable appraised for “collectibility.” Usually only a certain portion of the total accounts receivable are truly collectible. The age of the accounts as well as contractual deductions should be superimposed on the practice’s historical collection pattern in order to arrive at an appraisal.

Goodwill is generally treated as a capital gain and will therefore be held favorably by the seller. The seller may benefit even more if the payment for the goodwill is spread out over several years, thereby deferring some of the tax burden to future years.

Furniture and equipment will also have tax implications for the buyer and seller. Revenues allocated to the difference between the original cost and the depreciated value will be taxed as ordinary income. The seller has already gained the benefit of a tax break for this amount in depreciation over the years and therefore any revenue collected in excess of this is taxed at a higher rate. Only amounts received beyond the original costs would be considered capital gain.

The value for stock is considered a capital gain, to the extent that it exceeds the initial price paid for the stock. If the practice was started by the seller, the entire amount allocated for stock may be considered a capital gain. A buyer, however, may not be interested in purchasing stock. Buyers generally seek to purchase assets which, unlike stock, can be depreciated for tax savings.

If real estate is part of the buy/sell transaction, the amount paid to the seller in excess of the base cost will be taxed at the capital gain rate, much like all furniture and equipment. The base cost is the original cost plus the cost of improvements.

Getting Behind the Wheel

Prior to the practice changing hands, decisions need to be made in order to facilitate the transition. If the seller is willing to remain as an employee for a period, goodwill may be retained and enhanced, but additional protective covenants for the buyer should be addressed. These include:

* The seller’s agreement to maintain licensure, insurability and privileges.
* The seller’s agreement to full work effort.
* The seller’s agreement to clear and concise production standards.
* The seller’s agreement to accountability and loss of governance.
* The seller’s agreement to a reasonable restrictive covenant.
* The seller’s agreement to any termination clauses.

Additionally, the seller, whether remaining as an employee or ceasing to practice, should also have protective covenants. They include:

* An agreed-upon payment schedule
* Timely payments from the buyer
* Length of employment contract (if applicable)
* Length of notice upon termination (if applicable)
* “Backing out” clause should the buyer default on agreement

Conclusion

Essential to the success of buying and selling a medical practice is the understanding of vital information. A practitioner should never attempt to engage in this endeavor alone, or with the “helpful advice” of well-meaning colleagues or friends. Accountants, consultants and attorneys experienced in these types of transactions are indispensable.

It’s crucial for both the buyer and seller to keep a keen eye out for each other’s needs and interests. Understanding the needs, emotions, and concerns of the other party helps build a strong and durable bridge of trust... a bridge that will effortlessly transport your new purchase or sale down the road towards success.