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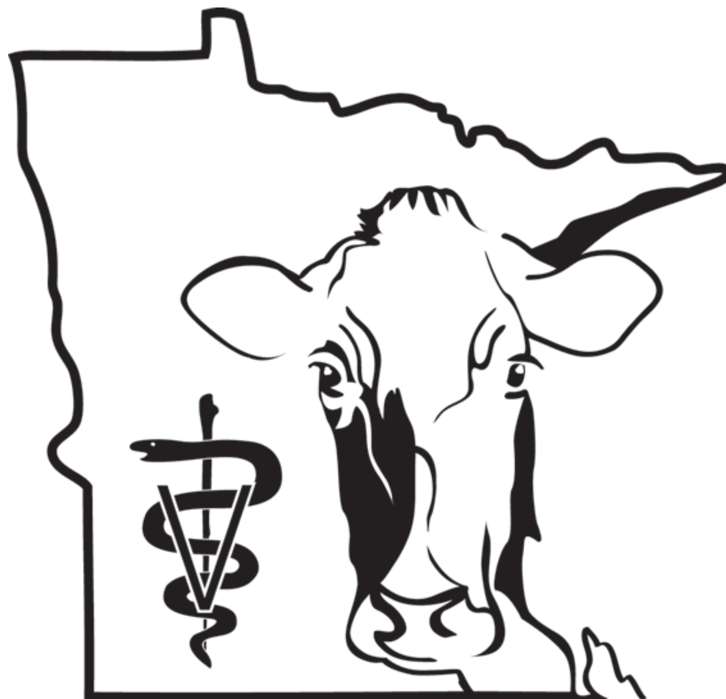

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Appraising The Professional Practice

by Dr. Eugene W. Heller

Appraising the professional practice is, unfortunately, much more of an art than a science. Therefore, how an appraiser determines the appraised value frequently appears rather mysterious and almost magical. The appraiser seems to take a "bunch" of numbers, apply some magical secret formulas, and the outcome represents the value of a lifetime of practice.

If one interviews ten different appraisers, they will describe ten different methods. In fact, the best appraisers will use several different methods to cross check the validity of the value they have determined. Many books have been written on the subject. Hopefully, the brief article which follows, will take some of the mystery out of the process.

Purpose for the Appraisal

There are many reasons to have a professional practice appraised. The following represents a list of the most frequent reasons for an appraisal.

- Divorce
- Practice Sale
- Partner Termination from Practice
- Associate Buy-in
- Merger of Practices
- Sale to Outside Third Party
- Estate Planning

The outcome of the appraised value for a practice is frequently dependent upon the purpose of the appraisal. While it would appear that it should not matter why a professional practice is being appraised, and the final outcome should always be the same, it usually is not. However, the reason for the appraisal frequently dictates the appraisal method used.

Each method will usually yield a different value. For instance, if the cause of the availability of the practice for sale is due to the death of the sole proprietor, the appraisal method will be based upon a depreciating method of appraisal. In this instance, the value will rapidly deteriorate over a matter of months if another provider does not immediately step in.

A partner termination may be due to a voluntary or involuntary termination of employment and subsequent buy-out of equity interest in the practice. Loss of license, death, or disability may all have different consequences. Frequently, in the event of termination, the method of appraisal will be dictated in the employment and other agreements and the normal rules of appraisal will not apply.

With the advent of practice buy-outs by hospitals or other large corporate buying groups, many of the traditional methods of appraisal do not apply. In this instance, the appraised price is driven by the market and tends to be far in excess of normal appraised values. Estate planning always requires a market value approach, and yet, due to the conditions which may be present at the actual time of sale, the actual sales price and/or new appraisal done at the actual time of sale may be totally different than that arrived at for estate planning purposes.

METHODS

In comprehending how the final appraised value is arrived at, the first step requires an understanding of the various methods of appraisal used. There are over a hundred different methods, but most are variations of the following four commonly recognized classifications.

The primary methods presently used are:

1. Market Value *(Comparable Sales)* Approach
2. Revenue Multiplier Method
3. Asset Summation Method
4. Capitalization of Earnings Method

Market Value Approach

The first is the determination of value through the market value approach. This approach frequently blends three different approaches, giving more weight to the approach the appraiser feels is more relevant. The replacement cost of the item being appraised is used, with an allowance for present wear and tear. This is blended with an appraisal based on best use of the item to generate revenue, and the earnings are capitalized to yield a value for the item as an investment.

