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Appropriate Use of Extraordinary Assumptions and Hypothetical Conditions

Recognizing that economic or financial value is forward looking, i.e., *"value is the expectation of future benefit,"* the valuation analyst must, accordingly, project the most realistic, probable benefit to be derived from the ownership of the subject outpatient enterprise in the future. Therefore, the valuation process related to the analysis of the future benefit stream related to the subject outpatient enterprise must rely upon accurate, predictive information.

However, due to the nature of the current transactional marketplace involving outpatient enterprises, valuation analysts are required, from time to time, to consider, and disclose, certain *underlying assumptions*, based on the unique facts and circumstances of the subject outpatient enterprise (e.g., *highest and best use* of the enterprise's assets, standard of value, and level of interest sought) to develop a credible valuation opinion. The valuation analyst's decision to utilize any *assumptions*, *conditions* and/or *restrictions* that *qualify* the *conclusion(s)* and *opinion of value*, should be identified, defined, and disclosed at the start of the valuation assignment. This may include *laws and regulations*, *jurisdictional exceptions*, *restriction on the availability of data*, and other conditions that may affect the scope of work. *Laws* include *constitutions*, *legislative* and *court-made* law, *administrative rules*, and *ordinances*. *Regulations* include *rules or orders*, having *legal force*, issued by an *administrative agency*. There are essentially three methods by which laws are manifested in order to have *legal force*, i.e., (1) *statutory* – federal and state legislation and ordinances; (2) *regulatory* – administrative and agency rules or orders; and, (3) legal precedent – judicial directives, orders, and established case law.[1]

Additionally, on certain occasions, the valuation analyst may be required to utilize *hypothetical conditions* and/or *extraordinary assumptions* in order to be in compliance with the stated valuation standards guiding their work.

A *hypothetical condition* is:

> *"…a condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of the analysis."*[2]

The *Uniform Standard of Professional Appraisal Practice* (USPAP) further defines a *hypothetical condition* in a comment, as follows:

> *"Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis."*[3]

A *hypothetical condition* may be used by a valuation analyst in an assignment only if:

(1) *"Use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;*

(2) *Use of the hypothetical condition results in a credible analysis; and,*

(3) *The appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions".*[4]

When using a *hypothetical condition*, the valuation analyst knows for a fact that the underlying assumption utilized in the development of the valuation opinion is not true, but is considering the assumption, for the purpose of the valuation engagement, as if it were true.

An example of an instance when a valuation analyst may use a *hypothetical condition* is if the *ancillary services and technical component* (ASTC) service line(s) of a physician practice were to be considered as an independent, separate and stand-alone going concern enterprise, which is contrary to present fact, but assumed for the valuation project.

There are two general types of services provided by a physician practice: (1) *professional services*; and, (2) *ASTC* services. *Professional services* are those services that require a physician, or midlevel provider (MLP) that requires the contribution of that provider's, *time* and *effort*, i.e., the "*sweat of their brow.*" ASTC services, on the other hand, are services which do not *require* a professional provider's work input, but which may, nevertheless, be performed by the physician or MLP, e.g., performing diagnostic imaging tests.[5]

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These ASTC related services are referred to as "*technical"* because they are technologically intensive in nature, such as *radiography* (x-rays) and other *diagnostic imaging procedures*, and the provision of these ASTC services may require significant *capital equipment* and an appropriately trained *technical staff*. These services are referred to as "*ancillary"* because they are not directly related to the provision of *professional medical services* but can *assist* in the provision of these services. As these services can assist a physician in the performance of their duties, they are often *offered by*, and *integrated with*, a professional practice enterprise, in contrast to being provided through a *free standing ancillary service enterprise*.[6]

The fact that these *ASTC services* are often integrated within an *physician practice enterprise* does not restrict these *ASTC service lines* from having *value*, separate and apart from that of the *physician practice enterprise* within which they are integrated (i.e., as an *independent ASTC Service Line*). Service lines, or business units, within large corporations are commonly *valued* separately and sold as though they were independent, *stand-alone entities*. The use of a *hypothetical condition* is required for the valuation of an *integrated ASTC service line* as a *stand-alone ASTC Service Line*. [7]

