Navigating consolidation consideration in healthcare acquisitions under CPOM

In recent years, private equity firms and healthcare companies have experienced greater profitability and economies of scale through acquiring and consolidating physician practices. Healthcare investors and independent physician management companies are more focused on enhancing practice profitability by leveraging cost structure via corporate functions and management service organization (MSO) back-office capabilities, leveraging nationwide advantage managed care contracts, expanding ancillary revenue streams, acquiring services in adjacent specialties, and aligning with emerging value-based payment models. Hospitals, health systems, and distributors have benefited through consolidated patient referrals, increased network adequacy for members, and payor-agnostic capitated arrangements. Many physician practices, however, are subject to the Corporate Practice of Medicine (CPOM) laws in their states. CPOM laws prohibit persons without a medical license from employing physicians or owning a medical practice to provide medical services. Consequently, CPOM laws effectively prohibit corporations, partnerships, or other legal entities (together, buyers) from directly owning physician practice professional corporations (PC).

Due to CPOM laws, many buyers acquire the PC through an asset purchase agreement (APA) and either set up or simultaneously acquire a MSO that has a management services agreement (MSA) with the PC. The physician owner of the PC will typically retain majority or full equity ownership due to these laws (these physicians are often referred to as friendly physicians). The APA grants the buyer ownership over all the nonclinical assets of the PC whereas the MSA typically grants the buyer the right to oversee the strategic direction and direct the operations of the PC in exchange for a management fee. Typically, the only activity the buyer cannot direct or have influence over, through the APA and MSA under CPOM laws, is clinical decisions that would impact the patient outcome, which are retained by the friendly physician.

In some circumstances, the physician employee of the MSO will be appointed to oversee clinical decisions or, alternatively, to assume the equity from the friendly physician (a nominee shareholder). Typically, the nominee shareholder can be changed or replaced by the buyer at any time and cannot sell or exchange its equity without the buyer's approval.

Considering the above, buyers must carefully analyze the different organizational structures that are created in consideration to the CPOM laws to determine whether the acquired set (e.g., the assets acquired under the APA and the activities directed through the MSA) represents an asset or a business and, if it's a business, analyze whether the buyer controls the physician practice and consolidates the physician practice.

As physician practices and roll-ups are in the spotlight now more than ever, it is important for current owners to revisit their consolidation analysis to avoid issues when selling a physician practice/roll-up to another buyer as that buyer will scrutinize the consolidation analysis.

We have seen instances where the buyer disagrees with the historical consolidation analysis, which can increase the risk of a transaction not closing.

Below, we explore each of these accounting issues in more detail and provide an overview of the relevant literature in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic No. 805, Business Combinations, and ASC Topic No. 810, Consolidations.

01 Asset versus Business

In situations where a buyer purchases a PC subject to COPM laws, the buyer must first determine if the acquired set constitutes a group of assets or a business, as the accounting treatment differs depending on that determination.[1]

ASC Topic No. 805 provides two steps to determine whether an acquired set is an asset or a business. The first step (commonly referred to as the screen test) requires the buyer to determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single (or group of similar) identifiable assets. If yes, then the acquired set is not a business and the guidance related to asset acquisitions in ASC Topic No. 805-50 is applied. If no, then the second step requires the buyer to evaluate whether the acquired set qualifies as a business. A "business" is an integrated set of activities (processes) and assets (inputs) that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits (outputs) directly to investors or other owners, members, or participants.

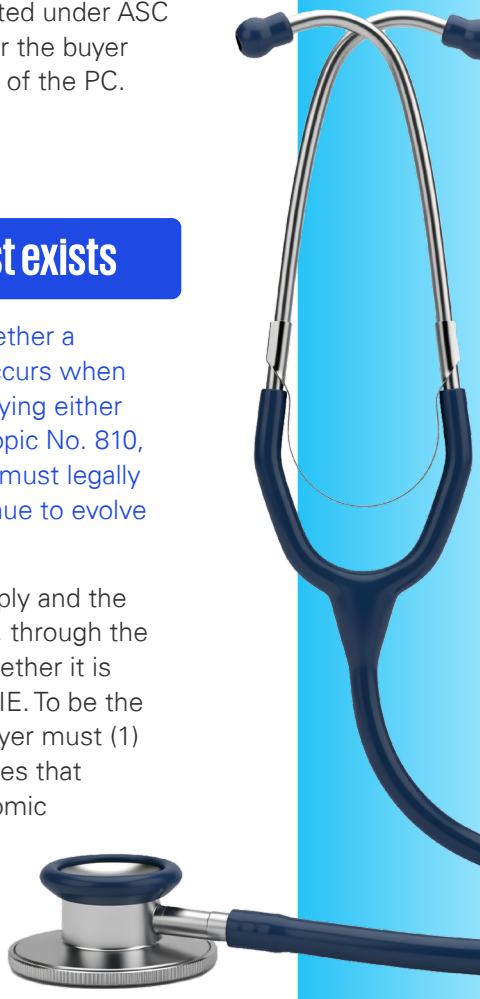
For PC transactions under the CPOM laws, the set acquired may be either an asset or a business. If an APA is executed in isolation for specific nonclinical equipment, then the set acquired may be an asset and the asset acquisition guidance in ASC Topic No. 805-50 may be appropriate. However, when an APA and an MSA are entered into in conjunction with one another and the buyer has the ability to direct inputs and processes of a physician practice, the physician practice (inclusive of assets, employees, in-place contracts, and the like) may be a business. We note the majority of these transactions meet the definition of a business and thus would be evaluated under ASC Topic No. 810 to determine whether the buyer holds a controlling financial interest of the PC.

