Appraisal of Medical Practice Value

by Keith Borglum

There are many occasions when the valuation of your medical practice is important, and there are a number of ways to value a practice.

Most often, a physician is seeking the Fair Market Value under a Premise of Going Concern.

Fair Market Value is defined as the price at which this business would change hands between a hypothetical willing buyer and a hypothetical willing seller with neither being under a compulsion to buy or sell, and with both having knowledge of all of the relevant facts.

The Premise of Going Concern is used, measured by a practice's ability to generate income without interruption as a consequence of a change in ownership.

Approaches include:

(a) **The Asset Approach,** including the Adjusted Book Value Method, Net Asset Value Method or Asset Accumulation Method, which adjust the book value of the assets and liabilities to fair market value. It also includes the Excess Earnings Method codified in Revenue Ruling 68-609, for valuing intangible assets. It is most applicable to practices with a high amount of tangible assets, like radiology. It is also used under the premise of liquidation when no goodwill value is present.

(b) **The Market Approach**, including the Direct Market Data Method for closely held companies including medical practices; the Mergers and Acquisitions Transactional Data Method used more frequently for large or public companies, and the Guideline Public Company Method which uses minority interest transactions in publicly traded companies. The Market Approach applied to professional practices compares the subject to other practices that have sold, separately valuing goodwill and tangible assets, then adding them together.

"Goodwill" is the area that generates the most controversy in practice valuations. The value of intangibles – often described in a valuation as "goodwill"– generally includes a favorable location; going concern value; use of seller's name; favorable leasehold; covenant not to compete; compensation for past managerial and entrepreneurial services; patient lists; credit records; patient care contracts; employee contracts; as well as assignment of future incomes from the practice. Goodwill value can be modified by a myriad of factors best determined by an impartial third party.

A common error in amateur valuation is to add the value of the tangible assets to a value for goodwill as found by the average or median of one of the Goodwill data base registries. A subject practice value *must* instead be adjusted in relationship to the registry-reported values, since the registries report values over many years and many situations. For example, if a specialty has a yearly declining goodwill value of 100%-80%-70%-60%-50%, is it worth the average of $70 if the current reports are 50%? No!

(c) **The Income Approach** is a way of determining value by converting anticipated benefits into a current value. In a typical method, value is represented by the return-on-investment available above what you could earn through the result of your labor in simple employment. The IRS has published Business Valuation Guidelines in its Revenue Rulings 59-60 and 68-609 that clarify the Income Approach. With slight modifications, those Rulings have become the standard for professional practice appraisal.

There is some confusion about including in the name of the "income method" a word or words which represents the stream of returns on earnings or income. These words have included the use of "earnings" (which excludes cash flow), "cash flow" (which excludes pure earnings), "discounted cash flow, seller's discretionary earnings, excess earnings, returns, benefits, economic income", etc. "Dividend-paying capacity" is what is encouraged in Revenue Ruling 59-60. Dividend-paying capacity in medical practices is identified through the use of net cash flow *after* considering the equivalent market-rate compensation of the owner as if the owner were employed and the remaining cash flow was available to shareholders/investors. I've skipped issues here for simplicity about tax-effecting, discounts for lack of control and discounts for lack of marketability.

Goodwill value is not separately valued in this approach, as it might be when taking other approaches to valuation. The income approach results in a value that includes all tangible and intangible assets, including that described as goodwill. It does not separately seek to break out goodwill value, but to include it. The underlying concept is that when using income of the business as the approach for valuation, that income results from the value of both tangible and intangible assets together.

(d) **Rules of Thumb,** such as "one times net", are virtually never used any more because changes in the marketplace and the increasing diversity and complexity of the medical marketplace have eliminated what minimal accuracy they might have once enjoyed.

Practice valuation is an inexact science attempting to reach a value within a reasonable range; therefore, even knowledgeable people can differ in their opinions.

An important factor in valuation is why and how a value is achieved. Good reports generally contain background information and documentation so the protocols followed are clear, and data can be confirmed.

You should demand to have the appraiser present the resources-used, the currency of his/her data bases, and the assumptions underlying the opinion. Many so-called appraisers appear to base their valuations on rumors and hearsay, with little-to-no substantiation of their opinions. I recently had a practice-broker tell me that the extraordinary value she placed on a physician's practice with her "appraisal" was based on "that's what the seller wants" (!).

When you ask "What is my practice worth?" a definitive answer may be elusive, but common sense, professional judgment and adherence to bonafide statistical analysis can result in a usable opinion.

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