

What type of information will prepare you to accept, reject or renegotiate a transaction with confidence?

# DUE DILIGENCE



**EW:** The due diligence review plays an important role in the purchase and sale process. Usually included in the 'Offer of Purchase and Sale,' it is a condition of the sale that is often misunderstood.

The due diligence process consists of information collection and verification procedures. Information is obtained and analyzed to assess value of the practice to be sold. The information is verified to ensure that it is reliable and substantiates the value originally determined. These procedures are used in reviewing both the financial information and operating procedures of the practice.

It is common for a purchaser to undertake a due diligence review of a proposed acquisition. This is done to ensure that the purchaser has all the necessary information to make an informed decision. For them, the process would actually start with the first meeting with the selling doctor, or his or her representative.

A selling doctor is less likely to initiate this process. It can, however, be extremely valuable because it can ensure that the practice/business is in a condition to maximize its saleability and price. The process would be undertaken long before the practice is offered for sale, even a few years in advance. The type of information reviewed would be the same as if the purchaser were conducting the due diligence review.

## GENERAL INFORMATION

### FINANCIAL CONSIDERATIONS

From a financial standpoint, the most-often-requested items of information are the financial statements. This would consist of a balance sheet, income statement and notes to the financial statements if they are available for the three years preceding a sale. If the financial statements are somewhat dated because the date of sale is long after the year-end, interim financial statements or bookkeeping information for the current period should be provided.

Additional substantiating information can be requested, such as income tax returns, notices of assessment and bank statements. These are meant to increase the level of assurance and verify consistency with the financial statements. This is especially necessary when a professional accountant has not prepared the financial statements.

### PRACTICE OPERATIONS

If one is to rely on the financial information, it is prudent to review the information system. This would consist of bookkeeping procedures, patient management system and related patient files. If a budget or forecast is available, it would be useful to compare actual results to

those predicted. An office policy manual, if available, could be reviewed to provide an understanding of the process that takes a patient from entering the office to paying their bill, as well as duties and responsibilities of staff.

Critical to the success of the purchaser is obtaining and maintaining patients subsequent to the purchase. This highlights the importance of determining the source of vendor's patients. Included in this category would be determining if a marketing plan exists and what, if any, investment there is in advertising. General referral sources are also reviewed.

The general state of the chiropractic profession and the health care industry in general must be considered in any due diligence review. Trends in health care, as they affect the profession, are necessary to examine because of their impact on the practice subsequent to its sale. Furthermore, it may be necessary to analyze specific aspects of the profes-

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sion if they apply. For example, understanding the insurance legislation and trends in rehabilitation would be crucial in evaluating a practice that deals with Motor Vehicle Accident (MVA) cases.

In more populated areas, evaluating the competition may be necessary. Identifying where they are and what type of practice they have can be helpful in determining if the purchaser might encounter a drop in patients after taking over. Key among factors in evaluating the practice's competitive strengths and weaknesses are the services offered and the related fee structure.

#### SPECIFIC ISSUES

Once the general financial and practice operations information is obtained and reviewed, specific areas can be identified for a more intensive review.

#### REVENUE

In previous articles, we have repeatedly acknowledged the importance of practice revenue and the ability to maintain it after purchase. A number of factors should be reviewed to obtain a better understanding of the practice and greater assurance as to the revenue's reliability and accuracy.

Financial information that is specific to revenue is often obtained. It may include day sheets, monthly summaries of billings and receipts, fee schedule and monthly financial statements.

In attempting to establish the components of revenue, it is necessary to obtain statistics relating to the number of

new patients, patient visits and types of treatments offered. Furthermore, it should be determined whether income from associates or the sale of other products or services is included. The source of payment should also be analyzed to determine what amounts are paid by patients, Medicare, Workplace Safety & Insurance Board (WSIB) and private insurance.

#### ASSOCIATES

Two important elements to identify when associates are present in the practice are the nature of the relationship and whether there is a written agreement. The information required includes the timing of, and responsibility for, payment, along with the basis of calculation of the associate fee. If there is an agreement, it should be reviewed to see what impact it might have on an impending purchase. A clause giving the associate first right of refusal to purchase is only one example of a critical factor that would affect an offer by a third-party purchaser.

Inquiry of the associate would also be considered to determine if they intend to stay on subsequent to sale.

#### SUPPLIES

A review of the supplies is especially necessary where products are sold in the practice. This analysis is important to assess the 'gross profit' on sales so as not to overstate revenue. An inventory listing at the closing date should also be supplied.

#### RENT

In an effort to determine expected rent, the lease should be reviewed where applicable. Identifying lease rates and the lease term provides potential future information. Needless to say, it is extremely important to determine if the lease is transferable.

#### STAFFING

A listing of the office staff should be obtained which identifies their duties, experience and salaries. The payroll book or employment contracts can also be used to substantiate the salaries. Inquiry should be undertaken to determine whether staff will continue subsequent to sale. Cut-off issues, such as vacation pay, have been addressed in a previous article.

#### CAPITAL (FIXED) ASSETS

A list of tangible assets to be sold/acquired should be obtained. To determine whether the assets are owned or leased, any purchase agreements and lease or loan agreements should be reviewed. The condition of the assets will help to indicate their value.

In cases where the fixed assets have significant dollar value and impact on operations, appraisals should be obtained. It is common, in these cases, to engage the services of a qualified appraiser.

