THE HIDDEN VALUE IN YOUR PRACTICE

From both a valuation and a brokerage standpoint, *professional practices* are significantly different from entities engaged in manufacturing, distribution, or retailing. For instance, a professional practice renders a service as opposed to producing, distributing, or selling a product. Also, the owner/practitioner level of a professional practice is always composed of at least one licensed individual who has demonstrated the requisite skill to practice in their specific field of endeavor. Major differences also exist in the nature of the operational assets necessary for the successful functioning of a professional practice. The professional practice is considerably more reliant upon intangible assets than are the other entity types.

> *Black's Law Dictionary* defines the term "profession" as:
> A vocation requiring special, usually advanced, education, knowledge, and skill. The labor and skill involved is predominantly mental or intellectual, rather than physical or manual…. implies professed attainments in special knowledge as distinguished from mere skill.
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> *West Publishing Co., 1990, p. 1210*

This article focuses on the professional practices' intangible assets. All of the intangible assets of the professional practice may not be clearly apparent to the owner/practitioner. Hence, the value of intangible assets may not be readily understood by the owner/practitioner. A sizable *hidden value* is often found in the practice's *intangible assets*.

To appreciate the magnitude of this hidden value it is first necessary to understand the primary differentiating characteristic of the tangible asset versus the intangible asset. Tangible assets as a property class have a common characteristic of a physical existence, as evidenced in machinery, vehicles, office & computer equipment, and inventories. This class of asset occupies space, and has "mass". In contrast, intangible assets have the characteristic of property that is incorporeal, having no physical substance apparent to the senses. At most, an intangible asset may be evidenced by some type of written record, such as a "procedures manual".

Most owner/practitioners readily understand the value of tangible assets in their practices. After all, tangible assets are typically purchased after a model comparison analysis, are often acquired in a discrete expenditure, and have a physical existence. The purchase of each tangible asset is often approved personally by the owner/practitioner. Conversely, intangible assets are not "purchased" per se, are often acquired over extended periods of time, and are not physically visible. Intangibles also differ in that they are not always readily identifiable. Specific intangibles are often difficult to precisely explain. This leads to a difficulty in accurately quantifying their value. As a result of these characteristics, intangibles are often overlooked in either the valuation of a practice or in a transfer price of an ownership interest in the practice.

One confusing aspect of intangible assets is that they are not typically stated on the professional practice's financial statements (i.e., the "books and records"). In accounting parlance the intangible asset is typically not "booked" and therefore does not show-up on the practice's balance sheet. Contrast this with assets such as vehicles, office equipment, and computer equipment, which are recorded on the books. Nonetheless, "intangibles" are absolutely necessary for the production of income. A notable exception to the otherwise non-recording of an intangible is where one practice purchases another firm, and where the buying firm pays more than the amount allocated to the purchased net tangible assets; in this instance the difference (i.e., the excess) is collectively referred to as "purchased goodwill". The excess in this case is booked as an asset, either collectively or in components, and is shown on the balance sheet financial statement.

> In some professional practices the entire property class of intangible assets may constitute nominally 70% of the firm's total value. Due to the magnitude of their value, intangibles can easily become an important factor in an ownership transition scenario or in even a nominal change in an ownership interest.

The question frequently arises as to why the professional practice's balance sheet does not reflect the value of the intangible assets. The answer lies primarily with two factors. First, most professional practices are cash basis tax entities and the opportunity to write-off an expenditure is an opportunity to immediately reduce taxable income and hence, income taxes. Note that an expenditure cannot be treated as a deduction for income tax purposes and simultaneously treated as an asset. Tax reduction is often the owner/practitioner's primary objective.

Second, most accounting systems are not designed to accurately identify, measure, and capture portions of expenditures that might incrementally be capitalized to the practices' balance sheet. For instance, assume the weekly wage of a staff person is $500, and that one full day is involved in software programming. Theoretically, $100 might be capitalized as programming, an intangible asset, on the balance sheet (the other $400 is expensed). To record both the expense and the asset, the time record for the staff person, as well as all staff, would need to be designed to capture this information and the information appropriately entered onto the books in different accounts. While this is feasible, it is not practical. Subsequent accounting issues arise as to when and how to relieve (i.e., expense) the previously capitalized amount.

For the above two primary reasons, most intangible assets are never recorded onto the balance sheet financial statements.

Further, confusion results because a universal definition of intangible assets is not available. Terminology and classification vary. Intangibles are often collectively referred to as "goodwill", a term that is both misleading and confusing. Goodwill, in and of itself, is best understood as stemming from either the ability of the practice to produce excess earnings or the ability of the practice to continuously attract clients. Goodwill is but one of a number of intangible assets. The term "goodwill" is however often used by the layperson to describe the entire category of intangible assets.

Another intangible asset is "going concern value". This intangible is noted as being the value of a number of assembled and integrated assets (i.e., equipment, people, etc.) into an operating entity with the capacity to render services.

Perhaps you have noted that some degree of overlap exists in the term's goodwill and going concern value. You are correct, as this is so. The lines between intangible asset classes is not always as clearly differentiated as that of tangible assets, such as the differences between vehicles and office equipment. Some classes of intangibles are differentiated more by degree than by absolutes. Nonetheless this does not detract from their value to the professional practice.

