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Valuation of a Doctor's Office According to the Modified Capitalized Earnings Value Method

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1.1 Background

At the end of the year 2017 approximately 172.000 doctors were practicing in Germany. This is an increase of 14% compared to the number of 2009. Family doctors are the major part with almost 55.000 representatives (Kassenärztliche Bundesvereinigung, 2019). The admission for the contractual medical care is regulated by an admission committee. If the doctor fulfils the necessary conditions, he or she receives an admission for a contractual medical care due to public-law right. Nevertheless, since 1993 there are some admission restrictions regarding the planning areas. If a specific county has an over-supply of doctors, then the area is closed. As a result, no new doctor can settle down in this planning area (cannot treat the legally insured people). In so called "open planning areas" there are no restrictions regarding the admission. Hence, the doctor can settle down in this area without any restrictions.
The total number of practicing doctors increases, while closed planning areas stay closed for new founded doctors' offices. Even if a doctor's office closes due to e.g. retirement, a closed planning area could potentially stay closed and cannot be replaced by opening a new doctor's office within the county. Hence, year after year a large number of doctors' offices do not close but change their owners. There are various models for succession in practice. For instance, there are external takeovers and also internal solutions. Whether the practice owner wants to e.g. sell the doctor's office or transfer it to an heir it is always advisable to determine the enterprise value of the doctor's office (Bridts, Bewertung von Arzt- und Zahnarztpraxen Verfahren, Methoden und exemplarische Berechnungen, 2014). Nevertheless, the question of how to determine the value still causes confusion among the owner of a doctor's office and potential buyers.

1.2 Basics Capitalized Earnings Value Method

The capitalized earnings value method and the discounted cash-flow method are two approaches acknowledged by the Institute of Public Auditors in Germany to determine the value of an enterprise (Serf, 2009, p. 171). When applying the capitalized earnings value method, the market value can be calculated by capitalization of expected financial surpluses to be received by the shareholder (Schmeisser & Spree, 2008, p. 108).

In order to determine the earnings value, a prediction about future financial surpluses must be made. This requires a prediction of the company's development. The prediction is mainly based on past adjusted earnings and is subdivided into two phases. The first phase predicts expected financial surpluses, while the second phase assumes that the company has an infinite lifespan and constant future financial surpluses. This is also called ‘perpetuity’. Based on the purpose of the valuation, different assumptions and approaches must be drawn for the prediction. Afterwards, the financial surpluses must be capitalized to the measurement date. This is necessary in order to make the financial surpluses comparable despite being due at different times (Serf, 2009, pp. 171-172).

1.3 Background Information Modified Capitalized Earnings Value Method

There is no legally binding method for the enterprise value determination of a doctor’s office. However, the Federal Court of Justice and the Federal Social Court provided some clarity. On 9. February 2011, the Federal Supreme Court declared in verdict (Az. XII ZR 40/09) that the pure capitalized earnings value method is inadequate for the enterprise value determination of a dentist’s office (Bundesgerichthof, 2011). Based on this decision, the Federal Social Court accepted in verdict (B 6 KA 39/10 R) that the modified capitalized earnings value method is appropriate for such a determination (Knief, 2011, p. 154; Bundessozialgericht, 2011). The modified capitalized earnings value method differs from the capitalized earnings value method in that it has limitations, particularly in regard to the capitalization period. This period is supposed to symbolize and standardize the sustainability of the doctor’s office (Friebe & Beusker, 2012, pp. 244-246). Moreover, the method is oriented according to the IDW S 1 of the Institute of German Certified Public Accountants (Dostal, n.d.). It is currently considered the standard procedure for determining the enterprise value of a doctor’s office. This value consists of an intangible value (goodwill) and a tangible value. The goodwill is determined by intangible assets like the location or patients. This is reflected in the revenues and cost structure. Therefore, the buyer pays to achieve a similar financial result as the previous owner (Bridts, 2014, p. 136). Tangible value is the asset value at the end of the prediction period.

1.4 Limitation Capitalization Period

When valuating an enterprise, classic valuation theory assumes an infinite capitalization period. This circumstance is justified by the fact that determining a finite lifetime of the enterprise is difficult (Ballwieser & Hachmeister, 2016, p. 90). For instance, a limited public company has independent management, and the shareholders are mostly anonymous, thus hindering the determination of a limited lifespan (Bridts, 2014, p. 48). One should be able to clearly notice that, due to the personality of the doctor, an infinite capitalization period must be questioned (Merk, 2010, p. 460). Hence, assuming perpetuity is not possible. The successor of a doctor’s office buys the chance to earn existing patients' trust to recreate the success of the former doctor. Nevertheless, this chance is limited. If the successor prospers, then this can be attributed to his activity. However, the limitation of this chance means that the capitalization period must be adjusted. The earnings value is the sum of capitalized discounted financial surpluses which last until the end of the capitalization period. This is also the end of the buyer's previously described chance to earn the trust of the patients (Bridts, 2014, pp. 48-49). If a doctor's office is managed by two or more doctors, then the retirement of one has a smaller impact on the patients than the retirement of a doctor who manages his office alone. This is because the personality of one doctor in a joint practice is less important than in a single practice. Hence, the new doctor has more time to earn the trust of the existing patients (Merk, 2010, pp. 460-461). In the literature, a capitalization period of two to five years is recommended. The literature also mentions that the capitalization period of capital-intensive doctors' offices and joint practices must be longer (Bridts, 2014, p. 49; Cramer & Maier 2002, p. 550). The exact determination of the capitalization period depends on the analysis of the doctor's office (Merk, 2010, pp. 371-372).

1.5 Wage of the Management

Defining an imputed doctor's wage is necessary, as the doctor could work somewhere else but instead contributes to his office. The salary of every doctor must be deducted from the cash inflows. Therefore, the imputed wages or salaries of the doctor(s) can be seen as a cash outflow (Winter, 2009, p. 50).

There are two approaches to determine a doctor's wage. The first approach is the so-called 'subjective approach', whereby the imputed wage is determined by what the doctor would earn as an employee at a hospital or another doctor's office. The 'objective approach' is the second method. With this method, the wage is determined by what a doctor would earn for the job of the owner of the doctor's office (Aschauer & Purtscher, 2011, p. 87).

1.6 Other Imputed Costs

One should also determine whether imputed costs besides the doctor's imputed wage must be considered. An example of such a cost is the rent or leasing rate. These costs must be considered if the doctor owns the building and pays no rent. Hence, rent expenses are a fictive cash-outflow because the potential buyer would have to pay rent (Posluschny, 2009, p. 23).

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