Determination of the Appropriate Standard of Value

National Association of Certified Valuators and Analysts

An In-Depth Series on Healthcare Valuation

This first installment will discuss *Fair Market Value*, the most prevalent *standard of value* in the healthcare industry, and why this is the required standard of value for most healthcare transactions. This article will also discuss the *premise of value*, which further defines the circumstances of the transaction, and how to determine which methods may be applicable to valuing an outpatient enterprise.

As the demand for healthcare services continues to grow, the site of service at which these services are performed is transitioning from the *inpatient* (e.g., hospital) setting to the *outpatient* setting.[1] For example, Catholic Health Initiatives set a goal of having 65% of its patient revenue come from the outpatient setting by 2020 through the strengthening of their ambulatory care network and a reorganization of their physician services.[2] This transformation is being driven by such factors as:

1. Technological advancements;
2. An increasingly consumer-driven and convenience-driven healthcare delivery environment;
3. Pressure from payors and patient demand; and

4. The entrance and diversification of new and different outpatient enterprises. [3]

Outpatient enterprises, whether operated as independent freestanding facilities or affiliated with larger hospitals or healthcare systems, are influenced by certain market forces related to the four pillars of healthcare valuation, i.e.: (1) regulatory, (2) reimbursement, (3) competition, and (4) technology—each of which relates to almost all aspects of the U.S. healthcare delivery system.[4] Each outpatient enterprise has unique value drivers impacting the valuation approaches, methods, and techniques often utilized in determining the value of these enterprises.[5]

This first installment will discuss *Fair Market Value,* the most prevalent *standard of value* in the healthcare industry, and why this is the required standard of value for most healthcare transactions. This article will also discuss the *premise of value,* which further defines the circumstances of the transaction, and how to determine which methods may be applicable to valuing an outpatient enterprise.

Understanding financial valuation concepts is important in order for analysts to create the foundation for a well-reasoned and defensible valuation analysis.[6] At the outset of each valuation engagement, it is critical to appropriately define the *standard of value* and *premise of value* to be employed in developing the valuation opinion.[7] The *standard of value* defines the type of value to be determined and answers the question, "value to whom?" Several *standards of value* may be sought by the analyst, including:

1. *Fair Market Value*;
2. *Fair Value*;
3. *Investment Value*; and/or,
4. *Fundamental* (Intrinsic) *Value*.[8]

However, due to regulatory edicts contained within the Internal Revenue Code (IRC), Stark Law, Anti-Kickback Statute, and False Claims Act, most types of healthcare transactions are required to adhere to the standard of *Fair Market Value.*[9]

In general business valuation terminology, *Fair Market Value* is defined as: "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[10]

For purposes of healthcare valuation, the standard of *Fair Market Value* is further defined by the IRC, Stark Law, and Anti-Kickback Statute as follows:

1. The IRC and accompanying Treasury Regulations, IRS revenue rulings, and other IRS commentary gives guidance pertaining to *Fair Market Value* for transactions involving tax-exempt organizations (e.g., in an excess benefit transaction):
    - "the general rule for the valuation of property, including the right to use property, is fair market value (i.e., the price at which property or the right to use property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of relevant facts)";[11]
    - An "excess benefit transaction" is a "transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a disqualified

person, and the value of the economic benefit provided by the organization exceeds the value of the consideration received by the organization";[12]

- The hypothetical transaction contemplates a universe of typical potential purchasers for the subject property and not a specific purchaser or specific class of purchaser;[13]
- Buyer and seller are typically motivated;14and
- Both parties are well informed and acting in their respective rational economic self-interests.[15]

