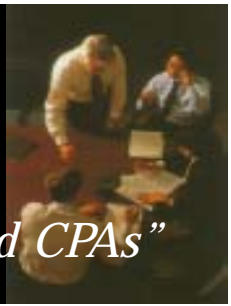


Medical Management Advisor

"The E-Advisor for Healthcare Professionals, Valuators, and CPAs"



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Two recent settlements by physician IPAs with the Federal Trade Commission demonstrate again that physicians need to watch their conduct when they "group together" in an attempt to negotiate with managed care plans. These settlements also demonstrate the need for physicians to monitor the activities of any "messenger" they engage to assist them with their dealings with the managed care plans. The rulings provide clear areas for caution...[\(Read full article\)](#)

Standard Cost Analysis: Extracting Meaning From The Internal Benchmark Data Of A Practice

Much has been written and presented in recent years on the topic of benchmarking for medical practices. Most of the information from these writings has dealt with the general idea of the value of finding internal and external sources to compare practices' financial and operational performance. Unfortunately, little has been written about how to go about analyzing and interpreting the causes of variances from such benchmark data, and the consultant or administrator benefit of having a more complete understanding of the causes than plain differential analysis allows. This is where techniques in standard cost analysis enters the picture; by providing a multi-dimensional explanation for those variances. This article presents a methodology for using traditional cost accounting analysis to analyze and explain practice performance. ...[\(Read full article\)](#)

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Drafting Proper Buyout Clauses In Shareholders' Agreements

With FMV and GAAP at the heart of these- among the core provisions of any shareholders' agreement, ensuring that they are properly designed calls for financial – not legal – expertise.

Quite surprisingly, it is not uncommon for a CPA, financial advisor, or valuator to not be included in the process of drafting buyout agreements among the owners of a practice. Not surprisingly, the result is fertile ground for future problems and litigation. The serious consequences arise quite frequently, when attorneys and other advisors, who may lack sufficient familiarity with finance or generally accepted accounting principles, fail to understand or address issues that would be red flags to a financial specialist. Presented in this article are some of the specific errors we see committed, and the information needed to prevent them. These include: misuse of terminology, choice of inappropriate or senseless formulas, over or under valuation, and others. ([Read full article](#))

Control Adjustments In The Excess Earnings Method: A Control Value Method

In the October issue of MMA we looked at the computation of the weighted average return on tangible assets for use in valuing a physician practice using the excess earnings method. We noted that failure to consider how much of the tangible asset value could be financed with debt often leads to incorrect results. In the second article of this series (Volume 2, Issue 12, 2002) we determined the weighted average cost of capital (WACC) for the practice based upon the results of the excess earnings method and used that to determine the practice's value under the Capitalization of Cashflows (CCF) method. Both values must be the same. In this third and final article of the series, MMA looks at the method for correctly making control adjustments to the valuation model. ...([Read full article](#))

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DRAFTING BUYOUT CLAUSES IN STOCKHOLDERS' AGREEMENTS

Far too often CPAs, financial advisors and valuers are conspicuously absent from the process of drafting buyout agreements among the owners of practices. It stands to reason that if lawyers are the only professionals licensed to practice law, the interpretation of financial terms and the related computations should be primarily entrusted to those who specialize in the finance professions. Let's look more closely at some of the key issues, and frequent problem areas.

THE AGREEMENT ITSELF

The buyout agreement is both a fundamental and key portion of any well-designed stockholders' agreement. It provides for the orderly disposition of a terminating shareholder's stock in the event of retirement, disability, death or other dissociation from the practice. Often times, the price assigned to the share will, in fact, vary depending upon the reason for the dissociation.

