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Marmer Penner Newsletter

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VALUATION OF PROFESSIONAL PRACTICES – APPROPRIATENESS OF THE EARNINGS APPROACH

In a recent newsletter, we discussed the problems of relying solely on rules-of-thumb when valuing a professional practice. While rules-of-thumb may be useful in determining the reasonableness of a business valuation, generally, an earnings-based approach should be used to reconcile any rule-of-thumb approach.

A revenue rule of thumb may be common in dentistry for example. However, consider two practices where each one grosses $1,000,000 in fee revenue. One is located in a small town with little or no growth prospects and has to over-pay for dental assistants who must be encouraged to come from a neighboring city. The second is located in the city. It has growth opportunities due to the new candy factory next door and pays less for its staff. As a result, the net income of the second practice is $100,000 higher annually than the first practice.

Logic would dictate that the second practice is more valuable for a number of reasons, not the least being that it earns more money. But the rule of thumb approach based purely on revenue would result in equivalent values.

While many rules of thumb deal with revenue, some exist based on multiples of earnings. Revenue rules of thumb are more prevalent since income may be subject to discretionary expenses while revenue is generally viewed as a figure less susceptible to manipulation.

When determining the maintainable earnings, the valuator generally reviews historic earnings and makes certain adjustments such as the following:

a) Non-recurring items;

b) Fair market value of services provided by non-arm's length parties; and

c) Elimination of revenue and expenses relating to redundant assets.

The valuator weights the earnings depending on which years are considered most indicative of the future. A simple average of the adjusted earnings may be used if all the years examined are considered equally representative of future performance. On this basis, the valuator arrives at the maintainable earnings.

The area where the most professional judgement is exercised is in selecting the earnings multiple. The multiple is based on a multitude of factors, such as:

a) Location of the practice;

b) Competition in the area;

c) Growth prospects;

d) Percentage of patients who have insurance;

e) Reputation of the practice;

f) Patient turnover.

An analysis of prior transactions in the geographic area may indicate that goodwill has a closer relationship to adjusted earnings than to revenue. However, revenue is a much more readily available figure than true earnings. Therefore, both approaches may be used, and the resulting value may be an average of the two approaches, as shown in the example on the next page:

	Years ended December 31,		
	1999	2000	2001
Net income before income tax	$177,454	$198,926	$207,029
Add			
Non-recurring moving expenses		12,652	
Salary to spouse	40,000	26,000	45,000
Less			
Gain on sale of investment	(15,000)		
Adjusted earnings before income tax	$202,454	$237,578	$252,029
Weighting	1	2	3

Weighted average maintainable earnings before tax	$238,950		$238,950
Earnings multiplier range	0.6	to	0.7
Goodwill under earnings approach	$143,370		$167,265
Midpoint	$155,318		

	Years ended December 31,		
	1999	2000	2001
Gross revenues	$496,869	$534,614	$576,103
Weighting	1	2	3

Weighted average gross revenues	$549,068		$549,068
Revenue multiplier range (rule-of-thumb)	25%	to	30%
Goodwill under rule-of-thumb approach	$137,267		$164,720
Midpoint	$150,994		

Final goodwill value (average of two approaches)	$153,000
Fair market of other assets net of liabilities	210,000
Fair market value of the practice	$363,000

It should be noted that professional practice appraisers who are involved in selling practices, often appraise the fixed assets and goodwill of the practice only, assuming the other assets and liabilities will be retained by the vendor. However, in a notional valuation, the entire package must be valued, which should properly include all the assets and liabilities of the practice. As well, the contingent income taxes must be considered. These are not normally addressed by practice brokers.

It is of interest to note that the income multiple and practice goodwill tend to increase in a competitive industry or geographic area. While it may seem irrational to pay more to buy a practice in an over-serviced area, it reflects economic reality.

Consider the following example. Downtown Toronto may be over-serviced with dentists. As a result, a new practitioner has little chance to open up a new office and attract patients. Accordingly, the new dentist would be willing to pay for goodwill and avoid years of low income while building a new practice. Conversely, in an under-serviced area there is no need to pay for significant goodwill as presumably there are patients waiting for the arrival of a new practitioner.

In conclusion, where industry rules of thumb exist and are deemed to be applicable, the valuator should reconcile the values determined under both the earnings and the rule-of-thumb approach.

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This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.