What Is a Practice Worth?

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Before getting too involved in the many ways to establish a *fair* price to pay for a practice—or the *fair* price for selling a practice—let us examine the elements that determine the *value* of a practice.

First, divide the selling price of the practice into its two elements: *tangible assets* and *intangible assets.*

Tangible Assets

The practice's tangible assets are generally the assets that appear on the financial statement (balance sheet). These include Cash, Accounts Receivable (which are usually not shown on a cash-basis balance sheet), Furniture, Fixtures, Equipment, Leasehold Improvements, Supplies and Instruments (which are usually not shown on any balance sheet), and all other tangible property owned by the practice. The total of these assets is reduced by whatever debt the practice shows as Liabilities. The resulting amount is called *tangible net worth.* This truly represents the tangible value of the practice, subject to some adjustments, which lie in three areas:

1. If the practice's financial statement does not show Accounts Receivable as an asset, there should be a measurement made of the actual amount of money owed to the practice for work that has been completed but has not been paid for. Many practices set up a contract for work to be performed as an Account Receivable. This is an improper use of the term; Accounts Receivable should be only for work completed that has not been paid for. A Reserve for Bad Debts should be established based upon the bad-debt experience of the practice. By subtracting this figure, the net value of Accounts Receivable can be included in the assets.
2. Some portion of the Depreciation taken should be added to the stated value of the Furniture, Fixtures, Equipment, and Leasehold Improvements, increasing the value of those assets to their "Current Market Value" as "Used Equipment". Frequently, this is accomplished by having a professional appraisal made of those assets and substituting the appraised value for the stated value. This adjustment is appropriate because the tax laws allow a faster depreciation of the Furniture, Fixtures, and Equipment than the actual decline in value of those assets as *used* Furniture, Fixtures, and Equipment.

For some years, when valuing practices that were going to be offered for sale, I have added back one-third of the Reserve for Depreciation (the total of accumulated Depreciation) as an arithmetic computation of the true current value of those assets. This rule-of-thumb measurement is less accurate than an appraisal, but I believe it is a workable substitute.

3. If Supplies and Instruments are not shown on the balance sheet of the practice, an inventory should be made and the total added to the assets. Current tax law generally allows all Supplies and Instruments to be charged off as current expenses at the time of purchase. The actual inventory value of these assets represents a significant addition to the total assets at the time of practice sale.

When the above steps have been taken to

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correctly calculate the tangible value of the practice assets, that portion of the price for the practice should be fairly and accurately determined.

The next matter for decision is to examine the *ownership* of the tangible assets. They can be held in a corporation or partnership, or they can be owned by an individual doctor, or by the children, wife, or parents of the doctor. Should they be owned by a corporation, the seller will probably ask the buyer to purchase the stock of the corporation. *There are significant disadvantages to the buyer in buying the stock of a corporation.*

The buyer cannot deduct the cost of the stock, and therefore receives no immediate benefit. There is, however, a significant benefit to the seller, who can pay tax on the payment for the stock as a *capital gain.* This capital gain is the amount by which the selling price exceeds the original cost of the corporate stock. The maximum long-term capital-gains rate for federal taxes is 20%. Alternatively, if practice assets are sold, much of the proceeds would be taxed at the *ordinary* rate, with a maximum of 39.6%. This would result in a considerably larger federal income tax obligation, and the state tax obligation would be added to that. State income taxes range from zero in five states to a high of 13%.

The tax benefit would be tempered somewhat if the taxes were applied only to the *profit* arising from the transaction. Still, I believe that a *fair* basis for the purchase of the tangible assets is to have the buyer purchase the assets themselves rather than the stock of the corporation that owns the assets. If the buyer and the seller agree to transfer the stock, I believe some downward price adjustment would be in order. It is only fair that the tax benefits that accrue to the seller should be shared by both.

There is another reason for a buyer to resist purchasing the stock of a professional corporation. The buyer would be assuming all liabilities that might exist at the time of the practice transfer, whether known or unknown. For example, a tax audit for past years' tax returns that resulted in added income-tax assessments would create an unexpected obligation for the new practice owner. Furthermore, the corporation would carry with it the liability for malpractice claims that might later arise from work performed by the former owner.

These detriments can be overcome by having the seller give the buyer an *indemnification agreement.* This is a separate contract stating that the seller will pay for any unknown practice liabilities that might turn up later. Any claims relating to the period of the seller's ownership prior to the practice transfer would thus be retained and settled by the seller. The seller essentially gives the buyer a *hold-harmless* agreement for all claims that might later present themselves.

