MSG ACCOUNTANTS, CONSULTANTS & BUSINESS VALUATORS

PHYSICIAN
AN INDUSTRY STUDY

Things you will learn from this whitepaper:

1. How does the government's healthcare policies affect the practice of medicine?
2. What are the economic outcomes from increased malpractice insurance costs?
3. What other industries have a meaningful impact on physicians?
4. How has consolidation affected the practice of medicine?

This whitepaper will have special interest to:

1. Attorneys consulting with physicians.
2. Judges presiding over malpractice, business disputes, & litigation cases.
3. Business mediators & arbitrators.
4. Those concerned with the valuation of physician medical practices.

Notice & Disclaimer

In a forensic accounting setting, the purpose of an industry analysis is to allow a comparison of the subject company to its industry. This comparison is vital to assess the strengths and weaknesses of the subject company, as well as its industry and company specific risks.

The following study contains a brief, selected analysis of the specified industry. It is based upon a review of current economic statistics, articles in the financial press, reviews found in current business periodicals and information posted on numerous internet sites. It does not purport to be all-inclusive or to contain all of the information which a prospective investor or lender may require. Projections and opinions are based upon information provided by third parties. We make no representations or assurances that this information is complete or accurate. Neither Mark S. Gottlieb, CPA, PC nor any of its officers, employees, or representatives make any representation as to the accuracy of completeness of this report or its contents, nor shall any of the foregoing have any liability resulting from the use of the information contained herein or otherwise supplied.

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Industry Overview

Of the 195,000 physician offices in the U.S., the vast majority are small with fewer than 10 employees (including doctors). Around 13,000 offices have more than 20 employees, and 1,000 have more than 100 employees. In total, physician offices produce revenues of $200 billion and comprise 37 percent of all medical specialties offices. The average annual revenue for offices is slightly less than $1 million. Most physicians see over 100 patients each week, with general and family physicians averaging slightly more than specialists.

Approximately 112,000 physician offices are staffed by primary care medical doctors. Physician offices average seven employees, and employ 797,526 staff persons overall. According to the U.S. Department of Labor, Bureau of Labor Statistics, healthcare practitioners and technicians may be categorized as: 66,700 family and general physicians; 42,420 surgeons; 41,370 general internists; 19,500 anesthesiologists; 18,200 general pediatricians; and 13,970 obstetricians and gynecologists.

Physician and clinical services account for 22 percent of total health care expenditures in the U.S., behind hospital expenditures (31 percent). Primary care offices in particular are tools of economic development, both in rural and urban areas. Annual revenue per employee is close to $100,000, but is generally higher for small offices and lower for large ones. This apparently odd trend reflects the tendency of larger offices to staff more lower-paid, clerical employees.

Operations

Some physicians practice privately, though most join other practitioners who may or may not practice similar specialties. Offices with a mixture of specialties are more common in smaller communities. Many physicians and surgeons prefer to join group practices as backup coverage is affordable, overhead expenses are minimized, and consultation with peers improves service and enhances flexibility. Group practices may be owned by the practicing physicians, by a health maintenance organization (HMO) or preferred provider organization (PPO).

While general practitioners deliver most treatments in-office, surgeons use offices for consultation but deliver treatment in hospitals. The type of patient care a physician provides depends partly on his or her area of expertise, partly on advances in diagnostic and treatment knowledge, and partly on the payment plan held by the patient. Some offices contain basic laboratory and x-ray equipment, but sophisticated testing is usually contracted to hospitals and independent labs.

A typical physician office works with one hospital and refers patients to that hospital for tests and treatment. For this reason, the relationship between doctors and hospitals is often regarded as a buyer-seller relationship, where, in the manner of pharmaceutical companies, hospitals approach local doctors for business.

Some diagnostic and laboratory procedures may be performed in physician offices, however, bypassing the need for outsourcing while increasing office revenue. The American Family Practice Association (AFPA) has compiled a survey of procedures commonly carried out in physician offices, listed by percentage of offices offering such services:

- Fecal occult blood: 92.5 percent
- Urine pregnancy test: 91.4 percent
- EKG: 88.4 percent
- Dermatology procedures: 86 percent
- Rapid Strep: 86 percent
- Endometrial sampling: 66.6 percent
- Spirometry: 56.3 percent
- Audiometry: 49.8 percent

Daily operations at physician offices involve patient care, appointment scheduling, recordkeeping and insurance-payment processing. Typically, a patient makes an appointment several days or weeks in advance and medical records are retrieved and reviewed by the appropriate doctor. At the time of the appointment, the patient sees the doctor for ten or twenty minutes, wherein the doctor makes an evaluation. He or she may then order tests or prescribe treatment, which are entered into the medical record. The cost of the visit is then billed.

