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FAIR VALUE™

Reprinted from the March 1994 Issue

Medical Practice Sales To Hospitals: A Valuation Minefield - Part I

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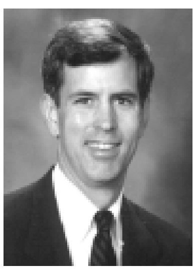
Introduction. Independent medical practices in the Carolinas are being acquired at a rapid pace, often by not-for-profit hospitals, driven by the forces of managed competition, uncertainty associated with health care reform, and the mutual fears of both physicians and hospitals of being left out if they fail to strike an alliance before their competitor. These acquisitions give rise to complex and partially unresolved valuation issues that can have serious tax and legal ramifications for both selling and acquiring parties. This can include possible violation of the Medicare and Medicaid anti-kickback statutes administered by the U.S. Department of Health and Human Services (HHS).



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This article will highlight several critical valuation issues, among many, raised in a recent IRS internal training manual as factors agents should consider in reviewing practice valuations arising from these transactions and the potential risks these may pose to the selling practice and acquiring hospital. Five valuation problem areas are discussed, as follows:

1) **Practice goodwill-** Is it real or just a disguised payment for future patient referrals?
2) **Physician compensation-** If selling doctors make the same after the sale has goodwill been transferred?
3) **Required financial analysis-** The importance of a thorough and independent financial analysis of the practice.
4) **Discounted cash flow valuation method-** Is the use of the method based on realistic assumptions and are its findings confirmed by other methods?
5) **Past Physician Buy-Ins-** Do past prices paid contradict the selling price for the practice?

We will not attempt to outline all issues raised and emphasize that these are possible interpretations only. While the manual is not official Service position, it provides insight into what the IRS thinks its people should be scrutinizing and may be suggestive of current actions to prevent future problems.

Sale Must be at Fair Market Value: But What About Goodwill? The Office of The Inspector General (OIG) of HHS has notified the IRS that transactions should be carefully analyzed to insure that the price paid for a practice reasonably reflects fair market value. Any portion of the amount above the fair market value of hard assets, often ascribed to the value of practice intangibles, may, according to OIG, really be compensation for future referrals, a prohibited payment under the Medicare fraud and abuse statutes, a felony. Examples of intangibles might include patient lists, covenants not to compete, a trained and skilled workforce and other elements encompassing goodwill. One asset, frequently overlooked, is the intangible value afforded a practice by exclusive contracts some specialists (e.g., anesthesiology and radiology) have to serve all patients needing their services at the hospital.

The problem with goodwill is that most practices have few hard assets other than medical equipment, perhaps real estate and an investment in receivables. Therefore, the parties must prove that practice goodwill actually exists and set forth its estimated value in a sound and demonstrable manner. The importance is that goodwill must represent a real asset of value that is actually sold, and not simply a ruse for patient referral values.

This attention on fair market value is not new, but the pace of acquisitions, the scrutiny they are being given, and the fraud and abuse ramifications are. Revenue Ruling 76-91 (issued in 1976), dealt with the purchase by a charitable hospital of intangible assets from a taxable hospital that contributed explicitly to the accomplishment of the acquiring hospital's tax-exempt purpose. The ruling indicated that when buyer and seller have a close relationship, the buyer must establish the aggregate fair market value by an independent appraisal, as well as provide detailed support for the values of the various intangible and tangible assets acquired.

Post Transaction Physician Compensation: A Potential Problem. Typically, selling physicians execute professional services agreements to provide needed support to the hospital's patients. However, the agreements cannot require physicians to admit patients to a specific hospital, making the whole issue of whether or not the "goodwill" purchased has value a central valuation issue. Perhaps one of the biggest potential bombshells in this regard is the following suggested inquiry for examining agents:

> *"Will the projected net salaries Applicant's (acquiring hospital) physicians receive from the IDS (the resulting 'integrated delivery system') be similar to their prior net income? If so, how is the fact that the physicians no longer are entitled to payment for the use of capital assets reconciled?"*

This question cuts deeply into the fundamentals of the whole income approach used in the valuation process. Since physicians often take the majority of a practice's income in the form of compensation (salary and bonuses) and profit sharing, there may be little or no reported income to capitalize to estimate value. Therefore, practices are often valued for other purposes by first adjusting compensation to the median for similar practitioners within the area of specialty. If the physicians earn an above average compensation, the effect of this adjustment is to increase the practice earnings to be capitalized, raising the value and also entering into a later determination of the possible existence of goodwill by other methods.

Yet, the IRS appears to be implying that if the physicians still earn what they did before, the goodwill was never really transferred to the hospital and should not have been considered in the valuation or the purchase price paid. This also then sets up the possibility that OIG could then claim that the transaction was a payment for more than fair market value, representing an obfuscated bribe by the hospital to insure a source of continuing referrals.

This places great importance on retaining an experienced business appraiser with the ability to skillfully and accurately determine the existence of goodwill, and if present, provide legitimate, detailed and objective support of its value that will withstand a high degree of scrutiny. Otherwise, any payment price that exceeds the value of tangible assets runs a significant risk of being challenged. Additionally, legal advisors to both parties should consider and deal with the possible impacts of alternative compensation structures well before a final deal is struck.

Valuations Must Examine Financial Performance. Besides referring to the various valuation fundamentals in Revenue Ruling 59-60, the manual also sets forth analysis that should be undertaken to determine if the practice is financially sound and how well it performs relative to its peers in the medical profession. In addition to trying to insure that hospitals do not buy failing practices, the IRS also want to determine if the practice was, in fact, readily salable.

