How much is your practice worth? Often, it depends on who wants to know and why.

Practice valuation professionals — often CPAs with specialized training — follow different tacks depending on whether a practice will be sold to another physician, valued for a divorce proceeding, or if practice partners just want to go their separate ways.

The traditional building blocks of practice value are:

- **Hard assets** — equipment, facilities, supplies, patient records (the cost of the files themselves, not the information in them), etc.;
- **Cash** — what’s left after expenses, including physician compensation;
- **Accounts receivables** — money due for professional services; and
- **Goodwill** — anything paid above the value of hard assets, cash, and A/R.

Appraisal professionals can follow several pathways to put a value on these four items. The market value approach — what other practices in the area sold for recently — is dandy for houses. But it can be an exercise in uncertainty to compare medical practices in different parts of the country.

Another approach is to try and project future cashflow, the component most important to business investors. While it works well for many types of businesses, cashflow valuation is of little help to the typical medical practice owner. Most have little cash left after paying for overhead expenses and physician compensation, explains Jim Sacher, a CPA with the accounting and consulting firm Skoda Minotti.

“Partners tend to take whatever’s left after expenses as their compensation,” he says. “If physician compensation is set at a fair market level for the same area but there’s never any cash left at the end of the year, then what’s it worth to an investor?”

Sacher explains that unless a physician earns substantially more than the fair market rate for his or her specialty and the area, that money is physician compensation, not profit. That’s why figuring in goodwill — the ability to make profits — historically was a major component in determining practice value.

That’s changing.
Goodbye, goodwill

Reed Tinsley, a Houston-based CPA, says goodwill isn’t that useful anymore as an indicator of what a practice will sell for. It’s losing ground because hospitals are moving back into practice-purchasing mode. They are setting the standard.

“Goodwill is tied to the performance of the practice,” Tinsley says. “The hospitals are now saying, ‘Why should I pay for that performance upfront when I can get you on the payroll for a small amount, see how your practice goes and pay you through compensation with performance incentives?’”

There’s another reason that hospitals won’t offer any goodwill for your practice: the Feds. Thanks to the Stark and anti-kickback laws, this intangible form of measuring the new owner’s profit opportunity just sounds too much like paying for future referrals. And that’s strictly forbidden.

![Goodwill Trends Table](image)

Unfortunately, the practice values that physicians assumed would still apply when they were ready to sell were built on the concept of goodwill. Without it, the value of a medical practice is primarily found in its tangible assets: equipment, supplies, facilities, furnishings, etc. And those values depreciate during the valuation process, often by using a 10-year scale that leaves just a fraction of the original value after a decade of use.

Wait, you may be saying, ‘I have lots of patient records and very nice accounts receivable (A/R) to pass on to the new owners.’ Sorry. You’ll probably need to collect that A/R yourself — most buyers aren’t interested in handling your collections. Besides, you may need it for payables, like existing leases, if the purchaser doesn’t want them either.

As for medical records, don’t expect a windfall. Sacher says the Internal Revenue
Service’s guidelines for setting medical record values between $12 and $22 is fairly accurate and widely followed. That’s about what it would cost in staff time and materials to rebuild the paper file. So, a family physician with 3,000 active (no more than three years old) patient records might hope to get $66,000 from a very generous buyer. Other specialists may be able to get credit for records as old as five years. All the same, buyers know that in most communities patients can choose other physicians and that insurance plan changes may steer them to find other providers anyway. Besides, in a legal sense you don’t really “own” your patients’ medical records, they do.

With goodwill off the table and cashflow equations usually of little help in establishing value, physicians must carefully scrutinize any valuations made of their practices. As they do, it helps to seek expert advice to be sure that every credible shred of value is accounted for.

**EMR can count**

It was easy for Pittsburgh-area family physician Fran Meyers, DO, and his partners at Chestnut Ridge Primary Care to confirm the value a prospective buyer placed on their 19-physician, multi-site practice. After all, Meyers and his partners still had the valuation report from several years earlier when they had sold the practice to another hospital. That deal didn’t pan out so the group was anxious to try it again, but on its own terms.

Neither Meyers nor officials from Excela Health, the hospital system that bought the practice last March (2008), will disclose the purchase price. However, John Sphon, vice president of Excela Health Physician Practice Group — Chestnut Ridge’s new owners — confirms that goodwill was not part of the deal.

“We didn’t buy any goodwill, just tangible assets,” says Sphon. “Those days of paying for goodwill are gone. Physicians have to understand that this is a fair market value system for practice purchases now.”

Finding a rock solid comparison for fair market value is tricky when it comes to a medical practice. Instead of dwelling on the selling price, Meyers and his colleagues kept their focus on what life would be like at Chestnut Ridge after the sale.

“It was really more a matter of (asking) do we want to sell to that entity because then we can do things together, and are there synergies we can both work with and make the future brighter for both of us,” Meyers says.

One sticking point early on in the deal was how to value the electronic medical record (EMR) that Chestnut Ridge had purchased a couple of years before the sale. The outside valuation experts hired by Excela set a lower value on the system (a Misys product) than Meyers felt was justified.
“The entities buying medical practices and the appraisers do not appreciate the real value of an electronic health record and what it does in terms of quality initiatives and practice management,” Meyers says. “We know where we are sending patients, the productivity of the physicians. In the future, an EMR is something appraisers need to look at differently — not merely as a paperless chart, but more as a practice management tool.”

Sphon explains that traditional practice valuation would view the EMR as a tangible asset, just like an EKG or X-ray machine which declines in value as a durable good every year after you bought it.

But “an EMR is different than a chair or an EKG,” Sphon says. “Traditional straight-line depreciation doesn’t take into account that it is really building in value as you spend time and money to implement it, so we valued the group’s EMR as a tangible asset with some intangible benefit.”

