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Goodbye Goodwill, Hello Cash Flow: A Perspective on Practice Appraisal

If one searches the peer-reviewed business, accounting and scientific literature, it is arguably surprising to find little evidence-based practise or consistently validated methods upon which dental practices are valued and sold. Regardless of the accounting formula or valuation approach used in the appraisal of a dental practice, every appraisal has a certain degree of subjectivity, even when math is used. As with any commodity, context matters and, today, dental practices are uniquely positioned given the high buyer demand, valuable fixed assets and leaseholds, and relative investment security in maintaining cash flow after purchase. At present, low interest rates also contribute to relative affordability when premium prices are paid with standard rates of financing and amortization schedules.

Problems with practice appraisals

As dentists, we should all practise as evidence-based clinicians. The standards of practice that define our profession and ensure patient protection are often highly regulated and, some argue, are black and white. Yet, practice valuation can often be grey, given the many different opinions of and methods used by individual appraisers. As clinicians, we are accountable to our patients and expected to practise under set standards of care. The role of a dental practice appraiser is more complicated, since the accountability must be to both the party that has contracted the appraisal and also to prospective lenders who evaluate the risk of the investment and ability of a loan to be paid. But the industry of dental practice appraisal and brokerage remains largely unregulated. A dental practice appraisal, in theory, should not only justify a given value to the vendor, but must also assess the risk at a given cost and standard rate of financing to a lender in order for a buyer to secure financing.

How does one value "goodwill"?

In a dental practice, the assets, equipment, leaseholds and supplies all have a fixed value. As dentists, we should understand what these elements of a practice cost. But where things get grey and inconsistent is in the valuation of the intangible that we term "goodwill." What commonly exists in dental practice goodwill valuation methods are accounting formulas that, ironically, are based on projections, assumptions and subjectivity. Although these various methods of establishing the value of a business are intended to create a more concrete approach to overall value, none of them have been developed specifically for dental practices.

Income-based approaches such as the discounted cash flow model are based on an expected rate of return. Therefore, this model not only can be manipulated to justify the appraiser's desired outcome, but it is also based on subjective projections and assumptions.

Comparative sales approaches look at "comparable" practices and work backwards to establish a value for a given practice. The problem with this method is that the comparative practices can be case-selected by the appraiser and may not be truly accurate "comparators," since they may be based on the unknown characteristics of the chosen practices or the possibility that a buyer was an outlier on the price paid for the comparable (either under or over true market value).

The capitalization of net earnings approach is based on how the return on investment would perform if the funds were simply invested in the marketplace at its current rate of return. Since dental practices require an owner to be involved in the practice function, it would seem to the authors that this methodology has little application to any accuracy in dental practice appraisal or value comparison, not to mention that today's investment marketplace has its fair share of struggles.

Another commonly used goodwill valuation tool is a weighted average, whereby a percentage factor is applied against the gross revenue to represent the value of the goodwill. This, again, is an arbitrary and opinion-based method that is not reproducible from one valuator to the next.

The result of these inconsistent methods for valuing goodwill in dental practices is that little agreement exists amongst practice appraisers and brokers. The fact that one brokerage will not accept the opinion of value of another brokerage reinforces this claim. Additionally, using any of the methodologies mentioned, goodwill valuation can be manipulated to accommodate any appraisal value. With demand high and interest rates low, dental practices are selling well. But using methods not validated for dental practice sales to value intangible assets begs the question: Are we as transparent, consistent and confident in our appraisals as we can be in the Ontario dental practice marketplace? More importantly, can we create a formula to accurately reflect the intangible value in a dental practice?

Goodwill can be "personal" or "enterprise" in nature. Personal goodwill is represented by the non-corporate entity of the practice and the relationships that create revenue. Essentially, personal goodwill is the people — your team and your patients — and the revenues generated as a reflection of this. Enterprise goodwill is the draw of patients created by the practice in the form of advertising, location and services provided. For goodwill of either form to have value, it must be proven to be saleable in a relatable market.

Normalized cash flow: a better way

There is no doubt that the goodwill of a practice is represented by the revenues generated. But we argue that the opposite is more accurate, meaning the cash flow of the practice not only reflects the goodwill, but also the practice's efficiency, function and philosophy of care (to an extent). Taking this a step further, an accurate normalized statement of cash flow — or adjusting for out-of-the-ordinary or non-recurring expenses and revenues — not only reflects the above parameters including goodwill, but also the affordability and take-home income of a practice in its present state of operation. And, since it is the ability of a buyer to take home an income from a practice that motivates the purchase of a practice, and the normalized cash flow represents what should remain after practice expenses but before financing, this number also provides an assessment of lender risk at a given practice value. Finally, if using normalized cash flow can accurately reflect the net revenue available to both finance the practice at a given purchase price as well as sustain the net pre-tax income that would remain for a buyer, the appraisal can demonstrate justification in a simple, transparent manner, since a practice cannot be valued beyond the ability to generate income for a buyer after financing. Therefore, we would argue that it is normalized residual cash flow of a practice that is the most transparent, legitimate and justified approach to the intangible elements of dental practice valuation.

Valuators cannot seem to agree on how to value goodwill, nor are we consistent at it, so let's forget it and allow it to be reflected by what is tangible. Goodwill valuation does not assess risk or carrying costs of practice purchase, whereas normalized residual cash flow does. This approach still leaves room for some degree of appraiser opinion, but at least it can be grounded on the evidence of what presently exists in current practice operations and existing rates of financing and amortization periods offered by major Canadian banks. This methodology accommodates practice affordability with interest rate increases without manipulating data or imposing subjective projections. Indeed, it makes the grey more black and white. OD

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