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For most Americans, the entire world of estate planning got turned upside down when the new tax law (ATRA) abolished the federal estate tax. Now, unless you are among the very wealthy, the bigger challenge in estate planning is with the ever-increasing income tax, which, many believe, will be making up for much of the newly lost revenues. The author explores some aspects of this new world order that may help your clients.

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The changing regulatory environment caused by the passage of the Patient Protection and Affordable Care Act (PPACA) has led to additional uncertainty in the healthcare industry on many levels. Practices are consolidating to gain market share and increase efficiency, as many believe that a larger group or network will produce greater profitability. This article explores the factors that are impacting the healthcare industry and complicating the valuation of medical practices.

16  WHAT TO CONSIDER WHEN USING GUIDELINE TRANSACTION DATA
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Income taxes play a major role in the pricing and structure of business transactions because income tax consequences associated with the sale or purchase of a business can substantially reduce the seller’s net proceeds and/or lower the net cost of a purchased ownership interest to the buyer. In this article, the author discusses the impact of federal income taxes on transaction prices and terms, and considers the impact of taxation on the selling prices reported in guideline transaction databases.
Software programs can be a boon to business valuers. In this first of a series, The Value Examiner puts some questions to Lorenzo Carver, founder of one of the most influential programs available, Liquid Scenarios.

**PRACTICING SOLO**

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By Stephen D. Kirkland, CPA, CMC, CFC, CFF

The author provides some tips on compensation.

**LITIGATION CONSULTING**

**POTENTIAL ISSUES IN USING BUSINESS APPRAISAL AS THE MEASURE OF DAMAGES IN LITIGATION—DEALER TERMINATION**

By Rodney J. Bosco, MAFF, CVA, CFE, and David J. Ottenbreit, CVA, CFE

In this article, the authors provide insights into the types of inquiries that can help valuation analysts serving as damages experts.

**UNDERSTATEMENT OF THE VALUATION IMPACT OF FUTURE STOCK-BASED COMPENSATION GRANTS: IMPLICATIONS FROM THE ANCESTRY.COM OPINION**

By Clifford S. Ang, CFA, and Andrew Lin, CFA, CAIA

The authors illustrate how, by employing the approach used by Respondent’s expert in Ancestry.com, the economic cost of future SBC grants is understated and, all else being equal, overstates the fair value of the firm’s equity.

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**Articles are color-coded by topic for easy identification.**

- Editorial ....................... Gray
- Valuation ....................... Blue
- Forensic Accounting ............. Green
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- Education Review ............... Purple

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The changing regulatory environment caused by the passage of the Patient Protection and Affordable Care Act (PPACA) has led to additional uncertainty in the healthcare industry on many levels. Practices are consolidating to gain market share and increase efficiency, as many believe that a larger group or network will produce greater profitability. Different medical specialties yield different results of operations (such as primary care versus surgery). Geography also matters, as reimbursement rates and costs of operations are vastly different in different parts of the U.S. Local competition and state regulation also materially impact the risks and sustainability of a healthcare practice. These and other factors impacting the healthcare industry, including the PPACA, federal and state regulations, Medicare guidelines, commercial payer contracts, and more, complicate the valuation of medical practices.

Valuation analysts are trained to consider guideline transactions as a potential indicator of value. Such transactions presumably take into consideration the factors noted above. However, many transactions involving hospital or large group acquirers specifically exclude goodwill in the purchase price of a physician practice. Instead, the selling physician may receive a higher compensation from the acquirer than was previously received by the physician(s) in their own practice. The increased future compensation is in lieu of goodwill paid as part of the practice purchase and must be considered for valuation purposes.

In a different situation, where an employee is buying a practice or interest in a practice from its physician owner, the employee is buying the goodwill of the practice. The selling physician’s future compensation is either not a factor, because the seller is retiring, or the seller will work as an employee and does not have the expectation of making more than he did as an owner. The goodwill has to be valued in this situation as part of the purchase. Goodwill includes the patient charts, name of the practice, phone number, staff in place, IT systems, etc.

