

Understanding the Practice Evaluation Process

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ABSTRACT

Identifying the steps of the practice evaluation process, you must understand the basic information regarding definitions and terms commonly used with practice sales. The questions most asked by doctors who are considering purchasing a practice.

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Valuation vs. Evaluation

As dentists decide to sell their practice, the question they may ask themselves is “*what is the sales value of my practice?*” The prospective purchaser may ask “*is the asking price warranted?*” An *evaluation* of the practice is necessary to find trends in all aspects of the practice over a defined time period. The practice evaluation process collects information which answers questions most asked by purchasers.

- How do they know that the information provided by the seller is accurate?
- How do they determine the validity of the number of active patients?
- How do they choose the right practice?
- How do they determine if the asking price is within fair market value?
- What is the selling practice’s cash flow?
- Is the practice overhead within accounting norms?
- How do they identify a viable practice?

Walking through these questions and the entire process of the Due Diligence/Practice Evaluation has been a difficult process and learning experience for doctors. Primarily, one must understand that the Due Diligence/Practice *Evaluation* is vastly different from the Practice Appraisal/Practice *Valuation* process.

Valuation and Evaluation

By definition, a dental practice appraisal (practice valuation) is prepared by a CPA or Practice Broker that is based on Asset Approach, Income Approach and Market Approach. An accurate appraisal is key when selling or buying a dental practice.

A dental practice evaluation (due diligence) is the verification of the data provided by the seller/broker and an inspection of

practice data gathered by the buyer’s contracted representative. Additional data is generated from the seller’s practice management software and accounting software.

Due Diligence is analogous to a home inspection. Dentists would not purchase a home without a professional home inspector verifying the home’s safety and current condition.

The same holds true for dentists considering a similarly large investment, a practice purchase. They will want to surround themselves with a team of trusted advisors they have interviewed. Members of their trusted advisors would include an Attorney, an Accountant, a Banker, a Consultant, and an Equipment Representative. This team of advisors works for them, as the potential buyer, while the broker works for the seller. Due to a conflict of interest, they would avoid having the same representation as the seller.

The buyer’s trusted advisors would verify all the data on the Prospectus and Pro Forma, which is provided by the seller’s representative, the Practice Broker.

Documents Buyers and Sellers Need to Understand Letter of Intent (LOI)

The letter of intent is a legally non-binding document that contains all the elements of the practice transition that the dentist has negotiated with the seller. This is the first step in the purchase process. The **LOI** can be comprised with a few or many details but in short it is stating “The purchaser intends to purchase the seller’s practice for a disclosed amount of money, *pending due diligence and bank loan approval.*” Additional components of the practice transition can be covered in the **LOI**, but if not in the **LOI** it needs to be included in the Purchase Agreement. When the letter of intent is accepted and signed

by both parties the purchaser has a certain number of days to complete the due diligence and bank approval.

Practice Purchase Agreement

The purchaser's or the seller's attorney will begin drafting the Purchase Agreement following approval of the bank loan.

Components included in a purchase agreement may include accounts receivables, assets to be purchased, goodwill, debt, liability and patient accounts receivable credits, noncompete clauses, lease agreements, dental retreatments, confidentiality, employment, expenses and closing date.

Considerations When Choosing a Practice

When dentists are inspecting practices, they will need to determine which practice is the best fit for them and their family. Important aspects in determining value of the practice are cash flow and the net profits of the practice. Other considerations are historical growth, staff longevity, future growth potential, types of dental procedures being performed, and the demographics of the neighborhood.

Additionally, they will want to examine the philosophy and personality of the selling doctor and determine if it compliments their own philosophy and personality.

Demographic data such as location, average income of the population, educational attainment level, and most importantly, a healthy patient to dentist ratio, are all paramount considerations.

Understanding the Practice's Insurance

- Is the practice participating in network with insurances? If so, how many plans and what is the percentage of participation. The participation percentage is practice specific. See [Table 1](#).
- How many insurances are PPOs, DHMOs, hybrid plans, membership in-house plans? Determine the number of patients who have pre-paid their annual subscription on the membership plan. Have all no charge services been delivered and how will that affect the buyer.
- Is the practice a participant in a premier plan and how does that participation affect the new owner? In California, as an example the purchaser will be grandfathered into the premier plan but not able to charge the premier fee schedule. The new owner is only able to charge the PPO fee schedule, not the premier fee schedule. In short, the purchaser will write more off in adjustments. This situation should not discourage the buyer from purchasing a premier practice but rather assess what procedures the seller is not performing that the buyer does perform.