Finally, the item is appraised using comparable sales. Anyone who has needed an appraisal to buy or refinance a home is familiar with this approach. This method relies on the frequency of sale of the particular item being appraised and the ease of comparability of the items being sold. The more common the sale, the more applicable and accurate the method.

The problems with applying comparable sales to the appraisal of a professional practice are the two things which

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lend credibility to the approach in the first place.

There are not enough comparable sales occurring to allow for the setting of industry standards. Furthermore, there is a tremendous demographic effect on the value of practices, and what practice sales are available for comparison are spread out across the country. Also, there are a tremendous number of variables involved in what is or has been sold which makes a comparison of two sales meaningless.

Averaging these three approaches gives a best guess by the appraiser as to what the practice might be sold for on the open market. However, this approach has little real value in appraising a professional practice.

Gross Revenue Multiplier Approach

Of the remaining three methods, the most easily understood and easily taught method is the "Gross Revenue Multiplier" approach. If an appraisal company is looking for an easy method to train a group of appraisers, this method can be taught in about one hour. It is also the method most widely quoted by practitioners when discussing what their practice is worth amongst themselves because it allows the easy comparison of perceived practice value. Unfortunately, while commonly used because it determines value through an easy "rule of thumb", it is the least accurate and most widely abused method in use.

> ***"Unfortunately, this appraisal method is the least accurate and most widely abused method in use."***

To sum up the method, one takes a percentage and multiplies it times the previous years' gross revenues. It is fairly simple to determine where the name of the method, Gross Revenue Multiplier, comes from. The appraiser will say, "practices on the average are presently selling for X% of last year's gross." However, remember what we previously said about the difficulty in comparing two average sales.

Therefore, the problem with this method is that the determination of X becomes the magical variable. Each appraiser has his/her own secret formula for determining X. Many will actually increase their chance of accuracy by giving a range, i.e. "practices have been selling for Y-Z% of last year's gross." Further compounding the problem with this approach lies in the fact that generally, the higher the gross, the lower the net percentage is of gross. Therefore, one gets a higher appraised value with a lower bottom line.

Now that we have completed our discussion on what doesn't work, we will turn to the two most accurate methods of appraisal for the professional practice. These are the "Asset Summation" method and the "Capitalized Earnings" method. What follows are the rules of thumb used in determining value by these methods. However, once the method has generated a basic value, there are a multitude of variable factors which must be applied to either method before the final figure can be determined. A partial list of these variables, and their affect on practice value, will follow the discussion of the various methods.

Asset Summation Method

The Asset Summation method uses the sum of the present market value of various hard assets, then adds the value of the intangibles, or so called "goodwill" items. The items commonly valued include equipment and furnishings, supplies (office supplies, clinical supplies and drugs), leasehold improvements, and accounts receivable.

The used equipment and furnishing are generally valued using the esti mated useful life of the item compare with its original cost. Therefore, this i based on the remaining "useful life and is not the stated book value carrie on the practice's balance sheet. Tak the original cost, divide by the usefu life, and multiply times the number o years remaining.

The supply figure is generally deter mined by taking the total supplie purchased for the previous year an dividing by twelve to get the monthl average. This figure is then multiplie by two to get the average inventor available for sale. Leasehold improve ments, despite the IRS's recent deter mination to give a 39 year life for ta purposes, are generally given a te year life for practice sale purposes.

Accounts receivable need to be adjuste for aging and costs of collection. Al accounts older than 120 days are firs subtracted from the total due. Th balance is usually valued at the previ ous historical collection ratio minus 5 for the cost of collection.

This leaves goodwill. The IRS ha recently reversed it's long-standin policy of not allowing goodwill to be tax deductible item. To get around th non-deductibility, tax accountants spen years devising other things to cal goodwill which would allow for a ta deduction. The IRS, tired of endles court battles, now gives goodwill a 1 year tax life, whether it is called good will, client records, non-compete agree ments, blue sky, or any other intan gible item.

Defined as the value of intangibl items, we are back to magically assign ing a value to this asset. However, if w are only dealing with goodwill, fairl accurate comparative values for pas practice sales are available. There ar several sources for this information

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the most commonly known and used being the "Goodwill Registry". This book maintains an annually updated list of how much of the actual practice sale value was assigned as goodwill and therefore the percentage of revenues used to determine this value.

This arbitrary assignment of a percentage is much more accurate, as determined for valuing goodwill, than the previous example of the gross revenue multiplier. The GRM uses the same percentage to compare two practices which not only could have a tremendous variation in net profits, despite similar gross revenues, but could also have a tremendous difference in hard assets used to generate those revenues. The percentages used for goodwill value determination are based on actually occurring sales and therefore can be used with reasonable accuracy.

