



Financial Due Diligence in Purchasing a Dental Practice

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ABSTRACT Purchasing a dental practice can be a minefield. The office you are looking at could be the most beautiful office with all of the newest technology. But if it is not profitable, it will be a nightmare. This article will help navigate what the dentist and his or her CPA should be looking at when reviewing the books and records, based on the author's experience of reviewing more than 400 dental practices on behalf of buyers.

AUTHOR

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You've found the perfect dental practice. Five fully equipped treatment rooms, digital X-ray, and a networked intraoral camera system. The office is on a main street in the town you grew up in and where you now live, so many of the people who watched you grow up will probably become your patients. Sounds great but you have some work ahead of you.

In this article, the author covers the due diligence one needs to do to review the books and records. This could be the greatest-looking practice on the face of the earth, but if you are not making the money needed to pay bills, it might not work.

As a dental CPA who has evaluated hundreds of dental practice books and records for potential buyers, the author will focus on three areas:

- Review of management information,
- Bank deposit analysis, and
- Cash flow and profitability.

Management Information

Before beginning this area, the author would like to emphasize that it is critical one hire a qualified dental management consultant to assist in reviewing the systems in the office such as recall, scheduling, financial arrangements, etc.

From the author's perspective, it is important to assess (independent of the consultant) at what type of practice the dental CPA is looking.

The dental CPA wants to know whether this is a fee-for-service practice, includes PPOs, HMOs, and/or capitation programs. For example, if the practice does \$1,000,000 of dentistry that includes \$300,000 from an HMO plan, it is

important to determine the actual amount of production for the \$300,000 the dentist is receiving using their UCR fee schedule. For example, it is important to know if the \$300,000 really represented \$550,000 of dentistry using your usual fee schedule. That would mean that if one bought the practice, one would be paying overhead on \$250,000 of dentistry that you would not be receiving payment on (\$550,000 of production using your fee schedule less the \$300,000 the dentist will actually receive). That has to be taken into consideration in doing a valuation of the practice and determining the true net profit of the practice.

The dental CPA also wants to see the mix of procedures. What percent of the practice is operative, restorative, and hygiene? Many sellers do not, for example, perform endodontic procedures. If the seller does this, this could be an immediate boost to the practice. Also, one needs to see if one is capable of keeping the production at the level the seller has reached. Ask the seller how long he or she takes to prep a crown or bridge, and how long they spend on a new patient exam.

The dental CPA would like to review the fee schedule. Many times fees are lower than customary in the area. Even if this is the case, the author strongly urges the dentist to wait at least a year until settled into the practice before raising fees.

Bank Deposits

To verify the deposits of the practice, the author performs the following functions:

- Reviews the practice computer report for collections;
- Compares that to the monthly bank statements (here the dentist needs to take out transfers between accounts and any personal deposits made to the practice);
- If possible the dentist should get a copy of the general ledger prepared either

by the practice CPA or by the client, usually in Quicken or QuickBooks and review the collections in this program; and

- Finally, compares the first three to the tax return.

This gives the dentist four independent sources to compare deposits. It is not unusual to find in all cases that there will be differences. This is generally due to the timing of deposits. For example, the practice might be closed the week between Christmas and New Year's Day. The collections could show up on the computer

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reports, but because the office is likely on vacation, these deposits might not be made until January. The author feels that if all these numbers are within 2 percent of each other, he is confident that the collections are correctly represented. Any major discrepancies should be investigated.

Cash Flow and Profitability

The final step in the due diligence process is to review the financial statements, tax, and payroll returns.

The author starts with the net profit from the tax return or profit and loss statement. Then the true net profit of the practice is calculated by adding back items that are deductible for tax purposes but are not necessary to run a dental practice, such as owner's insurances (health, disability, and life), auto expense, travel, meals and entertainment, pension and profit-

sharing contribution. If the seller is incorporated, the seller's salary is added back in.

If the dentist's spouse and/or children are on the payroll, the dentist needs to ask if they are working in the office or not. For example, if the dentist's wife is on the payroll and earning \$40,000 a year, and she is a full-time employee in the office, one cannot add her salary back to the profit as her position will need to be filled.

If she is the only front office employee, one must request that she stay for a reasonable transition period, usually three to six months.

The author also recommends asking the seller if there are any items written off through the practice that are more personal in nature. This is a very sensitive area so one must have discussions with the seller and his or her CPA regarding this.

The author also likes to look at key percentages, which gives an indication about the practice:

- Are staff salaries (not including hygiene) at or above the average of 18 percent to 20 percent of revenues? This could mean, for example, if the percent is low, that the dentist's wife is working full-time without drawing a salary (recommended in many instances to save payroll taxes). If the percentage is too high, is the practice overstaffed or underproducing?

- Lab expenses should run 8-10 percent unless there is a CEREC machine, which cuts that to 2-4 percent. If the lab expense is low, this indicates more operative procedures are being done so the seller might be conservative in diagnosis. If this is the case, and the dentist is more aggressive in diagnosis, one must be careful not to intimidate new patients right out of the gate.

- Dental supplies should run 5-6 percent; rent 5 percent. Also, one should look at what type of marketing is done. A mature practice should be getting most

of its referrals from internal marketing. If no internal marketing program is in place, this is an area which, for very little cost, one can grow the practice.

Lastly, the author has a rule as an adviser for a buyer: the 75 percent rule. This rule states that 75 percent of any major life decision: getting married, buying a house, or buying a business is in one's gut. If, when one sees and reviews the practice, everything feels really good, and the numbers look good, buy the practice. On the other hand, if it does not feel like the right location, production mix, or that it isn't right for any reason, do not purchase it.

Happy practice hunting. ■■■■

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