In summary, a dollar paid for a dollar's worth of tangible assets seems to be a fair basis for payment. Resist the purchase of corporate stock to the degree possible. The buyer should always attempt to buy the actual assets for the agreed-upon price. Should the practice be incorporated, the *corporation* can sell the tangible assets to the buyer, and the seller can then either dissolve or keep the corporation as desired.

Intangible Assets

The value of intangible assets is more difficult to measure. Another term for intangible assets is *good will.* They could also be considered as the *income-generation value* of the practice. All these names really describe the *continuity* of expected future income.

Good will is an elusive and hard-to-measure benefit that goes along with the purchase of a functioning practice. It means buying an existing patient family that supposedly will continue its care at this practice. Other factors include having a competent staff in place, a physical office that continues to work efficiently, and used but functional equipment. There are all sorts of benefits that the buyer realizes in addition to the cold, hard assets listed on the balance sheet.

The problem, however, is to establish a *fair* value for these intangible assets. When all is said and done, we tend to fall back on that old cliche, "The good will is worth whatever a willing buyer is prepared to pay a willing seller." That doesn't do the prospective buyer much good in trying to

evaluate the fairness of the proposed selling price.

Without a doubt, the *worst* way for a young doctor to buy the good will of a practice is as part of the price for the stock of the corporation that operates the practice. When that happens, the buyer needs $1.52 in pretax dollars (at the federal corporate income-tax rate of 34%) to have $1 remaining to pay the seller. Stock is *always* purchased with after-tax dollars. The buyer cannot deduct any of the purchase price until such time as those shares of stock are sold. It is the same as if one were buying shares of General Motors Corporation. On the other hand, the seller can treat the profit on the sale as a long-term capital gain, subject to a maximum tax rate of 20%. The only way the buyer should agree to purchase stock for both the tangible and intangible assets is if the price is reduced to the degree that the buyer would not be penalized.

Buyers have always sought to characterize the amount paid for the intangible assets as good will so they could charge off that portion of the purchase price as soon as possible, while sellers have sought to consider the payment a capital gain for tax purposes. Meanwhile, the Internal Revenue Service is constantly battling these efforts to obtain preferential tax treatment.

In the past, doctors have sold patient records as a separate asset to achieve tax savings. In fact, a well-known tax case—Los Angeles Central Animal Hospital, Inc., vs. Commissioner of Internal Revenue, filed May 25, 1977—permitted such treatment. In that case, the court ruled that money paid for the purchase of the patient records (animals being treated) could be charged off over the "average" life of a patient in an animal hospital, which the court determined to be seven years. Thus, the buyer could charge off the value of the patient records over a seven-year period, while the seller received favorable capital-gains tax treatment.

Currently, buyers can amortize (deduct) all intangible assets, including good will, over 15 years, with the write-off taken annually in equal amounts. For the seller, the amount received for the tangible assets in excess of their depreciated value on the balance sheet is generally taxed as ordinary income. Amounts received for tangible assets that were not listed on the balance sheet, such as Accounts Receivable and Supplies and Instruments, are also taxed as ordinary income. Whatever additional amount is received is attributable to good will or intangible assets, and is taxed as a capital gain.

I believe the good will for just about any practice is worth *two times the last year's profit.* For an incorporated practice, an unincorporated practice, a partnership, or a limited-liability partnership, I consider profit to include four items *only:*

1. The salary of the practice owner.
2. Charitable donations paid from the practice.
3. Contributions to a pension or profit-sharing plan.
4. Corporate or other stated profit (in addition to the owner's salary) noted on the annual profit-and-loss statement.

This definition does *not* include "perks" (short for "perquisites", an old English word meaning "an incidental emolument, fee, or profit over and above fixed income, salary, or wages"). Perks are such items as fringe benefits, travel, ownership and use of automobiles, entertainment, gifts, country-club expenses, payment for domestic help that might be shared between home and office, and a host of other items.

Other consultants and many practice salespeople, particularly those who represent the sellers, will almost always *include* perks as part of the profit for the year being measured. Some still ask for the two-times-profit figure as the price for the good will of the practice. Others use smaller multiples, from 1.5 to 1.8 times the profit including perks.

The reason I follow the above formula for determining good will is that whenever I asked doctors what their practice perks amounted to, I found them stretching out the list of expenses they wanted buyers to accept as part of the profit, thus raising the value of the good will as high as possible. It became difficult for me to curb the expansion of perks. I ultimately decided to use a larger multiple (two times profit) and *not* to

include any perks. None of this should be interpreted to mean I do not favor the extensive use of perks by the owners of dental practices to the maximum degree that the government allows them to be tax-deductible.

Historically, perhaps 20 or more years ago, the annual gross income of the practice was used as the basis for establishing the value of good will. Although there was actually a wide variance in practice profits, the accepted theory at the time was that the "average" net profit was 50%. Over the years, that figure has declined to around 40%, with many practices even lower. Therefore, it became apparent that gross income was a faulty basis for measurement. The buyer can pay for the practice only from the *profit* generated by the practice.

