

Mark O. Dietrich

Excerpt from:

BVR/AHLA Guide to
**Healthcare Industry
Finance and Valuation**

Fourth Edition

BVR
What It's Worth

AHLA
American Health
Lawyers Association

BVR/AHLA Guide to Healthcare Industry Finance and Valuation

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Editor



What It's Worth

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What It's Worth

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ISBN: 978-1-62150-069-8

Library of Congress Control Number: 2016940646

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Introduction

In 1997, when I started to write my first book, the *Medical Practice Valuation Guidebook*, I did so¹ because there was a disconnect between knowledge of the healthcare industry and knowledge of business valuation, the latter of which by today's standards was a fledgling industry. Having spent at that point the first 20 years of my career as a healthcare auditor, tax advisor and consultant, and frontline negotiator of managed care contracts, I was intimately familiar with such things as the healthcare revenue cycle, CPT® codes, the Stark Law and anti-kickback statute, Medicare, payment policies of the various commercial insurers, and Medicare risk contracts, now one element of Medicare Advantage. In the matter of valuation, it was studying the 1992 *Friendly Hills* valuation report and discounted cash flow model—and later passing the first ABV exam—that opened my eyes to the dual import of industry subsector knowledge and technical valuation knowledge. I will also credit my late mentor Jim Rigby for his valuation guidance. Retention as the defense expert in an early qui tam case opened my eyes to the unique requirements of valuation practice in the healthcare industry as well as the nearly limitless enforcement power of the federal government.

Nearly two decades after that first exercise in writing about valuation, the healthcare valuation industry is mired in mud at another crossroads, confronted with the Yogi Berra-ism of “when you come to a fork in the road, take it.” Standing at that crossroad, valuation analysts and appraisers are confronted with an inherent conflict between the expectations of physicians as to the value of their practices to hospitals and other institutions and facility-based providers and the need to quantify those expectations in a manner that does not consider the volume or value of referrals. Similarly, valuation professionals confront a conflict between the need of those institutions for alignment with physicians and the same issue of the volume or value of referrals. They are also confronted with what have proven to be irreconcilable conflicts between industry thought segments on the use of the cost approach as a sole means of determining fair market value and the exposure in qui tam cases of the alleged or apparent² abuses of survey-based compensation data to establish fair market value physician compensation in employment and practice valuation scenarios. The 4th edition of this guide attempts to direct readers down the appropriate fork, one which leads to defensible and regulatory-compliant results.

The Contents

New Chapters

The 4th edition is almost a complete rewrite of the 3rd edition, with 14 entirely new chapters and numerous updates to other chapters. Perhaps the most significant contribution is four new

1 Admittedly, I also spent a lot of time on the road teaching valuation and managed care seminars and was bored in airplanes and hotel rooms and needed something to keep me occupied.
2 Take your pick.

chapters on the cost approach by Tim Smith³ of Ankura that arguably resolves once and for all the cost approach debate by exploring in detail the textbook body of knowledge from leading authorities and applying that knowledge to healthcare industry valuation. Tim brought to this task 14 years in fair market value compliance at the world's largest hospital system and an intimate familiarity with deal making under a corporate integrity agreement. There are two central themes in these chapters. The first theme is that the valuation body of knowledge as expressed in the leading texts requires that assets be evaluated for economic and functional obsolescence and lack of any economic return—excluding the volume or value of referrals—is conclusive as to economic obsolescence. The second theme centers on the idea that commonly accepted and employed assumptions vastly overstate the value of a trained workforce.

Robert Reilly, certainly one of valuation's thought leaders, has completely rewritten and expanded his chapter "Valuation Issues Affecting Tax-Exempt Healthcare Organizations," effectively creating a new chapter. He added an important discussion titled "Analyst Common Misconceptions Regarding Healthcare Property and Services Valuations." I would encourage all readers to read that section in particular and notably the context of Robert's statement that "the analyst should consider if there are several contracts being entered into as part of the healthcare property transfer.... And, the analyst should consider whether there are employment agreements, noncompete agreements, intellectual property licensees, lease transfers, or other agreements that are part of the overall transaction. If so, the analyst should assess the fair market value of the total (multi-contract) transaction."

As editor and contributor to the guide, I developed a new chapter titled "Patient Medical Records, HIPAA and State Medical Records Law in Valuation and Litigation," for which I am most grateful to reviewer and technical contributor Lara B. Winn, Esq., of Ankner and Levy in Boston. The focus of this chapter is threefold: one, to provide knowledge of the law; two, to identify circumstances in which valuation analysts and experts become subject to HIPAA's privacy and security rules; and, three, to explore how HIPAA, state law, contract law, and technology in the form of electronic health records have combined to end the appropriateness of conventional application of the cost approach to value medical records. More often than not, it is likely that the liability for secure storage and retrieval of medical records, especially paper records that will soon be functionally obsolete, exceeds the potential value of those records.