Buyout agreement formulas can be divided into several categories:

Book value

Book value and its derivations are perhaps the most common reference points for buying out a physician's interest. In an accounting sense, book value means historical cost less depreciation and amortization, as reflected in the practice's accounting records. However, what basis of accounting is to be utilized to determine book value? Certainly, very different results could be obtained using the income tax basis of accounting – typically a modified cash basis – and generally accepted accounting principles or GAAP, a term that requires careful definition. Remedy: the clause should specify the basis of accounting to be used in determining book value. If the income tax basis is to be used, it will usually make sense to specify that the effect of any section 179 deduction should be adjusted, and that any other distortions resulting from this method should be similarly adjusted. Other examples of where specificity is often lacking include recording prepaid expenses, e.g., malpractice insurance, or accrued expenses, such as the retirement plan contribution or accrued vacation and sick pay for employees. Accounts receivable should also be considered, although these are typically addressed as deferred compensation through the employment contract.

If book value is to be computed based upon GAAP, everyone involved should understand not simply what the acronym stands for but what it means and what the implications are. In the healthcare industry, there *is* a definitive listing of GAAP: the AICPA Industry Audit and Accounting Guide for Healthcare Organizations. The hierarchy of GAAP rules is laid out in Statement on Auditing Standards (SAS) 69, with FASB Statements and Accounting Principles Board Opinions at the top in Category A. The Guide is in Category B, just one step below and higher than other publications in Categories C and D. A statement prepared in accordance with GAAP must conform to the Guide and CPAs

assisting with drafting clauses based on GAAP should be certain to be familiar with it. Bear in mind as well that GAAP is a moving target, and that the financial results could change over the years as new requirements for GAAP conformity are adopted.

GAAP will differ from the modified cash basis income tax method in a variety of ways, including:

- The depreciable life for furniture may be longer.
- The depreciable life for leasehold improvements will almost certainly be shorter.
- The depreciable life for equipment will vary depending upon its character, e.g, equipment with a significant technology component like MRI may have a shorter life for GAAP than income tax purposes.
- The section 179 deduction is not taken, of course.
- Prepays and accruals will need to be recorded.
- Depending upon the type of practice, inventory may need to be reflected. In an office-based radiology practice, film, contrast and developer may represent significant assets, just as pharmaceuticals might in an oncology or urology practice. Note: an inventory of free samples of prescription drugs should likely not be valued since it cannot be sold and therefore would not generate any cashflow. (As support for this position, we cite the \$845 million fine against TAP Pharmaceuticals for participating in a scheme where physicians sold “free” samples of the cancer drug Lupron to patients and billed the Medicare program.)
- Technically, bad debts cannot be recorded under the income tax method until actually written off (the direct charge off method) while for GAAP purposes they must be allocated to the period in which the revenue is recorded (the reserve method.)
- As noted above, the *Net Collectible Value* of the accounts receivable is typically paid out as deferred compensation via the Employment Contract. If this is the case, an offsetting liability accrual needs to be made for GAAP purposes.
- GAAP statements *always* include income tax, since Net Income, and therefore the annual increase in retained earnings, is always after-tax. If the entity is a partnership or S corporation, then the tax rate is typically zero and no accrual results.

Formula value

Many times, the owners of the practice will attempt to develop a formula that is easy to apply to some common measure of profitability. The intention is to avoid having to rely upon a version of book value, since book value does not always reflect the true value of the practice. The development, or choice, of Formulas is inherently fraught with risk, particularly if developed before a practice has actually engaged in any business, since it will not be possible to apply the formula and see if the result is meaningful.

As a rule, formulas should always be based upon a measure of *Profitability*. Those based upon other measures such as revenue or collected revenue, for example, make little or no sense. A business that loses money would have a value based upon a revenue formula, even though it may be worth nothing. Further, and more obvious, formulas based upon revenue do not account for the right hand side of the balance sheet, otherwise known as liabilities. For example, assume we have a practice with debt of \$500,000 and collected revenues of \$3.0 million. A formula that says the practice value should be based upon 40% of the most recent year's collected revenue would have a "value" of \$1.2 million and leave the continuing owners holding the proverbial bag for the \$500,000 of debt.

