PURCHASING a PRACTICE

SECTION

2

Valuation and Purchase of an Eye Care Practice

CHAPTER 8

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Never buy what you do not want, because it is cheap; its cost will be dear to you.
Thomas Jefferson *Canons for Observation in Practical Life*

Optometry school graduates who want to "be their own boss" should consider the purchase of all or part of a practice. This method of entering optometry can often be preferable to starting a practice "from scratch." Surveys show that within 5 years after graduation a significant percentage of optometrists purchase an ownership interest in a solo, partnership, or group practice. Unquestionably, purchasing a practice is a complicated process (Box 8-1). If done properly, however, the purchase of an existing practice offers far more advantages than disadvantages—higher potential income, equity ownership, flexibility and control over your life, and options at retirement.

ADVANTAGES OF PURCHASING A PRACTICE

A practitioner who buys an existing practice is purchasing a business with a proven track record. Although there may be a minor amount of patient attrition, often less than 5%, patient loss can be minimized by properly implementing the necessary transition procedures and in fact, very often there is growth and not attrition in the case of an optometrist who is selling all or a portion of his/her practice as they near retirement and have not had the energy to promote the practice as they did in earlier years. In addition, the new practictioner is often involved in other social circles and activities that will bring new patients into the office. An existing practice allows a prospective owner to project anticipated income and operating expenses with more certainty than a practice opened "cold." The new practitioner can expect to have patients scheduled for examinations from the first day of operation, producing an immediate financial and emotional benefit. The new practitioner will initially incur significant out-of-pocket expenses such as the down payment for the practice, closing costs, attorney's and accountant's fees, security deposits for the premises and utilities, and initial operating costs (such as payments for stationery, additional equipment, and inventory). It is important that the buyer secures adequate funding to handle these initial costs. Fortunately, income from the practice will help ease this financial burden. Emotionally, the new practitioner receives the benefits of being busy, helping and satisfying the existing patients of the practice, and using a wide range of skills.

The purchaser of an existing practice is also purchasing an existing location. Usually, the purchaser will assume the existing office lease but should be prepared to negotiate for an extension or change in terms with the landlord. Leasehold improvements may not be needed, but if a new practitioner wants to modify an office, it may not be necessary to do so immediately and the cost should be reflected as an adjustment in the purchase price. Because the office has already been used to deliver patient care, any problems related to patient flow have probably been eliminated. The telephone system and other utilities are already connected and operational. There is a current telephone listing for the office in the telephone book. Laboratory accounts, as well as accounts for contact lenses, frames, and other materials, have already been established, making it easier for the new practitioner to obtain credit when opening new accounts.

Purchasing an existing practice in a given area does not change the optometrist-to-population ratio in that area because the new practitioner merely replaces the departing one. In an area that has experienced no growth, new patients will either transfer from another practice or come to the practice as new arrivals to the area. When a practice is purchased, the new practitioner is not totally dependent on drawing these patients to the practice and can use the revenue from existing patients to supplement efforts to attract new patients. The practitioner also can devote more effort toward internal office marketing, which has been shown to be five times less costly than external marketing.

The purchase of an existing practice usually allows the new practitioner to assume command of a trained staff. The staff is familiar with the operation of the practice, the patient population, and the problems encountered by the practice. A familiar staff person answering the phone can ease a patient's fear of being seen by a new, unfamiliar practitioner. Having the selling practitioner remain in the practice for a transition period of several weeks to months facilitates the transfer of patients, enabling the purchasing practitioner to become familiar with office operations. The selling practitioner also can introduce the new practitioner to key people in the area such as bankers, accountants, lawyers, and other health care professionals.

BOX 8-1

Significant Events in a Practice Transfer

- Conduct buyer-seller interviews.
- Confirm the intent of the buyer to purchase.
- Obtain an independent appraisal of practice value.
- Negotiate and compromise as necessary to finalize sales terms.
- Agree to purchase terms and to a restrictive covenant for the seller.
- Sign an offer to purchase, and place earnest money in escrow (this is an optional step; the parties may directly negotiate the terms of the purchase agreement).
- Seek financing for the purchase, if required.
- Verify contracts, leases, profit and loss statements, tax returns, provider agreements, assets, and inventory.
- Sign the purchase agreement.
- Apportion the sales price among the various assets and fill out Internal Revenue Service Form 8594 tax declaration.
- Pay off or transfer liabilities to complete the transaction.
- Transfer title to the buyer.
- Notify vendors and suppliers of the transfer of ownership.
- Apply for third-party and managed care plan credentialing.
- Notify patients.

Often, the new practioner can purchase an existing practice with all of the advantages mentioned for the same price as opening a practice "cold."

DISADVANTAGES OF PURCHASING A PRACTICE

A purchasing optometrist always assumes the initial risk of potential loss of some patients. Because it is difficult to predict whether the previous practice's patients will return to the practice under new ownership, there is considerable financial pressure on the new practitioner. The new practitioner usually will not want to disrupt operations or initially make drastic changes for fear of alienating the existing patients of the practice. Thus the new practitioner will probably have to incorporate changes gradually until the practice reflects the style of the new practitioner.

If the selling practitioner is retiring after many years of practice, older equipment and the physical layout may need to be updated. Equipment may have to be purchased or improvements made, requiring an outlay of capital. Management information systems incorporating new technologies, such as electronic data transmission, will often need to be purchased. The new practitioner will probably want to keep the existing staff, but this may necessitate paying slightly higher wages. Staff members may require retraining or altering their duties. It may be difficult to change habits or duties if staff members have been with the selling practitioner for some length of time. Most importantly, provider panels of which the seller is a member may not be easily transferred to a new practitioner.

However, purchasing an existing practice affords the new practitioner the luxury of not having to perform the many tasks that are a part of opening "cold." The burden of finding a location; leasing an office; hiring employees; purchasing equipment, supplies, and inventory; setting up accounts; arranging for utilities; and building a patient base are greatly lessened since these tasks already have been performed. Indeed, it is this immediate operational viability that is the appeal of purchasing an existing practice. Unlike the practitioner who opens "cold," however, the purchaser of an existing practice must fully evaluate its potential worth and determine an acceptable fair market value.