To address the explosion in qui tam case litigation and settlements involving valuation issues, Tim Smith and I have contributed separate chapters analyzing key cases, including *Tuomey*, *Halifax*, *DaVita*, *Citizen's Medical*, *Meridian*, and *North Broward*. These two chapters look at issues involving the use of surveys as well as business valuation techniques and analyze expert testimony and expert reports. Readers should find a wealth of insight and warnings in these chapters, regardless of whether one accepts or rejects the position of the relators. Joseph Wolfe and Alyssa James of Hall, Render have provided an in-depth review of the Stark law and regulations' volume or value of referrals prohibition that can serve as a useful guide in evaluating the qui tam cases.

³ Two of which he wrote with Angie Smith.

I have also added what I regard as the most significant and revolutionary work I have done since the *Medical Practice Valuation Guidebook* in the form of “Using Work RVUs and ‘Particular Market’ Rates to Establish Fair Market Value Physician Compensation.” Working with Tim Smith and seven other credited peer reviewers,⁴ I systematically analyze and critique the use of physician compensation and productivity survey data as a basis for establishing fair market value compensation, especially when the factor utilized is compensation per work RVU. Of note is the singular lack of a basis for drawing inferential conclusions from the commonly cited descriptive statistics taken from the surveys. I then provide a fair market value methodology based upon the RBRVS—from which, of course, work RVUs are derived—that takes into account local-market factors that are the basis for the Stark regulation requirement of “a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement.” Importantly, I demonstrate how to use practice expense RVUs to identify when losses on practices are due in whole or in part to the inadequacy of overhead recovery through the physician payment system. I follow this chapter with one devoted to fair market value compensation under the Internal Revenue Code’s section 162, including explaining the independent investor test developed through case law. An extensive discussion of relevant case law is also included.

In the Healthcare Enterprises section of the guide, there are three new chapters. Elliott Jeter of healthcare valuation firm VMG contributes one on urgent care, a rising phenomenon in the post-ACA era that has attracted much attention and equity capital. Darcy Devine of PYA, another boutique healthcare valuation firm, has added a chapter on the valuation of pathology labs. Finally, Karin Chernoff Kaplan, Stuart J. Schaff, and Jessica E. Stack of Veralon contribute “Valuing CINs, ACOs, PHOs, and IPAs,” an in-depth look at the mechanics of valuing common forms of clinical integration arrangements between physicians and hospitals.

Chapter Revisions

“Assessing Intangible Value in a Physician Practice Acquisition,” the publication of which ignited much of the present debate about the cost approach, features an extensive new introduction of nearly 3,000 words highlighting issues in that debate and insights that have since come to light. There are significant revisions to Chapter 1, retitled “Five Years of Healthcare Reform,” that take a more in-depth look at the insurance market reforms that are critical to having a context for understanding the impact on providers of expanded coverage and the increased out-of-pocket exposure of consumers in the individual and small group markets. Carol Carden of PYA and I have substantially revised “Factors in Estimating Cost of Capital and Forecasting Cash Flow in Healthcare” to focus more on finance and expanded examples of cash flow forecasting anomalies in the industry. “Choosing and Using the Right Valuation Methods” has been completely revised and updated, including a new section on “Terms Make the Deal,” illuminating how transaction terms and structure affect fair market value. “Converting Physician Practices to Tax-Exempt Status” is retitled and updated as well.

4 Any or all of whom may or may not agree with my conclusions.

Don Barbo of Deloitte and Robbie Mundy of PYA updated and expanded their chapter on valuing hospitals in the post-ACA era. Doug Smith of Integrated Medical undertook a complete revision of his chapter on revenue forecasting in the imaging sector, and Alan Simons of CliftonLarsonAllen brought the home health chapter up-to-date. Finally, Todd Sorensen of VMG updated the chapter on ambulatory surgery centers.

Closing

As an industry, the government and by extension the public, as well as our clients, rely upon us to exercise professional judgment in a sound and reasoned manner that reflects not only technical knowledge of finance and valuation, but also a profound respect for the law and regulations. I hope readers of this 4th edition will find herein technical knowledge that is also practical and tempered with respect for the law.

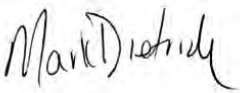
Acknowledgements

I am deeply indebted to all of the contributing authors for taking the time out of their business or personal lives to provide content for the guide. With an unprecedented volume of work in healthcare appraisal and transactions, this is a considerable commitment to the profession's body of knowledge.

I would like to extend my personal gratitude to Tim Smith for his time and efforts in evaluating and reviewing my work.

Although they are specifically thanked in "Using Work RVUs and 'Particular Market' Rates to Establish Fair Market Value Physician Compensation," the reviewers of that chapter deserve special credit because of the extensive time they devoted to the task and their influence on the contents and conclusions.

As editor and technical editor for this 4th edition of the guide and on behalf of the American Health Lawyers Association and Business Valuation Resources, our thanks to all the contributors.



Mark O. Dietrich, CPA/ABV



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