Asset Summation Method

Furnishings and Equipment
\+ Supplies
\+ Leasehold Improvements
\+ Goodwill

= Practice Value

Capitalization of Earnings

The final appraisal method, the "Capitalization of Earnings" approach, is dependent upon the use of an adjusted income statement. This method determines net profit, subtracts the cost of professional labor, and then determines, considering the risk of investment, what the value of the available practice earnings are on an investment basis. While the most scientific and subsequently most reproducible of the appraisal methods available, there are certain financial conditions of the business which may not render an accurate value using this method. This is again the reason why most appraisers will use more than one method to verify their final value.

This method begins with an evaluation of the practice's profit and loss statement. While there are many legitimate items which can be expensed through the professional practice, they are not all necessary for the actual production of services. A veterinarian in a large animal practice has no problem justifying a vehicle expense, including depreciation, for the truck required to carry drugs and supplies between farms. However, an anesthesiologist's profit and loss statement would need to be adjusted for the costs of his/her Mercedes needed to travel between two hospitals to provide services.

Therefore, the P & L must be adjusted for all elective expenses, any expenses which could be classified as part of the doctor's compensation package, or which are not necessary for the provision of services. This would include the doctor's continuing education expenses, pension and profit sharing expenses, personal auto, country club dues, etc. Also subtract the cost of depreciation and interest for practice acquisition or equipment purchases. Lease payments are allowed. Deducting these items yields the true cost of providing services prior to owner compensation.

From this net pre-owner available compensation, the cost of hired professional labor, replacing what the owner is producing, must be subtracted. What would be the labor costs to hire an associate producing the amount shown on the profit and loss statement? After subtracting this number, what is left is the true net value of owning this asset, the **professional practice**. This is the amount of money the asset itself generates.

This number is then capitalized, using a rate determined by the investment market as a reasonable rate of return on the investment, given the level of risk involved. The capitalization rates used for professional practices range from 20% to 45%. The net earnings are divided by this percentage to determine the practice appraised value. Therefore, a practice with a net after labor costs profit of $50,000, using a 25% capitalization rate, would have an appraised value of $200,000. Which percentage number is actually used is dependent upon the skill of the appraiser in assessing the other factors listed below. These factors affect the level of risk and subsequently the value of the investment.

Factors Affecting Appraised Value

The following represents a partial list of the many other factors which will have an affect on the final practice value, regardless of which of the above methods is used. While this list contains a number of the major things affecting value, it is not all inclusive.

- What are the area population demographics?
- What are the area employment demographics?
- What are the demographics of the practice physical location?

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- What will the method of payment for equity transfer be?
  - a All cash
  - b. Bank financed
  - c. Owner financed
  - d. Re-allocation of earned income
  - e. A combination of the above
  - f. Deferred compensation to Seller
- Is real estate involved? This will frequently decrease the value of the practice due to decreased marketability in view of an increase capital need to finance the sale.
- What is the practice gross vs. practice net? A higher grossing practice with a smaller net will appraise for less than a lower gross with a higher net.
- Type of practice. This includes practice differences due to specialty and due to practices catering to a special market niche.
- Practice Growth. Have practice revenues kept up with inflation, exceeded inflation, or are they in decline?
- Revenue history for past five years.
- Do existing associates have an enforceable non-compete agreement?
- Has an associate without a non-compete left the practice within the past two years to set up a competing area practice?
- Timing of the sale. If the appraisal assumes the sale is between a willing buyer and a willing seller with a full knowledge of facts and under no compelling time obligation to complete the transaction, a different value will be obtained than if the appraisal and subsequent anticipated sale is due to the death of the sole proprietor.

Summary and Conclusions

As the previous discussion indicates, there are a multitude of variables which must be considered when appraising a practice. The value and validity of the appraised value determined will depend upon the experience of the appraiser.

For the doctor who wishes to determine for themselves an approximate idea of the value of a practice, using the sum of assets approach will yield the easiest and best "rule of thumb" guesstimate. The only unknown which the doctor will need to determine will be the appropriate multiplier for the goodwill calculation for the practice.

However, if the purpose of the guesstimate is to sell part or all of the practice, a miscalculation could cost the doctor ten's of thousands of dollars.

As the above discussion indicates, if this is the purpose, it will be in the doctor's best interest to obtain competent professional assistance.

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