The implication is that shoddy, cursory valuations will not suffice. Only a thorough, objective and expert analysis can demonstrate if the practice is indeed a superior performer and, if so, warrants the price at which it is valued. The business appraisal should compare the practice on a variety of performance criteria against peers from medical, financial, ratio, compensation and other related studies, and reach clear and concise interpretations as to how this impacts value. The results of these analyses and findings should be clearly and effectively communicated in the valuation report and should be supported by objective, verifiable data.

All Valuation Methods Must Be Considered. Further, the IRS says the valuation should be scrutinized to insure that the three valuation approaches are considered, which include the following:

1) Income approaches deal with the value of the income the practice produces, and include the capitalization of earnings and excess earnings and discounted future cash flow methods;

2) Market approaches involves considering the

prices paid for past transactions in the shares, and prices paid for the sales of similar practices; and,

3) Cost approaches, which focus on the values of tangible and intangible assets.

A professional practice valuation, for any purpose, should always explore these three approaches and consider all relevant techniques available. Further, it should clearly articulate which ones were used and why, and why others were not.

IRS Expresses a Preference for The Discounted Cash Flow Method. The IRS manual indicates that the discounted future cash flow (DCF) method is particularly favored and should receive the most attention of the valuation procedures presented in the valuation.

DCF involves the forecasting of annual revenues, earnings and cash flows of the practice, often for 5 to 7 years, and then discounting the annual cash flows back to a present value today at a discount rate representing a return for risk. The IRS says the forecast assumptions and discount rate used should be examined for reasonableness and tested against the findings of other valuation methods. Therefore, the valuation must provide a full explanation for any forecast or other assumptions made, and clearly demonstrate that they are both reasonable and defensible.

Because the values achieved by DCF can be manipulated by changes in critical assumptions, all parties to a transaction must hire a business appraiser who will estimate realistic forecasts that can be legitimately defended.

Medical Practice Sale Comparables Provide Valuable Information. While not mentioned in the manual, the business valuation might consider comparable sales of similar medical practices (a market approach). Substantial data is available concerning the prices paid in medical practice transactions, by specialty and geographic region. While there are many limitations inherent in these statistics that must be considered, they can also provide valuable information on the "goodwill" component of various transactions. Even though they may not be the linchpins of the final valuation estimate, these sources can serve to provide a valuable crosscheck to the reasonableness of the findings by other methods.

Do Past Physician Buy-Ins Contradict the Deal Price? Another market approach that must be dealt with (and which is mentioned in the manual) is past transactions in practice shares by entering and departing physicians and what they imply about value. The IRS rightly raises the question of whether or not these transactions were considered, and if so, do they tend to confirm or conflict with the value paid for the practice sale?

The dilemma is that physicians joining the practice may only be required to pay for their share of the practice's hard assets, which excludes goodwill. When contrasted with the actual price paid in a sale of the entire practice that results in a large payment for goodwill, the obvious contradiction that arises is how can this higher price be justified? Several factors might provide clues to the reasons for any contradictions and might warrant consideration in assessing valuation implications:

1) Control Versus Minority Ownership- The entering physician is likely a minority shareholder, with limited ability to singularly affect the practice, whereas the sale of the entire practice constitutes the sale of a 100% controlling interest and may warrant a premium for control; and,

2) The Structure of the Buy-In Arrangement- The actual circumstances of how buy-ins were accomplished can provide clues on the actual value implied, which may be different than the apparent stated amount.

For example, it is not uncommon to find that new employee physicians are required to work at below market compensation for an understood period of three years, with a high degree of likelihood that they will be allowed to buy-in based on a set price or formula. Therefore, in some circumstances, it might be reasonable to determine the present value of the amount of under-compensation over the employment period, at an appropriate discount rate, and then add this to the buy-in price, to determine the actual total implied "price" being paid, both in payment and foregone compensation.

Required Federal Standards for Valuations. While not discussed by the IRS, the valuation must be prepared to comply with the Uniform Standards of Professional Appraisal Practice pertaining to required content and standards, now a federal law. Many valuations of other firms that we are routinely asked to review fall far short of these and other basic standards.

Additionally, business appraisers accredited by the American Society of Appraisers (ASA) must prepare reports to meet stringent requirements as to methods, procedures, report content and independence. These requirements are the standard in the profession and should be the guidepost by which the hospital and medical practice should judge the soundness of the appraisal.

Accredited Business Appraiser a Must. The dollars at stake are large and the impacts of mistakes substantial. Hire only a business valuation firm with professionals engaged full time in the profession and accredited by the American Society of Appraisers (ASA). Knowledge of finance is not enough to value a professional practice in the face of rapidly changing business conditions, techniques, tax and case law. Value goes far beyond numbers and requires a diverse degree of skills and insights into the factors that create or diminish value.

Summary. With the valuation ground rules so unclear, how is the hospital or the medical practice to effectuate a transaction that makes good sense for both parties, without having it later explode to the financial and legal detriment of all involved? The best advice is to engage skilled legal, tax and accredited valuation advisors well before a deal is reached. This enables critical issues to be identified, ramifications understood, a valuation prepared, and appropriate actions taken. It is much harder, more costly and infinitely less convincing to close the deal, and then confront the problems as they arise later. Even if the original price reflects fair market value, the use of a valuation prepared after the fact that later confirms the transaction's validity, even though unbiased and sound, is perceived with great suspicion by the IRS and the courts. ♦

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