FACTORS AFFECTING PURCHASE FEASIBILITY

Many variables, both internal and external, of a practice affect the feasibility, desirability, and ultimate value of a practice. First, the more prominent the local market position and the better the practice reputation, the more willing a buyer should be to pay a higher price. Second, government and managed care regulations affecting provider reimbursement have an impact on value. Third, more efficient and updated office operations and computer systems should make the practice more valuable. Finally, newer equipment and leasehold improvements that offer more of a turnkey operation will add value and facilitate the transfer to a new owner. However, although these factors affect purchase feasibility, no factor affects value more than cash flow after expenses (i.e., net operating income).

Trends that are specific to a practice under consideration will have an influence on a prospective purchaser's decision. Patient volume, ratio of new to former patients, ability to retain former patients, active ongoing recall, patient communications, and various sources that refer patients to the office will all affect the desirability of a practice.

The efficiency of practice operations, including the staff 's ability and willingness to offer high-quality service and the way cost savings mechanisms are passed onto the patient as part of the value chain, will impact the desirability of a purchase.

Evaluation of the area in which a practice is located will provide information about the current and future viability of the practice. This area may be defined as the probable drawing area of the practice and it can vary from eight blocks to 15 miles, depending on whether the practice is located in a city or a suburban or rural area. The potential buyer can evaluate existing patient demographic data to determine the extent of the practice's present drawing area. Since a major portion of the payment for a practice is used to secure goodwill or active patient records, moving from one drawing area to another is not a wise idea. The drawing area should be evaluated as though the purchaser were opening a new practice rather than maintaining an established one. The goal in buying an existing practice is to expand its patient base and to have it increase in value rather than attempting merely to maintain the status quo. In evaluating the area, the potential buyer must determine whether factors that will support new growth are present.

Evaluating the Current Economic Climate

Economic factors to consider include the employment rate, the viability of other practices, population demographics, key economic indicators, and social factors. Employed people are more likely to have disposable income and health insurance; therefore employed individuals are more likely to seek and be able to afford health care, including optometric care. Also, areas with large employer groups will have more managed care plans that offer vision services to employees. The employment rate of an area may fluctuate from year to year, but the trends of the area can be compared with state, regional, and national trends. This information can be obtained from local, state, or federal government statistics.

A survey of other health care providers should be performed to determine the number of practitioners who have full- and part-time practices in the area. Full-time practitioners derive all of their income from the area; part-time practitioners, unless semi-retired, must supplement practice income with income from outside the area. Retail businesses should be evaluated for reinvestment. A reinvestment in new equipment, machinery, and inventory generally is undertaken when business owners are experiencing growth or when there is potential for new growth. Speaking to these health care professionals or small business owners would be time well spent on the part of the prospective new practitioner.

Evaluating the Local Demographic Conditions

The following five demographic factors must be considered: optometrist-to-population ratio, growth rate, population age, income level of the population, and key economic indicators.

Optometrist-to-Population Ratio

It is estimated by American Optometric Association (AOA) manpower studies that one full-time optometrist is needed for every 7,000 people. This statistic may be misleading because it does not take into account the presence of ophthalmologists or opticians who may be duplicating some of the optometrist's services. A more correct estimate would be one optometrist per 5,000 people as a result of changed demographics, such as baby boomers needing more vision care, and the increased scope of optometric practice across the nation. A more realistic appraisal must consider the setting of the practice: rural, suburban, or urban. The following are the minimum population requirements needed for these settings:

- Rural: 4,000 to 6,000 people per optometrist
- Suburban: 12,000 to 18,000 people per optometrist
- Urban: 25,000 to 45,000 people per optometrist

Using these ratios as a rough estimate of practice viability, a prospective buyer can evaluate the saturation level of practitioners in the drawing area of the practice. Although these ratios will not be changed by the purchase of an existing practice, the potential for new growth may be affected by an unfavorable ratio.

Growth Rate

The infusion of new people into an area means the arrival of prospective patients with no eye care practitioner. These people will be the most fertile source of growth for the practice. In an area with relatively flat growth, new patients will have to be obtained from the patient population of other practitioners more than from the few new arrivals who have moved into the practice area.

Population Age

The population age of an area should be favorable to the type of services that may be added to the practice by the new practitioner. For example, a new practitioner who wants to add low-vision services to an existing practice needs to have a population that is skewed toward senior citizens.

Income Level of Population

The per capita income of the drawing area needs to be evaluated for the type of services provided and the fee structure of the practice.

Key Economic Indicators

The following economic factors should be reviewed to ascertain the viability of the area:

- *New business starts*. New business in an area generally means that there is a favorable economic climate. The success (or failure) rates of these businesses and the turnover rate of small businesses in the area should be analyzed.
- *New housing starts*. This statistic indicates the movement of new people into an area. It also may signal the movement of new jobs and new businesses into an area.
- *Home prices*. The largest investment that most Americans make is in their homes. When real estate values are favorable, people feel more confident about the economy and are more likely to spend disposable income. Downward trends in real estate generally mean a downward economic trend, which will exert an effect on all businesses in an area.
- *Industry*. Practicing in an area that is tied to a specific industry or company may be favorable when economic times are prosperous. However, it can be disastrous in tighter economic times when the industry or company is not doing well. The ideal situation would be to practice in an area that has a diversified economy and offers jobs in various industries.
- *Social factors*. Even though there is no rule that says a practitioner must live in the same area as the practice, there are geographic limits to the separation of primary residence and practice. Living in the same area as the practice affords the practitioner the opportunity to meet prospective patients such as neighbors, vendors, soccer moms, fellow Parent-Teacher Association (PTA) or Lions Club members. Just as with any business, running an optometric practice requires time well beyond that needed to examine patients. The stress and strain of long hours spent commuting to and from the practice will undoubtedly take a toll on the practitioner and may affect the practitioner's willingness to tend to the practice beyond patient care hours. Factors to

consider include the quality of the school system, cultural and recreational opportunities, health care facilities, climate, affordability and desirability of housing, religious institutions, and the ability of a spouse to earn an income in his or her field of expertise.