Participation in medical insurance plans is a necessity for most physician offices, as only 12 percent of payments to doctors come directly from patients. Nearly 50 percent of payments are covered by private insurance plans, and 33 percent come from government plans, like Medicare and Medicaid. Administration of physician offices is wholly computerized, and most offices use software created specifically for medical office management. Appointment scheduling and insurance billing have been streamlined, and medical records are easily retrieved and updated via computer technology.

Organization & Structure

This industry is most easily organized by the type of practice or medical specialty performed at each office. Since the mid-1980s, managed care organizations such as HMOs and PPOs have forced practice consolidation through the negotiation of favorable managed care contracts. Many physicians merged with larger medical groups or sold their practices to hospitals, and the proportion of physicians with managed care contracts increased from 56 percent in 1986 to over 90 percent today, with little variation between specialties. Despite the proliferation of larger medical groups, however, small offices can compete very effectively with large ones if the expertise or reputation of their doctor or doctors is high.

Of physicians who sold their practices in the past decade, most received generous compensation. Specialty and multi-specialty practices command the highest median value, and more than 80 percent of physicians who sell their practices receive bonuses for several years thereafter. The largest number of physicians who sold their practices at the onset of HMOs and PPOs were primary care physicians, especially family physicians and internists.

Workforce

Prospects are bright for job opportunities in physician offices, as the next decade should see a large number of retirements. Tougher immigration rules are slowing the number of foreign health care workers entering the country, and advances in medical technology will continue to improve the survival rate of severely ill and injured patients. New technologies will also make it possible to identify and treat

conditions that were previously untreatable. It appears inevitable that group physician practices as well as integrated health systems will become larger and more complex, increasing the need for office and administrative support workers. With rising demand should come rising pay: according to the U.S. Department of Labor, Bureau of Labor Statistics, wage and salary employment in the health care industry is projected to increase 27 percent through 2014, compared with 14 percent for all industries combined.

Government Programs

Medicare and Medicaid— Medicare and Medicaid, jointly passed by the Lyndon B. Johnson administration in 1965, offer financial assistance for medical treatment. To qualify for Medicare, individuals must be at least 65 years of age, disabled, or have End Stage Renal Disease (permanent kidney failure requiring dialysis or replacement). Medicaid is designed for low-income parents, children, seniors, and, in some cases, people with disabilities.

These programs are funded by both federal and state sources, primarily through Social Security payroll taxes. Although their names are similar, Medicaid and Medicare are very different programs: Medicare is an entitlement program, while Medicaid is considered a form of social welfare. Dealing with Medicare and Medicaid patients is an essential task of physician offices, as with the health care industry at large.

While both programs cover similar groups, there are important differences between them. For example, Medicaid covers a wider range of health care services than Medicare, and Medicaid does not have premiums, deductibles, and co-pays like Medicare, making paperwork somewhat simpler. Currently, 55 million people received Medicare and Medicaid payments. About 6.5 million Americans are enrolled in both Medicare and Medicaid (known as “dual eligible”). Physicians must take care to file these claims correctly.

In addition to adding administrative and paperwork responsibilities to physician offices, Medicare and Medicaid set costs for medical services, thereby functioning as industry regulators. Currently, the U.S. government supports over $300 billion in Medicare and Medicaid expenses annually, and 33 percent of physician office insurance claims are filed to these two programs.

Malpractice Insurance

The cost of medical malpractice insurance began to rise at the beginning of the 21st century, after a period of essential stability. Though the overall number of claims has increased only modestly, the average dollar amount of each claim is sharply on the rise, growing at a rate of 7.5 percent annually. In 2005, medical malpractice costs totaled over $30 billion.

Due to this proliferation of malpractice costs, the practice of “defensive medicine” has increased considerably. Physicians have become more likely to order duplicate tests, request additional diagnostic procedures, and utilize consultants. A recent AMA survey revealed that over 76 percent of physicians are concerned that malpractice litigation has compromised their ability to provide quality care to patients. It is estimated that the elimination of defensive medicine costs would save $70 to $110 billion annually.

According to a study by the Health Research Group of Public Citizens, the most common complaints against doctors are for negligence, mis-prescribing drugs, and substance abuse by physicians. Obstetricians and gynecologists are among the doctors most commonly sued for medical malpractice, though malpractice litigation is a universal concern among physicians. Doctors working in smaller offices have less exposure than their cohorts in large hospitals, as hospitals tend to hold higher insurance coverage. Consequently, many claims are directed at hospitals in the pursuit of higher awards.

Malpractice liability insurance cost physicians over $6.3 billion in 2005, and is expected to increase commensurate to rising awards in the coming decade. This trend is a major concern for most physician offices, and the AMA has put forth proposals to curb litigation in an attempt to make malpractice liability insurance more affordable. These include:

Efforts to expand the number of states with pretrial screening panels. Currently about 30 states have such panels.

