20 Due Diligence Considerations for a Successful Healthcare Industry Transaction

By Brian W. Kerby, CPA

The fundamentals of due diligence to ensure a successful transaction remain essentially unchanged under healthcare reform. But understanding the risks before signing a definitive agreement includes being aware that due diligence also must be performed while keeping an eye on the evolving business and legislative landscapes.

As always, due diligence must include an understanding of the business’s historical financial statements and the trends that have shaped its financial performance. But add an important new consideration to these essentials: How will the business change in the near and long terms as the provisions of healthcare reform continue to unfold?

Adding this consideration goes beyond the basics of financial due diligence. In many cases, it might call for specialized regulatory and reimbursement services that focus on how healthcare reform is affecting each sector of the industry. These services include modeling the potential financial impact of changes in reimbursements based on the company’s past, current, and projected future performance.

Following are other due diligence considerations to ensure a successful transaction:

1. Develop a detailed due diligence plan, and designate a dedicated resource for leading the transactions. The intricacies and potential pitfalls that go hand in hand with the acquisition of new businesses in an ever-changing environment require the involvement of individuals whose time is devoted solely to these transactions.

2. Look beyond the numbers. Do your due diligence on every aspect of the business in addition to what is in the financial statements. What is driving financial performance?

3. Analyze quality of information. Validate critical information about the seller, including the integrity of the systems, people, and processes used. Access the independent audit work papers, and reconcile audit financial statements to internal financial statements.

4. Know revenue quality and sustainability. Understand the patient billing system and the methods used for establishing contractual allowances and bad debt reserves. Reconcile reported revenues to cash collections for the previous 24 months. Analyze revenue by service line and changing revenue caused by volume and pricing/payer mix, new services, and discontinued offerings. Understand any joint venture income arrangements and any capitation revenue as part of the business’s revenue streams.
5. Analyze costs and expenses. Analyze historical and budgeted operating expenses by department. These include salaries, benefits, full-time employees by job class, physician compensation arrangements and turnover, and supplies and pharmacy expenses.

6. Perform a quality-of-earnings analysis. To understand recurring cash flows, analyze the historical revenue and expense accounts for unusual items, such as nonbusiness expenses, that might affect the sustainability or the quality of the earnings following the transaction. Consider out-of-period and one-time transactions, cash to accrual basis adjustments, market compensation adjustments, and discontinued costs post-transaction.

7. Understand accounts receivable. Analyze aged accounts receivable balances, days revenue outstanding, and the method for calculating bad debt and contractual reserves, if they exist. Has the company changed how it values accounts receivable and the related reserves as of the dates you are reviewing? If so, how has that affected sustainable earnings?

8. Analyze working capital requirements. Analyze working capital trends and fluctuations and the quality of the current assets and liabilities reported on the balance sheet. Is sufficient working capital available to operate the business going forward? Has the business overstated its assets or understated its liabilities?

9. Don’t overlook tax due diligence. Tax due diligence tends not to get the attention it deserves, but it matters. Understand the company’s legal entity structure and recent corporate history. Review federal income tax returns for all years for which the statute of limitations is not closed. Identify material actual and potential federal, state, and local employment tax issues and exposures. Identify any issues related to employee versus 1099 contractor status to determine whether a 1099 contractor should be treated as an employee according to IRS guidelines.

10. Analyze the integration between operations and technology. Understand the quality, scalability, and reliability of the business’s software and hardware platforms to identify any associated capital expenditures that will be needed. If a transition services agreement (TSA) is going to be in place, understand and quantify the terms of the TSA during the integration process.

11. Quantify the potential benefits of payer contracts to ensure compliance with antitrust guidelines. External consultants can perform a confidential analysis of the potential impact of applying commercial and managed care payer contract terms of each party to the related utilization statistics.

12. Analyze insurance coverage. It might be advisable to hire actuaries to analyze the various types of insurance to evaluate whether reported reserves and assets are adequate. Pay particular attention to shortfalls and funded reserves to cover any potential claims exposure for self-insured businesses.
13. Review legal contracts. If necessary, hire a legal firm to review contracts for regulatory compliance. These include lease agreements, purchase agreements, joint ventures and employment contracts, and assignability and other terms that might change as a result of the transaction.

14. Review the seller's compliance program to identify potential areas of fraud and reduce the risks of regulatory noncompliance. Evaluate past billing and collection practices to make sure that no undercoding or overcoding has occurred and that services provided support services billed and payments received.

15. Evaluate benefits packages. Compare pay rates, health benefits, pension programs, and other benefits programs across your organization and the seller's organization. Assess the potential costs and opportunities of combining plans.

16. Think about key employee or physician departures. Will the seller need help developing a transition plan because of pending retirements?

17. Review the owner and physician compensation model. How will you compensate the owners, employees, and physicians post-transaction?

18. Consider the impact of looming reimbursement cuts. Determine what it would mean to the business if reimbursement were to go down 5 percent over the next five years.

19. Examine whether there is a history of fraud and abuse. Review the company's record, and determine whether liabilities will extend to you when you take over the business.

20. Be aware of potential cash flow issues. Cash flow issues will depend on whether the transaction is a stock or asset purchase.

Healthcare reform will continue to affect organizations for years to come. Decisions about acquisitions must be made through this lens. As a result, financial and nonfinancial due diligence matters now more than ever.
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