Meyers and his colleagues were lucky that their new owner was not already committed to another system. Sacher explains that if a hospital pays off your investment in an EMR or any other big ticket items, but just puts them on the shelf after the purchase, regulators might view that as paying more than fair market value. And paying over fair market value in a hospital-physician transaction will raise suspicions about the legality of the deal.

**Getting help**

At The Coker Group, a healthcare consulting firm, almost all recent requests for practice valuations seem to be coming from hospitals looking for medical practices, says the firm’s manager of financial services, John Reiboldt.

To remove the threat of suspicion, hospitals and other institutional purchasers of medical practices hire outside appraisers to give unbiased opinions. The team will spend up to three or four days on site in confidential meetings, mostly with the practice’s business manager, asking lots of questions. The final written report will often run from 50 to 120 pages.

The biggest problem Reiboldt and his firm’s teams find in doing practice valuations is ‘dirty data.’ “The data we get from medical practices is unbelievably unreliable,” he says. “It makes it very hard for us to conclude anything and it might well hurt what your practice would be worth to someone else.”

A number of organizations offer credentialing in business appraisal, including the American Society of Appraisers, and two that also require CPA certification: the American Institute of Certified Public Accountants and the National Association of Certified Valuation Analysts. Appraisers should have additional knowledge of healthcare
industry rules, such as opinions issued by the Office of Inspector General of Health and Human Services.

Reiboldt recommends reviewing the purchaser’s valuation report instead of ordering your own — reports appraising a small practice can cost from $10,000 to $12,000 dollars. “These reports are opinions, so we always recommend you have one of your experts look at the appraisal a purchaser has prepared,” Reiboldt says. “Maybe they project a growth rate lower than you think is valid, or you are recruiting a new physician and they didn’t fully recognize that.”

**Valuation methods**

Selling a practice to a nonhospital buyer might open a few more options that could involve goodwill.

The Health Care Group reports a national benchmark for median and average practice goodwill expressed as a percentage of practice gross revenues in the year preceding the reported sale or other transaction. Its database includes several thousand medical practices. The trend in recent years shows goodwill amounts are declining — when goodwill is part of the deal at all, that is.

Still, if you can structure a deal that includes goodwill, how do you measure it? One way is to figure out what it would cost to hire a doctor to take your place. The difference between your compensation and that replacement doctor could be considered goodwill. This method might help to reward the experience and productivity of seasoned physicians who have built their practices over many years.

Another method recognizes business enterprise value, or practice goodwill. It is influenced by a host of intangibles, such as a prime location, favorable relationships with patients, and so on. Many states use this factor in valuing the practices of physicians involved in divorce proceedings.

Another form of goodwill, professional enterprise value, is the physician’s reputation, special knowledge and even personality, but is not transferable.

**Get a quick estimate**

To get a quick, very rough estimate of what your practice might be worth in today’s market, try what Sacher calls, the ‘back of the napkin’ valuation. This bare bones approach looks at free cashflow and the rate of return a hypothetical investor might expect for buying your practice.

**Step one:** Determine your practice’s free cashflow. That’s the amount of cash left after
paying operating expenses (staff and nonphysician provider salaries, rent, leases, loans, insurance, etc.) and the fair market compensation of the physicians.

Say you have a three-physician primary-care practice that pulls in $1.5 million after contractual adjustments. Operating costs are $900,000, leaving $600,000 for the three of you to divvy up. You each take $185,000, which leaves $45,000 in total cash. That $45,000 puts you well above the median for single specialty groups in terms of profitability, according to Medical Group Management Association annual surveys of group practice cost. Or maybe your profit is a bit under $5,000, which is closer to the MGMA median for many small primary care group practices.

**Step two:** Propose a required rate of return on investment (ROI). While 30-year Treasury bills may pay a little less than 5 percent now, investors who take large business risks will look for returns closer to 20 percent annually, Sacher says.

**Step three:** Divide the cashflow ($45,000) by the ROI amount (0.20). The result is the value of the practice ($225,000).

“That kind of calculation may get you in the church, but it won’t get you into the right pew,” Sacher says.

Depending on the buyer, you also may have room to negotiate on other issues, such as your practice’s location, the quality of its management, patient growth rate, payer mix and other factors, Sacher says.

Even when you try all the different forms of appraising a practice, you still won’t know what it will bring on the market, says Robert Bohlmann, a consultant and principal with the MGMA Health Care Consulting Group.

“I often run into doctors who think their practice should sell for its appraised value, but that’s not always the case,” he says. “If you want to get a good deal, start thinking about life after the sale and how you’ll have the chance to get paid for what you do as opposed to what’s left on the table after all of the practice costs and contract discounts are taken out.”

Adds Reiboldt, “the hardest thing to convey in presenting appraisals is that it’s just business. It’s not personal, but to some people, hearing what their practice is worth is like we’re saying their baby is ugly.”

And for now, buyers seem to be getting the upper hand in determining what your baby — your practice — is worth.
Documents That Help Appraisers Value Your Practice

A valuation team visiting your medical practice will want to learn a lot more about your operations than what’s your recent profit and loss statement. Expect appraisers to ask for:

• State and federal income tax returns (up to five years worth)
• Bank account statements
• Corporation bylaws and articles of incorporation
• Partnership agreements
• Employment contracts
• Physician compensation agreements
• Retirement plan commitments
• Revenue and expense reports
• Collections and adjustments reports
• Aged accounts receivables and payables reports
• Payer contracts
• Fee schedules
• Cashflow statements
• Lease agreements
• Mortgages and other loans
• Supply inventory

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