Finding answers to the following questions will lead a young practitioner on a journey of discovery about any practice that is being considered for purchase.

- Does the practice deliver cost-effective quality care?
- Is it able to document outcomes?
- Can it easily integrate with other practices if needed?
- Has the seller taken steps to eliminate inappropriate care?

Specifically, the practitioner should review patient flow and satisfaction, the level of the medical information system, the type and number of communications and recall messages, the ability to schedule an appointment, and the ease with which records can be interpreted by others.

OFFERING A PROPOSAL

Fully investigating the economic and social factors previously identified requires a significant time commitment when a potential buyer visits the practice area. Information can be obtained from local chambers of commerce, local government planning and building permit offices, real estate offices, banking institutions, other health care practitioners, other business owners, public service companies, local newspapers, direct mail companies, and friends and relatives who live in the area.

Several documents and forms pertaining to the financial and legal aspect of the eye care business to be transferred should be fully investigated and analyzed by both the purchaser and consultants. Box 8-2 lists the major items that should be described in an offering proposal that a prospective practice purchaser is given. The process of uncovering this information requires "due diligence" and includes a review of the ownership structure of the practice. Is creditor or lender consent required to enter into agreements to transfer assets? If so, the prospective purchaser should consider obtaining a letter of Assurance or Good Standing with a full disclosure from attorneys, accountants, and malpractice insurers.

Financial statements that should be reviewed include the following: 3 to 5 years of federal tax returns for the practice, the most recent profit-and-loss statement, short- or longterm debt (with maturity dates), the amount of accounts receivable and accounts payable, depreciation schedules, and assumed liabilities. Are there any local property taxes for which the purchaser would assume responsibility? Has the seller received any unusual legal or financial correspondence recently?

What are the details of the present staff members' terms of employment and benefit plans? Is a restrictive covenant, noncompete, or liquidated damages clause reasonable? What material contracts, service contracts, commitments, leases, and consignments is the practice obligated to fulfill? Obtain copies and evaluate any management, third-party, and managed care contracts. Ascertain what, if any, use permits, licenses or business permits are required to operate the business. Are any types of agency filings necessary? Obtain copies of any tangible property liens, liabilities, chattel mortgages, security interests, and Uniform Commercial Code filings that will be assumed by a purchaser.

A purchaser will also want to ensure that employee salaries, payroll taxes, vacation time, sick leave, and retirement plans are all paid current.

BOX 8-2

Information Required for an Offering Proposal

- Compile a brief history of the practice including age, location, and finances.
- Obtain at least 3 years of tax returns: for a sole proprietorship, Schedule C; for a partnership or limited liability company, Forms 1065 and K-1; and for a professional service corporation, Schedule 1120 (1120S if organized as a subchapter S corporation).
- Get the profit and loss statement or the income and expense statement and balance sheets, if available, for at least 3 years, but as a minimum, obtain the current year's quarterly statements.
- Complete a list of the assets that are to be transferred by equipment model, age, and fair market value (if available).
- Complete a list of the wholesale or acquisition cost of the current useable frame, spectacle, and contact lens inventory.
- Plot the competition on a map using a radius of 1 to 2 miles in an urban area, 3 to 5 miles in a suburban area, and 7 to 10 miles in a rural area; differentiate between optometrists, ophthalmologists, opticians, and corporate chains.
- Calculate the current patient volume, using a breakdown of new and former patients by number of visits per year, zip codes, and age (if available).
- List the fee schedules for all services and the percentage of patients seen in specialty areas.
- List the practice promotional materials used.

FACTORS THAT INFLUENCE PRACTICE VALUE

To evaluate the worth of a practice, the potential buyer should consider the gross and net income of the practice, scope of practice offered by the selling practitioner, practice location, existing office lease, patient records, transition period, physical resources of the practice, and accounts receivable.

Gross Income

Gross income is the total amount of money taken in by the practice for goods and services. The gross income for the 3 years before the sale should be reviewed in detail. This information can be obtained from Form 1120 and the profit and loss statement of the practice if the practice is a professional association or corporation, from Form 1065 if it is a partnership or limited liability company, or from Schedule C of the

seller's tax return if the practice is a sole proprietorship. The gross income should be evaluated for growth from year to year. A practice with an increase in gross income that is less than the increase in the cost of living index for that same period has actually lost income. A decrease in the gross income from year to year indicates that there may be major changes in the area, the economy, or the perception of the practice or practitioner. If there are increases in fees, they must be considered because an increase in gross income may be related to the change in fees, rather than to real growth of the practice.

Gross income also should be compared with the regional average gross income. This comparison may provide some indication of the economic viability of the practice and the area. The number of hours that the practice is in operation must be considered. A practice that is only open part time may have increased earning potential if hours are expanded; reduced hours may also indicate a practice that has peaked in its earning potential. As the gross income of a solo practitioner increases, there will come a point at which further growth in income can only be achieved by the addition of another optometrist, extra technical support, or an increase in space. Practices with lower gross incomes may not be able to support a new practitioner who is required not only to finance the purchase of the practice but also to repay student loans.

Net Income

The prospective buyer should determine both the actual net income that is realized by a practice and the ratio of net income to gross income. Most dispensing optometric practices will have an adjusted net-to-gross income ratio of 25% to 35%. Nondispensing practices that are strictly service based may have a higher net-to-gross income ratio, since the overhead expenses are usually lower. Practices that have a lower-than-average net-to-gross-income ratio may incur higher-than-normal overhead expenses. This may be a result of the area or the location of the practice, or it may indicate that there is inefficient office management. Practices with low net-to-gross-income ratios also may be charging lower-thannormal fees for services and materials or may have incurred considerable debt service.

