

A CASE STUDY

Dr. Elaine J. is a general surgeon at a university hospital. Elaine was in a 20-year marriage to plastic surgeon Dr. Jerry J., who owns 90 percent of a cosmetic surgery practice. Structured as a California regular C corporation, it is a community property business employing a receptionist, a nurse, and another surgeon, who is the 10 percent shareholder.

Attorneys for the divorcing parties agree that the date of valuation should be the date of separation, which is December 31, 2012, instead of the date of trial.[11] However, they are unable to agree to a joint forensic accountant under Section 730 of the Evidence Code.[12] They hire experts, who value Jerry's practice according to the different methods described above.

With the capitalization of earnings method (an income-based approach), the earnings for a representative single period are converted to value through division by a capitalization rate, which is also known as a cap rate.[13] The resulting value is for the business as a whole (i.e., net tangible and intangible assets).[14] Another income-based approach, the capitalization of excess earnings method (also known as the formula method) was created by the IRS in 1920 to compensate owners of breweries and distilleries confiscated during Prohibition.[15] This method finds a value for goodwill. The IRS subsequently criticized this method, however, most notably in Revenue Ruling 68-609, which indicates that the excess earnings method "may be used only if there is no better basis available for estimating the value of intangible assets." [16] This method requires highly subjective judgments on variables such as rates of return on net tangible assets, capitalization rates, and reasonable compensation.[17]

Despite these criticisms, many California cases discuss the excess earnings method. As described in *Marriage of Rosen*:

"Pursuant to this method, one first determines a practitioner's average annual net earnings (before income taxes) by reference to any period that seems reasonably illustrative of the current rate of earnings. One then determines the annual salary of a typical salaried employee who has had experience commensurate with the spouse who is the sole practitioner or sole owner/employee. Next, one deducts from the average net pretax earnings of the business or practice a 'fair return' on the net tangible assets used by the business. Then, one determines the 'excess earnings' by subtracting the annual salary of the average salaried person from the average net pretax earnings of the business or practice remaining after deducting a fair return on tangible assets. Finally, one capitalizes the excess earnings over a period of years by multiplying it by a factor equal to a specific period of years, discounted to reflect present value of the excess earnings over that period. The period varies according to factors such as the type of business, its stability, and its earnings trend." [18]

Both the excess earnings method and the capitalization of earnings method require the normalization of earnings. Normalizing the practice's earnings lets the valuator make

adjustments to reflect the actual economic benefits compared with opportunities in the market for an outside investor.[19] This is based on the economic theory of opportunity cost, or the cost of foregoing the next best alternative investment opportunity.[20] In order

to normalize earnings, valuers must remove or adjust unique nonrecurring expenses and expenses that reflect the personal influence of the practice's owner.

In the case study, the valuers adjust the unadjusted earnings of the practice (which shows a loss of \$100,000 on the tax return) to normalized earnings of \$235,000 by adding a payment made to settle a malpractice suit as well as Jerry's personal expenses and a payment to Jerry's mother that was not for services. Other common adjustments include retirement plan contributions and vehicles.

Normalized earnings also require an adjustment for a fair market determination of the replacement value of Jerry's services. In other words, what would be the amount a practice would have to pay a doctor to adequately perform all the duties that Jerry currently performs? The reasonable compensation or replacement value of services can have a significant impact on the value of the practice. Most owners of small- and medium-sized businesses such as Jerry's practice base their salaries on company profits, which may be much greater or less than the actual value of their services. In the case study, for example, the financial history of the practice seems "reasonably illustrative of the current rate of earnings,[21] and the practice's unadjusted income is a loss. Often, salary decisions depend on tax considerations. [22]

TABLE 1		
ADJUSTED EARNINGS		
	Jerry's	Elaine's
	Valuator	Valuator
Previously adjusted earnings	235,000	235,000
Add back owner-determined salaries:		
shareholder salary	400,000	400,000
Jerry's salary	550,000	550,000
	1,185,000	1,185,000
Less: RVOS 10% shareholder salary	(320,000)	(300,000)
Less: RVOS Jerry's salary	(450,000)	(320,000)
		\$565,000
Adjusted earnings	\$415,000	

Note: This case study assumes that the practice earnings are equal to its equity net cash flow and excludes analysis of net cash flows and taxes.

