

Understanding and Determining Enterprise Goodwill in a Medical Practice

Note: This article was among nine additional sources of information cited by Robert Wietzke, CPA, CVA in Marital Dissolution and Divorce Valuations in the June 2000 issue of Litigation Service Counselor.

The Second Edition of **The Medical Practice Valuation Guidebook** includes a detailed spreadsheet example, case studies illustrating the concepts and an Author's Insight and Analysis section elaborating on the material.
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Introduction

Valuation consultants working with medical practices will encounter a variety of circumstances in which separating *enterprise intangible value* (we deliberately do not use the term *enterprise goodwill* in order to de-emphasize that misunderstood term) from personal goodwill is critical. Perhaps the most common of these is in the divorce valuation area where many states do not recognize personal goodwill (or noncompetition agreements) as a marital asset. Many hospital-buyers are reluctant to pay for "goodwill" in a medical practice, claiming (with questionable accuracy) that there are regulatory barriers thereto, although the real reason is often driven by price concerns and lack of confidence in their ability to make use of the goodwill post-transaction. In a practice buy-in, the buyer is generally reluctant to pay for "goodwill" if that represents an asset that he or she has generated and that attaches to that person if they leave the practice. Covenants not to compete are an important element of this buy-in issue (and the tax planning discussed below), but negotiations will often proceed more smoothly if the personal goodwill issue can be eliminated or minimized at the outset.

Finally, valuers retained for tax planning purposes may need to isolate enterprise intangible value from personal goodwill for asset allocation purposes. Another strategy sometimes considered is to isolate personal goodwill from the enterprise intangible value of a C corporation in order to report capital gain directly on the individual's tax return (see *Norwalk vs. Commissioner*), with enterprise intangible value reportable by the corporation.

Specific Intangibles

To understand the intangibles present in an established medical practice (and to one extent or another, in any professional practice) the following list of tasks necessary to start-up a practice are enumerated, along with those specific intangibles which are developed during the start-up period. One might think of these in a fashion similar to that of fixed assets under a "value in use" standard.

1. Conduct a feasibility analysis
2. Retain advisors
3. Prepare a business plan
4. Obtain financing
5. Identify a location
6. Negotiate the lease
7. Choose and order furniture, equipment, billing system
8. Hire and train employees
9. Develop employment policies

10. Develop a filing system
11. Develop marketing materials
12. Advertise for patients
13. Prepare patient charts
14. Develop coding and compliance policies
15. Develop an encounter form
16. Develop a general ledger system
17. Develop a compensation system in a group practice
18. Establish professional relationships
19. Recruit patients
20. Register patients in the billing system (data base)

Valuing the Practice Intangibles

This can be done by constructing a cash flow forecast for a hypothetical start-up practice like the industry average and comparing that cash flow to that of the contested practice. If the contested practice is of industry average size than it will have practice (or enterprise) intangible value but no "pure" goodwill, or excess earnings power attributable to the individual physicians. If it is greater than the average, it may have pure goodwill. (The method used to accomplish this is commonly referred to as replication cost or avoided cost.) If the subject is *greater than* the industry average, *four* forecasts will need to be done: one each for 1) the start-up of the average practice, 2) the start-up of the subject practice, 3) the established average practice and 4) the established subject practice.

In terms of the actual preparation of the forecast, the present value of the difference between the start-up average practice forecast and the average practice forecast should consist of three distinct assets: Net Working Capital (accounts receivable less accounts payable), Workforce in Place, and Going Concern Value (whatever is left after the other two are computed). The enterprise intangible value may be defined as the present value of the excess cashflows of the practice of average size over that of a start-up, not attributable to working capital or workforce in place.

Comparison to DCF

In a discounted cash flow model (DCF), the end result of the valuation is business enterprise value, consisting of net working capital, fixed assets and intangibles. A key element of this computation is the inclusion of cashflows associated with the purchase and depreciation of fixed assets, resulting in their inclusion in the valuation result.

The replication cost method presented herein is a cash operating or profit and loss model only and assumes that the fixed asset investment is made up front. One could charge the model with an additional expense representing the return on that investment, but this "return" is usually part of compensation expense to the physician. We assume that expenses are fixed in the start-up period and, therefore, that the total difference in cashflow between the average practice and the start-up is attributable to physician compensation. This is consistent with "real world" experience of small practices.