1. This is because a payment for goodwill could be construed as a payment for future referrals from the physician.
2. The higher compensation is due to the acquiring entity having more favorable contracts with insurers and thus can compensate physicians at a higher rate per wRVU (wRVU is the abbreviation for work relative value units).

By Monica Kaden, MBA, ASA

The Market Approach

Revenue ruling 59-60, and applicable professional valuation standards—such as those promulgated by the American Society of Appraisers (ASA Business Valuation Standards), National Association of Certified Valuation Analysts™ (NACVA® Professional Standards), and the American Institute of Certified Public Accountants® (VS Section 100)—all consider the market approach a critical valuation approach to be considered and used if possible. Nevertheless, many valuation analysts utilize the income approach to value physician practices but do not use the market approach.

Applying the market approach when valuing physician practices involves analyzing actual sales of physician practices and applying relevant valuation market multiples to the subject practice. Many analysts have tried to use generic databases to value medical practices, such as Pratt Stats. However, these databases often do not provide data that is segregated by medical specialty, and there are typically not enough transactions in a particular specialty, or that meet other important criteria, to be meaningful.
THE GOODWILL REGISTRY

There is a database that is specifically designed for the healthcare industry that contains only health care transactions, called the Goodwill Registry (GW Registry). The GW Registry is published by The Health Care Group and is updated annually. The data is provided to the GW Registry by practice advisers who fill out surveys based upon actual transactions. Other databases, including Medical Group Management Associates data (typically used for physician compensation), are also based on survey data. One of the main purposes of the GW Registry is to reflect the portion of price paid that was allocated to the target practice’s goodwill. The database is reliable because of the volume of transactions and the clarity of the definitions of the financial components. The GW Registry has been recognized as an authoritative source by the courts. 3

The GW Registry database, which includes all healthcare transactions, represents fifty-three different medical specialties with general classifications:

- primary-care practices
- primary-care surgical practices
- internal medicine subspecialties
- surgical specialties
- hospital-based and freestanding imaging center practices
- other healthcare practices such as dentistry, chiropractors, and veterinary medicine

The data provided for each transaction includes:

- sale year
- state
- location (rural, suburban, or urban)
- valuation reason
- valuation methods used
- gross revenue
- overhead as a percent of revenues
- practice price
- goodwill value
- goodwill as a percent of gross revenue

Based on the information provided, one can calculate the sellers’ discretionary Earnings (SDE) for each transaction (calculated as gross revenue less overhead). The overhead figure excludes all compensation and fringe benefits paid to the physicians. SDE multiples, such as SDE to gross revenue and SDE to purchase price, can be calculated for each transaction.

The database has more transactions for certain specialties than others. For example, the table below reflects the number of transactions in different specialties in 2014.

<table>
<thead>
<tr>
<th>SPECIALTY</th>
<th>NUMBER OF TRANSACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family practices</td>
<td>214</td>
</tr>
<tr>
<td>Internal medicine</td>
<td>146</td>
</tr>
<tr>
<td>Ophthalmology</td>
<td>283</td>
</tr>
<tr>
<td>Dentistry</td>
<td>1,809</td>
</tr>
</tbody>
</table>

Following are key terms published by The Health Care Group regarding the financial indicators reflected in the GW Registry database:

- **Gross Revenues** is the practice cash basis gross receipts for the twelve-month period immediately preceding the transaction date.

- **Overhead Percent** is the practice overhead rate, which excludes all doctor compensation and benefits, for the twelve-month period immediately preceding the transaction date. Malpractice premiums are treated as an overhead item.

- **Practice Price** is the total sales price for 100 percent of the practice—even if less is being transferred in this transaction. The practice price normally does not include trade accounts receivable.