In looking at a practice's net income, the itemization of office expenditures should be investigated. These expenditures can be found on the profit and loss statement of an incorporated practice or on Schedule C of an individual proprietor's tax return. Office expenses should be evaluated relative to national or regional averages. Deviations from average can indicate to the prospective buyer how efficiently the practice has been run and how practice income has been spent. The prospective buyer can use these figures to calculate how expenses might increase or decrease after the purchase of the practice.

When a practice is purchased, there is an inevitable loss of some existing patients. These are patients who, for whatever reason, decide not to see the new practitioner. They will need to be replaced by new ones whom the purchaser will attract to the practice. The potential effect of a loss of patients on practice income should be determined; the economic effect of a 5%, 10%, 15%, and greater loss can be calculated using scenario analysis. Although patient attrition will exert a direct effect on the gross income of the practice, fixed expenses, such as salaries, rent, and utilities, will not be affected. Variable expenses, such as laboratory costs for ophthalmic materials, will change with a decrease in gross income. By calculating the changes in these expenses, a hypothetical net income can be determined as a worst-case scenario should the gross income of the practice initially decrease.

There are certain fixed personal expenses, such as rent or mortgage payments, home utilities, and student loans, that must be paid regardless of how successful the practice becomes. These expenses should be deducted from the net income of the practice. The amount that remains is the amount that the new practitioner can use to finance the purchase of the practice. From these calculations, it should become apparent that the practice with the highest gross income may not necessarily be worth the most. It also should be apparent that a practice with a low gross income must produce sufficient net income to cover the practitioner's expenses, including the financing of the practice. If the practice cannot do so, the new practitioner will have to supplement this income by working outside the practice.

Scope of Practice

The number and type of services provided in the practice and the primary emphasis of the practice (services or materials) constitute the scope of the practice. Full-scope practices, providing the highest level of optometric services and materials, generally possess more up-to-date equipment and thus have a higher value. Many retiring practitioners may not have practiced primary care optometry. For the recent graduate, these practices offer an opportunity for a quick increase in the gross income of an existing practice. This can be achieved through attracting new patients to the practice or—with the addition of services or the expansion of hours to include evenings and weekends—through an increase in income derived from the existing patient population.

Practice Location and Lease

When an established practice is purchased, location usually is not a factor affecting the retention of existing patients. However, location is a primary factor in the ability of the practice to attract new patients. The practice location should be in an accessible, viable, professional or commercial area. In most suburban or rural areas, parking must be readily available. Handicapped and elderly patients require a location that is either on ground level or in a building with elevators. Visibility to street traffic also is desirable. Moving the practice during this initial 2 to 3-year period would create a greater erosion in the existing patient base and would saddle the new practitioner with additional moving and renovation expenses at a time when these expenses could probably be least afforded.

A favorable lease agreement is essential and should include options to renew for specified periods after the expiration of the initial lease term (see Chapter 12). These options give the prospective buyer the security of a longer lease term while retaining the flexibility to leave if the existing space becomes insufficient.

For the buyer to assume an existing lease, the lease must allow the selling practitioner to assign it to a successor. When evaluating the existing lease, the buyer should be sure that the terms are at least as favorable as could be obtained if a new lease were negotiated. The more favorable the lease terms are, the greater its value to the purchaser.

Patient Records

Having an established patient base is the greatest advantage of purchasing a practice. In evaluating the practice, however, the most difficult factor to assess is the likelihood that patients will remain with the practice after it is sold. A patient record in and of itself has no value for such evaluation. Transfer of records to a successor practitioner allows existing patients to feel that continuity of care will be preserved, while allowing the new practitioner to internally market to the existing patient base. The likelihood that a patient will return to the practice for care is greatest for active patients. Since most patients will return for eye care approximately every 1 to 2 years, the greatest value is given to those patients who have received care within that period. Patient records with no activity for more than 2 years but less than 5 years have significantly reduced value; however, these patients often provide a great opportunity to convert back to active patients once communicated with. Patient records with no activity for more than 5 years may have little or no value to the new practitioner; most of these patients are likely to have moved, passed away, or selected another practitioner. Even these patients should be contacted so they are advised of the transfer because they may not be completely satisfied with their new optometrist or ophthalmologist.

An active practice will have a 25% to 35% rate of new patient visits each year. This rate can be calculated by determining the number of new patients seen during the preceding 2 years. Appointment books or patient records may be used to make this analysis. A certain number of patients examined in prior years should have returned to the practice for subsequent care. This return rate also should be evaluated to determine how well the practice has performed in retaining patients. Patient records also should be sorted by the percentage paid by third-party payers and the percentage paid directly by patients themselves. Third-party payments will not generate the same gross revenue for the practice as fees for service. Practices that have a large percentage of third-party payments need a larger patient base which can only be transferred successfully if the new practitioner will be able to serve as a provider under the third-party plan. These patients generally have less loyalty to the selling practitioner than fee-for-service patients; their primary loyalty is to the practitioner who continues to provide them with the same excellent care.

The average primary care practice (as of 2006) provides 2,229 examinations per practitioner per year. This statistic can be used as a benchmark to measure patient flow for a prospective practice. Practices with fewer than this number of examinations will require higher fees to generate the average gross income. Practices with higher-than-average examination fees but with average gross incomes result from fewer patients being seen or more third-party patients being treated.

The age range of the patient population should be closely representative of the area in general. If the average age of patients is greater than the average age of the population in the area, it could indicate that the practitioner has done little to attract new patients to the practice. There are regulations created by the Health Insurance Portability and Accountability Act (HIPAA) that must be adhered to when dealing with patient records (see Chapter 16). Figure 8-1 provides a sample letter that can be used to notify patients about the transfer of care to another practitioner attendant to the sale of a practice.