As seen in Table 1, Jerry's valuator sets the replacement value of Jerry's salary at \$450,000 (and \$320,000 for the 10 percent shareholder), notwithstanding the practice's unadjusted income. The valuator's opinion is based on analysis of surveys of similar practices and other case facts. According to market-based data, salaries comparable to Jerry's are \$300,000 to \$320,000. Jerry's valuator believes a premium of approximately 40 percent over an employee-level salary is reasonable and comparable to available survey data concerning Jerry's specialty, work hours, production, marketing, and other responsibilities.

On the other hand, Elaine's valuator learned that Jerry was engaged in a romantic relationship with the 10 percent shareholder. Elaine believes the relationship began a few years before, when the shareholder received her 10 percent of the practice and an increase in salary from \$300,000 to \$400,000. Survey data indicates that \$400,000 is well above the median salary for someone with the 10 percent shareholder's experience level.

However, the difference between the adjusted earnings in Table 1 is primarily attributable to the use of two different standards that have emerged in the case law to measure reasonable compensation: the "similarly situated professional" and the "average salaried person."^[23] Jerry's valuator used the "similarly situated professional" standard, and Elaine's valuator used the "averaged salaried person" standard. The "similarly situated professional" standard employs the annual salary of a replacement with experience commensurate with the professional spouse who is divorcing. The "average salaried person" uses the cost to hire a non-owner employee to perform similar services. The average salaried person standard is typically a lower amount, as it implies the compensation of a non-owner rather than an owner. For medical practices, the courts tend to use the "similarly situated professional" standard. In *Marriage of Iredale v. Cates*, the court used the "similarly situated professional" standard because it concluded that the compensation of an average salaried person failed to account for the non-billable hours expended by the in-spouse.^[24] Nor would an associate have the same client base as in the in spouse.

A business valuation expert often considers compensation surveys to assist in a reasonable compensation analysis.^[25] There are risks, however, in solely relying on compensation surveys. The case of *Marriage of Ackerman* is illustrative.^[26] In *Ackerman*, the husband, a plastic surgeon in Newport Beach, based his reasonable compensation opinion on statistical data from the American Medical Association's surveys. The wife's forensic accountant used a different industry survey.^[27] The husband's forensic accountant also used, at the court's request, an informal survey of surgeons in Newport Beach.^[28] Even so, the court criticized both the wife's and the husband's surveys as not "sufficiently fine-tuned and honed to our area here to be particularly valuable," and suggested that it would have been helpful if both had employed a vocational rehabilitation specialist familiar with the local market or a medical head hunter, or an economist, to supplement the surveys.^[29] Even though the wife's data was more specific, the court ultimately selected reasonable compensation that was closer to the husband's methodology, which considered evidence of his actual business situation,

talent, training, expertise, and reputation. The trial court reasonably determined that a plastic surgeon in Newport Beach would generate a greater income than the national average.

In light of *Ackerman*, Jerry's valuator should be careful to render an opinion based on a number of factors, including the rates for other plastic surgeons practicing in a similar specialty in a comparable geographic location, with similar credentials and work experience, working a comparable number of hours, taking comparable holidays and time off and with comparable gross collections and marketing responsibilities as Jerry. Further, consideration of compensation data from any surveys should take into consideration revenues generated by the practitioner (the professional element) and those generated by equipment and ancillary services (technical element), if possible, and also employ any additional analyses based on the available case facts and circumstances, such as the salaries of others within the practice.

Table 2
BUILD UP METHOD FOR CAPITALIZATION RATE

Risk Free rate	5%
Equity risk premium	7%
Size Premium	6%
Company Specific	15%
Discount rate	33%
Long Term growth rate	2%
Capitalization rate	31%
<p>Note: This cap rate is applicable to earnings, not excess earnings. The cap rate on excess earnings is generally believed to be greater than a traditionally derived cap rate.</p>	

CAPITALIZATION

Under an income-based approach, the evaluator applies a cap rate to normalized earnings (or to normalized excess earnings). A cap rate converts an earnings stream into a numerical value based on the risk of receiving the earnings stream. It can be thought of as a quantification of an investment's risk. (The equation is $PV = E/C$; PV is present value, E is expected income, and C is the cap rate.) [30] Due to market and company-specific factors, the evaluators may estimate that Jerry's practice carries more risk than other available investments because an investor would expect to pay less to invest in Jerry's practice than in a more secure investment.[31]

In the case study, the investor is Jerry, who must buy out his former wife's interest in his practice. To calculate what Jerry should pay, the evaluator applies a cap rate to the practice's normalized earnings.