The fact is that there are numerous intangible assets in a professional practice. So, just what are these intangible assets? A convenient classification of intangible assets is the following:

1. *Client and Customer Related*.
   These may be evidenced as customer lists. Included are contracts.

2. *Goodwill and Client/Customer Related*.
   These are the custody of charts, records, and files. It included personal/professional goodwill, as well as practice/commercial goodwill.

3. *Human Capital Related*.
   It includes a trained and assembled workforce. Include also policies and procedures. It includes employer/employee contracts. This includes the existing depth of management.

4. *Intellectual Property Related*.
   These are practice protocols. Included are procedural manuals. Patents and patent applications, copyrights, trade names, trade secrets, and royalty agreements.

5. *Locations and Operations Related*.

This is management information and executive decision systems. It includes favorable leases and leasehold interests. Also include going concern value, asset assemblage costs, historical documents and firm studies. Include supplier contracts and group purchasing organizations.

6. *Governance and Legal Structure Related*.
   These are organizational documents (such as ByLaws, Minutes), and a functioning BOD. Include non-compete agreements, and income distribution plans.

7. *Marketing and Business Development Related*.
   These are print ads, telephone numbers, billboards, etc. It includes franchise and licensing agreement. Also are market entrance barriers or factors.

8. *Regulator Legal Related*.
   These are facility licenses, practice licenses, and permits.

9. *Financial Revenue Related*.
   These are office sharing arrangements, management service contracts, and financing agreements. Include underwriting or private placement memoranda, budgets, forecasts, and projections.

10. *Technology Related*.
    These are computer software, network integration, technical & software documentation, maintenance and support relationships.

Let's examine more closely one of the above specific classification of intangible assets, the *Technology Related* group. First, this group in itself is a composite of several separate but overlapping intangibles. A segment is computer software and its related component assets. For instance, the expenditures incurred in evaluating and selecting software, and the expenditures of installation, troubleshooting, and customizing the software are intangible assets. Consider also that this group might include the expenditures for staff training. Often overlooked are the related expenditures such as inputting client/customer names, addresses, and many other details into a data record (i.e., a database). The technology related group also includes internet website design, development, domain name registration, and the related email addresses and installations. All of these are intangible assets, and all have taken time, effort, and money to acquire and/or develop. Their existence implies value.

A characteristic of the intangible asset is that they are often acquired in numerous or indirect transactions. Intangible assets are often accreted slowly over long periods of time and in a number of ways. For instance:

Over a number of years document flows and internal controls are formulated, adapted, refined, updated and documented. Collectively, these have taken time, effort, and money. Their equivalent is value.

Proprietary procedures and processes are intangible assets. Every practice, particularly those established over a long period of time has developed unique and proprietary ways of expediting the services it performs. Proprietary procedures have value.

Prior advertising expenditures are intangible assets. More specifically, the residual benefit of all types of it's prior advertising, often previously expensed over a number of years, has value. The firm that has consistently promoted itself, often through a variety of means, has a recognized tradename with the public. Recognized tradenames have value.

The hired and trained staff. A portion of the costs of interviewing, evaluating, hiring, and training staff is an intangible asset. Typically the costs have been incurred for each of the staff employees and other professionals.

A referral network. Almost every established firm has either a formal and/or an informal network for client referrals. Perhaps your firm has a reputation for a particular specialty of service and receives most of its new clients via its referral network. A referral network can be a particularly valuable intangible asset.

The fact is, intangible assets are necessary to the successful operation of all professional practices. Intangible assets contribute to the practice's income and profits even if not visible.

In most instances expenditures have either been made years ago, made over a long period of time or have been made in nominal increments. It is important to understand that these assets may not be recorded on the books, are not physically visible, and hence may not be susceptible to easy description or identification. Yet, they are assets with considerable value.

Now a caveat (and there is always a caveat).   The valuation of intangible assets is a particularly challenging assignment. First, an intangible asset must be identified, and second, their contribution to the practice must be determined. The proper identification and subsequent appraisal of intangibles is the domain of the experienced valuation expert. Pragmatically, intangible assets are often identified conceptually and valued as a composite figure. Practices don't separately sell, for instance, their "policies and procedures" to another firm. Hence, there is little need to separately value this discrete intangible asset. Composite valuation is the norm.

And now, a second caveat. Assets, including intangible assets, may not always have a value in the marketplace. A mere collection of assets, while having a value, may not clearly be generating income value. As an example, suppose an auto dealership has several hundred autos in inventory, but in weak economic times sells very few autos. Suppose the projected future is not promising. The floor value of the dealership is perhaps its wholesale value of its tangible inventory. The revenue stream may be nearly non-existent. The dealerships intangible assets are not clearly contributing to sales or net income. This is because the dealership, as well as all economic endeavors, have market value primarily in the income stream they generate. A mere collection of assets have only nominal value if they are not allowing the practice to generate a net profit.

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In a future article we will present methods for valuing a firms intangible assets.