Transition Period

The transition period allows the selling practitioner to acquaint the new practitioner with the management of the practice. This process includes review of office procedures, ordering of ophthalmic materials, meeting with suppliers, and working to transfer the loyalty of staff members. It also means introducing the new practitioner to key people in the area, including the main referral sources of the practice.

The transition period also applies to staff. In some instances, having existing staff members remain in the office can be more valuable than having the selling practitioner remain. This is especially true for staff members who have been working in the office for many years and who know all of the patients. Since staff members will have the first contact with patients both on the telephone and in the office, they can be a vital part of the effort to ease patient apprehension about a new practitioner and can reassure patients who are hesitant about returning.

The selling practitioner should be provided with financial remuneration for assisting during the transition period. Payment is usually provided on a per diem or weekly basis. The new practitioner also should expect to increase the salaries of staff members who are to be retained. This gesture demonstrates good faith on the part of the new practitioner and will pay for itself many times over in goodwill from staff members.

Physical Resources

The physical resources of a practice include tangible assets, which usually are the equipment, furnishings, office supplies, inventory, and leasehold improvements. The value of tangible assets is often easier and more accurate to determine than that of the intangible assets such as restrictive covenants.

This letter is to advise you that I am (retiring from, or selling) my practice as of ____(MM/DD/YY)____. The reason for my departure is (describe the reason). At this time I would like to take the opportunity to announce that Dr. _____ will be taking over my practice as of ____(MM/DD/YY)_____ and will continue to provide the same quality eye care you have received at this office for so many years. I believe Dr. _____ 's ability and knowledge will satisfy your eye care needs and have personally instructed him/her in the important aspects that have made this practice unique and well appreciated by all of my patients. Dr. _____ graduated from _____ optometry school and performed a postdoctorate residency at _____. I am very confident that you will quickly agree that I am leaving the practice in quite competent hands. In addition, the same loyal support staff that you are very familiar with will be available to take care of your needs, as well as answer any of your questions. Should you wish to make an appointment, simply call the same telephone number _____ . Our office hours will be ____ . A copy of your record will stay at this office; however, you are under no obligation to accept Dr._____ as your primary eye care practitioner. Should you desire to have your records transferred to another office, we will need your written authorization and a completed record release, which you can obtain by calling this office. If you wish to continue to use the services of this office, you may authorize the release of your records to Dr. _____ at your next visit. In closing, let me express my appreciation for your many years of loyalty, support, and friendship. It has been a pleasure to be your optometrist and I want to take this opportunity to wish you much happiness and good health for future years.

FIGURE 8-1 Sample letter to patients announcing the transfer of records to another practitioner.

Older, fully depreciated equipment will have some fair market value but must be evaluated as to its usefulness. Equipment that is in good working order and not obsolete can be used by the new practitioner and replaced when practice revenues allow. Obsolete or nonfunctional equipment that needs to be replaced should not be included when determining the value of the practice. This same consideration applies to furnishings, office supplies, inventory, and leasehold improvements.

The buyer should make sure that the seller owns all the frame and contact lens inventories that are to be purchased. Many contact lenses are supplied on consignment, and the new practitioner assumes responsibility for the consigned material. Frames usually are not consigned, but frames transferred to the new practitioner may not always be returnable if they had been purchased by the seller.

Accounts Receivable

Any fees for services or materials owed to the practice must be accounted for. The longer a debt is outstanding, the less the chance of its ultimate collection. For this reason, accounts receivable are often sold on a discounted basis, calculated on the age of each account. For example, accounts that are less than 30 days old may be purchased for 80% to 90% of their value; accounts 30 to 60 days old, for 60% to 70% of their value; accounts 60 to 90 days old, for 30% to 50% of their value; and accounts 90 to 120 days old, for 10% to 25% of their value. Accounts in excess of 120 days would not have any value. An alternative method is to pay a flat percentage rate, such as 50% to 70%, for all the accounts receivable.

If possible, it is preferable for the new practitioner not to purchase the existing accounts receivable but instead allow them to be collected by the selling practitioner during the transition period. If the transition period is very short, the new practitioner may agree to transfer the amounts collected over a specified period to the seller. Also, it is not unusual for the selling practicitoner to pay the purchaser 5% of the accounts receivable collected to compensate the buyer for the staff time and efforts utilized in the collection of these funds.

FACTORS THAT DECREASE PRACTICE VALUE

There are several factors that can significantly reduce the value of a practice to a potential buyer. Some of the most common are the following:

- Recent cutbacks on time spent in the office, resulting in reduced practice income.
- Failure to have an active recall system to ensure the buyer of uninterrupted patient flow.
- Inadequate and outdated computer and office management systems.
- Office equipment that has not been updated.
- Lack of participation in third-party vision and eye health reimbursement plans.
- Inadequate use of Medicare.
- Low net/gross ratio.
- Decrease in number of examinations performed.
- Decrease in revenues.
- Higher than average overhead costs.

Despite all of the factors that have been described, the “bottom line” in any transfer of property is the law of supply and

demand. The greater the demand for an existing practice, the more valuable it becomes. As a corollary rule, the greater the need and urgency to sell, the lower the price that will be attained. In any event and no matter what the circumstances, there is always a way to determine whether a proposed price is reasonable.

PRACTICE APPRAISAL

The basis for analyzing the value of a business can be found in Revenue Ruling 59-60, issued by the Internal Revenue Service (IRS). The fair market value of a practice as described by IRS Ruling 59-60 and defined by the American Society of Appraisers is "the price, in cash or equivalent, that a buyer could reasonably be expected to pay and a seller could reasonably be expected to accept if the property, business or professional practice were exposed for sale on the open market for a reasonable period of time, both buyer and seller being in possession of the pertinent facts, and neither being under compulsion to act."

In the valuation of an optometric practice, regardless of the purpose for such a valuation, the most important principle is that of "future benefits." Anticipated future earnings can be "capitalized" to reflect a present value.