- **Goodwill Value** is the intangible portion of the total sales price, including patient charts, leasehold interests, use of seller’s name, going concern value, patient lists, credit records, restrictive covenants, consulting payments to seller, patient-care contracts, etc.

- **Goodwill Percent** is calculated as: goodwill value divided by gross revenue.

If we subtract the overhead provided from the gross revenues of a practice, the result is SDE, which reflects all of the earnings (compensation and profit) available to the owner. We can determine a goodwill to SDE multiple from the transactions, and then apply the multiple to the subject practice’s SDE to determine a goodwill value based on SDE.

OTHER CONSIDERATIONS

The GW Registry data does not include normalization adjustments that an appraiser would make. This same issue arises regardless of what market transaction database is used (Pratts Stats or other), as the transaction data is as reported and not normalized. This fact does not preclude appraisers from using the information, but rather, it is a risk factor associated with relying on the data.

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3 Per the GW Registry Yearbook 2014.
The analyst has to make her own determination regarding the number of data points, the information provided, and whether there is enough credible data to make the valuation multiples credible as indicators of value. The analyst has the option to weigh the market approach results less than the income approach results if the analyst believes the market approach provides an indication of value, but with less certainty as compared to the income approach.

**HYBRID APPROACH**

The net asset approach includes the valuation of intangible assets, which may be reliably determined using the GW Registry. In order to apply the net asset approach, first one must value all of the tangible assets and liabilities of the practice. Second, a separate calculation using the market approach should be performed for goodwill (which in this analysis captures all of the practice intangible assets including identifiable and non-identifiable intangible assets). Lastly, determine an appropriate adjustment for deferred income taxes. After completing these analyses, the fair-market value of the equity or invested capital (if interest-bearing debt is added to the equity) can be determined. The following example illustrates this hybrid approach.

**EXAMPLE**

Ophthalmology Associates, Inc., is an S corporation with a December 31, 2013 valuation date. Information derived from the practice’s 2013 income tax return indicates that the cash basis equity of the practice is $253,000. However, this amount does not include the value of the practice’s accounts receivable, goodwill and intangible assets, accounts payable, and deferred income tax liability; it also does not reflect the fair market value of the practice’s fixed assets. Normalization and valuation adjustments are required to convert the reported cash basis assets and liabilities to a fair-market value for valuation purposes.

Exhibit 1 (see facing page) summarizes the information derived from the practice’s income tax return and the normalization adjustments for accounts receivable, fixed assets, and accounts payable based on forensic procedures performed by the appraiser. Exhibit 2 (see facing page) presents the calculation of the practice’s goodwill. Exhibit 3 (see facing page) presents the calculation of the deferred tax liability resulting from all other normalization adjustments.

The fair-market value of 100 percent of the equity of the practice applying the net asset/market approach is $3,004,000.

The resulting equity value using the net asset/market approach should be compared and/or reconciled to the equity value determined using the income approach. If the results are not fairly close, the valuation analyst should analyze the reasons for the differences and consider making appropriate adjustments to one or both approaches.

An issue to consider when reconciling the values derived under different approaches is whether there are enough transactions that meet the criteria to be relevant indicators of value. Other factors the valuation analyst should consider include: practice specialty, geographic location, size, overhead, year of transaction, whether there is a covenant not to compete, appreciated real estate, practice debt, and more. Other issues to consider include whether the guideline transactions involved the sale of assets or equity.

**CONCLUSION**

The practice of medicine and the overall healthcare industry is changing, impacting the value of medical practices and what private practice medicine will look like, along with how well hospitals and large groups—acting as physician employers—will perform. The healthcare trend has been consolidation, but we do not know whether this is permanent or temporary. History has shown us that it may be temporary. For example, after the 1990s, there was a significant unwind of practice acquisitions and employed physicians from hospitals. Despite the current changes in the health care industry, certain valuation guidelines and parameters still must be used.