A copy of all insurance fee schedules from the seller and a copy of the previous year's 1099s from insurance carriers allows buyers to evaluate the percentage of participation in those plans and verify this data. An example:

- The seller reports 53% insurance participation.
- Software collections from insurance reports vs. 1099s indicates a discrepancy.

Table 1. PPO in-network participant.

INSURANCE COLLECTION SUMMARY vs. TOTAL OF 1099S ABC DENTAL CARE	
Data Source	Data Results
2022 Practice Collection Summary	2022 Collections Total: \$949,348
2022 1099 Totals	2022 Insurance Total: \$499,556 (53%) \$599,548 – Indicates a discrepancy of \$99,992 (11%) Actual insurance participation percentage: 64%
Possible Reasons for Discrepancy	Assigning payments into incorrect categories Missing 1099s

A discrepancy between the software collections report and the 1099s provided by the insurance company would prompt a conversation between the seller and the buyer.

A practice evaluation includes the most recent three years of data from the practice management software. A review of these reports identifies if the practice has had steady growth over the last three years without factoring in a fee increase. A practice evaluation should include a demographic report, a fee analysis based on the seller's zip code, and a thorough review of any revenue opportunities the buyer may have. For example, if the seller doesn't perform endodontic, orthodontic or oral surgery procedures but the buyer does that is an opportunity for the buyer.

Additional data should be gathered by the buyer's representative including the percentage of patient retention, staff retention, new patient counts, active patient base numbers, past due patient numbers, accounts receivables and credit balances. Additionally, examination of the saturation or non-saturation of the doctor and hygiene schedules to identify open units of time. Open units of time is lost revenue opportunities.

The Active Patient Base

The active patients are the lifeblood of a practice. Meeting the needs of your patient base is crucial to the retention of those patients. The active patient base is determined by using the recall due date. Each patient is assigned only one recall due date, whether scheduled or unscheduled. The date range used is from one year ago to one year in the future which provides the total active patient base number. Using the same recall due date from one year ago to one month ago will provide all patients overdue for a recall appointment. Typically, one dentist can serve 1200–1700 active patients. See [Table 2](#).

Table 2. The value of knowing the active patient.

IMPORTANCE OF KNOWING THE ACTIVE PATIENT BASE SOLO DOCTOR PRACTICE WITH 1600 ACTIVE PATIENTS	
Number of hygienists needed	2 Hygienists
Number of hygiene days per week	4 Days of hygiene per 800 patients
Number of chairs needed to accommodate the patient base	4 Chairs
Number of dental assistants needed per doctor	2 Dental Assistants
Number of administrative team members needed	2 Administrative Team Members
Quantity of supplies, instruments, etc.	As needed

Percentage of patients within the total Active Patient Base that are *appointed* ahead for hygiene is critically important because it helps to determine the retained patients in the practice. The evidence-based value is 80–90% retention.

Evaluation Practice Software Reports

Production by Provider Reports

- The value of the provider's time based on production and the schedule provides the following:
 - This report provides the total number of ADA procedures performed by each provider within a certain period of time.
 - Production becomes collections and collections support the economics of the practice and the team.

Copies of Providers Schedules

- The schedule demonstrates *efficient* use of each provider's time, affected by failed or canceled appointments, and treatment plan changes. For example:
 - The daily production goal of Dr. Lyons is \$5,000. Each hour of her schedule has 6 units of time or 48 units of time in her 8-hour schedule. Each unit of time has a value of \$104.16. Each hour of canceled or failed appointment time has a value of \$624.96.

Accounts Receivable Report

- This is the amount of money patients and insurance companies owe the practice and is affected by production, collection expectations and efforts. This is important for the following reasons:
 - The A/R represents the strength of the cash flow.
 - A positive cash flow is necessary to meet practice expenses – including payroll. It reflects the practice strategies and systems in place.

