



Fair Market Value Issues in Physician Practice Acquisition and Employment Deals by Health Systems

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Speaker Biography - Timothy Smith, CPA/ABV

Tim is the Director of Professional Practice with HealthCare Appraisers, Inc., where he specializes in the valuation of physician employment arrangements. He is a noted speaker and author on valuation and fair market value (FMV) issues in the healthcare industry. Prior to HealthCare Appraisers, Mr. Smith worked for more than 14 years at Hospital Corporation of America, Inc. (HCA), the nation's largest hospital company. During his tenure at HCA, he performed regulatory compliance reviews and evaluations on hundreds of third-party appraisals that were prepared by nearly two dozen appraisal firms for business and asset acquisitions and divestitures, service contracts, leasing agreements, and other forms of compensation arrangements. Mr. Smith also oversaw HCA's program for using third-party appraisers. His HCA experience also included managing contractual negotiations, due diligence, and the outside appraisal process for hundreds of physician practice acquisitions and divestitures. He holds the Accredited in Business Valuation (ABV) certification from the American Institute of Certified Public Accountants (AICPA).

Speaker Biography – Mark Dietrich, CPA/ABV

Mark is a *summa cum laude* graduate of Boston University where he also earned an MBA with high honors; he also holds a Master in Taxation degree. He is Editor of the new American Health Lawyers' Association/Business Valuation Resources *Guide to Healthcare Valuation 2d Edition*, Editor and Principal author of BVR's *Guide to Physician Practice Valuation*, author of the *Medical Practice Valuation Guidebook*, co-author of PPC's *Guide to Healthcare Consulting* and numerous articles on valuation, taxation, managed care and the healthcare regulatory environment. Mark has lectured in the United Kingdom on Managed Care and on Valuation of Medical Practices to Her Majesty's Revenue and Customs. He serves on the AICPA's Healthcare Expert Panel (through 2010) and National Healthcare Industry Conference Committee.

Mark's career experience includes 200 healthcare industry valuation engagements; serving as partner-in-charge of the annual audit of an 80 physician faculty group practice; representation of exempt and taxable entities in IRS field audits; participation in developing a 250 physician Network; negotiation of managed care contracts including capitated Medicare plans; consulting to group practices; and issues of reasonable compensation, healthcare markets, regulatory planning and defense, personal and enterprise goodwill and noncompete agreements. Mark has served as an expert witness in shareholder disputes, marital dissolution and *qui tam* matters.

Current Acquisition Trends

- **Physician practice acquisitions in the current market tend to focus primarily on specialty practices, especially cardiology.**
- **Market forces driving acquisition/employment:**
 - Reimbursement cuts
 - Physician coverage and retention
 - Uncertainty and playing defense
- **The market appears to have learned some lessons from the 1990s.**
 - No trend in “high multiple” purchase prices
 - Emphasis on productivity-based compensation
- **Many misguided assumptions exist into today’s marketplace for physician compensation.**

Employment Structure Trends

Group Practice Model with Ancillaries:

- **Physicians employed in entity meeting Stark group practice rules.**
- **Ancillaries remain in practice and can be part of compensation under Stark criteria.**
- **Compensation based on group-level or individual physician models.**
- **Group models:**
 - Group comp pool is distributed to individual physicians based on various performance measures or other criteria.
 - Maintains or fosters group synergy and integration.
 - Specialty comp pools in multispecialty groups.

Employment Structure Trends

Group Practice Model with Provider-Based Ancillaries:

- **Group's in-office ancillaries are converted to provider-based, excluding them from "direct" compensation formulas.**
- **Compensation based on group-level or individual physician models.**
- **Comp models based on fixed rates from pre-transaction data.**
- **Source of negotiating tension:**
 - Hospitals receive higher reimbursement for ancillaries once converted to provider-based.
 - Healthcare regulations disallow sharing of higher revenues.

Employment Structure Trends

Independent (“Captive”) Group Practice Model:

- Group remains independent as separate legal entity and employs the physicians or providers.
- Health system contracts with group to provide professional services to health-system practice.
- Group maintains and pays for malpractice, benefits, and provider-related expenses.
- Compensation paid to group for services based on group-level or individual physician models.
- Group determines individual physician compensation pay.
- Group retains internal autonomy.

Employment Compensation Trends

- **“Hot” model: compensation per wRVU**
 - Fixed rate for all productivity levels
 - Graduated rate for specific wRVU levels
- **Greater of base or incentive compensation.**
- **Base compensation plus an incentive bonus, with minimum productivity required to maintain the base.**
- **Incentive bonus models:**
 - Comp/wRVU
 - Pre-compensation earnings (“PCE”) or practice earnings after physician base and benefits
 - Quality outcomes
 - Longevity
 - Productivity, revenue, or cost targets

Employment Compensation Trends

■ Individual Physician Models

- Individual physician's performance and/or outcomes determine compensation

■ Group or Specialty Pool Models:

- Group or specialty's performance and/or outcomes determine a pool that is then distributed to individual physician's based on individual performance relative to the group or other criteria.

