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SEPTEMBER 2013

The hidden risks in health care M&A

Addressing challenges from compliance, reimbursement and post-payment evaluations in the post-PPACA environment

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Executive summary

Acquisition activity in the health care sector is expected to persist as more provisions of the Patient Protection and Affordable Care Act (PPACA) are implemented. Declining reimbursements, combined with an overall rise in health care costs nationally, are creating an incentive to gain scale through consolidation.

Merger activity has captured the attention of both private equity and strategic investors. Health care providers have been among the most favored acquisition targets in recent years, a trend that is likely to continue. Health care deals had an aggregate value of $98 billion in 2012[1], and underlying factors continue to drive M&A activity.

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The merger activity in the health care space underscores the significance of due diligence in identifying factors and key risks that can undermine a transaction's value after a deal closes. Too often, these risks are considered secondary to the evaluation of a target's enterprise value.

However, by applying proper due diligence techniques, buyers and sellers can identify obstacles to a transaction, and implement strategies and solutions to minimize the risks.

The highly fragmented nature of many subsectors within the health care industry has resulted in a focus on consolidation of smaller companies. Due diligence solutions for these transactions will become even more valuable. Such companies are less likely to have stringent controls and processes for governing coding, documentation and billing, commonly referred to as revenue integrity. Acquirers will need to identify and address these and other new aspects of deal risks brought on by the implementation of health care reform.

PPACA and incentives for consolidation

The changes injected in the health care industry by the implementation of the PPACA continue to drive merger activity. Deal activity in 2012 remained at about 1,280 transactions, the same level as 2011.The concern about declining reimbursements and rising costs is driving consolidation among health care companies.[2]

With the 2012 Supreme Court ruling on health care reform, much of the uncertainty surrounding the implementation of new programs is beginning to clear. This may lead to an increase in deal activity and transaction values, as many pent-up transactions that were awaiting clarity on the PPACA begin to move forward.

The importance of revenue integrity

In evaluating potential acquisition targets, equity firms often focus on the traditional assessments for evaluating a deal, such as targets' profitability, efficiencies and synergies. Too often, important criteria for revenue integrity either get overlooked or are seen as secondary to more prominent financial considerations. Failure to address this can undermine the value of a transaction.

Careful due diligence can identify those primary sources of potential risk unique to the health care industry. Spotting these potential obstacles early in the process can enable buyers to account for their potential impact or to change acquisition strategies before the terms are finalized. Ultimately, identifying revenue integrity issues early can prevent a deal from unraveling.

[1] "Reviewing the 2012 health care industry," *Health Care M&A Snapshot*, Grant Thornton Corporate Finance LLC, March 2013. See www.grantthornton.com/issues/library/whitepapers/health-care/2013/HC-2013-Review-of-2012-health-care-M-and-A.aspx.

[2] *Ibid.*

Coding, billing and compliance

For the buyer, gaining an accurate assessment of a target's coding and billing practices is vital to establishing revenue integrity and proper valuation.

Most transactions are priced based on a multiple of historical earnings and the potential for future growth. Practices such as "up-coding," in which a seller may inflate or alter procedure codes for services provided to drive up billings, can quickly undermine a deal's value. Because it affects earnings, up-coding can artificially overstate how an acquired business may look going forward.

It also can leave the buyer exposed to fines and civil penalties, especially if the up-coding involves Medicare or Medicaid billing. In the worst case, consequences can become the equivalent of a "scarlet letter," resulting in criminal sanctions or a prohibition from participating in programs that receive funding from the federal or state government. Providers that face these sanctions may also find themselves barred from hospital privileges or other clinical activities.

In conducting due diligence into billing and coding issues, Grant Thornton examines a provider's infrastructure, gaining an understanding of the people and processes, then compares it against the compliance guidance outlined by the U.S. Department of Health and Human Services.[3] These criteria include development of written standards of conduct, designation of compliance officers or committees, development of employee training programs, audits to monitor compliance, and the investigation and remediation of problems. We determine not only that the target meets the guidelines but also that it is effective in doing so.