Credit Balance Report

- Credit balances are the amount of monies owed by the practice to the patients or to insurance companies.
- Credit balances included within the A/R report can falsely reduce the actual money owed to the practice.
- Monies owed by the seller would need to be reconciled prior to the buyer's purchase of the practice.

New Patient Report

- New patients are those who have had either a D0150 (comprehensive oral evaluation – new) or D0180 (comprehensive periodontal evaluation – new).
- Determine if the practice is billing D0150/D0180 - for new patients only versus both new and existing patients.
- A D0140 Limited Oral Evaluation-problem focused is not considered as a new patient until they have completed a comprehensive evaluation.

- Acquiring the accurate new patient count is critical to the historical growth of a practice.
 - The number of new patients seen represents the future of the practice.
 - More *retained* new patients create growth of the Active Patient Base, and a need for additional team members to support the growing patient base.
 - Invited new patients are compliments from existing patients.
 - A growing active patient base presents the potential for adding an associate in the future.
 - New patient referral sources should also be examined.
 - Referral sources in a specialist practice is a critical component to goodwill.

Practice Acquisition Timeline for the Seller

- Two to five years prior to selling a practice the selling doctor should review the following data:
 - Evaluate the UCR fees. If they have not been raised in the past 12–18 months consider an increase. Utilize a zip code based specific fee schedule analysis to help in this assessment.
 - Ensure the selling dentist is current with PPO credentialing. Renegotiation of fees is often allowed at the time of the recredentialing process. Some carriers don't allow you to renegotiate fees. Policies may vary with each carrier. Consider using an insurance credentialing company to assist with this. Consider converting some of the commercial PPO plans to umbrella plans. Umbrella plans often have higher reimbursement fees.
 - Regularly monitor the dollar amounts of adjustments made against the practice production and collections. Limit the number of elective adjustments on a monthly and yearly basis such as “professional courtesy, doctor's adjustment, or miscellaneous adjustments”.
 - Ensure the profit and loss statements are in order. Use guidelines from the accounting firm for percentages in each category so it shows awareness of the overhead and spending. Ideal overhead percentages are 55%-58%. Acceptable overhead percentages can be as high as 62%. Understand any discrepancies, why and where they occur.
 - If the practice management software requires closing out the day, the month, and the year, *do it!* In many software systems if you are not closing out the month your accounts receivable will not be accurate and it also can affect your other practice management reports.
 - Retain 1099s received from insurance carriers for the past two years prior to selling.
 - If the practice has not experienced financial growth in the last two years without a fee increase, explore why not.
 - Generate the accounts receivable (A/R) report excluding credit balances and reconcile old, outdated A/R. Generate the accounts receivable credit balances report and settle with patients owed money.

- Ensure business operations systems are in order. If they are not at an acceptable level per industry standards improve those systems before selling. For example:
 - Past due recall patients at 10% of the active patient base
 - Outstanding A/R should be no more than 100% of the monthly gross production.
 - 90-day accounts receivable should be 10% or less of the overall A/R
 - Generate unscheduled treatment plan report for 90 days, six months and develop a follow-up strategy.

The Executive Summary and Report

The final Executive Summary and Report delivered to the prospective purchaser should not be opinion-based but fact-based utilizing industry standards. The results of the report should provide data of how the current operational systems compare to industry standards. The report should identify existing revenue opportunity available to the purchaser. The report should help the purchaser define the impact of any business management decisions after the purchase.

The purpose of a practice evaluation is to provide the buyer with a comprehensive understanding of what they

are purchasing. The buyer's accountant provides a valuation of the purchase price. However, it is important to review and compare the practice management reports to the tax returns and profit and loss to make sure they reconcile. When comparing these two documents the biggest discrepancy often found is in the adjustments to collections reports.

Information the seller provides to the broker is important to the prospective purchaser. However, the most important information is the data captured from the seller's own historical data from the software, the accountant, and the demographic report. This data is the buyer's insight into the practice's reality and potential for continued success.

Communication and analysis is the key to the successful acquisition of a practice. The seller may be going through a bittersweet experience. The seller may have built the practice from the ground up over 20, 30 or 40 plus years. It can be difficult to relinquish such history. The buyer's purchase is likely the single biggest investment in their career. Patience of both parties is critical during such an emotional process such as a practice sale and acquisition.

Notes on contributor

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