Generally, the value of a business or professional practice is a compilation of tangible and intangible assets: intangible assets are primarily goodwill, which equates to the expectation that patients will return and thereby produce future revenue. For purposes of a sale, some assets, such as cash and accounts receivable, are excluded from the sale and liabilities, such as equipment debt and accounts payable, are paid by the seller and also are excluded from the sale unless specifically assumed by the buyer.

Tangible Assets

The tangible assets of a practice may include the following:

- Cash/cash equivalents, accounts receivable (less an allowance for doubtful accounts), prepaid expenses (including prepaid income tax and insurance), deposits, and notes receivable. Although these are not always transferred in the sale of a sole proprietorship, they may be transferred as part of the purchase of corporate shares or of a partnership interest.
- Inventory and supplies.
- Equipment and furnishings.
- Lessee-owned leasehold improvements. These may include counters, plumbing and lighting fixtures, carpets, drapes, paneling, and built-ins such as cabinets and shelves. In many instances, the lessor or owner of the building provides and owns many of these items, which are paid for as part of the rent. In other instances, the lessee owns the items and depreciates them over the term of the lease.

Intangible Assets

The intangible assets of a practice may include the following:

- The ongoing functioning practice with a patient base in place and the resultant expectation of a continuing income stream.
- Past and present advertising, publicity, and promotion.
- The tendency of patients to continue to utilize the services of the practice and refer other patients to the practice.
- The reputation of the selling practitioner and practice and the practice name and telephone number.
- The desirability of the practice location in terms of its proximity to patients, to related supporting services, and to other practices.
- The trained employees/staff who are ready to assist a potential successor owner with their expertise and knowledge of the practice.
- The assembled functioning systems of equipment and supplies that are ready and available for use.
- The premises lease, if the lease is at a lower rate than that for similar space in the area and the successor is able to assume the favorable lease.

The term *goodwill* is often used to encompass all of the intangible assets. A sale of a professional practice includes two additional components that may affect the market price. These are the transition services performed by the seller and a restrictive covenant on the seller.

1. *Transition services.* A portion of the value of a practice is established in recognition of the services that would be performed by the seller for the benefit of the successor in the event of a sale. In the sale of a practice, these services would include the seller's efforts to make introductions and announcements to the community at large. Often, a reception is held for other doctors and medical personnel to meet the successor. A social event is sometimes arranged by a seller for patients to meet the new owner.
2. *Restrictive covenant or covenant not-to-compete.* The seller is required to agree not to enter a practice in competition with the buyer within a specified radius of the practice for a specified number of years, unless otherwise approved by the buyer, or unless the seller is working for or with the buyer. This agreement is a condition to most practice sales and part of the goodwill value is usually allocated to this covenant.

Liabilities

The liabilities of the practice may include the following:

- Notes, contracts, and equipment loans or leases payable.
- Accounts payable and accrued operating expenses.
- Income taxes payable.
- Accrued employee expenses: salaries, vacation time, sick leave, pension/profit sharing, taxes, etc.

In the event of a sale, these liabilities are normally deducted from the practice value or they are paid by the seller. Lease/ purchase payments on equipment are often assumed by the buyer or the outstanding balance is paid off by the seller as part of a transfer of ownership.

No set formula can be applied to simplify the fair market valuation process. For this reason, some appraisers use an average of several methods to estimate fair market value. This is an absurd approach in that averaging good information

with bad provides a worse result not a better one. Revenue Ruling 59-60 states that "a sound valuation will be based on all relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance." There are several approaches an appraiser may choose when attempting to determine the fair market value of a practice. These methods can be divided into the following three basic categories: asset approach, income approach, and market approach. Only the income approach provides meaningful data for most optometric practices.

The Asset-Based Approach

The asset-based approach is most applicable for a newer practice in which a track record of tax returns or profit and loss statements does not yet exist. This method values the two primary components that contribute to practice value: tangible and intangible assets. Tangible assets include equipment, machinery, instruments, furnishings, leasehold improvements, supplies, and inventory. The value of tangible assets is determined by fair market value itemization (using comparable sales data and price listings of used equipment) or "book value" (the value remaining from the original basis after depreciation, obtained from the seller's tax returns). Current and unused inventory also may be valued this way, or the wholesale replacement cost may be used. Intangible assets include goodwill, office lease, telephone number, practice name, incomeproducing ability, and quality of patient records—all factors that should help minimize patient attrition and maximize patient growth during and after the transition.

The Income Approach

The income approach takes into account both income and excess profits (if any) using a capitalization rate methodology. This method develops a value for the practice using a viewpoint similar to that of a disinterested investor who is considering the purchase of a business with comparable investment characteristics. The current value of the practice is based on what earnings the practice can generate in the future for the new owner. This is determined by calculating the future annual net cash flow for the business which is then "discounted" back to the date of sale using a "present value" formulation (explained later in this section). The "discount rate" is equivalent to the estimated rate of return on the purchase of the practice viewed as an investment and its value reflects the inherent risk of the purchase. This approach is also known as the "excess earnings approach," which values goodwill as a multiple of what the practice earned in excess of an economic salary to the owner(s) and of earnings on tangible assets. These earnings are accounted for in the calculation of a capitalization rate that reflects (1) costs of funds; (2) a fair return on investment; (3) the inclusion or exclusion of a covenant not-to-compete in the case of sale of all or part of the practice; (4) the risk of future loss; and (5) the need for replacement of equipment, furnishings, or leasehold improvements.