Specifically, in the case of an *integrated ASTC Service Line* being valued as a *stand-alone ASTC Service Line*, the valuation analyst may use the *hypothetical condition* that the *ASTC Service Line* as an *independent*, *stand-alone operating entity*. This is contrary to the fact that the *ASTC Service Line* is currently, as of the valuation date, being operated as a service line, or business unit, integrated within the *physician practice enterprise*.[8]

A *hypothetical condition* is different from an *extraordinary assumption*. As set forth in USPAP, an *extraordinary assumption* is defined as:

> *"…an assumption, directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser's opinions or conclusions."*[9]

In other words, an *extraordinary assumption* is a supposition, utilized by the valuation analyst, that *may be true or fact*, unlike a *hypothetical condition*, whereby the underlying assumption is *known to be false*. An *extraordinary assumption* assumes certain information about physical, legal, or economic characteristics of the subject property; or, about conditions external to the property, such as market conditions or trends; or, about the integrity of data used in an analysis is true; however, if found not to be true, may materially affect the final valuation opinion.[10]

An *extraordinary assumption* may be used by a valuation analyst in an assignment only if:

(1) It is required to properly develop credible opinions and conclusions;

(2) The appraiser has a reasonable basis for the extraordinary assumption;

(3) The use of the extraordinary assumption results in a credible analysis; and,

(4) The appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.[11]

However, when relevant information is not available because of assignment conditions that limit research opportunities (such as conditions that place limitations on the valuation analyst's ability to properly inspect or gather information), and the valuation analyst is unable to use an *extraordinary assumption* about such information to develop a credible analysis, the valuation analyst must withdraw from the assignment.[12]

As a result, when using an *extraordinary assumption*, the valuation analyst has a responsibility to consider the likelihood of the assumption to be true or false. The use of an unreasonable, or unrealistic, *extraordinary assumption* does not meet USPAP guidelines and may result in a misleading value result and may not be useful for the valuation analyst's intended purpose.[13]

For example, a valuation analyst, when valuing an outpatient enterprise employing an income approach-based method, may assume management's representation that office rent paid by the outpatient enterprise to another entity, that has common ownership as the outpatient enterprise, is at *Fair Market Value*. The valuation analyst's obligation in the development of a credible valuation opinion does not end with the use, and disclosure, of this *extraordinary assumption.* If the "true" *Fair Market Value* office lease rate is different from the actual office lease rate that is assumed by the valuation analyst, the resulting valuation opinion may be in error.

As evidenced in this article, the use of *hypothetical conditions* and/or *extraordinary assumptions* may be necessary in the valuation of outpatient enterprises. The use of these assumptions requires careful consideration as they can have a significant effect on value. In addition, the valuation analyst must adhere to the disclosure requirements set forth in USPAP which requires the valuation analyst to clearly and accurately disclose all assumptions used in the assignment.[14] It is also important to consider that that if the valuation opinion is dependent on the outcome of one key assumption, the valuation analyst needs to examine that assumption very carefully, and have some level of confidence in the use of the assumption(s) underlying the valuation opinion.

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1 “Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services” By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, p. 228-229.

2 *Ibid*.

3 *Ibid*.

4 “2014-2015 Uniform Standards of Appraisal Practice,” Appraisal Standards Board The Appraisal Foundation (2014), p. U-61.

5 “Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services” By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, p. 571.

6 *Ibid*, p. 572.

7 *Ibid*.

8 *Ibid*.

9 “2014-2015 Uniform Standards of Appraisal Practice,” Appraisal Standards Board The Appraisal Foundation (2014), p. U-3.

10 *Ibid*.

11 “2014-2015 Uniform Standards of Appraisal Practice,” Appraisal Standards Board The Appraisal Foundation (2014), p. U-61.

12 “2014-2015 Uniform Standards of Appraisal Practice,” Appraisal Standards Board The Appraisal Foundation (2014), p. U-14.

13 “Editor’s Column: Appraisal Assumptions,” By Paul R. Hyde, Business Appraisal Practice, Send Quarter 2009, p. 2-4.

14 “2014-2015 Uniform Standards of Appraisal Practice,” Appraisal Standards Board The Appraisal Foundation (2014), p. U-64.

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