



**HealthCare Appraisers**  
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**A Primer on Compensation  
Valuation in the  
Healthcare Industry**

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# Compensation Valuation



- A large proportion of the third-party valuations prepared for the healthcare industry appraise the FMV of service agreements.
- The Stark Law/Regulations and Federal Anti-Kickback Statute require transactions between providers of certain healthcare goods and services and referrals sources for those goods and services to be at FMV.
- Typical service arrangements: medical directorships, call coverage, employment, management services, etc.
- Healthcare provider entities frequently engage independent appraisers to value these arrangements for regulatory compliance purposes.

# Compensation Valuation



- A new appraisal discipline is emerging for valuing service arrangements: compensation valuation or “CV.”
- In CV practice, appraisers seek to apply or adapt concepts and techniques from the general valuation and the business valuation (“BV”) body of knowledge to appraise service arrangements.
- Key premise in CV practice: all appraisal disciplines share a common conceptual framework
  - Definitions of value: FMV, investment, strategic
  - Three approaches: cost, market, and income
- *The 2009 BVR Guide to Healthcare Valuation is a key text in establishing a formal body of knowledge for healthcare CV.*

# Compensation Valuation



- Some precedent for CV in real estate leasing and intellectual property (“IP”) licensing and royalty valuations.
- BV-related development: Fair value of owner’s services.
- Healthcare valuation appears to be the most active market for CV:
  - Various forms of physician services
  - Goods and services (resources) provided as part of medical or healthcare procedures or activities
- BV appears to be the most relevant body of knowledge for CV.

# Compensation Valuation



The challenges of applying the common valuation framework to CV:

- Appraisal body of knowledge developed for buy-sell transactions of property
- CV seeks to value the compensation paid in service arrangements related to the provision or usage of goods and services for a period of time
- Healthcare Regulatory Context: FMV as defined by the Stark Law & Regulations and the Federal Anti-Kickback Statute
  - Stark definition of FMV vs. the “classical” definition
  - “Any commercially reasonable method” for determining FMV
  - Limitations on the use of market data

# CV: Market Approach



## Application and Adaptation to CV:

- Methods comparing subject arrangement to existing service agreements in the marketplace.
- Principle of Substitution: Pay no more for a service than would for a substitute service of equivalent economic utility.
- Key issue: comparability of services provided

# CV: Market Approach



## Issues in Comparability of Services Provided:

- Physician qualifications
- Physician scope of duties
- Work time requirements
- Types of goods and services provided
- Level of service provided
- Example: call coverage factors and burdens

# CV: Market Approach



## Using Physician Compensation Surveys

- Several publically available surveys on physician compensation (MGMA, SCA, AMGA, etc.) that are widely used to establish the market value of physician services.
- Key Issue: Is the subject physician and service arrangement comparable to the respondents in the survey?
  - Review the respondent characteristics for the survey.
  - Be aware that reported compensation may includes all kinds of income sources for physicians: ownership profits, ancillary earnings, medical directorships, compensated call coverage, etc.
  - Address the distinction between clinical and administrative services.

# CV: Market Approach



## Use of Market Transaction Data:

- Key challenge: Do you have enough information to assess comparability between the subject and the market data?
- Regulatory issue: Stark prohibition on the use of market data from referral source and DHS provider transactions
  - Referral source/DHS provider transactions raise the same concerns as the use of related party transactions: family members, parent-sub, affiliates.
- Major pitfall: Uncritical use of market information

# CV: Cost Approach



**Application to CV:** Cost Approach seeks to value the compensation for a service arrangement by valuing the cost to recreate or replace that service with one of similar capacity or utility.

- Value the cost of the individual resources included in the service, *i.e.* a build-up approach.

- Value the cost to re-create based on its historical cost as adjusted or normalized for FMV purposes.

# CV: Cost Approach



## Build-Up Technique:

- Break down the service into its constituent parts or into the discrete resources that are included in the service
- Obtain market or cost information on the usage or consumption of these resources.
- Critical issue: Re-create the same or comparable service.
- Cost includes a market return on the provision of the resources:
  - By individual resource
  - On total of all input resources

# CV: Income Approach



International Glossary Definition: *a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.*

**Conundrum for CV:** How to value the fee for a service arrangement based on a “present single amount”?

# CV: Income Approach



- **CV Adaptation of the Income Approach:**
  - Value the compensation for services by evaluating the future economic benefits received by a party or both parties to a service agreement.
  - Analyze the rates of return and/or levels of profitability when measured against the levels of investment, risk, and resource utilization for the party.
  - Rates of return and/or profitability are compared with market rates for similar investment, risk, or resource utilization profiles.
- **CV Adaptation of the DCF Method:** Use a DCF model to solve for the level of compensation that makes the NPV of the cash flows equal a party's investment over the life of the contract.
- **Adaptation of the Excess Earnings Method :** Use market rates of return on the assets or resources utilized in the service.

# CV: Opinion Synthesis



- Evaluation of the indications of value provided under each approach to arrive at an opinion of value.
- The results of one approach may or may not be the best reflection of the appropriate level of compensation for a service.
- Similar to BV, not all approaches and/or methods may be relevant or practicable to valuing a given service arrangement.