The build-up method is one way of calculating the discount rate by adding published rates of return expressed as percentages of risk. These rates of return represent the opportunity cost of investing. In other words, an investor would demand a higher rate of return to invest in Jerry's practice than in a more secure public company. As shown in Table 2, the build-up method for Jerry's practice produces a cap rate of 31 percent. A valuator selects a practice-specific rate based on his or her judgment. No objective source of data fully quantifies company-specific risk and benefit.[32] While presentations and calculations vary, company-specific risk assessment includes such factors as business risk, operating risk, asset risk, market risk, and regulatory risk. These risks are affected by such conditions as the general economy as well as the specifics of the practice and its location, market barriers, competition, and management.

As shown in Table 3, the two valuers divide the normalized earnings by the capitalization rate [33] to derive an indicator of value.

**TABLE 3
APPLYING THE CAPITALIZATION RATE**

	Jerry's Valuator	Elaine's Valuator
Normalized earnings	415,000	565,000
Capitalization rates	31%	31%
	1,38,710	1,822,581
Value indicator rounded	1,340,000	1,820,000

A variation of this method is the capitalization of excess earnings method. Table 4 shows how a capitalization rate is applied to excess earnings after separating the earnings attributable to the net tangible assets from intangible assets.

**TABLE 4
THE CAPITALIZATION OF EXCESS EARNINGS METHOD**

		Jerry's Valuator	Elaine's Valuator
Adjusted earnings		415,000	565,000
Less: Return on net tangible assets			
Net tangible assets	670,000		
Rate of return (valuator's judgment)	15%		
Earnings attributable to net tangible assets		(100,500)	(100,500)
Excess earnings		314,000	464,500
Capitalization rate or multiple (valuator's judgment)		2.75	2.75
		864,875	1,277,375
Indicated value of goodwill (i.e., intangible assets, rounded)		860,000	1,280,000
Value of net tangible assets		670,000	670,000
Indicated value of Jerry's practice		\$1,530,000	\$1,950,000

No empirical data supports the selection of the 15 percent rate of return on net tangible assets or the 2.75 multiple. These inputs vary by valuator and the analyses that support

them. Understandably, the excess earnings method has been criticized as more subjective than other valuation methods. Generally speaking, rates of return on net tangible assets can range from 8 percent to 20 percent, more or less, depending on the subject's mix of assets. An excess earnings multiple range can be from .5 to 3, more or less. The 2.75 selected multiple equates to a 36 percent cap rate. As expected, the cap rate for excess earnings, which carries greater risk, is greater than the traditionally derived cap rate of 31 percent that is based on empirical data.

MARKET DATE TANS ACTIONS METHOD

A market data transaction method, such as using a number of transactional databases of the sales of companies [34] requires the valuator to analyze comparable arm's-length transactions. Valuators use qualitative and quantitative analyses to determine comparability. Commonly, the valuator selects reported sales of comparable transactions based on what they consider to be comparable criteria such as gross revenue, profitability, type of business or practice, similarity of business model, and so on. [35] The valuator uses a transaction database in the same way that a certified real estate appraiser uses the Multiple Listing Service database. Just as a real estate appraiser selects comparable transactions from the MIS data, so must the valuator select company sales transactions providing comparable and useful information.

Thehealthcaregroup.com annually publishes the Goodwill Registry, which is a database of medical practice sales that lists sales prices, revenues, earnings, and ratios, among other details. Many valuators apply the gross revenue multiple from the Goodwill Registry to the gross receipts of a practice, with adjustments, for example, for practice profitability. [36] Table 5 shows how, based on data from the Goodwill Registry, the value of Jerry's practice is approximately \$1.27 million.

**TABLE 5
THE GOODWILL REGISTRY MARKET-BASED METHOD (SIMPLIFIED)**

Practice revenues	2,000,000
Goodwill Registry	
% of revenues multiple for the value of goodwill	30%
Goodwill, or intangible asset value, rounded	600,000
Net tangible value	670,000
Practice value	1,270,00

VALUATION OF NET TANGIBLE ASSETS

The *Foster* method is an income approach based on a rule of thumb.[37] *In Marriage of Foster*, it should be noted, the court sanctioned the expert's use of "three months gross" to value goodwill. In the case study, the practice's financial statements use cash-basis accounting, making adjustments necessary because the balance sheet includes no receivables or payables. For most professional practices, the major assets typically not shown on tax returns are receivables and works in progress. [38] If, after considering the

terms of any partnership or buy-sell agreement, the court determines that the community has an interest in such assets, the valuator should make an adjustment based on past collection rates.[39]

Further, a medical practice valuation should consider that payments from the government and private insurance companies are often less than the amounts billed. When valuing a practice, a valuator should analyze all the practice's detailed accounts receivable reports to determine the appropriate collectible net accounts receivable. The valuator can quantify accounts receivable and work in progress to convert the balance sheet from a cash basis to an accrual basis. As seen in Table 6, the valuator determines that for Jerry's practice, the tax-adjusted collectible accounts receivable on an accrual basis is \$120,000.

