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Marmer Penner Newsletter

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VALUATION OF PROFESSIONAL PRACTICES – WHY RULES OF THUMB (ALONE) SHOULD NOT BE RELIED ON

Valuation theory teaches us that businesses are usually valued based on one of two approaches. Where a business is earning a sufficient return on its investment, it is generally valued on a multiple of its earnings. Where the return is insufficient, it is generally valued on a net asset approach, that is, the value of its assets less its liabilities.

In certain types of businesses, it is common to use a third approach which is known as industry rules-of-thumb. Most self-employed professionals, such as medical practitioners and accountants know that their business values are often measured by a percentage of revenues.

When faced with the valuation of a professional practice, it may be tempting to apply a rule-of-thumb exclusively in order to determine the goodwill of the practice. This method is simple, and may avoid the need for a business valuator. As long as maintainable fee revenue is consistent, this calculation is relatively simple. However, blind application of rule-of-thumb may be inappropriate.

Rules-of-thumb are not usually used as the primary valuation approach to any business, including professional practices. Rules-of-thumb tend to be averages of historical prices paid to acquire business interests. They are also used as substitutes for income multiples since income is subject to discretionary expenses while revenue is viewed as an independent measure. Also, rules-of-thumb often do not account for the current goings-on in the market for professional practices. In addition, rules-of-thumb based on net income do not necessarily consider accounting adjustments that would be made under other conventional valuation approaches. Lastly, rules-of-thumb generally value the goodwill of a practice only.

They do not account for other assets such as unbilled work-in-process. Where unreported income exists, applying a rule-of-thumb to an incorrect revenue or income amount will clearly provide an incorrect valuation of goodwill.

Take for example the following rule-of-thumb for a general medical practice found in a 1990 publication:

> 20 – 60% of annual maintainable fee revenue for the equipment, supplies, and goodwill

Many changes have taken place since this rule-of-thumb was formulated. Beginning April 1, 1991, the amounts doctors could collect from OHIP were reduced at certain billing levels. This is commonly referred to as “caps”. The caps change every year. The most severe caps came into effect in 1996.

New doctors’ billings in “over-supplied” areas, such as Toronto, were restricted further from 1997 to 1999, making it difficult to find buyers for established practices. In an “over-supplied” area, a new general practitioner, for example, could only collect from OHIP 70% of regular fees to a maximum of $140,000 in year 1, 75% of regular fees to a maximum of $165,000 in year 2, and 80% of regular fees to a maximum of $205,000 in year 3. Assuming a 40% overhead, a new doctor would earn maximum net income before income tax of $84,000 in year 1, $99,000 in year 2 and $123,000 in year 3. At this income level, there may have been no demand for the practice. Where there is no demand, there is generally no goodwill. In an “under-supplied” area, any new doctor could expect to open a new practice and be fully booked within a short period, if the area is truly under-supplied.

Depending on your valuation date, changes in the medical profession may render the rule-of-thumb useless.

Take for example the following rule-of-thumb for optometric practices found in the same publication:

> 40 - 60% of annual maintainable fee revenue for equipment, supplies and goodwill

The above rule-of-thumb does not take into account the following changes that occurred on April 1, 1998.

- For patients in Ontario between ages of 19 and 64, eye examinations restricted to once every 2 years

- Elimination of "fitting fee" for patients with contact lenses

- No restrictions for patients 18 or younger or 65 or older

In British Columbia, payments for eye examinations for patients between 19 and 64 have recently been completely eliminated. A reduction in revenue will reduce the value determined by a revenue-based rule-of-thumb. However, at some point office overhead may reduce the practitioner's net income to such a low amount that no goodwill remains. The rule-of-thumb will not adjust for this situation.

Blind application of a rule-of-thumb based on net income may still fail to recognize factors that may affect business value. The most common example is non-arm's length payments.

In future newsletters, we will discuss conventional approaches to professional practice valuation as well as the other valuation issues unique to family law.

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We recently presented a seminar on the Valuation of Professional Practices. If you would like a copy of the handout materials, please contact Steve Ranot.