This approach calculates the excess annual net earnings of the practice after payment of a reasonable economic salary for the practitioner(s), if employed in comparable salaried position(s) of equal responsibility. As previously discussed, these excess earnings are then capitalized as follows:

$$\text{Valuation} = \frac{\text{Excess annual earnings}}{\text{Capitalization rate}}$$

As an example, if you were told you could make an investment in a CD that was guaranteed to return 5% and your annual return would be $10,000, you would know exactly what the invested amount (or value) should be: value is equal to annual earnings ($10,000) divided by the interest rate of 5%; thus value is equal to $200,000. However, in addition to a return on investment or cost of borrowed funds, there is also a risk factor. The capitalization rate is equal to the cost of funds plus the risk. It is the calculation of that "risk" that requires the expertise of an experienced appraiser. Risk may include adverse legislation or government health care policy, changes in demographics or employment, or competition from other optometrists, ophthalmologists, and health maintenance organizations; the need for services based on age distribution, income, or education (i.e., the local demographics); the extent of loss or gain of goodwill—a measure of the practice reputation, partially measured by recall rates and growth of the practice and to what extent prior patients are retained; the types of care provided; the attractiveness of the lease and renewal options; stability of staff; the type of third-party care provided; the percentage of new patients to total; and so on. The capitalization rate used enables one to determine an economic value that considers an optometric practice to be what it really is: an investment, a vehicle for the production of income.

The Market Approach

The market approach is most applicable when you have numerous comparable sales, as you do in the residential housing market. This is rarely the case for optometric practices and the data for optometric practice sales are difficult to obtain. For these reasons, this methodology is of little usefulness. This method takes into account the significant benchmark variables of the practice, such as net-to-gross income ratio, percent of income for staff salaries, cost of goods sold, and practice overhead expenses, and then compares these numbers to previous sales of similar practices. Once this analysis is completed, a guideline ratio is calculated as a percentage of the past year's gross revenue to determine practice value. As mentioned, data on sales of optometric practices are difficult to obtain, since information of this nature is used primarily on a proprietary basis by commercial brokers.

USING BREAK-EVEN ANALYSIS TO DETERMINE WHETHER A PRICE IS REASONABLE

Break-even analysis will not determine the value of a practice or the price for which a practice should sell. It is a useful tool, however, that all prospective practice purchasers should use.

It offers a method of calculating the affordability of monthly payments for the practice, based on current practice revenues and expenses, projected financial performance, desired personal salary, and contracted selling price. An example of how to make such a calculation is found in Box 8-3 (also see Chapter 38).

In the example, the break-even point of $35,649 is less than the average total monthly revenue of $37,500 by $1,851, indicating that there is enough income to provide the desired salary, to pay off the debt, and operate the practice at present revenues and expenses. There is a cushion or safety factor of $1,851 per month, or $22,212 annually, in this example. If the break-even point had been more than the monthly revenue of $37,500, then the available options would have been to take less income, to reduce the monthly debt service payments by obtaining a longer loan repayment schedule, to reduce the monthly total fixed expenses (which is difficult to do), restructure the proposed purchase terms, or to decline the purchase.

The most obvious assets of a practice are its tangible items: equipment, instruments, records, furnishings, supplies, inventories, real estate, and so on. These items can be assigned a fair market value with a reasonable degree of accuracy. The intangible assets of the practice, such as goodwill, lease value, and restrictive covenants, have a higher degree of variability as to the calculation of their value. This intangible value is sometimes defined as the likelihood that the buyer will be able to enjoy the same economic benefits as the seller.

The price paid for an optometric practice is often in the range of 45% to 75% of the practice's gross income for the year preceding the sale. This price may be more if the net-to-gross income ratio is high or if the practice has exceptional assets, such as a considerable amount of up-to-date equipment. The price may be less if the net-to-gross income ratio is low or if there is little usable equipment. Prices vary considerably from region of the country as do costs for rent and salary.

In the usual case, the proposed buyer and the selling practitioner must negotiate the terms of sale themselves (see Chapter 7). Because most optometrists are not knowledgeable about the legal, tax, and accounting issues that are part of such a sale, it is necessary to use a team of consultants so that needed technical advice can be obtained.

RESTRICTIVE COVENANTS

When one enters into an agreement for the purchase of a practice, the purchase agreement should include what is known as a restrictive covenant or covenant not-to-compete. Simply put, this is a clause that prevents the selling optometrist from practicing optometry for a specific period within a specified geographic area. The intent is to prevent economic harm to the buyer. Without this provision the selling optometrist would be free to open an office literally "across the street," thereby significantly lowering the practice goodwill by drawing away patients. An attorney will be required to draft the language of such a covenant so that it will be in compliance with state law and thereby enforceable in court if legal action were to become necessary.

CONSULTANTS

The purchase of a practice may be the single largest investment that an optometrist makes. An investment of this magnitude should not be attempted without consulting various experts, including an optometric practice appraiser, an attorney, and an accountant.

BOX 8-3

Sample Break-Even Analysis

For purposes of this example, it is assumed that the practice grosses $450,000 per year and that the agreed-on sales price is $290,000, of which $250,000 will be financed for 10 years at 9% interest.

STEP 1

Average gross monthly income for this practice is $450,000 ÷ 12 = $37,500.

STEP 2

Total fixed expenses (TFE) must be determined; TFE includes salary, rent, insurance, utilities, and similar expenses. In this example, 40% of gross income will be used as the TFE (which amounts to $180,000 annually, or $15,000 per month).

STEP 3

Monthly payments of $3,167 for the loan obtained from an amortization schedule.

STEP 4

Practitioner income must be calculated; for this example, it will be $90,000 annually, or $7,500 per month.

STEP 5 The total fixed cost (TFC) must be determined, which is equal to the sum of TFE, debt service payments, and practitioner income:

TFC = TFE + Debt service + Doctor's income

In this example, the total of the three figures is $25,667, expressed as a monthly average.

STEP 6

The formula for break-even point (BEP) is as follows:

$$\frac{\text{TFC}}{1\text{- VC *}} = \frac{25{,}667}{1.0 - 0.28} = \frac{25{,}667}{0.72} = \$35{,}649$$

ANSWER

The BEP is $35,649.

* *VC,* Variable costs (the laboratory bills or the cost of goods sold, which in this example are 28% of the gross income, or 0.28).