2. The Stark Law and accompanying regulations define *Fair Market Value* as:

   - The "value in arm's length transactions consistent with the general market value. General Market Value means the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party…";[16]
   - The most probable price that the subject interest should bring if exposed for sale on the open market, as of the valuation date, but exclusive of any element of value arising from the accomplishment or expectation of the sale.[17] This standard of value assumes an anticipated hypothetical transaction, in which the buyer and seller are each acting prudently with a reasonable equivalence of knowledge, and that the price is not affected by any undue stimulus or coercion;[18] and
   - An anticipated hypothetical transaction conducted in compliance with "Stark I & II" legislation prohibiting physicians from making referrals for "designated health services" reimbursable under Medicare or Medicaid to an entity with which the referring physician has a financial relationship.[19]

3. The Anti-Kickback Statute requires the payment of *"*fair market value in arms-length transactions…[and that any compensation is] not determined in a manner that takes into account the volume or value of any referrals or business otherwise generated between the parties for which payment may be made in whole or in part under Medicare, Medicaid, or other Federal health care programs.*"*[20]

Distinct from the valuation standard of *Fair Market Value* is the standard of *Fair Value*. *Fair Value* for financial reporting, as required by generally accepted accounting principles and the Securities Exchange Commission, has been defined by the Financial Accounting Standards Board (FASB) as:

"…the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date."[21]

In contrast to the valuation standard of *Fair Market Value*, the standard of *Investment Value* may be defined as:

"…the **specific** value of an investment to a **particular** investor or class of investors based on individual investment requirements; distinguished from market value, which is impersonal and detached."[22] [Emphasis added.]

There may be many valid reasons for the *Investment Value* of the subject interest to a given owner or prospective owner to differ from the *Fair Market Value* of that same subject interest, including such reasons as:

1. "Differences in estimates of future earning power;

2. Differences in perception of the degree of risk and the required rate of return;
3. Differences in financing costs and tax status; and,
4. Synergies with other operations owned or controlled."[23]

The valuation standard of *Fair Market Value* is also distinct from the concept of *Fundamental* (Intrinsic) *Value*, in that *Fundamental* (Intrinsic) *Value*:

"…represents an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather tempered by how these perceived characteristics are interpreted by one analyst versus another."[24]

In addition to identifying the *standard of value* to be used in the valuation engagement, it is imperative that the *premise of value* (i.e., an assumption further defining the standard of value to be used and under which a valuation is conducted) also be determined at the outset of the valuation engagement. The *premise of value* defines the hypothetical terms of the sale (i.e., "…the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g., going concern, liquidation"[25]) and answers the question of "value under what further defining circumstances?" The selection of the *premise of value* can have a significant effect on its application in the valuation process. Two general concepts relate to the consideration and selection of the *premise of value*: (1) *value in use* and (2) *value in exchange*.

Value in use is the *premise of value* which assumes that the assets will continue to be used as part of an ongoing business enterprise, producing profits as a benefit of ownership of a going concern. As defined by Dr. Shannon Pratt, CEO of Shannon Pratt Valuations, Inc.: "Value as a going concern" is "value in continued use, as a mass assemblage of income-producing assets, and as a going-concern business enterprise."[26] It should be noted that in order to use the *premise of value in use* as a going concern:

1. There must be a reasonable likelihood that the subject enterprise will generate sufficient net margin to generate an economic cash flow;
2. There must be a reasonable likelihood that this would occur in the reasonably foreseeable future; and
3. The cash flow must be supported by the tangible assets utilized to generate the revenue stream and support the value of the investment. [27]

It should also be noted that in the absence of a reasonable expectancy of sufficient economic cash flow to support the value of the investment represented by the tangible assets utilized to generate the revenue stream of the enterprise, the highest and best use of the assets may be under, and the appraiser may select, a *premise of value* of "value-in-exchange as an orderly disposition of a mass assemblage of assets in place", which includes all individually identifiable tangible and intangible assets, and is further defined below.[28] Note that highest and best use is defined as: "that use among possible alternatives which is legally permissible, socially acceptable, physically possible, and financially feasible, resulting in the highest economic return."[29]

This concept is often relevant in valuing physician practices, since many professional physician practice enterprises do not produce positive net economic cash flows once the economic operating expense burden related to physician compensation is adjusted to reflect *Fair Market Value* for those services provided. This circumstance may indicate that it is not appropriate to use an income approach based valuation method, which entails, "an analysis of the income-producing capabilities of the subject…including the projection of the related revenue streams and the economic cost burdens…necessary to support those revenue streams."[30] In that event, the highest and best use is reflected by selecting "*Fair Value in* *exchange*," and not "*Fair Market Value in use as a going concern*."