An emphasis on risk management by developing practice standards. This method seeks to identify the cause of most claims, and establish standards to avoid them. Other risk management proposals include: requiring doctors to study medical malpractice prevention as part of their licensing requirements; requiring states to report medical errors by health care facilities; and helping doctors invest in new health information technology such as electronic health records, electronic prescribing and experimental safety software.

Taking action against the small proportion of doctors with multiple judgments against them, who drive up the cost of insurance for all physicians.
Promoting “Risk Retention Groups,” or alternative markets providing coverage in health care.

Creating special courts to handle medical malpractice cases. Currently, several states are weighing this option. A federal bill, the Medical Liability Procedural Reform Act of 2005, has authorized funding to states that create a pilot program of health courts.

Industry Trends

Proliferation of Health Care Companies — In the past, most physicians were self-employed and ran their offices in a partnership or group, sharing office help and medical assistants. During the 1980s, some physicians started to franchise, which involved paying a franchiser (i.e. HMO) to handle administration, such as billing and insurance claims. The number of self-employed, patient-care physicians in private practice has dropped steadily over the past two decades. In a recent American Express survey of self-employed physicians, 25 percent of respondents described the dual role of practicing medicine and maintaining a business as “extremely challenging”, while 58 percent described it as “challenging.”

PHO’s — A Physician Hospital Organization (PHO) is a vertical arrangement that combines physician and hospital services within one organization. In theory, PHO’s may create incentives to lower prices and enhance quality. In practice, many PHO's have declared bankruptcy or dissolved.

MSO's —Management Care Organizations (MSO's) developed out of the trend toward close relationships of physicians and hospitals. MSO's create partnerships between physicians and hospitals with equal management services delegated to each. These organizations require physicians to purchase shares in the MSO. Should they so choose, physicians may later sell their shares in the organization for profit.

Company Clinics — Large companies across a variety of businesses have developed and expanded company clinics to combat rising health care costs. By 1990, 12 major employers sponsored clinics for their employees. Many of these clinics were operated by the companies themselves, while others were operated by medical management companies. Company clinics tend to hire physicians with set salary contracts, believing this will decrease the incentive to perform unnecessary tests.

In 1992 John Deere was the first company in the United States to set up a primary care clinic for its employees in conjunction with a third-party hospital, the Mayo Clinic of Rochester, Minnesota. The largest company clinic in the country was operated by Southern California Edison Company, which had 10 medical clinics and first-aid stations, employed a staff of 70 and facilitated more than 100,000 patient visits annually.

Specialization — The explosion of medical knowledge over the past two decades, coupled with a general increase in practice size, has led many doctors to specialize in specific areas of medicine. Research articles from publications such as the *New England Journal of Medicine* makes it easy for doctors to be aware of new developments, though many physicians have limited time for continuing professional education. New diagnostic devices and treatments are often introduced to physicians by sales representatives of device makers and drug companies, as doctors find it difficult to stay abreast of the latest diagnostic and treatment developments.

New Informational Avenues — Due to increased health care costs and rising competition among physician offices, medical information has increasingly become available outside of traditional venues. Nurse-call lines, self-help medical books, educational videotapes and online information all compete with physician offices for business. Some physician offices have adapted to this trend by showing videotaped programs as a way of educating patients about procedures and available treatment options; others have moved portions of their practices online.

Advertising — Physicians tend to gather business via referrals from other doctors, or from patients. Television, radio and print advertising, formerly considered unprofessional (and in some states, illegal) have become common strategies of many offices. Direct mailing may be used to solicit business. Marketing is closely bound with the operation of various insurance plans, as some plans limit the types of tests they will pay for and the types of treatments they will cover.

Technology — A recent trend has seen technology fuel the shift from inpatient hospital care to outpatient surgical clinics. The invasive element of many medical procedures has decreased, allowing them to be performed in outpatient facilities. Technological advances have decreased complications related to the administering of anesthesia, which has all but eliminated the need for overnight hospitalization in many cases.

At first, advances in information technology were adopted slowly by physician offices, particularly by self-employed doctors. In order to reduce office paperwork and maintain more accurate patient records, however, almost all physicians now use desktop systems for routine functions like accessing patients' medical histories and insurance records, and placing prescription orders with pharmacists.

Physicians have also begun using information technology to assist them in making diagnoses. Databases provide doctors with detailed information and success ratios on myriad treatments and procedures. This information is especially valuable to doctors who need data on rare diseases and conditions. Researchers continue developing software capable of handling the massive amounts of general practice information required by doctors.

Industry Outlook

Because health care is a basic human necessity, the overall outlook of physician offices seems stable, if not bright. Three main issues currently face the industry: the future of government insurance programs (Medicare and Medicaid); the rising cost of liability insurance due to increased malpractice litigation; and the continuing shift away from smaller practices toward large-scale operations like HMOs. While all of these factors have the potential to continue reshaping the industry, health care is a basic human necessity, and physician offices should continue on as key service providers. The big question is how these offices will adapt and retain profitability in the center of a complex and dynamic industry.

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