TABLE 6

Sample Analysis to Determine Collectible Accounts Receivable			
A/R per Practice's			
Dates	Internal Billing System	\$ Collected	% Collected to Total A/R
Total Month 1	8,500,000	150,000	1.76%
Total Month 2	9,000,000	175,000	1.94%
Total Month 3	9,500,000	200,000	2.11%
			1.94% Avg.
Date of value	7,900,000		
	2%		
	158,000		
Rounded	160,000		
Tax-adjusted	120,000		

During a visit to the practice site, the valuator noted that the equipment appeared to be in excellent, like-new condition. However, the practice used an IRS Section 179 depreciation deduction, which allows for an immediate depreciation deduction for a piece of equipment (up to \$500,000 in 2013). The valuator adjusts the equipment purchased for \$500,000 because its book value on the balance sheet was only \$25,000. In some cases, an equipment appraiser may need to be engaged. In other cases, a valuator may be able to estimate the value of equipment based on an estimate of the actual time for which the equipment will be useful. This is known as the equipment's economic life. In the case study, the valuator estimates that the economic life of the equipment is five years. It was purchased two years before. Applying depreciation of \$100,000 per year the valuator adjusts the value of the equipment to \$300,000.

Finally, valuator determines that a shareholder loan represents past amounts that Jerry had taken out of the business that are unlikely to be repaid. As seen in Table 7, after these adjustments, the practice's adjusted net tangible assets are \$670,000.

TABLE 7
Practice's 12/31/12 Balance Sheet Information

Practice's 12/31/12 Balance Sheet Information:	Unadjusted	Adjustments	Adjusted
Cash in bank	250,000		250,000
Accounts receivable	-	120,000	120,000
Equipment	500,000		500,000
Accumulated depreciation	(475,000)	275,000	(200,000)
Shareholder loan	500,000	(500,000)	-
Total assets	775,000		670,000
Less: Liabilities	-		-
Net tangible assets	775,000		\$ 670,000

TABLE 8
Conclusions of Value

	RVOS Opinion 1	RVOS Opinion 2
Goodwill Registry Market Method	1,270,000	1,270,000
Capitalization of Earnings Method	1,340,000	1,820,000
Capitalization of Excess Earnings Method	1,530,000	1,950,000
Conclusion of value	\$ 1,300,000	\$ 1,850,000

OTHER CONSIDERATIONS

Valuators should also consider additional factors listed in *Marriage of Hewitson*, which draws upon the IRS Valuation Guidelines in Revenue Ruling 59-60. They are:

- a. The nature of the business and the history of the enterprise from its inception.
- b. The economic outlook in general and the condition and outlook of the specific industry in particular.
- c. The book value of the stock and the financial condition of the business.
- d. The earning capacity of the company.
- e. The dividend-paying capacity.
- f. Whether or not the enterprise has goodwill or other intangible value.
- g. Sales of stock and the size of the block of stock to be valued.
- h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a *free* and open market, either on an exchange or over-the-counter[41].

In the case study, for example, a consideration under factor "a" is that the practice has a relatively long history of performing facial reconstructive surgery as well cosmetic surgery. Under factor "b," the patient base *is* stable, as it is either affluent or covered by insurance. Jerry's interest (factor "g") is a little more complicated. Elaine's attorney took the position, based on Jerry's relationship with the 10 percent shareholder, that the valuation should cover 100 percent of the business, not 90. Jerry acquiesced.

Reducing normalized earnings by a hypothetical income tax, also known as tax-affecting the earnings stream, is a complex issue. [42] In the case study, the valuator did not tax-affect the practice's earnings.[43]

As shown in Table 8, the three different approaches to the valuation of Jerry's medical practice yield different results. Jerry's valuator subjectively weighs the reliability of the different valuations, placing more reliance on the goodwill registry market method and the capitalization of earnings method. Many valutors present an opinion based on a weighted average. Elaine's valuator may expect cross-examination regarding the significant divergences in the values, which place more reliance on the capitalization of excess earnings method and less on the goodwill registry market method. Jerry's valuator contends that the market approach is more objective and accurate because it is less impacted by valuator's adjustments and judgments, and because in the market in question there is significant data for comparable plastic surgeries. The court agrees and adopts a value of \$1.3 million.