Socioeconomic tips of the month

Editor's note: *For several years now, the Socioeconomic Affairs Department of the American College of Surgeons has sponsored a coding hotline (800/ACS-7911) and coding and practice management workshops for its Fellows. Through the hotline and the workshops, issues are identified that are of concern to many Fellows and their staffs. In an effort to respond to Fellows' specific inquiries related to coding and practice management issues, we are introducing this new column, which will feature useful tips for surgical practices. Developed by College staff and consultants, this information will be accessible on our Web site for easy retrieval and future access. If there are topics you would like to see addressed in future columns, please contact the Chicago staff of the Socioeconomic Affairs Department via phone at 312/202-5150, via fax at 312/202-5021, or via e-mail at socioecon@facs.org.*

Practice valuation

Q. There are many circumstances for which a physician's practice must be valued–for example, when a young surgeon seeks a loan to start or buy a practice, when one or more practices wish to merge, when a surgeon wishes to retire from practice, when a surgeon is disabled and wishes to sell his or her practice, when a deceased surgeon's family wishes to sell the practice, and when a surgeon must include the worth of the practice in a divorce settlement. What are the important factors in the valuation of a physician's practice?

A. Thomas Loughrey, president, Conomikes Associates, Inc., an expert in practice management whose firm conducts the practice management workshops sponsored by the College, provides the following response to this frequently asked question.

Fair market value is derived from the tangible assets of the practice such as equipment, real estate, accounts receivable, and so on. Value is also derived from the intangible assets, such as goodwill. The goodwill value of the practice is a function of the ability of the practice to continue to provide an income stream into the foreseeable future. The lower this income stream, the lower the goodwill value and, hence, the value of the practice.

Several factors will influence the goodwill value, including how much time has passed since the practice has been active; the continuance, or assumability, of contracts; and the ability to maintain referral relationships. The tangible value of the practice will be affected by the condition and age of the equipment, the location and condition of real estate, and the collectibility of any accounts receivable. Typically, the major value of a surgical practice is going to be based on the intangible value. This is particularly true if the accounts receivable are either not being sold or are so old as to not have much value. The length of the lease can affect the practice value. A short-term lease for a desirable location can be a negative and a long-term lease for an undesirable location can be a negative.

Most tangible assets are relatively straightforward to appraise. The intangible value is more problematic. Most qualified appraisers will base the value on the present value of discounted future cash flows. The future cash flows will be estimated based on the history of the practice and the expectations that the revenues will continue. Most appraisers will use cash flows from the previous three years as a basis for their assessment. This basis will usually be weighted in favor of the most recent year. It will also be affected by the assumability of contracts. If a new physician based the cash flows on contracts that may not be assumable, the cash flow projections must be reduced. Since most contracts with third-party payors are not assumable, the cash flow projection will be lowered and the value will be reduced.

Values are enhanced when cash flows are uninterrupted. For this reason, group practices typically have higher values. The contracts, and payments, continue even after a group member has left or is in the process of leaving. Referral sources remain intact, and staff changes are usually minimal in the continuing group practice.

A real-life example may help illustrate these points. A surgeon in a solo practice suffered an injury just over one year ago that has prevented the surgeon from doing surgery. Fortunately, a disability policy has been taking care of overhead and income replacement since the injury. The disabled surgeon now wishes to sell the practice. The local hospital has helped recruit a new surgeon to town and is willing to help in a purchase of the practice. The purchase must occur at fair market value, and this is the problem. The surgeon believes the practice to be worth much more than the hospital and other

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audience, he completed his presentation, only to learn several minutes later that there had been a sizable earthquake in Seattle, the news of which had reached the Seattle physicians, who rushed to the telephones to call home and ascertain the welfare of their families.

Dr. Baker was admired and respected nationally and internationally. In addition to serving as President of the ACS, he was awarded honorary fellowship in the Royal College of Surgeons of England and Scotland.

He served for 25 years as consultant to Madigan General U.S. Army Hospital. In 1965, Dr. Baker toured all the medical facilities in Alaska and the Far East as the Inspecting General of the U.S. Army, Navy, and Air Force, after which he was awarded the Outstanding Civilian Service Medal by the Dept. of the U.S. Army.

In recognition of his service to patients from Alaska, including saving the life of then-governor William Egan, he was awarded an honorary degree from the University of Alaska.

Two of Dr. Baker's surgical innovations remain part of the surgeon's armamentarium to this day: (1) the low end-to-side anastomosis, a technique for joining the bowel to the rectum after removal of a diseased segment that often circumvents the need for a colostomy, and (2) the Baker tube, a modification of the Foley catheter with a balloon on the end, which can be led through an obstructed bowel, decompressing it without spilling its lethal contents.

Dr. Baker left a strong imprint on his surgical residents, who are now scattered across the country and around the world. This imprint consisted not only of technical excellence but also a strong commitment to integrity and quality care for patients.

When asked how he would like to be remembered, he said, "As someone who most enjoyed the friendship of my patients and their families. Through service to them I have felt some fulfillment in life."

Dr. Hill *is clinical professor of surgery, University of Washington, Seattle.*

Dr. Linderman *is affiliated with the University of Washington, Seattle.*

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incoming surgeon have offered.

It is time for a reality check for the disabled surgeon. The cash flow from surgery has been nonexistent in the last year, the staff has been reduced to a receptionist, the referring physicians have been sending patients to other qualified surgeons for over a year, and a competitor has already set up practice and obtained contracts for services. Few, if any, of the contracts held by the disabled surgeon are assumable.

The value is primarily based on tangible assets for equipment. If the physician is looking for a quick disposal of the equipment and fixtures, the value will be less than 25 percent of the purchase price for useable equipment. The fact is that the practice does not have much value at all.

What could this surgeon have done to protect some of the practice's value? First, obtaining the services of a qualified locum tenens surgeon to continue the cash flow would have improved the value. Second, the surgeon could have recognized earlier that a decision to sell would have to be made. Third, the surgeon might have identified likely buyers at the earliest opportunity while surgical volume and referral relationships are still being maintained. Finally, the surgeon had to be realistic about what someone else will be willing to pay for a going concern as opposed to creating his or her own new practice. In the long run, and before the need for a sale occurs, surgeons can increase the intangible value of their own practice by being in partnership with others.

It is important for surgeons to understand what factors are involved in practice valuation. As outlined in the specific example, it is imperative to value the practice at the appropriate time. It has been said that a practice left idle for more than approximately three months will have very little value. Ω