

PPD

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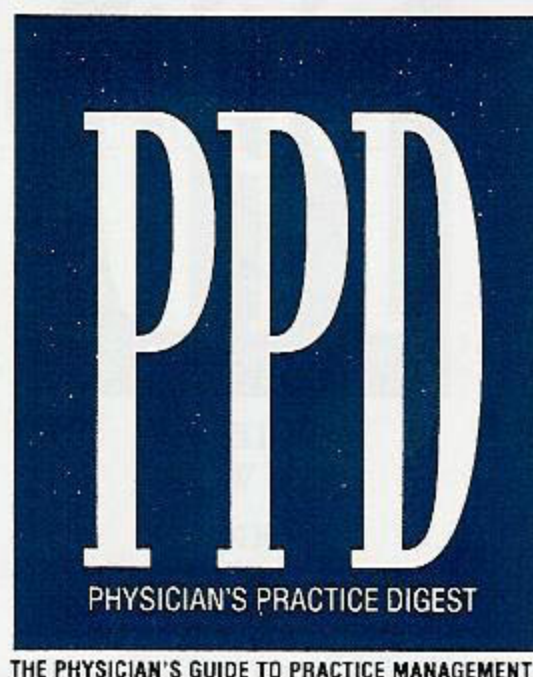
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FOR HEALTH CARE REFORM



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Goodwill in the Era of Health Care Reform

By Daniel Alan Lindendorf

Goodwill is one of the most important and least understood factors in determining the value of a practice.

The term goodwill conjures up thoughts of Mr. Smith the owner of the corner general store giving credit to Mrs. Brown for a pound of sugar. Although this "feel good" description of goodwill is analogous in some ways to the medical profession, goodwill in medicine, especially as a factor in the valuation of a practice, includes specific and distinct elements.

The component of the "valuation equation" that has the most value is goodwill. Actually, when a physician buys a practice or a partnership interest, he is really mostly buying the goodwill of the practice. In some medical practices, hard assets (i.e. medical equipment, furniture, building, etc.) can be valued significantly along with specialized staff and leasehold improvements.

Goodwill has been described as an "intangible asset" or a "soft" asset since it cannot be touched. While common wisdom holds that goodwill is difficult to assess, it is not as difficult as it would seem. Physicians know that this asset is quite real, very valuable and comprises a significant portion of their net worth.

Regulatory Change

Until August 10, 1993, (retroactive in some cases to 1992) the "softness" or intangibility of the goodwill asset was compounded by the fact that the Internal Revenue Service only allowed the depreciation of this valuable asset over twenty-five years as well as the restrictive covenant and other "intangible assets."

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BUT IS IN ESSENCE THE PRACTICE.

Accountants and lawyers, and of course medical providers, were disturbed by the IRS' previous position because it is desirable to properly weigh the full value of an asset in the valuation equation.

The position of the IRS has been reflected until recently in the manner in which Asset Purchase Agreements for the buying and/or selling of practices have been drafted. These documents have a provision that breaks down the value of each asset contributing to the total purchase price. Hard assets and other tangible assets are weighed heavily for tax purposes. Intangible or soft assets such as goodwill are weighed as little as economically feasible. Therefore, in the past, one could not look for guidance to such an agreement for the proper and truthful worth of goodwill.

Such a false valuation of goodwill is not in the best interests of physicians, because among other things, it leaves some practitioners with the feeling that their lifelong endeavor is vague and not quantifiable. Another problem in such a low valuation of goodwill is that, for example, in the case of a breach of a restrictive covenant, the breaching party may point to the low valuation of goodwill, thereby attempting to deflect criticism that the breach caused material damage to the value of the practice.

Recently the IRS has attempted to redress some of these problems by allowing for the depreciation of goodwill over a fifteen year period. Although

this doesn't resolve the problem, it indicates that the IRS has heard complaints affected and is beginning to acknowledge that goodwill is a real asset deserving of a shorter depreciation schedule like hard assets.