It is important that valuation analysts perform multiple approaches in valuing a medical practice. If anything, the hybrid net asset/market approach is a sanity check to the conclusion calculated using the income approach. Analysts must avoid overvaluing or undervaluing, which may occur when there is no second approach or sanity check performed.

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*Monica Kaden, ASA, MBA, is a director in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth LLP. Her practice, which is broadly focused on the valuation of businesses for acquisitions, mergers, sales, and litigation, specializes in the valuation of healthcare entities, including medical and dental practices and ambulatory surgery centers. E-mail: mkaden@markspaneth.com*
## EXHIBIT 1

Ophthalmology Associates, Inc.

### Adjusted Statements of Assets, Liabilities, and Stockholders’ Equity

**Net Asset/Market Approach**

**December 31, 2013**

<table>
<thead>
<tr>
<th></th>
<th>INCOME TAX BASIS</th>
<th>NORMALIZATION AND VALUATION ADJUSTMENTS</th>
<th>FAIR-MARKET VALUE BALANCE SHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$225,000</td>
<td>$-00</td>
<td>$225,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-00</td>
<td>1,216,000</td>
<td>1,216,000</td>
</tr>
<tr>
<td>Prepaid expenses and other</td>
<td>17,000</td>
<td>-00</td>
<td>17,000</td>
</tr>
<tr>
<td>Fixed assets, net</td>
<td>506,000</td>
<td>372,000</td>
<td>878,000</td>
</tr>
<tr>
<td>Intangible assets, net</td>
<td>4,000</td>
<td>(4,000)</td>
<td>-00</td>
</tr>
<tr>
<td>Deposits</td>
<td>15,000</td>
<td>-00</td>
<td>15,000</td>
</tr>
<tr>
<td>Goodwill—Practice (Exhibit 2)</td>
<td>-00</td>
<td>1,776,000</td>
<td>1,776,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$767,000</td>
<td>$3,360,000</td>
<td>$4,127,000</td>
</tr>
</tbody>
</table>

| **LIABILITIES AND STOCKHOLDERS’ EQUITY** |                  |                                        |                                 |
|                                          | $8,000           | -00                                    | $8,000                          |
| Note payable                          | -00              | 204,000                                | 204,000                         |
| Accounts payable                      | 506,000          | -00                                    | 506,000                         |
| Loans from shareholders               | -00              | 405,000                                | 405,000                         |
| Deferred tax liability (Exhibit 3)    | 514,000          | 609,000                                | 1,123,000                       |
| Total liabilities                     | 253,000          | 2,751,000                              | 3,004,000                       |
| Stockholders’ equity                  | $767,000         | $3,360,000                             | $4,127,000                      |

Fair-market value of 100% of equity

$3,004,000

## EXHIBIT 2

Ophthalmology Associates, Inc.

### Market Approach: Guideline Transactions Method

**Goodwill Value of Ophthalmology Practices**

**December 31, 2013**

|                           |                  |                                        |                                 |
|---------------------------|------------------|----------------------------------------|                                 |
| Total revenues 2013       | $7,194,000       |                                        |                                 |
| Goodwill computations based on revenues |                  |                                        |                                 |
| Goodwill as % of Metric - Median | 28.24%         |                                        |                                 |
| Goodwill as % of Metric - Average | 24.69%        |                                        |                                 |
| Selected                  | 24.69%           |                                        |                                 |
| Indicated Goodwill Value (Rounded) | $1,776,000 |                                        |                                 |

## EXHIBIT 3

Ophthalmology Associates, Inc.

### Calculation of Deferred Income Tax Liability

**Net Asset/Market Approach**

**December 31, 2013**

|                                |                  |                                        |                                 |
|-------------------------------|------------------|----------------------------------------|                                 |
| Accounts receivable           | $1,216,000       |                                        |                                 |
| Accounts payable              | -204,000         |                                        |                                 |
| Deferred tax liability (rounded) | $405,000      |                                        |                                 |
| Estimated tax rate            | 40.00%           |                                        |                                 |