In one recent transaction, a private equity firm hired our team to conduct financial and operational due diligence in the firm's acquisition of an occupational medical provider. Our team analyzed the billing and coding — including the target's annual claims billing — against industry benchmarks.

Case study: Due diligence for growth capital

Our client, a private equity firm, wanted to acquire an occupational medicine provider that was seeking investors to expand its operations outside of its home state.

The equity firm hired Grant Thornton to conduct operational and financial due diligence. We interviewed stakeholders and studied the provider's revenue integrity processes by reviewing its billable services, documentation, and coding and billing practices. This gave us an understanding of the provider's methods for coding assignment, regulatory compliance monitoring, compliance education, and awareness activities and issues resolution. We examined annual claims billing statistics and compared them with coding patterns for other clinical practices, as well as state and federal regulatory bodies.

As part of the evaluation process, the Grant Thornton team collected samples of unique records at each of the provider's locations. Certified coders and compliance experts studied these documents to determine consistency and conformity with billing rules. This allowed us to spot any overcoding or undercoding at each location.

Our evaluation found that the provider was overcoding, and therefore overbilling, for its services at all of its locations. The provider's stakeholders, as well as its internal and external auditors, showed a lack of understanding of coding rules, and the provider lacked an appropriate evaluation and feedback process.

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The overbilling reduced the provider's value and potentially exposed our client to the risk of fines and civil penalties. Based on our finding, the client decided to terminate its pursuit of the provider.

[3] "Compliance Program Guidance for Hospitals," *Federal Register*, Department of Health and Human Services, Office of Inspector General, pp. 8987–8998, Volume 63, Number 35, Feb. 23, 1998. See http://oig.hhs.gov/authorities/docs/cpghosp.pdf.

Based on our findings, we determined the company was up-coding, and therefore, overbilling. The findings showed that both internal and external audits had been ineffective and compounded the poor understanding of coding rules.

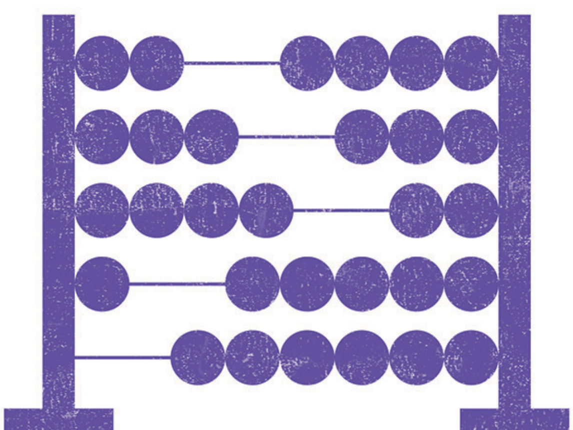
The up-coding was substantial enough that it negatively affected the provider's value, and it might have exposed the client to fines or civil penalties, had the transaction been consummated. Based on these risks identified through due diligence procedures, the client decided to terminate the deal. See "Due diligence for growth capital."

In a similar situation, we represented a private equity group (PEG) that wanted to acquire a chain of urgent care centers in the Mid-Atlantic region. Our team was retained to assess the target company's revenue integrity.

It was found that the target was consistently overbilling across all its locations because of consistent, widespread up-coding within the company. While the problems resulted from a lack of understanding of proper coding rules, they were significant enough to impact the transaction's value. What's more, the provider refused to report the billing errors to regulatory authorities or to escrow sale proceeds to cover potential fines and penalties.

The lack of regard for coding compliance prompted our client to terminate the deal. See "Analysis of financial performance, and regulatory and compliance matters."

Of course, inaccurate billing also can work to the buyer's advantage. Though less common, underbilling can drive down an acquisition's value and give the buyer an opportunity for cost savings by adopting proper coding procedures once the acquisition is completed.