■ “Stacking” compensation elements:

- ED call coverage
- Medical directorships
- Clinical or service line management agreements

FMV Issues: Regulatory Uncertainty Factor

- **Appraisal profession has an established body of knowledge for determining FMV.**
- **Many regulatory agencies follow or utilize standard appraisal practice methodology, e.g. IRS.**
- **Healthcare regulatory framework departs from standard appraisal practice, but does not substitute an alternative framework.**
 - Stark definition of FMV “is qualified in ways that do not necessarily comport with usage of the term in standard valuation techniques and methodologies.”
 - FMV can be established by “any method that is commercially reasonable.”
 - Limited guidance on what is the appropriate valuation framework.

FMV Issues: Use of the Market Approach

- **Key consideration in application of the market approach is comparability between the subject and the market data.**
- **Market physician compensation data does not often provide adequate information to allow comparability analysis.**
- **Usable local market data is often non-existent or not public.**
- **Stark disallows use of market data from hospital-physician transactions.**

Misconceptions of the Survey Data

#1 – The physician compensation surveys are the definitive snapshot of physician compensation in the marketplace.

Reality:

- **Voluntary participation: respondents are not selected using statistical sampling methods.**
- **Each survey tends to represent a different segment or practice-setting in the market place:**
 - MGMA and AMGA: large, multispecialty groups
 - SCA: health system-affiliated physicians and teaching institutions

Misconceptions of the Survey Data

#2 – The surveys present compensation for clinical physician services.

Reality:

■ Most surveys report compensation from all sources, including:

- Clinical services
- Ancillaries and technical revenues
- Medical directorships
- Compensated call coverage
- Other service arrangements
- Owner compensation

Misconceptions of the Survey Data

#3 – The compensation per wRVU rate should correlate with a physician's wRVU productivity level.

Reality:

■ MGMA states there is an inverse relationship in its survey data between productivity and the comp/wRVU rate:

- Highest wRVU producers have the lowest comp/wRVU rate.
- Lowest wRVU producers have the highest comp/wRVU rate.

Misconceptions of the Survey Data

#4 – Median compensation per wRVU is FMV and all physicians everywhere should make at least the median.

Reality:

- **Not true according to MGMA!**
- **Self-refuting: median means half make less.**
- **Factors affecting compensation per wRVU:**
 - Reimbursement and collections
 - Ancillaries / technical earnings
 - Overhead
 - Other revenues and earnings

Misconceptions of the Survey Data

#5 – The surveys reflect the current state of the physician marketplace.

Reality:

- Surveys reflect the prior year marketplace.
- Surveys reflect the outcomes for those that responded.
- The physician marketplace is generally local.

Use of the Cost and Income Approaches

- **Application of the cost and income approaches can offset and mitigate the limitations of the market approach in establishing FMV physician compensation under employment.**
 - The theory behind three approaches to value is that each approach can take into account data and analyses that reflect the totality of marketplace considerations in appraising an asset or service arrangement.
- **Provide view into the local marketplace.**
- **Allows analysis of the full array of economic factors affecting the compensation of the subject physicians.**
- **Provides a reality check!**

Use of the Cost and Income Approaches

■ Cost approach

- Normalized and adjusted historical compensation
- Realistic numbers for the cost to recruit

■ Income Approach

- Pro forma based on hypothetical-typical employer basis
- Reflects future market conditions

■ Apply the Independent Investor Test

- Pre-compensation earnings (revenues less overhead)
- Deduction for market-level physician benefits
- Deduction for economic depreciation
- Deduction for cost of capital / return on assets
- Residual amount = physician compensation

Valuation Synthesis: FMV

- **Indications of FMV compensation from each approach are assessed in terms of their relative strengths and limitations.**
- **Requires judgment in view of the facts and circumstances surrounding the subject arrangement.**
- **Appraiser usually weights the outcomes of each approach to arrive at an FMV range.**
- **FMV compensation range converted or allocated into the proposed compensation structure.**

Special FMV Issues

- *Key to service valuation is matching compensation to the services provided!*
- **Ensure contract terms provide for appropriate level of service:**
 - Clinical hours
 - Scope/mix of services
- **Compensation “Stacking”**
 - Key issue: double payment for same service or payment for services not provided.
 - Common issue for compensated call coverage, medical directorships, and “co-management” agreements.
- **Owner compensation**
- **Physician benefits**

Impact of Healthcare Reform

- **“New” market models from healthcare reform:**
 - ACOs and medical homes
 - Payment bundling
 - Quality outcomes
- **Expected marketplace shifts for physician practice patterns and compensation:**
 - High utilization no longer rewarded financially
 - Preventative diagnosis and care favored over procedural treatments
 - Lower reimbursement per unit of service or patient with higher patient volumes
 - Financial penalties for poor quality outcomes
- **Requires new compensation models!**

Questions?

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