

The Attorney's Guide to Business Valuations

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Chris David's Experience

- Founder & Principal of Health**Value** Group; founded in 2010.
- 18 years of professional experience in the areas of business valuation, accounting and transaction consulting.
- Extensive experience in the valuation of physician employment arrangements, management services, tangible assets, intangible assets, medical practices, outpatient centers and other healthcare entities for regulatory compliance (Stark Law and Anti-Kickback Statue), federal and state tax compliance, litigation, marital dissolution and mergers and acquisitions.
- Previously held positions at Ernst & Young and HealthCare Appraisers.

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Agenda

- What the attorney MUST know about appraisals
- Best practices for FMV compensation & other services
- Physician practice acquisitions

What Attorneys Should Know About Business Valuations & Other Appraisals

Identify the Purpose of the Appraisal

- The attorney should clearly determine this, not the appraiser
 - Compliance with laws and/or statutes or tax code
 - Buy/Sell agreement
 - Dispute resolution/litigation
 - Divorce
 - Financial reporting
 - Succession planning
- Make sure the appraiser knows exactly how the appraisal will be used

Purpose of Appraisal Compliance with...

- Anti-Kickback Statute Safe Harbors
- Stark Law
- Private Inurement Statue – *501(c)(3) Organization*
- Internal Revenue Code - Estate and Gift Tax Matters

Standard of Value

- The purpose of appraisal will dictate the standard of value
- Consult with appraiser to determine this
- Attorney and appraiser should agree on this
 1. *Fair Market Value; or*
 2. *Fair Market Value in Healthcare; or*
 3. *Strategic Value; or*
 4. *Fair Value*

Standards of Value - Defined

- **Fair Market Value** – *IRS Revenue Ruling 59-60*

"The amount at which the property would change hands between a willing buyer and 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."

- Most commonly used
- Tax purposes; 501(c)(3), divorce; shareholder dispute

Standards of Value - Defined

- **Fair Market Value – Healthcare**

Stark Law provides this definition:

The term “fair market value“ means the value in arm’s length transactions, consistent with general market value... (42 USC; Sec 1395nn)

- “general market value” means the price that an asset would bring or that would be included in a service agreement as a result of bona fide bargaining between well informed parties to the agreement who are not otherwise in a position to generate business for the other party.

Standards of Value - Defined

- **Fair Market Value – Healthcare**

Stark Phase I Preamble - FMV is established by a reasonable method that provides evidence that compensation is comparable to that paid for comparable items or services in the marketplace in arm's length transactions by parties not in a position to refer to one another.

- AKS doesn't provide an explicit definition for FMV
- AKS guidance and various OIG publications suggests definition of FMV to be similar as Stark

Standards of Value - Defined

■ **Investment Value**

According to the *International Glossary of Business Valuation Terms*:

“The value to a particular investor based on individual investment requirements and expectations.

- Includes synergies
- Commonly mistakenly used in healthcare transactions

Premise of Value

Unique set of specific circumstances pertaining to the transaction or situation.

- *Value as a **going concern***: Value in continued use, as a mass assemblage of income producing assets, and as a going-concern business enterprise.
- *Value as an **assemblage of assets***: Value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise.

Premise of Value

*Value as an **orderly disposition**:* Value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market.

*Value as a **forced liquidation**:* Value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business will be sold individually and that they will experience less than normal exposure to their appropriate secondary market.

Flesh Out Specific Valuation Assumptions

- Use of discounts (minority discounts)
- Which valuation methods will be used
 - Income Approach
 - Market Approach
 - Asset Approach
- Use of projections
- Ignore non-operating assets
- Valuation assumes asset or stock sale (e.g. seller keeps cash and assume liabilities)

Other Elements

- Determine the appropriate *Valuation Date*
 - Attorney, client and appraiser should discuss and agree on this
- Determine & clarify the actual *Subject of Valuation*
 - Business – 100% enterprise value; or
 - Business interest (e.g. 25% minority interest); or
 - Specific assets- tangible or intangible; or
 - Joint venture – pre-money or post money; or
 - A Service – clinical, management, administrative

Business Valuation Standards

- Ask the appraiser which standards he/she follows
- USPAP – Uniform Standards of Professional Appraisal Practices
 - Most commonly recognized
 - Used for asset appraisals and businesses
- SSVS1 - Statement on Standards for Valuations Services – promulgated by the **AICPA**
- ASA Business Valuation Standards – *American Society of Appraisers (ASA)*
- There are **no** published valuation standards for **Services**. Most appraisers follow USPAP and other BV standards.
- But, an appraisal for a Service is NOT compliant with USPAP

