Determining Value & Physician Compensation when Purchasing a Practice

June 18, 2013
Carol W. Carden, CPA/ABV, ASA, CFE
Lori Foley, CMA, PHR, CMM

Learning Objectives

• After this session, you will

  Understand valuation approaches for practice acquisition

  Describe how Stark and anti-kickback statutes affect practice acquisition

  Describe various compensation structures for post-transaction employment
**Agenda**

- The hospital/physician alignment environment
- Healthcare regulatory considerations
- Valuation methods and issues related to physician practices
- Physician compensation considerations

**The Hospital/Physician Alignment Environment**
Hospital/Physician Alignment Transactions

- Hospitals and physicians are actively seeking ways to strategically and financially align themselves.
- Successful alignment transactions can result in substantial benefits to all parties including patients.
  - Improved efficiencies and quality of care
  - Reduced costs and waste
  - Better bargaining power with third party payors

Hospitals & Health Systems

- Seeking efficiencies
- Diversifying, focusing on outpatient and wellness care
- Increasing emphasis on standardization, integration, and consolidation of services
- Experiencing physician shortages in key specialties
- Competition from other systems as well as physician owned outpatient centers
- Call coverage needs
- Healthcare reform
Physicians

- Financially squeezed - decline in reimbursement, increased overhead and loss of income
- Difficulty obtaining malpractice coverage at reasonable rates
- Working capital requirements
- Inability or unwillingness ($$) to recruit
- Exit strategy
- Quality of life
- Increasingly complex government oversight
- Healthcare Reform

Physician Alignment Vehicles

- More Common: Physician Acquisition/Employment, Medical Directorships, Physician Leasing Agreement, Real Estate JV, Equipment JV, Physician Advisory Council
- Less Common: Co-Management, EMR, PHO, Shared Savings, Quality, Physician Services Agreement, EMR

More Integration - Less Integration

Less Integration - More Common

hfma national institute 2013
Physician Practice Acquisitions – the “Buy and Employ” Strategy

- Hospitals and physicians are entering into acquisition and employment transactions at a torrid pace!
- Transactions often make good business sense but also involve substantial risk.
  - Regulatory risk;
  - Financial risk (i.e., hospital's ability to successfully integrate and operate the Practice without incurring substantial losses); and
  - Reputation risk (the two entities are now related).
- Very competitive environment in many markets

“Buy and Employ” Transactions

- Typical Transaction:
  - Hospital buys the practice at FMV
    - Usually structured as an asset purchase
    - Cash and AR normally excluded
    - Net after-tax proceeds can be substantially different depending upon the deal structure.
Physicians employed by the hospital –

- Generally under some type of productivity based compensation arrangement (wRVUs)
- Generally involves a period of guaranteed compensation (assuming productivity does not decline substantially).
- Often includes other types of arrangements as well (e.g., co-management, call pay, quality incentives, etc.).

**Key Issues**

- The hospital and physician practice should be a good fit strategically.
- Regulatory restrictions (e.g., fair market value)
- Deal structure
- Post-transaction governance
- Keeping the physicians engaged and motivated
- Ancillary services – impact on compensation
- Due diligence
Healthcare Regulatory Considerations

Navigating the Regulatory Environment

**STARK LAW**
Prohibited self-referrals for Medicare and Medicaid patients.

**ANTI-KICKBACK**
Knowingly and willful offers, payments, or receipts for referrals.

**IRS-NFP**
IRC Section 501(c) 3 requirements
Compliance Issues Regarding Hospital-Physician Financial Relationships

<table>
<thead>
<tr>
<th>COMMERCIAL REASONABleness</th>
<th>FAIR MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>SENSE</td>
<td>CENTS</td>
</tr>
<tr>
<td>Overall Arrangement</td>
<td>Range of Dollars Only</td>
</tr>
<tr>
<td>“WHY?”</td>
<td>“HOW MUCH?”</td>
</tr>
</tbody>
</table>

**Commercial Reasonableness**

- **Department of Health and Human Services Definition**¹
  - An arrangement which appears to be "a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals."

- **Stark Definition**²
  - “An arrangement will be considered ‘commercially reasonable’ in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential designated health services ("DHS") referrals.”

- **OIG Threshold**³
  - Compensation arrangements with physicians should be “reasonable and necessary.”

