

FOURTH  
EDITION



**BVR's Guide to**  
**Physician Practice**  
**Finance and Valuation**

**Mark O. Dietrich**

**EXCERPT**



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# BVR's Guide to Physician Practice Finance and Valuation

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FOURTH EDITION

By Mark O. Dietrich



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## Goal of the Guide

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The overriding goal of the guide is to enable an experienced general valuator in business valuation, compensation valuation, or divorce litigation to zero in on the type of analysis necessary for a medical practice. It also serves those familiar with medical practices, as it is designed as *both* a basic *and* an advanced valuation text, each of the five parts laying the foundation for the next part, culminating in Part 5's four chapters on advanced valuation issues.

### For Business Valuation

Understanding the services physicians provide is no different than understanding what a given business of any sort is selling. As is the case with different types of retail stores, for example, different physician specialties sell different things, and the profitability of the services varies among specialties. It wouldn't be appropriate to think of a convenience store as a department store, and it is not appropriate to think of an orthopaedic surgeon as a primary care doctor. The orthopaedic surgeon can exploit profit opportunities for durable medical equipment, physical therapy services, and X-ray and other imaging services, to name a few, that are unrelated to personal productivity and, therefore, create value. CPT® codes are the key to identifying what is being sold, and they are discussed throughout the guide.

### For Compensation Valuation

Compensation valuation for other than business valuation is a distinct discipline, but critical to both disciplines is understanding productivity, both in terms of services or procedures of a given specialty as well as the RVUs associated with those services and procedures. RVU values, of course, are the primary driver of physician revenue from payers, and work RVUs are the primary measure of productivity in many practice settings. The guide provides precisely the kind of background knowledge required to prepare an appropriate analysis before reaching a conclusion as to reasonable compensation. Again, CPT® codes are the key to identifying physician productivity and compensation.

### For Litigation Experts

For the expert in a divorce or civil litigation setting, much of the detail herein might strike you as unnecessary and/or over the head of the trier of fact. That may well be the case, depending upon who the opposing expert is, who the opposing counsel is—and how clever the marital litigant is, if you are opposite the physician. The guide enables the recognition of the types of income reduction (or enhancement) that may occur with a change in procedure coding, changes in a given market's insurer contracts, quality of care contract bonuses, delayed or incorrect billing, shifting cases to another member of a group practice, utilization incentives associated with ancillary equipment ownership, and many others, besides just simply describing the valuation aspects. My own experience with hundreds of litigation engagements settled without a trial suggests that, while a little knowledge is dangerous, a lot of knowledge can settle cases.

### For Litigators

One of the most important decisions legal counsel makes is the choice of an expert witness—and the same is true of opposing counsel, of course. Physician divorces, in particular, often involve significant income and significant assets, especially in the higher-income procedural or surgical specialties like dermatology, gastroenterology, OB-GYN, ophthalmology, and orthopaedics, with the question of whether the practice has goodwill value beyond its tangible

assets—equipment, furniture, and accounts receivable—being critical in many cases. When evaluating an expert for a medical practice case, the guide provides the background of what you should expect your expert to be familiar with. Further, if you believe income is being hidden, the guide demonstrates how to obtain all the Medicare claims data for a given physician, a particularly important forensic tool.

**For Staff Training**

As I indicated above, this guide is aimed at those who already understand how to value a business or professional practice. That said, a firm looking to develop specialized physician practice expertise in a younger member of the firm who has an interest in medical terminology and procedures will find precisely the kind of data necessary herein.

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## Using the Guide

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Compared to other types of businesses and professional practices, medical practices are unique in that practically all their revenue is a function of what health insurance companies pay in the practice's *local market*. Purported "national" trends in physician payment rates have little or no relevance to any specific practice, except for Medicare, which has a basic national fee schedule—although Medicare also has local-market variations for many counties. As such, when gaining an understanding of the local market, the single most important thing for a valuator is to identify the health insurance companies the practice has contracts with.

*Part 1, "The Healthcare Marketplace,"* consists of four brief chapters exploring the current market environment that valuers need to be familiar with. Notably, *Chapter 3* contains an overview of the *regulatory overview, current developments*, a critical aspect of knowledge for all healthcare valuation engagements.

*Part 2* looks at various regulatory aspects of healthcare valuation and begins with *Chapter 5, "Understanding Health Insurance, the ACA, and Their Impact on Physician Practices,"* dedicated to providing the valuator the tools to understand health insurance. This is an expansive chapter, covering all aspects of health insurance, including the Medicare Advantage program; Medicare accountable care organizations; the four primary types of health insurance coverage; the market concentration of insurers in various states; and the impact of the Affordable Care Act. Capitation—a form of payment to physicians that shifts financial risk to them—and its various forms are also explored, along with the workings of health status adjustments. The chapter concludes with a discussion of the *Medicaid* program and includes a table comparing state-by-state rates to those Medicare pays.