The three levels of *value in exchange*, as noted by Dr. Pratt,[31] are:

1. "Value as an assemblage of assets—*Value in place*, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise;
2. Value as an orderly disposition—*Value in exchange*, on a piecemeal basis (not part of a mass assemblage of assets) as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually and that they will enjoy normal exposure to their appropriate secondary market;
3. Value as a forced liquidation—*Value in exchange*, on a piecemeal basis (not part of a mass assemblage of assets) as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market."[32]

The level of value selected will have an impact on the results of the value calculations. For example, the costs of liquidation should be considered in the value estimate when using the value as a forced liquidation *premise of value*. Shortening the investment time horizon may have a deleterious effect on the valuation of the subject enterprise as it presents a restriction on the available pool of buyers and investors and the level of ownership, as required under the standard of *Fair Market Value*.[33]

A firm foundation in the basic valuation tenets of *standard of value* and *premise of value* will assist the valuation analyst in the development of the valuation model requisite for the assignment. The more complicated the valuation assignment, the more essential it is that the valuation analyst has a solid understanding of the economic principles that underlie valuation theory. All valuation projects will be unique exercises in the application of these economic principles. Complex valuation challenges can often be addressed by analyzing each of the discrete, constituent elements, with reference to the applicable theoretical concepts derived from established economic principles.

The subsequent installments of this series will discuss the three generally accepted valuation approaches that may be used in valuing healthcare enterprises, assets, and services.

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1. Ibid, p. 17-18.
2. Ibid, p. 17.
3. Ibid, p. 17-18, 26.
4. Ibid.
5. Ibid, p. 406.
6. "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. 405-406.
7. "The Great Migration" By Rebecca Vesely, Hospitals & Health Networks, March 11, 2014, http://www.hhnmag.com/display/HHN-news- dhtml?dcrPath=/templatedata/HF_Common/NewsArticle/d ata/HHN/Magazine/2014/Mar/cover-story-great-migration (Accessed 8/12/14).
8. "Hospitals: Origin, Organization, and Performance" in "Health Care USA: Understanding its

Organization and Delivery" By Harry A. Sultz and Kristina M. Young, Sixth Edition, Boston, MA: Jones and Bartlett Publishers, 2009, p. 75, 103; "Ambulatory Care" in "Health Care USA: Understanding its Organization and Delivery" By Harry A. Sultz and Kristina M. Young, Sixth Edition, Boston, MA: Jones and Bartlett Publishers, 2009, p. 121-124.