Factors in Determining CR

- Business Purpose
- Provider Analysis
- Facility Analysis
- Resource Analysis
- Independence & Oversight

Fair Market Value

- **IRS Definition**¹
  - Fair market value ("FMV") is defined as the amount at which property would change hands between a willing seller and a willing buyer when neither is under compulsion and both have reasonable knowledge of the relevant facts

- **OIG/Stark Definition**²
  - The value in arm's-length transactions, consistent with the general market value
  - The price that an asset would bring as the result of *bona fide* bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of *bona fide* bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement

¹Estate Tax Reg. 20.2031.1-1(b); Revenue Ruling 59-60, 1959-1, C.B. 237.
²Federal Register / Vol. 69, No. 59 / Friday, March 26, 2004 / Rules and Regulations.
Fair Market Value – Key Concepts

• Determined from the perspective of hypothetical buyers and sellers without the ability to refer business to one another.
• No consideration for post-transaction buyer synergies. However, such synergies often exist!
• The financial terms of the transaction must make economic sense based on the assets being sold/received.
• Post-transaction compensation must be taken into consideration.

Valuation Methods and Issues Related to Physician Practices
Valuation Methodologies Typically Used for Physician Practices

- **Asset (“cost”) Approach**
  - Derives an indication of value based on the anticipated cost to replace, replicate, or recreate the asset.
  - Often considered a “floor” value.
  - Net Asset Value Method

- **Income Approach**
  - Based on the entity’s earning power (i.e., ability to generate positive cash flow in excess of the physician’s fair market value compensation).
  - Primary methods include:
    - Discounted Cash Flow Method
    - Capitalized Income Method

Net Asset Value (“NAV”) Method

- Value is based on the entity’s underlying assets and liabilities.
- Assets and liabilities are adjusted to their respective current values. The liabilities are then subtracted from the assets to determine the entity’s net equity (i.e., “net asset”) value.
- Commonly used for physician practices that lack positive cash flow (in excess of physician “fair market value” compensation).
### Discounted Cash Flow ("DCF") Method

- Value is based on the entity’s projected net cash flows discounted to present value.
- Requires projections of revenues, expenses, capital expenditures, etc.
- Risk of the cash flows is factored into the discount rate.
- Commonly used for physician practices – especially large practices with substantial ancillary revenue and/or mid-level providers.

### Capitalized Income Method

- Relies upon a single period earnings steam as a proxy for future years (as opposed to projections).
- Value is determined by capitalizing the earnings stream.
- Generally difficult to use for physician practices – past is not always a reliable indication of the future for most practices!
Valuation Methodologies Typically **Not** Used for Physician Practices

- Market Approach – determines an indication of value based multiples derived from similar businesses/interests that have been bought/sold.
  - Guideline Public Company Method
  - Merger and Acquisition Transaction Data Method
- Normally not used for physician practices because:
  - No publicly-traded physician practices
  - Lack of reliable transaction data involving practices that are sufficiently similar

---

Which Method is Appropriate?

**IT DEPENDS...**

**If the Practice...**

- ...has profits remaining after FMV physician compensation
  - **an income approach** will probably be required
- ...does not have remaining profits after physician compensation
  - the **NAV method** will likely be appropriate
Enterprise vs. Intangible Value

- The sum total of the tangible and intangible assets can not exceed the entity’s total enterprise value
- Example:
  - If the enterprise value = $2 million (e.g., determined from DCF Method)
  - And the tangible assets (e.g., cash, accounts receivable, equipment, etc.) = $1,200,000
  - Then, (with limited exceptions) intangible assets can not exceed $800,000

Assessing Intangible Value

Determining whether a physician practice has intangible value (within the limitations of FMV) is primarily based upon cash flow. If intangible value exists, there should be an economic benefit of ownership (i.e., in excess of FMV compensation).

Practices that do not produce such positive cash flow, generally will have little or no intangible value.

Physician groups that generate positive cash flow (above the physician’s “FMV” compensation) will normally have some level of intangible value.
## Certain Practices Are More Likely to Have Intangible Value

- Large multi-specialty practices with mid-level providers and/or significant ancillary services are more likely to have intangible value because they generate revenue in excess of the physician’s personal efforts.
- Small highly specialized practices (e.g., general surgeons) are less likely to have intangible value because substantially all revenue is professional fees generated by the physician(s).

## Intangible Assets Acquired Should be Separable and Transferrable

- For an intangible asset to be transferrable to a buyer, it must be separable from the seller.
- Intangible assets that are separable generally have contractual or other legal rights (e.g., non-competition agreements, clinical trial contracts, etc.).
- Intangible assets that are not separable are generally components of goodwill (e.g., employee workforce).

Practice vs. Personal Goodwill

• **Practice goodwill** is an asset of the entity that produces economic benefits to its owners apart from their personal goodwill.
  – Factors generally influencing enterprise goodwill include: the entity’s name, reputation, location, phone number, etc.
  – Generally transferrable
• **Personal goodwill** is an asset of the individual (i.e., physician).
  – Factors generally influencing personal goodwill include: personal reputation, credentials, education, relationships, etc.
  – Generally not transferrable
• Often difficult to distinguish in a physician practice.