A further unique aspect of medical practices is that "customer" or patient lists are virtually never obtained, due to both federal and state laws about the confidentiality of an individual's medical data. *Chapter 6, "Patient Medical Records, HIPAA, and State Medical Records Law in Valuation and Litigation,"* covers both federal law (HIPAA) as well as offering insights as to where individual states take priority over federal law due to greater privacy protections. HIPAA violations can result in enormous fines, including for valuers, so it is critical to take it into account in your engagement planning and data requests.

Continuing with unique elements of physician practices, a host of federal and state laws are designed to prevent physicians from receiving anything of value for referring patients for services to other physicians or healthcare facilities. Some of these laws involve criminal liability, while others have large civil fines or can result in exclusion from the Medicare and Medicaid programs. *Chapter 7, "A Case- and Settlement-Based Understanding of Valuation Issues Under Stark and the AKS,"* describes these laws in detail and provides numerous actual examples of how government officials applied them. A valuator should be familiar with these laws in any event, but they are especially important in transactional valuation.

*Chapter 8, "Understanding Physician Billing Codes,"* explains the working of Current Procedural Terminology (CPT®) and some of the most commonly encountered codes, as well as recent changes in their values that are critical to an accurate valuation. Special attention is paid to surgical practices. Physicians bill health insurance companies for most of their

services using this set of codes, which the American Medical Association developed. Medicare and virtually all other health insurers also use these codes. With few exceptions, each of these codes is assigned a value in terms of *relative value units (RVUs)*. Services and products *not* covered by CPT® are contained in the Healthcare Common Procedure Coding System (HCPCS). *Note: The companion Engagement Guide to Understanding and Valuing Medical Practice Specialties describes in considerable detail billing codes for 11 common medical specialties a valuator is likely to encounter.*

*Part 3* is the methodologies segment of the guide. *Chapter 9, "Choosing and Using the Right Valuation Methods for Physician Practices,"* is a "how-to" guide to valuing a physician practice. It starts with an examination of the market approach and details how it is virtually impossible to find a comparable transaction due to the lack of information in the market databases on such fundamental characteristics of a physician practice as insurers and CPT® codes. It then elaborates on *Chapter 8's* discussion of CPT® codes and provides examples of situations the valuator may encounter in transactional valuation.

*Chapter 9* continues with a very detailed discussion of how to determine the collectible value of a practice's accounts receivable. The workings of a medical practice billing system are described, along with the difference between a contractual allowance write-off and a bad debt write-off. A number of comprehensive examples enhance the valuator's understanding of the nuances of this important element of the valuation process. Special classes of receivables outside the normal CPT® and HCPCS billing codes are also addressed.

The next section of *Chapter 9* describes the methodology for determining the appropriate discount and capitalization rate for the practice, as well as the weighted average cost of capital. A detailed list of some two dozen risk factors is provided, along with a graphic on relative risk of different physician specialties and classes of assets.

*Chapter 9* also contains a detailed presentation on using the discounted fee cash flow method. (The capitalization of cash flows and excess earnings method are described in *Chapter 10*). Forecasting revenues *from other than* CPT® codes is explored, as are expenses, working capital needs, and fixed asset acquisitions.

*Chapter 10, "An In-Depth Review of the Correct Use of the Excess Earnings and Capitalization of Cash Flows Methods,"* provides numerous examples of how to, and how not to, apply these methods. The most important conclusion from the chapter is that, whether you use excess earnings or capitalization of cash flows, the results must be identical. Excess earnings is simply an asset-based determination of the cost of capital, while capitalization of cash flows is a long-term debt and equity-based determination. The two sides of the balance sheet must always balance!

*Chapter 11, "The Cost Approach and the Debate About the Value of Intangibles Not Supported by Cash Flows,"* analyzes and debunks the belief that intangible assets such as trained workforce can have a value based solely upon replication cost, without taking into consideration a cash return on investment. The difference between the *cost method* applied to one or several assets is differentiated from the *asset approach* that requires *all* assets and liabilities to be considered. Among other detailed explanations, it highlights the need to consider both functional and economic obsolescence when valuing intangibles, which requires use of the income approach, the *requirement* of both "buyer neutrality" and use of actual transaction terms under the Stark law, and finally the use of the market approach and why the *Goodwill Registry* is not relevant for hospital-physician transactions.