Some practice management consultants believe the gross income and net income of the practice should be *averaged* over the past three years to determine intangible value. They feel this more fairly represents the trend of the practice in the valuation. I strongly disagree.

Many older doctors experience a reduction in personal energy and are no longer effective at keeping their practices growing and healthy. When that occurs, averaging the past three years of gross and net income is most unfair to the potential buyer. A declining practice requires an especially great effort to turn around. The decline may be an indication that added investment is needed to update the practice facility. It is likely to need redecoration to make its appearance more welcoming. It may also require new equipment that would make the practice more up-to-date—perhaps new computers and even more.

On the other side, in a growing practice, averaging the past three years of gross and net income is unfair to the seller. The three-year average discounts the *current* condition and value of the practice. A growing practice requires less effort on the part of the buyer to keep healthy and to continue the rate of practice growth.

We can conclude that a potential buyer should be aware of the past three-year history of the practice, but should *never* allow three-year averaging as a means of arriving at a suitable price for good will. In fact, I recommend that the price for the intangible value of a declining practice be further reduced, because the buyer faces added cost and effort to return the practice to a healthy condition. From the seller's standpoint, there is nothing to be gained by averaging the past three years when the practice is growing and healthy. The seller would be discounting one of the greatest values that can be transferred to the buyer—an inertial increase in practice rewards.

I have appeared as an expert witness in court cases involving the value of good will in a practice and have also furnished many depositions on practice valuation standards. I recall one case in which I was called by the practice purchaser to testify. The buyer claimed that the seller had not only *overstated* the value of the good will, but had *misstated* the value of the good will. The buyer refused to continue making monthly payments for the purchase of the practice after only 10 installments. I felt the seller had puffed up the good will of the practice somewhat, but no more than in many other cases in which I had been involved. In any event, the court ruled that the buyer did not have to make *any* further payments to the seller for either the good will *or* the tangible assets. Obviously, the seller paid a heavy price for his effort to build up the intangible value of his practice.

Of all the assets being purchased, good will is the most elusive to value definitively. I believe the price of the good will included in the purchase is *always* subject to negotiation. And so we return to the original premise: good will is worth whatever a willing buyer and a willing seller can *agree* to set as its value.

Restrictive Covenants and Consulting Agreements

For many years, payment for a *restrictive covenant* was used as a combination of preventive protection and a means of paying the seller for intangible value on a basis that allowed the buyer to charge off the payment as a tax-deductible expense. Since the government ended this tax advantage, the agreement can only be

thought of as protection for the buyer. That is still a valid reason to incorporate a restrictive covenant in any practice purchase agreement. Without it, the seller could reenter practice in competition with the purchased practice. This could occur if some sort of dispute with the buyer arose, or if the seller decided for whatever reason to return to practice.

The question is the length of time and the area that should be protected for the purchaser. I wish there were a definitive answer to this question, but there isn't. Laws for restrictive covenants vary from state to state. Most of them say that "a restrictive covenant is enforceable if it is reasonable". What is *reasonable,* however, is left up to the judge to decide. These decisions vary widely from state to state and from city to city.

I can say that in heavily populated urban areas, the covenant that seems to be enforceable can be for as little as two miles and two years. In rural areas, I have seen a whole county stand up as "reasonable" for protection over *five* years. I remember one case in which an orthodontist was hired by a pediatric dental practice in a large city. He was asked to sign a restrictive covenant that would prevent him for practicing within five miles of any office of the pediatric dental practice for five years if he separated from the practice. I told the orthodontist he had a problem in ethics: he could either tell the pediatric dentists that the asked-for covenant was unenforceable in that area, but that he would be happy to sign an enforceable agreement of two years and two miles, or he could sign the covenant, knowing full well that it was meaningless. I told him *not* to tell me his decision!

Another common practice used to be that the seller would sign a *consulting agreement* that entailed paying the departing doctor as a consultant for the good will of the practice. This enabled the purchaser to charge off such payments as tax-deductible business expenses, while allowing the seller to include them in intangible assets. Since the law now requires amortization over 15 years, however, I don't see many consulting agreements any longer.

In one case I encountered, the buyers could not reach an agreement with the seller as to the time and amount of consulting to be involved. I suggested the wording to be: "Dr. X shall be available for consulting with his former practice from time to time as convenient to both parties." This satisfied both sides, and I don't believe he was ever called upon for a consulting session.

Generally speaking, a restrictive covenant has an obvious practical advantage for the buyer, but a consultantship is of little value unless the seller stays with the practice for only a short period. ❑