Employed-Physician Compensation Planning
Transaction Drivers - Physicians

- Increasing pressure...
- Decreasing reimbursement
- Healthcare reform
- Operating costs
- Decreasing reward...
- Lifestyle preference/Quality of Life

Key Elements of Successful Compensation Alignment

- Directly linked to goals and objectives
- Encourage/reward hard work and production
- Balance individual and team responsibility
- Clarify performance expectations
- Aligned with reimbursement environment
### Key Elements of Successful Compensation Alignment

- Simple, understood, and explainable
- Clearly defined and consistently applied
- Open and transparent
- Fiscally responsible
- Legally compliant

### Components of Physician Compensation

- Base Compensation
- Incentive Component
- Quality Measures
- Good Citizenship
- Leadership

**Physician Compensation Philosophy**
Components of Physician Compensation

Models include:
- Salary plus bonus
- Productivity based
- Straight salary
- Revenue sharing (partial/equal)

Influenced by:
- Specialty area
- Physician’s experience and credentials
- Typically tied to historical compensation and/or industry benchmarks
- Often has minimum production thresholds; may be 100% at risk if pure “eat what you treat”
Components of Physician Compensation

**Base Compensation**
With Production

Many shapes and forms but most common is $ per wRVU in excess of threshold.

Other measures:
- Patient encounters
- Charges

Definition of wRVU matters -
- Personally performed vs. credit for others
- Base year vs. annual wRVU updates
- Impact of modifiers & denials
Components of Physician Compensation

- Achievement of quality, operational efficiency, patient satisfaction goals
- Baseline levels determined using the facility's historical and clinical data and/or comparable national or regional data, with incentives paid to reflect incremental improvement

Components of Physician Compensation

- Can be based on improvement or achievement of specific targets
- Incentives should be objective, verifiable, supported by credible medical evidence, and individually tracked
Components of Physician Compensation

According to Sullivan Cotter’s 2011 Physician Compensation and Productivity Survey:

- 72% of compensation plans include quality
- Currently 3-5% of pay is tied to quality & patient satisfaction, expected to increase to 7-10% in coming years

Quality Measures

Components of Physician Compensation

Examples include standards related to:

- Chronic disease management
- PQRS measures
  - Percent of patients that have BMI measured and documented
  - Documentation/verification of current medications in the medical record
Components of Physician Compensation

“Playing nice in the sandbox”
- Complete documentation within designated timeframe
- Attendance at requisite number of meetings, trainings
- Community involvement
- Supervision of non-physician providers

Good Citizenship

Components of Physician Compensation

- Identifies expected behaviors ahead of time.
- Motivates the physician to care about the details of the business in addition to clinical care.
- Paying for that which should be expected?
Components of Physician Compensation

Participation in leadership roles may take substantial time and energy and draw away from clinical care.

- PCMH
- EHR selection and implementation, champion
- Peer review

Compensation Plans Are Not Static

A recent HealthLeaders study indicates that systems regularly modify their compensation plans:

- 41% of respondents modify every 1-2 years
- 38% every 3-5 years
- 21% leave them unchanged for more than 5 years

*Physician Compensation: Shifting Incentives*, HealthLeaders Media/Intelligence, October 2011
Payment for Ancillary Services

- If physician/clinic is a department of the hospital, then revenue from designated health services (DHS) cannot be shared with the providers.

- If employment is structured to meet the “group practice exception” under the Stark regulations, then DHS revenue can be shared with providers provided that it is not allocated based on the volume or value of the provider’s ordered DHS services.
  - Allocations can range from equal to proportional based on professional (not technical) services provided by the physician.

- Often a financial decision based on the site of service differential.

Compensation and Regulatory Issues

- Post-transaction compensation structure factors into the practice valuation.
  - Health systems cannot pay for a revenue stream twice – once with the “purchase” and then on-going in the physician compensation plan.

- Fair market value and commercial reasonableness (addressed earlier) must also be considered with regards to physician compensation.
Contact Information

Carol Carden, CPA/ABV, ASA, CFE
Principal
(865) 673-0844 ext 213
ccarden@pyapc.com

Lori Foley, CMA, PHR, CMM
Principal
(404) 266-9876
lfoley@pyapc.com
Selection of a valuation method that fits the unique characteristics of a healthcare transaction results in a more defensible work product.