Understand the Typical Appraiser “Limiting Conditions”

- Relying on management representations
- Relying on financial statements and other assertions without verification
- Not required to update the report
- Management should use good judgement in selecting a value within the range – FMV compensation
- Management should review/assess physician productivity and duties each year

Hiring an Appraiser

- Do you need a:
 - Real estate appraiser; or
 - Business appraiser; or
 - Machinery & equipment appraiser?
- Use appraisers with formal appraisal training and certifications, such as:
 - ABV – Accredited in Business Valuation
 - ASA – Accredited Senior Appraiser
 - CVA – Certified Valuation Analyst
 - CFA – Chartered Financial Analyst

Best Practices for Determining Fair Market Value Compensation

FMV for Non-Clinical Physician Services

- Board Member/Advisor
- R&D or Product Development
- Management
- Medical Directorship
- Teaching/Training or Speaking
- Supervisory
- Strategic Consulting

FMV for Non-Clinical Physician Services – Best Practices

- FMV compensation is for a specific service not a specific professional
- Establish qualifications for the position
- Clearly identify and document the specific role, duties, responsibilities and tasks to be performed and the direct report
- Specify the time required for the duties and insist the physician document his/her time (good luck!) – e.g. call frequency
- Avoid “opportunity cost” calculations

FMV of MSO or Administrative Services – Best Practices

- Clearly specify and detail the scope of services to be provided
- Identify the staff who provides the service and their total payroll cost
- Identify third-party fees (i.e. EMR, IT, etc..)
- Identify any physical resources or assets used
- Identify the deliverables
- Market Approach not appropriate
- Svcs not dispensed in a similar fashion

FMVs for miscellaneous admin/management services are typically calculated using an industry standard mark-up on costs.

FMV of Clinical Services – Best Practices

- Compensation surveys are the most widely recognized and utilized source of FMV compensation
 - MGMA – Medical Group Management Associates
 - AMGA – American Medical Group Association
 - SCA -- Sullivan Cotter and Associates
 - IHS – Integrated Health Strategies
 - HHCS – Hospital & Healthcare Compensation Service
 - AAMC - Association of American Medical Colleges
- Robust surveys with a large number of participants/respondents
- Surveys for Medical Directorship, Clinical Compensation and On-Call services and other staff positions

FMV of Clinical Services – Best Practices

- Use a consistent method
- Don't cherry-pick survey data points (median is not always a safe figure)
- Use multiple data points
- Look at Comp/wRVU and Comp/Collections (productivity primary driver)
- Utilize more than one salary survey
- Consider a weighted average based on sample size
- Be cautious using a straight \$/per wRVU compensation model. Safer to use for productivity bonus.

75 th percentile compensation per wRVU	\$ 80.35
75 th percentile annual compensation per wRVU	<u>9,700</u>
Total annual compensation	\$ 779,395 exceeds the 90 th percentile

Responsible Use of Survey Data -

Best Practices

- Be cautious if total compensation/wRVU exceeds the 75th percentile
- Be cautious if total compensation exceeds professional collections
- Question the plausibility of excessive productivity. Suggest a chart audit
- Encourage physicians to track and document their time and frequency
- Understand the compensation being reported in surveys (total comp vs. base)
- Compare pre-employment compensation to post-acquisition compensation (more than 20% increase is a red flag)
- Be cautious of “compensation stacking”

Survey Data Problems

- Some data points can be misleading
- Limited regional data (limited responses)
- Survey responses vary greatly among groups
- Data is voluntarily submitted; may not always report accurately
- Compensation reported may not be FMV



Responsible Use of Survey Data - Compensation Defined

MGMA

- Majority of respondents were from non-profits (2017 report)
- All W2 earnings, contracted medical compensation (Form 1099; call coverage, med director, other admin svcs) and partnership distributions

HHCS

- Hospital-employed physicians and group practices
- Base salary, bonus and/or incentive payments

Sullivan Cotter

- Base Salary
- Total Cash Compensation – includes bonus but **excludes** on-call pay and other 1099 contract work

AMGA

- Total reported compensation includes bonus pay and 1099 contract work

Commercial Reasonableness (CR)

- Often taken for granted
- Multiple sources for definition of CR
 - CMS
 - Stark Law
 - OIG
- All basically mean the same
- Fundamentals:
 - Would you do the deal in the absence of referrals?
 - Reasonable and necessary services?
 - Commercial sense (look at qualitative and quantitative factors) ?
 - A prudent and sensible business agreement?
- Requires attorney, appraiser and **MOST OF ALL** management