This calls to mind the import of differentiating between a gross asset value and the value of equity when using such formulas. It is generally accepted that formulas give the value of assets (what valutors would call Business Enterprise Value) rather than equity. You have to deduct the debts outstanding to arrive at the equity value, which is all a departing stockholder is entitled to. The outstanding debts to be deducted, at least to a valuation expert, would generally be long-term debt, including the current portion. Whether or not accounts payable and accrued expenses – the current liabilities – should be deducted depends upon the formula and the parties' understanding – which, of course, should be specified in the agreement.

The chosen profitability measure should also reflect the reasonable costs of operating the business. But adding to the definition of "profits" such "benefits" as malpractice insurance, payroll taxes and the like is, plainly stated, foolish.

The formula should specify the method of accounting that is being used, *and* use terminology that is consistent with that method. For example, using the expression "income before income taxes" in a formula where the practice maintains its books on the modified cash basis mixes GAAP terminology with a non-GAAP method of accounting. If the formula is to be based upon the modified cash basis, the term "excess of revenues collected over expenses paid before income taxes" is preferable to "income before income taxes." If the formula contemplates the GAAP basis, then "income before income taxes" is correct but the clause should then specify that it is to be determined in accordance with GAAP. It should also state that the parties recognize that the books of account are not ordinarily maintained in accordance with GAAP.

Preparing an Income Statement in accordance with GAAP requires a beginning and ending Balance Sheet in accordance with GAAP as well.

A reasonable formula might be one (1.0) times normalized annual profit, defined as “excess of revenues collected over expenses paid before income taxes” and before physician compensation and benefits, and determined in accordance with the practice’s established method of accounting, which is the modified cash basis used for income tax purposes. A valuator familiar with medical practices should know to specify the normalization rule. For example:

“Benefits subject to normalization shall include continuing education, dues, subscriptions, automobile expenses, travel, entertainment, veterinary fees for pets and any other expenses specified by the parties in a written modification of this agreement. The amount subject to normalization shall be the excess over \$3,000 (the Base Amount) per shareholder per annum. The Base Amount shall be adjusted annually by a percentage based upon the percentage increase or decrease in the Medicare Physician Conversion Factor as published in the Federal Register by the Centers for Medicare and Medicaid.”

FAIR MARKET VALUE

Fair market value, like GAAP, is a term little understood by anyone outside the valuation profession, and even there much disagreement (or confusion) exists. Nonetheless, proper drafting can limit the likelihood and degree of future disagreement, and with it the potential for costly litigation.

Definition

Fair market value (FMV) is the value to a *hypothetical* buyer or seller, neither under compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Note that FMV contemplates *both* buyer and seller agreeing upon the value. Therefore, any value that places an unreasonable or impossible burden on the buyer is neither fair nor FMV, just as neither would be a value that shortchanged the seller.

Contracts

FMV is not computed in a void. The valuator must consider any and all provisions of the Stockholders’ Agreement and related Agreements that impact the availability and distribution of cash from the practice. FMV does not contemplate ignoring the law of contracts! Contractual agreements that impact the rights of a *hypothetical* buyer of an interest in a *specific* practice are both *relevant* and **required** in the FMV analysis.

Author’s note: This is particularly significant in a divorce proceeding when trying to value a minority interest in a practice. If the compensation is set by contract, what basis does the valuator have for normalizing the salaries of any but the shareholder whose interest is being valued? For marital dissolution purposes,

the non-physician spouse may be entitled to a portion of the value of the physician's individual practice based upon that physician's excess earnings, but is certainly not entitled to the excess earnings of any other physician in the practice.

Laws and regulations

Similarly, FMV does not contemplate ignoring federal, state or local laws and regulations. The federal Fraud and Abuse and the Stark laws forbid various types of referrals and kickbacks. The FMV of a healthcare entity *must* assume compliance with all such rules. Many states forbid or restrict noncompete agreements among physicians, and a noncompete is assumed to be part of any transaction under the FMV standard. FMV *must* factor such restrictions or prohibitions into the value of the practice. In valuing practices which have Certificates of Need or other forms of state licenses or permits, any restrictions or rules in those licenses or permits must be considered. The restrictions or limitations represent fundamental aspects of the practice's business and value.