9. "Limitation on Certain Physician Referrals" 42 U.S.C. § 1395nn(b)-(e) (2012); "General exceptions to the referral prohibition related to both ownership/investment and compensation" 42 C.F.R. § 411.355(a)-(i) (2010); "Exceptions to the referral prohibition related to ownership or investment interests" 42 C.F.R. § 411.356(a)-(c) (2007); "Exceptions to the referral prohibition related to compensation arrangements" 42 C.F.R. § 411.357(a)-(p) (2008); "Exceptions" 42 C.F.R. § 1001.952 (2007).
10. "ASA Business Valuation Standards," American Society of Appraisers, Accessed at http://www.appraisers.org/docs/default- source/discipline_bv/bv-standards.pdf?sfvrsn=0 (Accessed 8/29/14), 27.
11. Treasury Regulation § 53.4958-4(b)(i) (2002).
12. "Intermediate Sanctions – Excess Benefit Transactions," Internal Revenue Service, 28, 2014, http://www.irs.gov/Charities-&- Non-Profits/Charitable-Organizations/Intermediate-Sanctions-Excess-Benefit-Transactions (Accessed 8/29/14).
13. Revenue Ruling 59-60, 1959-1 C.B.
14. Ibid.
15. Ibid.
16. "Definitions" 42 C.F.R. 411.351 (2009).
17. "Limitation on Certain Physician Referrals" 42 U.S.C. § 1395nn(b)-(e); "General exceptions to the referral prohibition related to both ownership/investment and compensation" 42 C.F.R. § 411.355(a)-(i); "Exceptions to the referral prohibition related to ownership or investment interests" 42 C.F.R. § 411.356(a)-(c); "Exceptions to the referral prohibition related to compensation arrangements" 42 C.F.R. § 411.357(a)-(p); "Exceptions" 42 C.F.R. § 952.
18. Cimasi, 2014, p. 18-19.
19. 42 U.S.C.A. § 1395nn(a); Social Security Act § 1877(a).
20. 42 C.F.R. 952(d)(5).
21. "Statement of Financial Accounting No, 157: Fair Value Measurements," Financial Accounting Standards Board, September 2006, p.
22. "Investment Value" The Appraisal Institute, The Dictionary of Real Estate Appraisal, 4th ed., 2002, p.
23. Cimasi, 2014, p. 30-31, p. 24-25; "Valuing a Business: The Analysis and Appraisal of Closely Held Companies" By Shannon Pratt, 5th ed., New York, NY: McGraw-Hill, 2008, p.
24. Pratt, 2008, p.
25. "The Principles and Concepts of Valuation: Theory of Utility and Value, Value Influences, and Value Concepts" By Richard Rickert, Appraisal and Valuation: An Interdisciplinary Approach, Volume I, Washington, D.C.: American Society of Appraisers, 1987, p. 6-7.
26. Pratt, 2008, p.
27. Cimasi, 2014, p.
28. Pratt, 2008, p.

29. Cimasi, 2014, p. 28-29; Rickert, 1987, p.

30. Cimasi, 2014, p.

31. Pratt, 2008, p. 47-48.

32. Cimasi, 2014, p. 30-31.

33. Ibid.

Robert James Cimasi, MHA, ASA, FRICS, MCBA, CVA, CM&AA, serves as Chief Executive Officer of HEALTH CAPITAL CONSULTANTS (HCC), a nationally recognized healthcare financial and economic consulting firm headquartered in St. Louis, MO, serving clients in 49 states since 1993. Mr. Cimasi is the author of numerous chapters in anthologies, textbooks, and legal treatises; has published articles in peer reviewed and industry trade journals, research papers, and case studies; and is often quoted by healthcare industry press. His most recent publications include: "Accountable Care Organizations: Value Metrics and Capital Formation" [2013—Taylor & Francis, a division of CRC Press]; "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services" [2014—John Wiley & Sons]; and, the soon-to-be released "Adviser's Guide to Healthcare – 2nd Edition" [2015—AICPA]. Mr. Cimasi can be contacted at: rcimasi@healthcapital.com or (800) 394-8258.

Todd A. Zigrang, MBA, MHA, FACHE, ASA, is the President of HEALTH CAPITAL CONSULTANTS (HCC), where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang is the author of the soon-to-be released "Adviser's Guide to Healthcare – 2nd Edition" [2015—AICPA], numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: The Accountant's Business Manual (AICPA); Valuing Professional Practices and Licenses (Aspen Publishers); Valuation Strategies; Business Appraisal Practice; and, NACVA QuickRead. He is a Fellow of the American College of Healthcare Executives (FACHE) and holds the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers, where he has served as President of the St. Louis Chapter, and is the current Chair of the ASA Healthcare Special Interest Group (HSIG). Mr. Zigrang can be contacted at: tzigrang@healthcapital.com or (800) 394-8258.