

# Practice Valuation 101

By: *Chris Bentson*  
*President, Bentson Clark & Copple*



At some point in the life of a practice, there will most likely come a time to have it valued. This process usually occurs only once for most practitioners, but more in some cases. Let's discuss the practice valuation process by answering three commonly asked questions.

## 1. Why Value A Practice?

The reasons for having an orthodontic practice valued vary, but by far the most likely reason is the contemplation of a change in ownership. The valuation will declare the practice's current fair market value and will serve two primary purposes when a buy-out is considered:

- The valuation report will provide a transparent view of the practice and will help any candidate understand the practice's operational and financial health. We often refer to the valuation report as the first trust document in any proposed transaction. One of the main purposes for providing this document to a potential buyer is to transfer trust and visibility, insuring the asking price is fair and reasonable. We believe the valuation report should include a reasonableness test. This is a high-level financial projection that proves that the value calculated in the report can be repaid in a reasonable amount of time (generally 7-10 years), with interest (typically 7.25% – 8.25%), and provide an after-tax "livable income" to the buyer.
- The determined value will likely be used to anticipate the expected proceeds (after-tax) of the practice sale for financial planning. When the net after-tax income is plugged into one's financial picture, it is easier to decide whether the time is right to execute the sale of a practice



When a partnership is being considered instead of a sale, the valuation will provide a current value and operating metrics prior to another doctor's entry and contribution to the practice. The declared value can then be used to build and model an appropriate buy-in structure that meets the financial goals of the senior doctor. It will also illustrate the new partner's expected income for the years after entering the practice based upon the practice's anticipated performance. Without understanding the value prior to the new doctor's entrance into the practice, it is difficult to construct an appropriate buy-in model that is fair to both parties.

There are several other reasons why a practice may be valued. Some of the most popular causes include estate and financial planning, benchmarking the practice's current performance, and resolving marital discord issues.

## 2. Who Performs Practice Valuations?

Most Certified Public Accountants who have been involved in the sale of various businesses can prepare some type of valuation report. For reliability purposes, the report should follow accepted valuation methodology. It should also be completed and signed by someone who holds nationally recognized valuation credentials (such as CVA, AVA, ASA, etc.). The American Dental Association and American Association of Orthodontists suggest

that dental and orthodontic practices be valued using an earnings approach -- typically a discounted cash flow method or, more commonly, a capitalized income method. A valuation that does not use one of these methods will have difficulty being defended in court or withstanding strict accounting scrutiny, if challenged.

The AAO provides its members with a list of companies or individuals that offer valuation services to the orthodontic community. If the purpose of the valuation is for an ownership change, it is strongly suggested that a firm that specializes in orthodontic valuation and transition services is selected rather than using your local CPA or accounting firm.

### **3. How Does the Process Work?**

To determine the fair market value of your practice, a critical assessment of a practice's current and past operational and financial information is required. The valuator will provide an information-gathering package that will outline the information necessary to properly establish the practice value. The request data often takes several weeks or even months to gather. The information is pulled from a number of sources including the practice management system, the accounting system, and the practice's accountant, among other sources.

Once the information is gathered, the valuator will review, analyze and compile all the data into a readable document. A critical review of the income statements is completed, revealing the true overhead of the practice, after all doctor-related compensation and benefits are removed. Any adjustments made to the income statements are noted and explained within the valuation report.

Another important step in the valuation process is an on-site practice visit, which, ideally, should happen on a patient clinical day. Some firms bypass this important step, but it is a common requirement to visit the physical facility in order to sign the valuation report (most credentialed appraisers are required to visit the facility in order to complete the valuation). During the on-site visit, the appraiser will verify the fixed assets, examine the physical building and surroundings, ask questions to clarify certain data, observe patient flow, view the staff's interaction with patients and staff (including the doctor), and survey the facility's proximity to schools and its competitors. Through the site visit, the appraiser can get a good feel for the practice location, strength of staff, and many other critical intangibles as to their impact on the overall valuation of the practice.

The valuation report produced will also include an analysis of the current national, state, and city economic demographics. Key employers in the market will be identified, as well as school enrollment numbers, median family incomes, median housing prices, and other economic and demographic metrics that potential buyers will want to understand and consider.

Generally, the valuation process takes approximately 90 days to complete, but can vary based on numerous factors. Determining the fair market value of an orthodontic practice (or any business) is more of an art than a science or simple mathematical calculation. However, if the valuator performs the necessary due diligence and the valuation report is properly prepared, the report and the calculated fair market value will provide the doctor with a defensible value of the practice for use in sale, partnership, or good practice awareness.

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