<table>
<thead>
<tr>
<th>ENTITY/TRANSACTION TYPE</th>
<th>COMMON METHOD*</th>
<th>UNIQUE CONSIDERATIONS</th>
</tr>
</thead>
</table>
| HOSPITALS               | • Income approach  
                          • Market approach  | • Uncertainty regarding future reimbursement rates  
                          • Ensuring market multiples are comparable and can be applied across different geographic markets  
                          • Certificate of need (CON) requirements  
                          • Payor mix  
                          • Quality initiatives  
                          • Changing technology  
                          • Physician alignment and impact from joint ventures  |
| AMBULATORY SURGERY CENTERS | • Income approach  | • Recent fee schedule changes  
                          • Should not consider post-transaction changes in volume or referral patterns  
                          • Possible impact of CON laws  |
| DIALYSIS CLINICS        | • Income approach  | • Relationship with area nephrologists  
                          • Not generally subject to CON laws  
                          • Demographics of the immediate market area  |
| PHYSICIAN PRACTICES     | • Income approach  
                          • Asset approach  | • Non-compete agreements with providers  
                          • Trends in reimbursement rates  
                          • Impact of physician extenders and/or ancillary services  |
| IMAGING CENTERS        | • Income approach  | • Changes in reimbursement rates due to DRA  
                          • Potential changes in reimbursement due to different organizational structure  
                          • If billing globally, adjust projections to reflect any changes in post-acquisition reimbursement  
                          • Cost of keeping technology current  |
| CANCER CENTERS         | • Income approach  | • Impact on changing technologies and the risk of future cash flows  
                          • Possible impact of CON laws  |
| LEASES                 | • Cost approach  
                          • Market approach  | • Ensure rate of return is reasonable relative to risks assumed, consider current market data on interest rates, equity returns, and industry risk  
                          • Market data can be difficult to obtain  |
| MANAGEMENT AGREEMENTS  | • Cost approach  
                          • Market approach  | • Ensure rate of return is reasonable relative to risks assumed  
                          • Market data can be difficult to obtain  |
| FMV COMPENSATION       | • Market approach  | • Safe harbor has been eliminated  
                          • Differences between administrative and clinical FMV hourly rates  
                          • Watch for “double-dip” between duties  
                          • Consider relevant RVU data which can be found at http://www.cms.hhs.gov/physicianfeesched/downloads/cms-1385-fc.pdf  |

* Facts and circumstances may dictate use of other methods.
Understanding key valuation terms helps healthcare attorneys and business appraisers communicate more effectively.

<table>
<thead>
<tr>
<th>TERM</th>
<th>GENERAL DEFINITION</th>
<th>KEY CONSIDERATIONS</th>
</tr>
</thead>
</table>
| FAIR MARKET VALUE (IRS) | Amount of funds that would change hands between a willing buyer and willing seller without compulsion, both having reasonable knowledge of the facts | • Assumes hypothetical buyer and seller  
• Cannot consider synergies or post-transaction cost reductions |
| FAIR MARKET VALUE (STARK/OIG) | Value in arm’s-length transactions consistent with the general market area as a result of bona fide bargaining | • Consider similar sales or arrangements in the market if possible  
• Evaluate the business purpose of the transaction to ensure both parties are accepting proportional risks |
| INVESTMENT VALUE | Amount of funds that would change hands between a specific buyer and seller | • Consider synergies and post-transaction efficiencies  
• Does not often apply to transactions among potential referral sources |
| DISCOUNTED CASH FLOW (DCF) | A method of determining value which utilizes projected cash flows discounted to the present value rate | • Cash flows should be projected until in line with the long term growth  
• Remaining value is captured through the use of a terminal period |
| SINGLE PERIOD CAPITALIZATION | A method of determining value which utilizes a single period estimate of cash flow anticipated to represent the future | • Generally used for mature operations with stable cash flows |
| WEIGHTED AVERAGE COST OF CAPITAL (WACC) | Total required rate of return based on the weighted average cost of debt and the weighted average cost of equity | • Used as a discount or capitalization rate when debt is present in the business or when a controlling interest is being purchased and the buyer could utilize debt in the capital structure |
| NET ASSET VALUE (NAV) | A method of determining value that utilizes the fair market value of the entity’s assets and liabilities | • Used for businesses where the cash flows are not sufficient to generate a value greater than the NAV |
| GUIDELINE PUBLIC COMPANY METHOD | A market approach that utilizes pricing multiples developed by an analysis of publicly traded companies similar to the target company | • Not used extensively in healthcare valuations due to a lack of publicly traded guideline companies |
| MERGER & ACQUISITION TRANSACTION METHOD | A market approach that utilizes sales transactions from other privately held companies similar to the target company | • Used in certain segments where there is sufficient recent transaction data; i.e., hospitals and dental practices  
• Difficult to apply across geographic markets due to differences in payors and demographics |