In selecting the discount rate to be applied to the cashflows for determining their present value, note should be taken of the fact that there is no profit to tax effect. Physician transactions, at least for small practices, are usually consummated in the basis of pre-tax earnings/compensation. The valuator should use a discount rate reflective of both the pre-tax nature of the cashflows as well as the universe of hypothetical buyers and sellers. It is not clear the universe of small physician practice buyers and sellers would have a discount rate that is simply the result of taking an after-tax rate and dividing by one minus the tax rate. (In fact, such an approach would likely result in a discount rate higher than that which is the norm in such transactions.)

Mechanics

The actual mechanics of preparing the forecast require that the valuator make assumptions not only about the rate at which new patients would enter the practice, but also about the rate at which receivables are collected. The forecast for the first

year should be done on a month by month basis. The collectible charges (net revenue) for each month will then require a number of additional months to collect, typically at least six. For example, in a calendar year forecast, the net revenue for January will be collected in January through June (and perhaps thereafter). Each month's net revenue will therefore have six months of cash receipts associated with it. The forecast for a second and third year (if required in the valuator's judgment) can be done on a monthly basis (second year) or quarterly or annual basis (third year). If yet additional years are required to replicate the average practice, time and cost considerations will usually dictate that these be annual forecasts.

To determine the average size medical practice, one can use the Medical Group Management Association (MGMA) data for average gross revenue (before contractual adjustments) per physician and then multiply that times MGMA data for the (median) collection rate. Alternatively, one could use average income from MGMA and determine the required operating expenses to earn that income, and add the two together to come up with net revenues (or the amount expected to be collected). Valuers familiar with medical practices and who have access to data from their own firm's experience may want to use local values for average size practices.

This method can then be applied to the subject practice's revenue stream to isolate personal or professional goodwill, assuming the practice is larger than average size. One would expect a larger practice to have greater working capital requirements and perhaps a larger workforce in place value, but with most of the excess value attributable to personal goodwill.

The results of applying the replication cost method to an average practice can be combined with an excess earnings approach for the subject practice. To the extent that the "goodwill" under the excess earnings method exceeds the intangible value under the replication cost method, this would be attributable to personal goodwill. (Certain jurisdictions may attribute all of the intangible value of a professional practice to personal goodwill and valuers need to be familiar with the laws in the subject's state.) One might also use this method as part of the valuation of a covenant not to compete, since personal goodwill is generally deemed not transferable absent a covenant. Having determined personal goodwill in this fashion, the covenant would represent that portion of the personal goodwill value adjusted for the *probability* that the individual would, in fact, compete. For example, assume the covenant lasts for three years and there is a uniform chance of competition during that period of 50% and none thereafter. The present value of the income forecasted to be lost as a result of that competition in each year would be multiplied by the 50% probability to arrive at the covenant's value.

In a divorce proceeding where the professional will continue to practice post-decree, it is not difficult to conclude that the probability of competition by the professional with him or herself is 100%, resulting in all of the personal goodwill being attributable to the covenant. If the covenant were not marital property, it would be excluded from the marital estate.

With respect to that portion of enterprise intangible value representing workforce in place, a buyer would expect a nonsolicitation agreement with respect to the employees. As is the case with the covenant in a divorce proceeding, the professional will retain the employees post-decree and therefore the workforce in place value is attributable to the professional, in a manner similar to personal goodwill, and would not be part of enterprise goodwill.

Specialty versus Primary Care Practices

Certain medical practices have the benefit of repeat patronage while others require a steady stream of referrals of new patients in order to continue to generate income. Generally speaking, primary care practices such as general internal medicine, pediatrics and family medicine have established patient bases that will experience repeated visits. Other practices, such as various surgical specialties, often see a patient only for a few encounters and then never again. These practices require the stream of referrals from their primary care colleagues and other patients. The ability to generate such referrals is in large part due to personal characteristics of the physician and therefore attributable to personal goodwill. In turn, the patient records in a specialty practice are worth much less than those in a primary care practice. In fact, they may be worth very little. Much of this decreased value is reflected in the higher discount rate used for specialty practices.

Conclusion

Identifying and valuing the various categories of intangible assets can be an integral part of a meaningful valuation depending upon the purpose of the engagement. The use of replication cost affords the valuator with a method for separating personal goodwill from practice goodwill, subject to the provisions of local law with respect to noncompetition and nonsolicitation agreements, and to the type of medical practice being valued.

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last revised April 10, 2001
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