Many banks and financial institutions, especially in the tight commercial market of the past several years, have been even more reluctant to extend credit to medical practices collateralized by fuzzy or soft assets. Care must be taken by the practitioner and counsel in explaining to the loan officer the true worth of the goodwill to help the loan officer properly collateralize the loan. More banks are becoming sensitive to the uniqueness of the valuation of a medical practice. One must simply help the bank along in the process.

Elements of Goodwill

Today goodwill consists of the following elements:

- Stature of individual physician within one's discipline
- Extent and nature of referring physicians
- Length of time the practice has been established
- Identification of practice with trade name
- Affiliations with hospitals and institutions
- Advertising program and media profile of practice
- Revenue stream of practice

- **Reimbursement profile by insurance carriers of practice**
- **Level of professionalism, loyalty and length of employment of staff**

Stature of Physician

Obviously, the greater the professional stature of the selling physician, the greater the value of goodwill. A doctor held in high regard by his colleagues and patients will be able to translate this stature into tangible financial results. The new physician taking over from that doctor will benefit from his association with that doctor during the transference stage following the sale of the interest. In addition, a doctor held in high esteem will increase referrals to the practice and overall the practice will be associated with a high degree of medical care.

Extent and Nature of Referring Physicians

Depending on the nature of the medical discipline involved, the extent and nature of referring physicians, will be of significant value to the practice. With the marketing of medical services to the general public and the rise of managed care contracts and capitation plans, the old referral network is not as significant as it was. However, it is still an important element in goodwill and the value of a practice.

As competition to be associated with managed care plans and capitation programs grows, those practices having a solid referral base and a fine reputation may have an edge over other practices in securing these contracts.

Length of Time Practice Established

The longer the practice has been treating patients the greater the value of the goodwill component and the greater will be the retention rate of patients.

Practice with a Trade Name

Many medical practices today hold themselves out under trade names such as Diamond Medical Providers, P.C. or the like. This can be beneficial in advertising and developing an easily recognizable name. Many patients do

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not associate their treatment with a particular physician at the practice but rather with the facility on the whole. This is reflected in the valuation of goodwill of the practice.

Affiliations with Hospitals and Institutions

The greater the level of association with hospitals and other medical facilities, the greater the ability to transfer the intangible assets which truly comprise most of the value of the practice.

Location of Practice

Although a favorable lease for the medical practice (or a building if the premises are owned by the practice) may be viewed as a hard asset like many of the components of the valuation equation, it crosses over into the goodwill component as well. As in trade name recognition, some patients will be treated by a practice not because of a special physician but because of the convenience of the location.

In addition, some patients may not even identify with a doctor or the trade name but will just remember "the big doctor's office on the corner of Brown and Pine, you can't miss it." This factor must be considered in all situations in which a valuation and hence goodwill is to be determined.

Revenue Stream of the Practice

The nature of the revenue stream of the practice, means what percentage of the revenues generated are paid by third party assignment of benefits; direct pay by patients; managed care contracts; medicare; medicaid; self insured unions; and/or capitation plan contracts.

The mix or inclusion or exclusion of some of the above will have a signifi-

cant influence on valuing goodwill. For example, if the majority of the revenues of a practice are generated through capitation plan contracts, it is clear that the practice is not relying on the standard referral base or an advertising campaign to generate its revenues and its patients. Goodwill may not be weighed as heavily, despite increased revenues, because there is no guarantee that the contracts will be renewed.

Level of Professionalism, Loyalty and Length of Employment of Staff

The medical industry is basically one in which the major resource is people. One important and underestimated asset of the medical practice is the people who work for it. If staff are loyal to the practice and committed to the doctor and by extension the patients, this will engender an increase in the value of goodwill.

When a physician purchases a particular practice, he is concerned that in the transference stage the retention rate of patients will remain high and that he will be able to maintain and build on the historical patient base. A skilled and loyal staff will greatly increase the chances of success.

When valuing the practice, goodwill is not the gravy of the practice, but is in essence the practice. It is essential that practitioners and their counsel understand the various components of goodwill so as to maximize the valuation of goodwill and by extension the practice, thereby preserving and expanding this most important and valuable asset of the physician. **PPD**

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