Valuing the OMS practice

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This issue of Practice Management Notes explains how a practice valuation is performed and demonstrates the value of having an appropriate practice valuation when and if it is needed. OMS practices have significant value and one should not overlook the use of trained analysts to provide that very important number. Recklessly using “rules of thumb” to value practices that are worth hundreds of thousands to millions of dollars does not constitute prudent business sense.

Historically, the valuation of an OMS practice was more of an art than a science. There was some minimal guidance provided by the Internal Revenue Service (IRS) and minimal valuation development and reporting standards. Accordingly, many in the business valuation profession served as advocates for the practices, rather than an expert in determining a “conclusion of value.” The growth and diversity within the valuation profession, certification programs, improvement in software applications, growing sophistication and comprehension of valuation by the judiciary and availability of data through the Internet has transformed the valuation profession from an art form to an objective accounting specialty.

When discussing OMS practice valuations, the concept of goodwill inevitably arises. Goodwill is an intangible asset that exists in different amounts in different practices. When purchasing a practice or a share of a practice, goodwill is the economic recognition of the practice’s name, reputation, referral loyalty, location, future earnings, employees and business systems in place. In an OMS practice, there are two types of goodwill: practice goodwill (also referred to as institutional goodwill) and professional goodwill (also referred to as practitioner goodwill). Practice goodwill is associated with the institutional entity or business and professional goodwill is associated with the individual practitioner(s). Contemporary valuation software utilizes a court-tested approach to allocating practice goodwill and professional goodwill in privately held practices, which is necessary in some types of valuations. An OMS practice valuation typically will include goodwill in the valuation of that ongoing business.

Why do it?

First, before beginning the valuation process, the valuation analyst must know the purpose of the valuation. There are three basic purposes for valuing an OMS practice: tax, litigation and transaction (buy-sell). The purpose of the valuation will affect the assumptions and methodologies used to determine a conclusion of value. There are many reasons to have an OMS practice valued, including:

- Buy-sell agreements
- Sales and divestitures
- Succession planning
- Litigation support
- Shareholder transactions
- Marital dissolution

It is advisable to have a practice value amount in buy-sell agreements. Having a value specified in the buy-sell agreements should preclude any differences of opinion on the part of the owners and, hopefully, negate any perceived need for the multiple parties to obtain their own individual valuations.

When a valuation is prepared for one purpose, such as a buy-sell agreement, that valuation is not applicable to, and should not be used for, other purposes such as litigation support or a marital dissolution.
The value

The standard valuation of an ongoing OMS practice involves determining Fair Market Value (FMV). The term “Fair Market Value” is defined in IRS Ruling 59-60 as follows:

“...price at which the property (OMS practice) would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”

In the valuation context, once the standard of value is determined (FMV), the appropriate premise of value must then be selected. The premise of value relates directly to the reason the valuation is being performed. Typical premises of value in OMS practices are a “going concern” value or, in the case of no buyers for the business, “liquidation value.”

The process

The next step in the process is for the valuation analyst to review at least five years of historical financial data, key practice-related statistics, and legal documents. The analyst must also assess the efficiency and effectiveness of the organization, management’s skills and talent and make a site visit to assess the overall practice facility and its location. Simultaneously, the analyst is required to review the overall related economic and OMS industry issues from a national, regional and local perspective. The valuation analyst’s goal is to comprehend and distinguish the positive and negative financial, managerial and operational aspects of the practice. With that understanding, the analyst can objectively include those aspects in the conclusion of value.

In most practices, the compiled historical financial statements are presented in a fashion that is helpful in the annual preparation of the practice’s tax return. Commonly, it is accepted that financial statements prepared on a tax basis of accounting often present a picture that is very different from economic reality. Federal law permits a professional corporation to prepare tax returns on the cash basis of accounting. The cash basis of accounting simply means the financial statements and tax returns do not include accounts receivable or accounts payable. With that said, the analyst will typically need to adjust the practice’s historical financial statements so they reflect a truer picture of the practice’s financial condition. In the field of business valuation, this process is known as normalizing the financial statements. Based on the need to normalize financial statements, the ongoing financial statements provided by the practice or their accountant should not be used to determine any type of valuation.

If the practice owns real estate, collectables or other assets that can appreciate in value, the analyst will most likely want to have them appraised by someone knowledgeable about that asset. That appraisal will then become part of the valuation.

Three approaches

There are three commonly used approaches to valuing an OMS practice: the asset, income and market approach.

The Asset Approach, which is defined as “a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets minus the liabilities.” Generally, the Asset Approach is a sound method for estimating the value of non-operating businesses such as investment companies and real estate, ie, a practice’s office building. The negative aspect of this approach is that it does not address the operating earnings and profitability of the practice. Therefore, in an OMS practice it would generally be inappropriate to use this method, as it does not address the value derived from the earnings.

The second valuation approach is the Market Approach. The idea behind the Market Approach is that the value of a practice can be determined by reference to reasonably comparable “guideline” practices for which transaction data and sale values are known. There are several advantages and disadvantages to the use of the Market Approach to value an OMS practice. The advantages are:

- It is “user friendly.” Users of market valuation reports tend to find market-based methods to be familiar and easy to understand compared to other methods.
- It is relatively simple to apply. The Market Approach derives estimates of value from relatively simple financial ratios drawn from a group of similar practices. However, this is an advantage more in perception than reality.
The disadvantages of the Market Approach in valuing an OMS practice are:

- The standard of value may not be clear. Some authors argue that the transaction databases used in the market valuation process utilize Fair Market Value less than half of the time. This is a significant issue as the reliability of the comparable transaction data is questionable.
- Most of the important assumptions are hidden. Among the most important assumptions and reasons to buy into a practice is the practice’s expected earnings. Reasonable knowledge of comparable practice earnings would be instrumental in using the Market approach in valuing an OMS practice.