Case study: Analysis of financial performance, and regulatory and compliance matters

Our client, a private equity firm, wanted to invest in an urgent care center chain with multiple locations in the Mid-Atlantic region. The provider sought outside investment to fund its growth.

The equity firm hired Grant Thornton to conduct operational and financial due diligence, which included an evaluation of the provider's billable services, documentation, and coding and billing practices. We also evaluated the provider's legal compliance, physician leadership and clinical operations to gain a deeper understanding of its revenue integrity processes. This enabled us to examine the provider's methods for coding assignment, compliance monitoring, coding and billing, and issue resolution.

We conducted interviews with stakeholders involved in medical and billing documentation, and we collected samples of unique records at each of the provider's locations. Certified coders and compliance experts checked the coding and billing practices for consistency and compliance with coding rules. This enabled us to spot any overcoding or undercoding.

Based on our findings, the equity firm found the provider was overcoding, and therefore overbilling. The coding issues were consistent across the provider's operations and stemmed from a poor understanding of coding rules by all stakeholders. The provider also lacked proper evaluation and feedback from its internal and external auditors.

When confronted with these findings, the provider refused to report the billing errors to the appropriate regulatory authorities and would not agree to escrow sale proceeds to cover potential future fines or civil penalties. Because of the provider's disregard for compliance, our client decided to terminate its pursuit.

Financial and operational analysis

Strategic buyers typically are looking for cost savings through synergies, economies of scale or other financial benefits of consolidation. Depending on the nature of the deal and the companies involved, these synergies can be found through careful due diligence. Back-office operations, for example, may yield significant cost savings in finance, administration, purchasing or other parts of the business. Reducing head count often generates significant cost savings in a transaction, regardless of the target's size.

With careful analysis, consolidation also can offer significant cost benefits through economies of scale. Consolidation efficiencies may include reduced vendor pricing based on increased volumes.

Financial buyers, meanwhile, tend to focus on opportunities for improving an organization quickly, perhaps by adding more senior management oversight or implementing cost management procedures. Proper due diligence can identify duplicative functions or operations such as R&D, back-office support and administration.

Regardless of the nature of the buyer, financial and operational due diligence can identify potential obstacles to a deal's success.

For example, the Grant Thornton team was brought in by a financial buyer — in this case a PEG — that was pursuing a large urgent care provider in North Carolina. Due diligence performed on the target's operations included accounting functions, environmental and tax compliance, operational audit and examination of IT systems.

Our work identified the target as using incorrect contractual adjustment percentages that were affecting revenue. What's more, the provider had no allowance for doubtful accounts, and its revenue was concentrated in only a few locations. That indicated the provider was using the profitable care centers to subsidize unprofitable ones.

Case study: Evaluation of financial performance and tax exposure

Our client, a private equity firm, wanted to acquire an urgent care provider in North Carolina that had multiple locations.

The equity firm hired Grant Thornton to perform financial and tax due diligence, which included analyzing the provider's operating earnings and examining its accounting, compliance and tax processes. We also evaluated the provider's operations and IT systems. The operational analysis included examining the provider's controls and assessing its billing and coding practices. In addition, we collected and tested a sample of transactions to determine the accuracy of its billing and coding.

The IT evaluation focused on assessing the provider's current technology and identifying shortcomings such as underinvestment or technological limitations of its systems.

Our finance work found that the provider was using incorrect contractual adjustment percentages that affected net revenue. No allowance was recorded for doubtful accounts, and much of the provider's financial information was dubious because its financial functions were manual and unsophisticated.

Revenue and operating earnings were concentrated in a few locations, which indicated that a few profitable care centers were subsidizing other unprofitable ones.

Revenue and operating earnings were concentrated in a few locations, which indicated that a few profitable care centers were subsidizing other unprofitable ones. Our billing and coding evaluation found that the provider was not taking full advantage of its billing system and that it lacked competently trained coding staff. It also had insufficient controls to comply with regulatory requirements. As a result, the provider was overbilling, which could expose our client to fines and civil penalties.

The target's lack of adequate internal controls resulted in overbillings that could have exposed it to fines and penalties.

