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WHITE PAPER

Medical Practice Goodwill

If you are an accountant, you may not be a fan of the generalizations made in this article. The article is designed for physicians as an overview of the topic of goodwill. We are not trying to make physicians accountants here but rather to give them a high level overview of what goodwill is and how it factors (or doesn't factor) into a medical practice sale.

What is goodwill supposed to be?
Notice we aren't suggesting what goodwill "is", because there is much variability, as we will cover throughout this article. In short, the purpose of goodwill is to compensate the seller for the effort she put into building the medical practice. Broadly speaking, the value of a medical practice goes far beyond a collection of assets (e.g. medical equipment, office furniture, etc.) and inventory (e.g. medical supplies, office supplies, etc.). A medical practice has intangible assets such as practice brand, the reputation of the practice and its providers, its patient base, its loyal referring physicians, etc. These intangible assets are what go into the determination of goodwill. For medical practices, goodwill is often the largest component of the sale price (unless of course there are large included assets that are new). As an aside, there may also be other applicable factors in the goodwill of the practice such as copyrights, trademarks, patents, trade secrets.

Methodology
When physicians are looking at pricing their practice for a sale, they will most likely have discussions with their accountant about the dollar amount attributable to goodwill. The same holds true for physicians looking to purchase a practice. The difference is the perspective about how much money should be allocated to goodwill. Indeed, unlike with the pricing of assets, there is more variability in the calculation of goodwill and thus it is often referred to as a "blue sky" calculation. If you would like to know more about the methods behind calculating goodwill, you can ask your accountant about these:

- Average profit method
- Weighted average profit method
- Capitalization Method
- Annuity Method
- Super-profit method
- Capitalization of Super-profit method
- Sliding scale valuation method

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Tax implications
When it comes to negotiating goodwill, the interests of the buyer and seller are at odds with one another due to tax implications. The two parties must agree on the allocation of the components of the price of the practice and in part, this will depend on the advice each party receives from their respective accountants. It is extremely important for this step that you get with your accountants because they will look at any personal tax implications for you as well as (in the circumstance of a buyer acquiring an additional practice) the financial standing of your existing practice.

As a general rule of thumb, the buyer wants to maximize the allocation to tangible assets which are generally depreciated over a 5-7 year period, whereas the value of goodwill is amortized over 15 years. The seller, however, usually desires to minimize the allocation of the purchase price to tangible assets. From the standpoint of the seller, the dollar amount allocated to goodwill is generally classified as a capital gain with lower tax rates than ordinary income rates.

Negotiations
At the end of the day, however, the dollar amount attributable to goodwill is a negotiating point between buyer and seller, regardless of who did the calculation or what method was used. Valuing a medical practice for an acquisition involves finding a price that is mutually acceptable to both the buyer and the seller. Naturally, the seller will want to ask as much as possible and the buyer will want to pay as little as possible. This is especially true with the goodwill component. In my experience, the buyer tends to feel the goodwill amount is too high and the seller tends to feel it is too low. Successful negotiations of the medical practice transaction seek to strike a reasonable middle ground.

Goodwill assigned to a departing physician
As previously mentioned, there are many factors that can be attributed to goodwill in the price of a medical practice. One of those factors is the following that a physician brings to the practice. And this is one of the sticky points that can cause heated negotiations. Undoubtedly patients may come to a practice to faithfully see Dr. Jones for treatment and referring physicians may be loyal to sending patients to the practice to see Dr. Jones. However, how do we handle goodwill in the case where the practice has just one physician (Dr. Jones) and he is retiring upon the closing date of the sale? As just mentioned, patients come to see *this particular physician* and the referring physicians refer to *this particular physician*, so when he is gone, there is no guarantee that the following will remain for the buyer (Dr. Smith). Consequently, why should Dr. Smith allow for an allocation to goodwill for this specific factor?

It is worth repeating that there are many factors that contribute to goodwill and thus I'm not saying goodwill should be zero dollars just because the buyer is retiring. Even if there is just one physician, there may be other providers such as nurse practitioners and/or physician assistants who do indeed have their own contribution to goodwill. Additionally, there are many other factors that may increase the goodwill dollar amount; you just want to think twice about allocating significant dollar amounts in goodwill to the departing physician.

Final thoughts
Goodwill can include almost any intangible quality of a medical practice that makes it more valuable than just its assets. These could include word-of-mouth name recognition due to years of advertising, a great reputation for patient care, or anything else that contributes to the practice's net revenue that cannot be accounted for based solely on its assets. Because of all this,

it is important to have a team of skillful advisors on your team. An accountant is invaluable (whether you are the buyer or the seller) as she can assist with valuations and look out for your specific interests as they pertain to tax implications. A transactional consultant is invaluable (whether you are the buyer or the seller) as in addition to helping facilitate the entire process, he can assist in the skillful art of negotiations between the two parties.

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