02 Application of ASC 810 – Whether a controlling financial interest exists

When the acquired set meets the definition of a business, the buyer must determine whether a business combination has occurred. Under ASC Topic No. 805, a business combination occurs when a buyer gains control (that is, holds a controlling financial interest) over a business by applying either the variable interest entity (VIE) or the voting interest (VOE) consolidation model in ASC Topic No. 810, as applicable. This can be a complex analysis because, under the CPOM laws, physicians must legally retain ownership of the voting equity in the PC. In our experience, these structures continue to evolve and become more complex.

In performing the analysis under ASC Topic No. 810, the buyer should first determine whether the PC is a VIE and, if so, analyze the PC under the VIE model. Physician practices that are acquired via APAs and MSAs will often meet the following characteristics to be considered a VIE (PC-VIE): the equity investors lack the power, through voting or similar rights, to make decisions about the entity's activities that significantly affect its economic performance, or the equity investors do not have the obligation to absorb loss or receive expected residual returns.

Presuming no scope exceptions apply and the buyer holds a variable interest (e.g., through the MSA), the buyer should analyze whether it is the primary beneficiary of the PC-VIE. To be the primary beneficiary of a VIE, the buyer must (1) have the power to direct the activities that most significantly impact the economic performance of the PC and (2) have the obligation to absorb losses and right to receive returns of the PC.



Obligation to absorb losses and right to receive returns

In our experience, determining whether the buyer has the obligation to absorb losses and the right to receive returns can be simple. Typically, under the terms of the MSA, the buyer is required to provide additional funding when and if the PC requires and also has a right to the profits generated, through the constructs of the management fee.

Power to direct the significant activities

Due to differences in CPOM laws state by state and tax considerations of the buyer, there are various legal structures that have been implemented and used in practice. Due to differences in legal structures, the determination of which party has the power to direct the significant activities can be complex. The rights that the friendly physicians hold must be analyzed, along with transfer restriction agreements and other terms. Whether a board of directors is established (either at the PC or MSO level) could add additional complexities to the analysis. In addition, determining whether the friendly physicians are de facto agents of the buyer may be relevant to the analysis.

In certain situations, a party might not have stated power, but that party has the obligation to absorb losses and right to receive returns. In such situations and depending on the facts and circumstances of the arrangement, that party with substantially all of the economics may be viewed as the party who holds the power to direct the significant activities because the party that has the stated power could be acting as an agent to the party that has the obligation to absorb losses and right to receive returns.

Questions that may be considered when determining the primary beneficiary include, but are not limited to:

What are the activities that most significantly impact the economic performance of the PC?

How are decisions made regarding the significant activities?

Is there a transfer restriction agreement with the equity holder physician or is the physician required to get approval from the MSO to transfer the shares held?

Does a board exist that makes decisions? If so, who comprises the board?

If management of the MSO makes decisions, then how are managers appointed? Are managers also friendly physicians?

If a decision maker does not hold a variable interest, then is the decision maker acting on behalf of another variable interest holder that may have power?

Based on the above, if the buyer is considered the primary beneficiary and is the accounting acquirer, then the buyer applies acquisition accounting in accordance with ASC Topic No. 805.[2]

If the VIE model does not apply, then the VOE model should be analyzed. The VOE model focuses on ownership and control and the party that should consolidate is the one that has a controlling financial interest, generally indicated by ownership of more than 50 percent of the voting rights. If the buyer is considered to have controlling financial interest over the PC due to CPOM laws, then acquisition accounting in accordance with ASC Topic No. 805 would still be applied.

03 Application of the acquisition method

When a buyer determines the acquired PC constitutes a business and that it would consolidate the PC under either the VIE or VOE model, then the buyer applies the acquisition method of accounting under ASC Topic No. 805. Under ASC Topic No. 805, the identifiable assets acquired and liabilities assumed are recognized and measured at their acquisition-date fair values, with limited exceptions. Any consideration in excess of assets acquired and liabilities assumed is recognized as goodwill.

A noncontrolling interest would be recognized to the extent former equity holders retained equity of the acquiree. While the equity of the PC is typically held by the former owners (i.e., the physician or a physician group), as these structures are created to extract substantially all of the profits through the MSA, the value of the PC's equity is typically de minimis.

For more information on the acquisition method, please refer to the KPMG Business Combination Handbook, Section 7.

References:

[1] See the KPMG Business Combination Handbook, Section 2 for further details around the differences between the two accounting models.

[2] Of note, under current guidance in ASC 805, the primary beneficiary is always the accounting acquirer of a VIE in a business combination. However, the FASB issued Accounting Standards Update 2025-03, effective for annual periods beginning after December 15, 2026, which will require entities to consider the general accounting acquirer factors in ASC 805 when determining the accounting acquirer in business combinations primarily effected by the exchange of equity interests involving a VIE that is a business.

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DASD-2025-18492