In addition, our tax diligence identified a potential liability relating to misclassifying physicians as contractors instead of employees and failing to withhold appropriate taxes.

Our client decided to move forward with the transaction but structure the deal to minimize potential exposures from the provider's practices. Our assessment of the target's shortcomings became a road map for mitigating the issues. See "Evaluation of financial performance and tax exposure."

Pulling all these aspects of due diligence together not only presents a clearer picture of revenue integrity but also helps determine the valuation of a transaction.

Proper due diligence can offer similar benefits for strategic buyers. In fall 2012, the Grant Thornton team was engaged to conduct due diligence for the combination of two community health care systems. The two systems sought improved access to capital and physician networks. Valuation hadn't been determined at the time Grant Thornton was engaged.

Case study: Evaluation of financial performance and tax exposure (continued)

We identified areas in which our client could improve the provider's coding efficiency. The IT evaluation found significant opportunities to enhance the provider's technology and calculated the cost for these improvements. Our tax examination found transfer pricing exposure between the provider's centers. We also found that the provider was misclassifying physicians as contractors, rather than employees, and therefore wasn't properly withholding taxes from their paychecks.

The deal was structured as an asset transaction to reduce the risk of potential exposures to our client.

Despite these findings, our client decided to proceed with the transaction. The deal was structured as an asset transaction to reduce the risk of potential exposures to our client. Our findings served as a guide for addressing the issues, and Grant Thornton remains involved with the client in an advisory role.

Our scope included financial and tax due diligence, as well as assessments of billing and compliance, IT and HR. Our procedures evaluated the operational impact of a recent acquisition and nonperforming segments of the businesses such as its home health care and physician group operations.

We also assessed the systems' not-for-profit status and the technology environment for data security, and evaluated HR issues such as pension funding, executive compensation and the impact the merger would have on existing benefit plans.

Our findings were used as an independent evaluation of the boards' internal assessment of the target, and they ultimately were used to support the negotiations as the deal moved forward. See "Identifying risks and red flags for merger negotiations."

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Case study: Identifying risks and red flags for merger negotiations

When two community hospital systems were considering a merger, they hired Grant Thornton to conduct due diligence for the transaction. At the time, relative valuation had not been determined. However, our client and a potential acquirer had committed capital to assist one of the health care systems with two delayed capital projects that totaled about $20 million.

By combining, the health care systems hoped to improve their access to capital and physicians' networks.

Our due diligence identified five disciplines for evaluation: financial, tax, billing and compliance, IT and HR.

As part of this process, the Grant Thornton team:

- analyzed the impact of recent acquisitions, including their accretive or dilutive effects on the overall operations of the health care system;
- examined nonperforming parts of the system, including home health care and physicians' group businesses;
- conducted tax due diligence that included assessing the system's not-for-profit status and an evaluation of any pending or ongoing investigations or examinations by taxing authorities;
- performed a high-level analysis of the billing and compliance program;
- evaluated and tested the IT systems, which included a readiness assessment, system capacity, environmental monitoring, data security and other matters; and
- audited the system's retirement and benefit plans, which included determining the funded status of the pension, an evaluation of the executive compensation program and other matters that could affect the status of the benefit plans once the transaction closed.

Our findings were used as an independent evaluation of the boards' internal assessment of the target, and they ultimately were used to support the negotiations as the deal moved forward. In this instance, due diligence provided comfort that the target had no significant issues that would impact valuation or the decision to move forward.

Smaller company impact

As the merger activity in the health care sector encompasses smaller companies, using due diligence to assess revenue integrity will become even more important. In evaluating companies that may have fewer internal controls or less understanding of coding and compliance requirements, the need to spot potential obstacles that could undermine a deal's value is crucial.

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In one recent transaction, our team advised a provider of physician and management services on the East Coast in a transaction in which it was acquiring a similar business in the Midwest. Both companies offered fee-for-service contracts to hospital systems.