Physician *compensation* is the most critical aspect of any medical practice valuation. For this reason, *Part 4* of the guide devotes four chapters to the matter. *Chapter 12, "Understanding Physician Compensation Plans,"* explores the variety of methods used in private practices for allocating income, expense, and "profits." It is crucial to the valuation process that the valuator obtain an in-depth knowledge of the working of the compensation plan for purposes of forecasting as well as estimating the income of a particular physician, such as for support purposes in a divorce. A comprehensive example demonstrates the different results of the various methods of allocating compensation.

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*Chapter 13, “Debunking the Myth of ‘Survey Says,’”* is a comprehensive detailing of why the all-too-common mistake of using surveys like the Medical Group Management Association will invariably lead to an incorrect conclusion of value.

*Chapter 13* starts with a review of the Stark regulations requirements for determining fair market physician compensation and refutes the common belief that the Centers for Medicare & Medicaid approve of the use of surveys. It follows with an explanation of *descriptive* statistics in surveys and those statistics cannot be used as *inferential* statistics. The large standard deviations in the surveys are also addressed. One of the underpinnings of survey usage is that physicians as a profession are mobile, i.e., will relocate to obtain a salary equal to at least the median in a survey. Extensive research is presented to debunk this myth. Further research is provided on individual state and metropolitan statistical areas proving the dramatic variability in physician payment rates across geographies.

The third compensation chapter, *Chapter 14, “Using Work RVUs to Establish Fair Market Value Physician Compensation,”* picks up on lessons learned in Chapter 8 and explains how the valuator can use the same methodology Medicare and other insurers employ to separate physician compensation for labor from return on assets/equity. Common mistakes that can occur when nurse practitioners or physician assistants work in a practice are identified as is isolating technical component (TC) revenue associated with ownership of equipment such as an ultrasound unit or X-ray.

*Chapter 14* concludes with a detailed presentation on how to use RVUs, including an RVU calculator, to calculate fair market compensation, isolate technical component revenue and profit, and evaluate physician assistant revenue and profitability, including allocating the revenue from surgical procedures where the physician assistants perform certain services, such as the post-operative patient visits.

The final compensation chapter, *Chapter 15, “Reasonable Compensation for Physicians Under the Internal Revenue Code,”* is designed to apply the lessons of Chapters 9 and 10 specifically to valuations for income tax purposes. Tax-oriented valuations include conversion from “C” corporation to “S” corporation status, reasonable compensation for purposes of section 199A, valuations of practices for acquisition by a tax-exempt organization, and compensation valuations for employment by a tax-exempt organization where the Excess Benefit Transaction Rules of section 4958 may apply.

*Chapter 15* reviews the factors the IRS and the courts historically apply, as well as a review of relevant case law. This includes the independent investor test that originated in the *Exacto Spring* case. Key to many tax-oriented valuations is the question of who “owns” goodwill and other intangible assets: the business enterprise or the individual. The impact of employment contracts and noncompete agreements is described in detail for this reason.

*Chapter 15* then provides two comprehensive examples of the application of its principles. The first includes specific factors that can influence physician compensation, including supervision of nurse practitioners and physician assistants. The second example is application of the independent investor test to physician practice compensation versus return on assets/equity, including the isolation of technical component (TC) profits. The chapter concludes with a section on how to document the reasonable compensation analysis before an IRS audit takes place and an appendix summarizing the IRS Reasonable Compensation Job Aid for IRS Valuation Professionals.

*Part 5, “Special Issues and Situations,”* as the name suggests, provides four chapters that take an in-depth look at frequently encountered special types of valuations. *Chapter 16, “Identifying and Valuing Noncompete Agreements and Personal Goodwill,”* details methods and issues especially critical in divorce and tax-oriented valuations. This chapter is a “how-to” guide. The chapter begins with a review of statutes and case law on the enforceability of noncompete agreements for physicians in various states. It then provides a comprehensive example of the use of a discounted cash flow model in the “with and without” method of isolating personal goodwill from enterprise goodwill and breaking out the portion of the personal goodwill belonging to the noncompete.

*Chapter 17, "Buy-Ins, Buyouts, Owner Agreements, and Other Types of Valuations,"* addresses the specific issues of valuations for buy-ins and buyouts. Building on earlier chapters, including Chapters 9 and 10, it revisits reasonable compensation with examples, as well as noncompete agreements and related court cases. One of the most challenging aspects for a valuator is to advise on value and structure in a two-person practice. The associated problems and solutions are addressed in detail from the author's experience with hundreds of such transactions. Concierge or membership practices are increasing, especially in primary care. Depending upon the terms of the agreement(s) between the practice and any corporate sponsor of the program, a number of unique valuation challenges can occur. The chapter addresses a number of these with detailed mathematical examples.