One Market method of valuing a practice is using multiples of revenue or collections. The author does not recommend relying entirely on revenue pricing multiples because the specific practice may have certain positive and negative attributes that the pricing multiple would not take into account. Another Market method is the use of the Goodwill Registry. The Goodwill Registry, a publication produced annually by the Health Care Group of Plymouth Meeting, Pennsylvania, presents a compilation of OMS practice sales. While the Goodwill Registry is a useful transaction guideline source, like other Market approaches it should be used with caution. Many valuation analysts do not recommend relying entirely on this method.

The third approach, the Income Approach, is a general way of determining the value of a practice, practice ownership interest, or intangible asset using one or more methods that convert anticipated future economic benefits into a present single amount called the preliminary value. When “the earnings capacity of a practice” is a factor to be considered in a valuation, IRS Ruling 59-60 clearly requires that an income approach is to be used. This is because, in the majority of OMS practice valuations, the practices have adequate historical financial information, which is the foundation to using this method. This method assumes all of the assets, tangible and intangible, are indistinguishable parts of the practice. In its simplest form, this method utilizes net earnings from the historical normalized income statements and a capitalization (multiplier) rate to compute a preliminary value. The valuation analyst derives the capitalization rate in a number of different ways and it represents the return expected on the investment (practice purchase), which should be no more or less than any other practice would expect to receive. When determining the capitalization rate, the analyst objectively assesses risk regarding the external economic environment, the practice’s financial condition, managerial skills and talents, competition and overall practice stability. Depending on the analyst’s assessment, the capitalization rates can generally range from one to five.

The advantages of the Capitalized Income method are:

- It is widely used and, therefore, recognized and understood by many people.
- Conceptually, it quantifies the value of the practice’s collective intangible value in the nature of goodwill.
- It is codified in IRS Ruling 59-60, and it has been approved in many court rulings with respect to the valuation of professional goodwill.

The disadvantage of the Capitalized Income method is that it can be easily misapplied if the analyst is not familiar with OMS practices because it requires so many subjective judgments.

Once the valuation analyst completes the preliminary analysis and calculations, a preliminary value is determined. This preliminary value is derived by using one or more of the methods mentioned above.

Discounts

The final step in the process is for the analyst to consider if any discounts need to be applied to the preliminary value. The analyst is required to identify and consider those ownership interest characteristics that are specific to the practice. The two most common discounts found in valuing OMS practices are for minority or a non-controlling interest in a privately held practice and a lack of marketability discount.

Minority or non-controlling interests are ownership interests in the practice that are less than 50%. The minority owner:

- Is not in a position to set policy and influence operations of the practice;
- Cannot appoint management and determine compensation;
- Cannot acquire or dispose of practice assets; and
- Does not have control over practice savings or checking accounts.

If the analyst deems a minority ownership discount applicable, the discount, which lessens the preliminary determined value, has historically been from approximately 20% to 30% of the preliminary value.
The other common discount is for lack of marketability. Marketability is ability to convert ownership interest into cash with a minimum of transaction and administrative costs. OMS practices have two inherent marketability issues: finding another interested surgeon and, second, location. Empirically, finding an interested surgeon to be an associate with a proposed buy-in seems to be more related to location than any other variable. There are those instances where a surgeon wants to practice where he or she grew up or where their family resides. However, it is easier to attract an associate or future partner to a practice in upscale metropolitan areas than the more rural areas. If the analyst deems a lack of marketability discount is applicable, the discount, which again lessens the preliminary determined value, has historically been from approximately 23% to 45% of the preliminary value.

Another less common discount in valuing an OMS practice is the key person discount. Analysts would generally consider this discount for a company where thin management and a strong practice dependency on the efforts of a single individual for future operational and financial success would threaten the practice’s long-term viability. Such a discount is generally referred to as a key person discount.

Conclusion of value

Once the analyst determines a preliminary value then reduces that value for appropriate discounts, the remaining value is termed the “conclusion of value.” The conclusion of value can be a single number or a range of numbers. The conclusion of value should be part of a written report.

With the collection of historical information, the current economic and industry environment, and the many judgments made by the trained analyst, a written report should be issued to provide future guidance on how the analyst determined the conclusion of value. The reporting standards for an OMS practice valuation include the following at a minimum:

- Identification of the practice being valued;
- Ownership size, restrictions and agreements;
- Valuation and report dates;
- Purpose and use of the valuation;
- Identification of the standard and premise of value;
- Valuation and methods utilized by the analyst;
- Historical financial statements;
- Identification of assumptions and limiting conditions;
- Reliance on other specialists—such as real estate appraisers;
- Jurisdictional exceptions and requirements;
- Limitation on the future use of the report;
- A statement of the analyst’s financial interest;
- Whether the analyst is required to update the report;
- Disclosure of any contingency fee; and
- Qualifications and signature of the analyst.

Clearly, the conclusion of value report is an organized approach to bring forth a cogent understanding on the part of the buyer and seller so that they are well informed about the value of the practice and the market for such property. The report should serve as a basis for the negotiating process and can be referenced in future valuations.

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