The buyer hoped that the combined company would have a bigger market share and a broader geographic reach, enabling it to capitalize on hospital outsourcing trends.

We were brought in to assess the target's financial performance and validate its earnings, ensuring the transaction was fairly priced.

The target had never been audited, and we found several adjustments were necessary to bring the target into compliance with U.S. GAAP. In several instances we identified revenue and receivables reporting that was inaccurate or inconsistent with the client's methods.

We found that the expected cost savings may not be achieved as a result of the discrepancies. With a deeper understanding of the target's earnings, the client was able to negotiate the valuation down and successfully complete the transaction. See "Evaluating revenue integrity."

Case study: Evaluating revenue integrity

Our client was a provider of outsourced physician and management services that worked with hospital systems on the East Coast on a fee-for-service, low-subsidy contracted basis.

Our client wanted to acquire a similarly structured company that provided staffing and management services in the Midwest. Our client pursued the transaction because management believed the combined entities would become a market leader, benefiting from economies of scale and complementary capabilities created by the transaction. The combination would enhance the market position and geographic reach of both providers and enable them to capitalize on industry trends of outsourcing by hospitals.

We were hired to perform financial due diligence, conducting a high-level analysis of the billing and coding compliance of the target company, validating its reported earnings and ensuring our client's valuation of the business was based on sound, credible information.

The target company had never been audited by an outside accounting firm. Our client wanted us to ensure the target's accounting methods were consistent and in compliance with GAAP. We also were asked to determine if the reported earnings were valid and recurring, and whether the target's financial records were reliable.

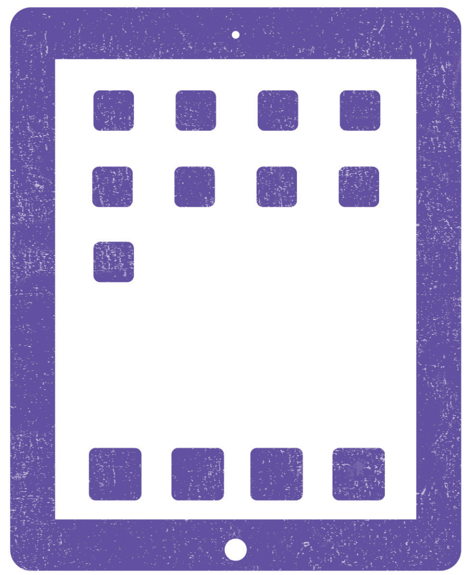
We found several adjustments to reported earnings and identified accounting practices involving revenue and receivables reporting that were inaccurate and inconsistent with the way our client accounted for the same transactions.

Our client had hoped to reduce its own third-party billing costs by using the in-house billing operations of the target. Our discovery of the revenue and receivables reporting issues indicated our client might not be able to generate the savings as quickly as it had hoped. As a result, we were able to warn the client that it might need to reconsider some of its expectations for savings from the transaction.

Thanks to our evaluation, our client had a better understanding of the financial and accounting issues at the target and was able to adjust its valuation. The transaction successfully closed by the deadline set by both parties.

Conclusion:
Preparing for a transaction

Companies that want to minimize the impact of potential obstacles to a transaction should consider several possible steps to resolving revenue integrity issues that could arise. For buyers that discover revenue issues, options include these:



- **Voluntary disclosure:** If deficiencies such as up-coding or overbilling are uncovered, the buyer can compel the target to disclose the issues, pay any penalties and change its procedures.

- **Escrow:** A buyer can negotiate an escrow fund to cover potential repayments. It can then self-report the deficiency to the appropriate regulatory bodies proactively and propose solutions.

- **Phase 1 financial due diligence:** Buyers can initiate interviews with a target's management to identify areas of potential "red flags" such as weak internal controls, poor issue identification and mitigation, and a lack of proactive monitoring.

Sellers, meanwhile, may consider sell-side due diligence. By examining its own accounting function, IT environment, tax compliance and compensation policies prior to going to market, a health care provider can reduce the risks that can affect valuation.

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