PROFESSIONAL PRACTICE SALES

295 Main Street North
Markham, Ontario L3P 1Y9
Tel: (905) 472-6000
Fax: (905) 472-0521
Toll Free: 888-777-8825
Web: www.ppsales.com

Excess Profit - The Second Key

Graham R. Tuck
H.B.A., C.A.

A motivating reason for owning a practice is its ability to pay you for more than your efforts as a dentist. This additional pay is called the excess earning capacity. It is calculated by normalizing the financial statements by adding back expenses that are not recurring, or do not relate to the ongoing costs to run the practice.

Such items as:

- Personal insurance, automobile expense and large legal bills to solve a special situation would be adjusted in a normalizing process.
- Leases to purchase equipment would be added back as this is how the equipment is paid for, not how it is consumed. The consumption, in the long run, is the depreciation which generally does not conform to the Capital Cost Allowance (CCA) that is permitted by Revenue Canada. Generally speaking the CCA is greater than the consumption of the assets i.e. Equipment is generally written off at 20% per year declining balance – in seven years one would write off 80% of the cost of the asset purchased. BUT it will probably last on average 20 years or more.
- Interest expense is also eliminated when normalizing the practice as the purchaser will have their own interest cost as the practice is turned over to them with all liabilities paid.
- Associate fees are also eliminated in normalizing the income to enable a review of the overhead after it is normalized.

The next calculation is to reimburse the Dentists, including the owners of the practice, for their efforts based on a 40% remuneration. The remaining balance is the income before taxes from ownership. Since the practice principal is paid off in after tax dollars, the tax on the income from ownership is calculated as if this was the only income of the owner.

The normalized net income after taxes (net income) is the basis of the calculation of the value of the practice. These are the funds the purchaser would use to pay for the practice. This net income would be “Present Valued” over ten years at a selected Capitalization Rate which would establish the value of the practice.

The Capitalization Rate is not static. With a high patient count and lower billings the rate would trend down. With contemporary equipment the value would also trend down and the lower the Capitalization Rate the higher the value. The community, the availability of parking, the new patients, and visibility of the practice would also have an impact on the Capitalization Rate.

It is critical that the practice has this excess earning capacity to payback the bank for the money borrowed to purchase the practice. Profit not billings establishes value.

Graham Tuck, H.B.A., C.A., is the broker/owner of Professional Practice Sales (Ontario) Ltd., which specializes in the valuation and sale of dental practices. He can be reached at (905) 472-6000 or 1 (888) 777-8825 or by e-mail at: grtuck@rogers.com.