Control and noncontrol value

FMV comes in two distinct flavors: the fair market value of a *controlling* interest and the fair market value of a *noncontrolling* or minority interest. The difference between the two reflects the fact that a control owner can make decisions that affect the course of the practice while a noncontrol owner cannot. The most important element of control is the ability to effect the distribution of cash. Other important elements include hiring new personnel, acquiring new equipment, and selling the practice or interests in it. *A control owner cannot be assumed to have the ability to void any contractual agreements the practice has entered into*, for example, with employees, landlords or others, unless those agreements are terminable as written.

Example

Assume that one of four shareholders of an orthopedic practice wants to acquire a MRI unit, while the other three do not. A control value could include the cashflows associated with the MRI while a noncontrol value would not.

The Agreement needs to specify whether control or lack of control FMV is to be the basis of the buyout. It is perfectly acceptable to provide that a minority owner is entitled to a pro-rata share of the control FMV, if that is what the parties contemplate.¹ *Such an Agreement makes a minority interest's FMV equal to a pro-rata share of a control value.* In fact, for practices with only a few owners, and particularly in the case of two owners, the pro-rata share of the control FMV is likely the most appropriate, the reasoning being that in the two-person practice, when one is bought out the other will own 100% and a controlling interest. Further, the nature of many medical practices is that the Stockholders' Agreement and Employment Contracts provide for the distribution of all the

¹ This is typically the case for dissenters' rights action where the standard of value is fair value, which typically does not consider lack of control discounts.

practice's cash, one of the major issues in determining a lack of control discount. In the absence of a specification as to whether a pro-rata share of control value is assumed, one should ordinarily proceed under the assumption that a noncontrol value is intended and apply lack of control discounts or assumptions in the valuation model. [This is a likely source of litigation.]

NUANCES OF CONTROL VALUE

If control value is to be used as the basis for the valuation, the Agreement should be made clear as to whether it contemplates a Stock valuation (which is certainly the norm) or an Asset valuation. The two produce distinctly different results, primarily because the control owner of assets will obtain a step-up in basis for those assets, resulting in higher depreciation and amortization deductions, and therefore a lower tax burden, and greater after-tax cashflows – which is what FMV values. It follows, of course, that the Asset value of a practice is higher. Bear in mind that a control value of Assets is only appropriate when the Agreement specifies that the entire practice should be considered as sold to a third party, or otherwise specifies the use of asset value. Even in that case, it would be highly unusual to make the assumption that the purchaser could void the practice's contractual obligations, such as those to other physician employees.²

For practices structured as partnerships, however (including most LLCs taxed as partnerships), a purchaser of the equity interests would get a basis step-up under §754 of the Internal Revenue Code. In this case, asset value should be assumed. Here again we see that the law cannot be ignored, in this instance the Internal Revenue Code, assuming that the §754 election is in place. Many partnership and LLC agreements require that the election be made. *Accurate valuation results require a solid grounding in the tax law as well as informed interpretation of Partnership and LLC Agreements.*

NUANCES OF NONCONTROL VALUE

If a noncontrol value is required, the valuator must (again) take into account all the existing contractual agreements that affect the distribution of cash. As was noted above, these tend to limit the lack of control discount in a medical practice – which makes a noncontrol interest more valuable than might otherwise be the case. The best way to accomplish this is by preparing a valuation using one of the methods under the income approach, and tailoring the assumptions in the valuation model to reflect the cash distributions *not* accounted for by contract and which are therefore subject to a control owner's decision. For example, assume that there is a long-time nonphysician employee of the practice who is paid 30% more than market value for his services. A control owner could fire that employee and replace him, while a noncontrol owner could not. In a *noncontrol* valuation, a reduction in salary for the employee's replacement could *not* properly be reflected in the valuation model.

² The Bulk Transfer Act of most states would seem to preclude voiding contracts.