Optometric Advisor/Appraiser

An optometric practice advisor/appraiser should have personal knowledge of the demographics of vision and eye care in the area; the value of equipment, inventory, and supplies; and the reputation of the seller and the practice. This advisor will be able to provide unique support in the transition after the sale. Advisors/appraisers may be found through local or state optometric societies, through schools and colleges of optometry, or independently through advertisements in professional journals. A qualified practice appraiser will be able to evaluate all factors and arrive at a fair price for the value of the practice. The appraiser relies on financial reports provided by accountants as being accurate and have no personal interest in the practice. Their fee should not be based on the value reported nor on the price realized in a sale—this would be an obvious conflict of interest.

Attorney

The prospective purchaser should hire an attorney who has experience in the sale of optometric practices. The attorney will prepare the contract for the purchase of the practice and will provide any needed documentation. The attorney usually will not negotiate the contract but may provide legal or tax advice concerning the sale. Your advisor or appraiser may be able to recommend an experienced attorney.

Accountant

The accountant will review the financial records of the practice. The accountant can evaluate the potential payment terms of the purchase, including the allocation of assets for tax purposes. It would be ideal for the accountant to have some experience with optometric or professional practice sales.

TAX CONSEQUENCES OF PURCHASING A PRACTICE

Changes in federal tax law have made the apportionment of dollar value to the assets of a practice transfer easier and less contentious to determine. One precaution is to make sure that the allocation is completed as an "arm's length agreement" (one with no hint of collusion between buyer and seller to minimize the tax implications). Both the buyer and seller are required to report the same values on IRS Form 8594 in the year of the sale.

TABLE 8-1

Tax Implications for the Buyer When Purchasing Practice Assets

Asset	Tax Deduction
Supplies and inventory	Deducted in the year of purchase
Computers, electronic equipment *	Depreciated over 5 years
Equipment and furnishings	Depreciated over 7 years
Goodwill and patient records	Amortized over 15 years
Covenant not-to-compete	Amortized over 15 years
Leasehold improvements, building	Depreciated over 39 years

Data from Taxpayer Relief Acts of 1997 and 2000, IRS Publication 535 (2007), and Section 197 of the Internal Revenue Code.* Purchased computer software may be depreciated over 3 years.

Note that as this text was going to press the United States Congress was considering renewal of the prior rules that allowed for the depreciation of leasehold improvements over a 15-year period.

Many practice sales are financed by the seller. The purchaser pays a certain amount down, and the balance is paid during the next several years to the selling practitioner, who holds a note from the purchaser. Because of this long-term relationship between buyer and seller, the sales agreement needs to be fair. Otherwise, the arrangement will fail, and the selling optometrist (who is usually retired) will not receive the bargained- for value from the buyer.

The note held by the selling practitioner should specify a reasonable amount of simple interest to be applied to the unpaid balance. Over the course of years, the interest adds significantly to the total amount received by the seller. Interest paid is a tax-deductible expense for the buyer.

One important aspect of the sale of a practice is the tax ramifications of the sale. Technical rules must be followed, particularly when allocating value to the practice assets for tax purposes. Tax advice is necessary to ensure that all requirements have been complied with. Current depreciation periods that affect the purchaser are listed in Table 8-1 for various assets. To calculate the after-tax net cash flow for the first year, a sample practice sale cash flow analysis is provided in Box 8-4.

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BOX 8-4

First-Year Adjusted Cash Flow Analysis

Dr. Seller agrees to sell the practice, which has gross revenues of $465,000, for a total of $250,000 to Dr. Buyer. Dr. Buyer will make a 20% down payment, and Dr. Seller will finance the balance due (80% of the sales price) for 6 years at a 9% simple interest rate, which will result in monthly payments of $3,600.

Dr. Buyer has inspected Dr. Seller's Schedule C forms and tax returns for the business for the past 3 years and is satisfied that the financial data and ratios are favorable. Based on this information, Dr. Buyer is projecting the first year's gross revenues to be $500,000. The relevant practice expenses in this analysis are as follows:

The fixed costs for this practice include a rental lease of $3,500 per month, an optician salary of $45,000 per year, a secretary-receptionist who is paid $25,000 per year, and an ophthalmic technician who is paid $30,000 per year. The telephone bill is $1,000 per month, which includes an advertisement in the Yellow Pages. The cost of utilities (i.e., water, electricity, and gas) and janitorial services is $15,000 per year. Miscellaneous fixed operating costs are another $1,500 per month. Variable expenses for the practice include the wholesale cost of materials sold and average about 30% of gross revenues ($150,000).

Dr. Buyer plans to draw a first-year income of $85,000, with $5,000 annual increases thereafter. Dr. Buyer believes that the previous year's annual growth rate of 8% in gross revenue and 4% in total office expenses can be sustained for the next 3 to 5 years, creating a stable practice income. Dr. Buyer's accountant advises that his effective overall income tax payment would be 25%.

Tangible assets to be purchased have a fair market value of $100,000 and will be depreciated $20,000 annually using a 5-year straight line schedule to zero salvage value. Based on this strategy, the first-year adjusted cash flow will be $20,300. This "positive" result indicates that there will be a financial cushion for the first year; a "negative" result would necessitate revision of financial projections because there would be a shortfall of cash for either loan obligations or personal income.

Anticipated gross revenue	$500,000
Less fixed costs of operation	−$187,000
Less variable costs of operation	−$150,000
Less depreciation	−$20,000
Less personal income	−$85,000
Pretax income	$58,000
Multiply by effective tax rate of 25%	−$14,500
After-tax income	$43,500
Add back depreciation	+$20,000
Net practice cash flow	$63,500
Less annual note payment to seller	−$43,200
Adjusted cash flow for the practice	$20,300

If all practice revenue and expenses are realized as projected, Dr. Buyer can anticipate earning $85,000 plus $20,300 ($105,300 total) the first year. However, if the actual net cash flow for the practice is negative, then that amount would have to be subtracted from the projected personal income of $85,000.

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