Commercial Reasonableness - continued

- An arrangement can be FMV but not CR
- A CR arrangement must also be FMV

Physician Practice Acquisitions

Physician Practice Acquisitions

- Many health systems have a policy of not paying for any intangible assets
- Afraid of paying for physician goodwill – too easily construed as “paying for referrals”
- Remember – Stark Law and Anti-Kickback Statute doesn’t prohibit the purchase of goodwill
- Typical assets being purchased:
 - Fixed assets – furniture, fixtures and equipment
 - Medical records
 - Workforce-in-place
 - Website, unique phone number or business name
- Using an income approach (discounted cash flow) will result in a total enterprise value which includes all intangible assets
- Physician goodwill is only one type of intangible asset

Physician Practice Acquisitions

- Safer to identify the assets you want to purchase and have them appraised.
- Typically an asset sale; physician keeps his cash, accounts receivable and pays his remaining liabilities.

Tangible Assets

Working capital

Furniture, fixtures and equipment

Start-up costs

Intangible Assets

Patient medical records

Workforce-in-place

Unique trade name or phone number

Website

Goodwill

Physician Practice Enterprise Value



Physician Practice Acquisitions

Fair Market Value v. Strategic Value

Price hospital is willing to pay for a physician practice (**Strategic Value**) – **Wrong!**



Fair Market Value

Physician Practice Acquisitions

Income Approach

- Discounted cash flows (DCF)
- Project future revenue and expenses (but not provider based reimb.)
- Project future capital expenditures and working capital
- MUST incorporate post-transaction provider compensation
- All cash flows exclude synergies
- Resulting value typically “enterprise value”

Physician Practice Acquisitions

Asset Approach – FF&E

- Cost/Asset Approach – uses appropriate depreciation factors based on age (not liquidation prices)
- FMV assumes the equipment is in-place, set-up and working (use proper standard of value and premise of value)
- Exclude leasehold improvements if considered in FMV lease rate

Physician Practice Acquisitions

Asset Approach – FF&E

- Cost/Asset Approach – uses appropriate depreciation factors based on age (not liquidation prices)
- FMV assumes the equipment is in-place, set-up and working (use proper standard of value and premise of value)
- Exclude leasehold improvements if considered in FMV lease rate
- Have capital leases assigned or paid-off
- Obtain fixed asset schedule and take accurate inventory of equipment on hand

Many items could have been expensed and do not show up on the fixed asset register.

Physician Practice Acquisitions

Asset Approach – EHR

- Cost/Asset Approach is most appropriate
- What is the cost to re-create the records?
- What is the value (to the buyer) of not having the medical records?
- Theoretically less valuable to an orthopedic practice, but more valuable to an OBGYN practice
- What constitutes the number of “active patient files”? How far back do you go?
- Appraiser needs cooperation from target practice
- Buyer and seller need to make these careful assumptions
- Valuation of intangible assets is very assumption-driven

Physician Practice Acquisitions

Asset Approach – Workforce-in-Place

- Recognized by the IRS (IRC Section 197)
- FASB includes it in goodwill
- Widely recognized in the valuation community and texts
- Cost Approach is most appropriate valuation methodology
- Non-physician workforce (mostly)
- Physician workforce (maybe; employed, non-owners)
- Cost to recruit (in-house or agency)
- Cost to hire (interview time, etc)
- Cost to train (how many hours?)
- What are all the costs to re-create a workforce of equal utility?
- Highly assumption-driven

Acquisition of Physician Practices - Post-Transaction Losses

- Must look at post-acquisition earnings of the practice net of *new physician compensation* (compare to MGMA benchmark)
- **Red Flag** – post-transaction practice posts a consistent and sizable loss
- Regulators don't like to see losses

Cardiology, Hospital/IDS Owned
(per FTE Physician)

6.4e: Net Income or Loss

	Count	Mean	Std Dev	10th %tile	25th %tile	Median	75th %tile	90th %tile
Total cost	85	\$981,350	\$318,307	\$627,664	\$774,382	\$978,711	\$1,162,208	\$1,382,015
Net nonmedical revenue	4	*	*	*	*	*	*	*
Nonmedical revenue	3	*	*	*	*	*	*	*
Financial support for operating costs	2	*	*	*	*	*	*	*
Net income, practices with financial support	4	*	*	*	*	*	*	*
Net income, practices without financial support	92	-\$246,510	\$329,648	-\$584,347	-\$474,926	-\$266,954	-\$80,638	\$25,360
Net income, excluding financial support (all practices)	96	-\$240,218	\$325,580	-\$582,785	-\$471,525	-\$257,112	-\$77,973	\$49,299

Questions??

Mr. David can be contacted for questions at:

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or

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Don't wrestle
with the **OIG...**

Get an FMV opinion from



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