For a second example, assume a physician is entitled to a salary equal to 40% of his/her collected revenues, excluding any Stark Designated Health Services (DHS) revenue, pursuant to the employment contract. The physician's share of any DHS profits distributed pursuant to a vote of the Board of Directors is based upon stock ownership. Therefore, the cashflow in the valuation model would reflect *only* the DHS profits as the other profits are paid out contractually. A control owner would have the ability to appoint the Board and decide whether or not to distribute the profits, while a noncontrol owner would not. The noncontrol owner would have uncertainty about when the profits would be distributed, if ever. This uncertainty would have to be reflected in a subjective discount in the value of the interest. Salaries based upon the employment contract however, would be an expense of the practice in the model. It follows that it would be consistent to have provided the dissociating physician with his/her accounts receivable as deferred compensation under the employment contract. Part of the value of the noncontrol owner's *overall* interest would be the claim to deferred compensation, although this is separate from the *equity* value.

As a final example, consider the valuation of a practice with two senior physicians, each of whom owns a 40% interest. There is one junior physician who owns a 20% interest. The 20% owner is terminating and is entitled to a FMV buyout under an agreement that does not specify a pro-rata share of control value. A noncontrol value is therefore assumed. The two 40% owners receive salaries in excess of reasonable compensation – based upon the terms negotiated when the 20% interest was acquired – totaling \$100,000, which continue for five years. At that point in time, the 20% shareholder is entitled to an increase in base salary of \$40,000 and the remaining \$60,000 becomes part of the profit distributed based upon ownership.

In this circumstance, the valuation could be based upon a DCF with the first five years of the forecast reflecting whatever profit is available, and then increasing in the sixth year by the \$60,000 detailed above. The 20% owner cannot influence the distribution of the \$60,000, even though it is excess compensation and would be normalized into the valuation if a *control* interest were being valued. This difference between control and noncontrol normalization is a critical factor in valuation of medical practices and one that is all too frequently overlooked.

Marketability

Fair market value on a noncontrol basis generally contemplates a discount for lack of marketability in addition to a lack of control discount. Valuers disagree on whether a control value requires a marketability discount. It is wise to specify whether marketability discounts are to be considered when drafting a buyout clause.

****ADMONITION**

Valuation is about *future* cashflow to the owners of the practice, not *historical* cashflow. FMV by *definition* is about future cashflow. An Agreement requiring

FMV to be paid for an interest therefore cannot be based upon historical cashflow, except in that circumstance where future cashflow will be the same. Methods of valuation employed by inexperienced or poorly trained valuers that use the weighted average of 3 or more prior year's results are of limited, if any, use and should be challenged.

CONCLUSION

Terms such as generally accepted accounting principles and fair market value should be understood and defined prior to being used in stockholders' buyout agreements. CPAs and valuers, and particularly those who are dual-trained as both, should be active participants in the process of drafting the language of a buyout clause. Self-serving as this might seem coming from me, it is also based on long experience as an all-too-frequently aghast witness to the results of agreements that did not have the benefit of proper financial expertise; specifically, costly, time-consuming litigation when the poorly-drafted clause is implemented, and the potentially avoidable destruction of the practice itself.

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Control Adjustments in the Excess Earnings Method: A Control Value Method

In previous issues of MMA we looked at the computation of the weighted average return on tangible assets for use in the excess earnings method, and the weighted average cost of capital (WACC) for the practice based upon the results of the excess earnings method for use in the CCF method. In this third article in our Excess Earnings series, MMA looks at the correct method for making control adjustments to the excess earnings valuation model.

INTRODUCTION

The Excess Earnings Method generally produces a control value. The technical reason for this is that the Tangible Asset measurement requires the cost approach, which always produces a control value. It is mathematically possible to adjust the assumptions in an Excess Earnings model to generate a noncontrol value, just as it is possible – and common – to vary the assumptions in a Capitalization of Cashflows model to produce a control or a noncontrol value. Medical practices are somewhat unusual in that the Excess Earnings method – properly applied of course – could be used to determine a noncontrol value. This is in large part because the distribution of cash is generally governed by employment contracts and other ownership rights via a stockholders agreement,