*Chapter 18, "Valuation for Marital Dissolution,"* aka divorce, looks at cases involving medical professionals in a number of states and focuses on factors that determine whether personal and enterprise goodwill are divisible assets. Each state's statute governing property division and appropriate valuation date are also described. A number of "Author's Insights" examine key cases in detail and offer lessons in how to avoid mistakes in divorce reports and testimony.

*Chapter 19, "Damages for Lost Compensation, Lost Profits, and Violation of Noncompete Agreements,"* addresses the specific issues with such engagements, building upon the knowledge gained throughout the guide, including compensation, use of CPT® codes and RVUs, technical component revenue, the Stark law, and health insurance.

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## About the Author

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Mark is a summa cum laude, Beta Gamma Sigma graduate of Boston University, where he also earned an MBA with high honors. He started his career in 1977 as the outside auditor for what was then the largest of the Harvard Medical School's Faculty Group Practices, a task that included several months each year studying medical charts and how procedures were coded and billed to insurance. As such, he was studying anatomy, medical terminology, procedure codes, and diagnosis codes during the more than four decades before sitting down to write this guide and continued to do so throughout his career. These *clinical* aspects of medical practices are important because, if you are going to understand the *financial* aspects of a medical practice, you need to understand the nature of the services the physician offers. It can be a challenging task to understand a physician practice, just as it is in many other complex businesses, but the primary goal of this book is to enable the valuation expert to meet that challenge. Mark's background was sufficient to get him appointed as one of only six members of the inpatient Patient and Family Advisory Council at Boston's Brigham & Women's Hospital, one of the nation's premier institutions and ranked as the 19th best hospital in the world by *Newsweek*.

In the early 1990s, Mark and a CPA colleague were the two consultants who put together the first independent physician network in Massachusetts, encompassing most of the communities south of Boston. Mark's role was negotiating risk-based contracts with insurers. As a result, he had the unusual opportunity to attend Medicare Advantage medical director training for that physician network, to assist him in understanding the actuarial dynamics of the health insurance business, as well as giving financial advice that was more consistent with desired clinical outcomes.

Using this knowledge of clinical and insurance matters was the foundation of a career in valuing more than 500 medical practices of just about every conceivable specialty. Representing Mark's second book in two years after 2023's *Engagement Guide to Valuing Medical Practice Specialties*, this guide represents a complete revision of the 3rd Edition.

Other books written/co-written/edited/co-edited by Mark:

- *BVR Engagement Guide to Valuing Medical Practice Specialties* (author)
- *BVR/AHLA Guide to Healthcare Industry Finance and Valuation*, 4th edition (primary author, editor);
- *BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements*, 2nd edition (contributor, co-editor);
- *BVR Guide to Ancillary Healthcare Services Valuation* (contributor, editor);
- *The Financial Professional's Guide to Healthcare Reform* (co-author); and
- *PPC's Guide to Healthcare Consulting*, 25th edition (co-author).





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## Acknowledgments

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I retired in January 2022 after a nearly 50-year career in accounting that started as a college sophomore with part-time work for a sole practitioner CPA. I remained in small firms my entire career, starting my own firm in 1990 with Kathie Wilson, who remained in practice with me right through my final trial. I fell a few states short of having valuation or litigation engagements in all 50, and also had several engagements and various speaking opportunities in the United Kingdom, thanks to the good graces of my friend and medical accountant, the late Ray Stanbridge.

In my previous book, the *Engagement Guide to Valuing Medical Practice Specialties*, I thanked a number of individuals who were valued colleagues, mentors, and referral sources. In considering the acknowledgments for this book, I thought I would take what I believe to be a unique approach: identifying the experts who I was happy never to have opposed. My strategy, of course, was to have a narrow industry focus and always “stay in my lane,” but there are skilled experts who could have crossed into that lane, and I am glad they didn’t when I was involved. I’ll add that they are all great people with exceptional abilities, who also contribute their time and effort to enlightening the profession. I count them among my friends.

In alphabetical order:<sup>1</sup>

- Neil Beaton;
- Mike Crain;
- Don DeGrazia (we *were* opposite once but settled the case easily);
- Nancy Fannon;
- Jay Fishman;
- Harold Martin (we worked together on several significant cases); and
- Barry Sziklay.

Outside the profession, as I have in the past, I thank my constant companion for 52 years and spouse for 47 of those. While I wrote stuff and talked a lot, she built stuff, like decks, bathrooms, kitchens—and an entire suite complete with kitchen, bath, game room, and home theater. She never got in my way, even when managing my practice for its last 23 years. Now we are sharing the fruits of our accomplishments in our retirement.

Mark Dietrich  
March 2024

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<sup>1</sup> I note that none of these individuals were asked to review or approve of this guide.



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