A review of the repairs and maintenance account can assist in assessing the condition of the assets and potential for future costs.

#### ACCOUNTS RECEIVABLE

Although accounts receivable are rarely sold as part of a transaction involving chiropractors, they are still significant in the information they provide about the source of funds and efficiency of the office in collecting the amounts billed. In a review of the accounts receivable listing, key elements would include the age of the outstanding balances and the overall amounts owing. The policy manual of office procedures related to collections should be reviewed if one exists.

#### DISCRETIONARY EXPENSES

Identifying discretionary expenses, or those expenditures that are subject to the individual spending habits of the vendor, is important in assessing *real* 'net income.' What is more important is separating 'fact from fiction.'

#### OTHER AREAS

Consideration must be given to some additional intangible assets of the sale. First among them is the telephone number and its transferability. It should also be determined if there are any security deposits for telephone or other utilities.

If the business is not named for the selling chiropractor, the name of the practice should be examined to see if it is registered and if it is transferable.

Finally, other contracts, including software licenses and maintenance agreements, should be reviewed for cost, term and transferability.

The information in the due diligence process is provided in stages. At the outset, before there is evidence of intent to submit an offer, the vendor is reluctant to release sensitive information that could be used by a competitor. As a result, summaries of financial data may be all that is provided. In some situations, a package of information about the practice may be prepared for potential purchasers. Once there is some intent to submit an offer, the purchaser and their advisors would require financial statements and revenue summaries in order to determine a price for the offer. It is usually after the offer is accepted that the more detailed information is obtained as part of the more extensive review process.

It is important to realize that this review process is not an exact science. The extent of the review is determined by an assessment of risk of misrepresentation, whether intentional or not. In the final analysis, the greater the knowledge of the practice, the less risk there is in the due diligence process and the greater the assurance that the transaction will be successful. >>

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**AMF:** The concept of 'due diligence' as it applies to the legal issues involved in the sale of a professional practice relates to the matter of risk management in the investigation of those issues that lead a purchaser to enter an agreement to acquire a practice. It has been noted in prior articles that both the vendor and the purchaser may make statements that constitute representations and warranties concerning various portions of their professional status.

For example, the vendor may make statements concerning the following:

1. the billings of the practice
2. the collection of the practice
3. the status of the lease
4. the relationship with any associates
5. the relationship with employees
6. the referral base of the patients
7. his or her practice technique

The fact that:

8. there are no issues of which the vendor is aware that would adversely affect the continuation of the practice
9. he or she is not, nor has been, the subject of a patient complaint
10. the vendor is a member in good standing with the licensing board
11. patient files and accounting records are kept in accordance with appropriate standards
12. the vendor is relocating to a specific area
13. the equipment is in good working order

With respect to the purchaser, he or she may also make representation such as the following:

1. he or she is licensed
2. he or she is a member in good standing with the licensing board
3. he or she has professional liability insurance coverage
4. he or she has no outstanding patient complaints

By no means is this an exhaustive list of representations that might be made by one or both of the parties. It is up to the professional advisors of the vendor and purchaser to ensure that the representations are true, in both substance and in fact.

The level of the due diligence exercise is left to the parties to determine what is appropriate. For instance, an institution loaning money to a purchaser may want billings verified to ensure that the borrower is in a position to generate sufficient funds to maintain the loan requirements. The extent of the process is analogous to that of preparing a financial statement wherein an accountant may merely do a review or alternatively prepare an audited statement. The level of work may be directly related to the cost that the party is prepared to spend to ensure the veracity of the statements being made in the agreement of purchase and sale.

While the lawyer acting for a vendor or purchaser may be required to complete certain searches such as a bulk sales search, an execution search, bankruptcy search, and building and zoning search, these searches should not be confused with the due diligence work undertaken as a separate matter, usually conducted by the purchaser's accountant. It is

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unlikely that a lawyer will be called upon to review patient files, income tax returns or billing records to ensure that there is consistency and validity in the information being provided to substantiate the representations concerning the status of the practice and its value and validity.

Even after the completion of the due diligence investigation on the part of a purchaser there will be certain representations and warranties that will continue to the closing of the transaction and thereafter, as in the case of equipment being in good working order, or the practice being maintained in an orderly fashion. However, the inclusion of such warranties in the agreement is no excuse for a purchaser not to complete the due diligence search immediately after the entering into of the agreement. If there are difficulties with the practice the purchaser would be well served by becoming aware of the difficulties at the earliest possible moment.

A vendor should expect, as a matter of course, the purchaser to require a review of the practice as a condition of the agreement. The vendor should ensure that the process is conducted in the least invasive fashion to the staff and patients of the practice. The process should be conducted by a professional who understands what he or she is looking at and for, and should be maintained in the strictest of confidence. Hopefully, little will be found during the process to concern either the vendor or the purchaser or cause the transaction to be terminated or renegotiated as a result of a diminished value and,

therefore, sale price.

As indicated, if the vendor has a concern that might arise during the process, he or she would have been diligent in having the practice reviewed by an accountant and/or lawyer to ensure that issues of concern were dealt with long in advance of any proposed sale. The message would well be, in considering the due diligence portion of any sale of a practice, that the vendor should be proactive in his or her approach to the transaction. It will save a great deal of time, stress and money. ●



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