



Financial Due Diligence is a Must!

Making the decision to pursue the purchase of a dental practice can be stressful. That stress level will only increase if you don't surround yourself with a team of professionals that understand the dental business and what is involved during the purchase process. Your team of professionals – CPA, attorney, dental management consultant, and dental lender – are there to support you and to help keep you from making uninformed decisions.

Once you've identified the desire to own your own dental practice, you should consult a bank specializing in lending to the dental community. Ideally you've kept your credit score high, even though you are likely to have several hundred thousand dollars of student loan debt. Dental lenders understand that you are saddled with this debt. It is probably not a great idea, though, to tack on a sports car loan and a recent purchase of a million dollar home. These items will reduce your ability to repay a loan when the debt to income ratio is applied. Careful planning with your dental CPA can enable you to obtain these things in due time. Once the bank pre-approves you for a loan, you are ready to start your search.

Ideally you will want to live in the area where you will be practicing. It is always a great idea to get involved in the community by way of rotary clubs, houses of worship, and even the soccer field. Don't underestimate the value of being able to market through your child's youth sports club.

Your dental CPA should be contacted once you've identified a practice you are interested in. You will most likely have access to only a couple of tax returns and a current profit and loss statement for the dental practice prior to making your offer. This is usually enough information to make a reasonable offer based on the cash flow analysis. Once the offer is accepted, you will have access to the information necessary to perform the financial due diligence review.

It is important to remember that this is also the time to consult with your attorney and dental management consultant. However, I will focus this article on the financial due diligence.

One of the contingencies set forth in the letter of intent (the offer) is the CPA's review of the books and records. It would be comparable to having a home inspected prior to purchase. There could be leaks in the roof and an unstable foundation that can't be seen by just looking. A professional is needed to uncover these issues.

The following items are usually looked at during the financial due diligence:

- Business tax returns
- Profit and loss statements
- Year to date general ledgers
- Bank statements
- Production/collection reports
- Payroll reports
- Fee schedules
- Accounts receivable aging

Your CPA will generally ask for the prior 2 – 3 years tax returns, as well as profit and loss statements for the same

periods. These tax returns and profit and loss statements are used to evaluate the true net income of the dental practice. The true net income begins with net income on the tax returns and profit and loss statements and adds back items that won't necessarily pertain to you as the owner. These items may include officer salaries, auto expense, retirement contributions, depreciation, and interest expense. The profit and loss statements will generally give more information as the tax return tends to group expenses, making it more difficult to pull out personal expenses. For example, staff wages are shown on a certain line of the tax return. The profit and loss statement, however, may separate out hygiene wages, and wages paid to family members, allowing the CPA to get more information about the practice.

The year to date general ledger gives even more detailed information about the practice. This report shows all the detail within a specific income or expense account. For example, utilities expense may show more than one payment per month to the electric company. That may mean the seller is running his or her home utilities through the dental practice. Being able to see these personal expenses only increases the true net income of the dental practice.

Certain key expense markers can be analyzed to be sure they are consistent with norms for the industry. When the review shows any of these expenses to be inconsistent with industry norms, questions can be asked as to why and appropriate adjustments can be made.

The bank statements are analyzed to be sure that all income reported on the tax return made it to the bank account. The CPA can usually find transfers of money as well as other unusual deposits by looking at the bank statements. It is hopeful that the bank statement deposits tie to the tax returns and profit and loss statements. If there is a small discrepancy, it can usually be attributed to timing of deposits. If there is large discrepancy, then questions must be asked of the seller.

Production/collection reports are internally generated by the seller's dental software system. It is preferable to see the production by procedure report so the CPA can look at what procedures are performed and by whom. The report may show that some procedures may be referred out by the seller when the buyer can perform these same procedures with ease. That would indicate the potential for immediate growth within the practice. The reports will also show if the hygiene department is performing an appropriate amount of perio maintenance. This report will also give us an idea of what percentage of the production is actually collected. Practices with PPO plans and capitation plans will show a much lower collection ratio than a fee for service practice. The collections report is also analyzed to be sure it ties to the deposits reported on the bank statements.

The payroll reports are looked at to be sure the totals tie to the expenses deducted on the tax return. They are also looked at to determine if there is continuity with the staff. It is beneficial to see the same names each year on the W-2s. These reports will also show if family members are paid. If they are paid from the practice, but not providing a function to the office, then you can add this back and increase the true net income. On the flip side, if a spouse works in the office and you notice there is no W-2 for them, then you will have to consider if this position needs to be replaced with a salaried employee, thereby reducing the true net income of the practice.

The fee schedules can be reviewed to determine if the fees charged are customary in the area. If they are lower than average, it is not advisable to raise them immediately, but over time and adjustment or two to the fee schedule would increase collections without incurring additional overhead.

Lastly, take a look at the current aging of accounts receivable – even if you are not purchasing the receivables. This report will give an idea of the collection procedures of the office. A higher than average accounts receivable may indicate lenient collection policies in the office. Also look for patient credit balances. These must be cleared by the seller prior to closing.

An idea of the financial health of the dental practice can usually be determined by a due diligence review. You will want to have some kind of idea of what you can reasonably expect to make once you purchase the practice. Keep in mind, however, that a due diligence review is based on historical financial information of the practice. Although it may check out historically, there is no guarantee that you will achieve the same results. It is therefore imperative that you continue with your team of dental professionals to teach you not only how to work IN your practice, but also how to work **on** your practice. Often times dentists like to focus on what they know – dentistry. This can come at the expense of the business side of the practice. Your dental professionals can help you with all facets of business ownership.

Once the review is complete, the buyer needs to make the decision to either pursue the practice, or move on. Remember that, no matter what the review determines, your gut feeling of whether or not to move forward is invaluable and must not be ignored!