

Veterinary Matters

Guiding your practice to lifelong prosperity

Goodwill - Do you know how much your practice is worth?

We often get asked, how much is my practice worth? It is understandably a question that is close to the hearts of all practice owners.

Reasons for valuing

There are many reasons why you may need to know how much your practice is worth, including:

- Retirement/succession.
- Change in practice structure, for example incorporation.
- Someone is buying into your practice or you are buying in yourself.
- You are selling or thinking about selling your practice.
- Dispute between the practice owners.
- Divorce.
- And, of course, general interest.



There are many variables depending on the type of practice, which cannot be covered in full in this article. As such, we have focused on Small Animal practices, although many of the principles will apply equally to Farm, Equine and mixed practices.

How is goodwill valued?

The first port of call should be your partnership or shareholders' agreement, as this may set out how goodwill is valued. This may indicate that goodwill is valued at its market value, or it may set out a specific method by which it should be calculated. If you do not have such an agreement, it would be worthwhile considering whether one should be drawn up.

Some sole trader and partnership practice owners choose to place no value on goodwill for internal and succession purposes. There are commercial considerations to take into account here because when buying into a practice an individual will not therefore be required to pay for goodwill. Similarly, when a partner reduces their partnership share, for example upon a retirement, they will receive no payment for goodwill. If you are making changes to a partnership agreement as to how goodwill is valued, it is crucial that the impact on future and existing owners is considered.

The position in a company is different and more restrictive. Accounting standards

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generally do not allow goodwill to be revalued on a company's balance sheet. Therefore, for the purposes of practice sale and purchases, whether internally or on the open market to a third party, a 'shadow' balance sheet needs to be drawn up separate from the company's statutory year-end accounts. This shadow balance sheet takes into account the appropriate goodwill value at the time.

In the case of the sale and purchase of shares in a company, HM Revenue & Customs require shares to be dealt with using a commercial valuation. It is therefore more restrictive and needs to be fully understood otherwise valuation and tax issues may arise. It is important to fully understand this before, for instance, incorporating a practice. Care needs to be taken when discounts are offered, for example, to assistants buying in.

In cases where practice owners have chosen to value goodwill at the market rate, an expert will need to be consulted.

Factors Impacting On Goodwill

The market value of your practice's goodwill depends on a host of factors, including but not limited to:

- Work type (e.g. small animal, large animal, equine, mixed).
- Referral versus non-referral.
- Competition.
- Profitability - actual and recent trend.
- Staffing efficiency.
- Pricing strategy.
- Your practice property's market rental value.
- Dependence on owners.
- Location.

Valuation Approaches

There are a number of recognised market valuation methodologies but the principal one in Small Animal is the Earnings Before Interest Tax Depreciation and Amortisation (EBITDA) valuation.

The EBITDA approach takes net profit as a starting point, which is adjusted to add back interest, tax, depreciation and amortisation. An adjustment for the practice property market rental value is required if a full market rent is not already included in the profit and loss account. An equivalent market rate salary for each owner also needs to be incorporated but any private and one-off costs/income are excluded.

The EBITDA is multiplied by a factor taking into account the particular circumstances of the practice and the purpose of the valuation. The expertise of the valuer is very important when establishing the multiple.

An example of this approach is set out in Fig. 1 using illustrative figures. All the figures would be taken from a practice's accounts where noted.

The EBITDA valuation method is particularly relevant for Small Animal work due to the prevalence of corporates who normally use this approach.

What is the practice worth?

It is worth dispelling one myth early on: the value of your practice is not just the value of goodwill. The value of your practice will comprise the value of its assets, for example property, cash and debtors, as well as its liabilities, such as amounts owed to suppliers, VAT and loans. Assets less liabilities are known as 'net assets'.

If you are an unincorporated practice, i.e. a sole trader or partnership, the value of your 'interest' in the practice will be the value of your current/capital account adjusted to reflect your share of the practice's goodwill and other assets and liabilities.

An example is shown in Fig. 2 using a goodwill value of around £440,000 taken from the EBITDA valuation example (Fig 1.).

This practice has a total value of £600,000 (excluding property) including goodwill, with the excess over the £160,000 net asset value representing goodwill of £440,000.



Fig. 1

	£	Note
Profit before tax, per accounts	116,131	
PLUS:		
Interest, per accounts	1,160	
Depreciation, per accounts	1,627	
Amortisation, per accounts	3,000	
Directors' remuneration, per accounts	16,000	
Employer's National Insurance on directors' remuneration, per accounts	1,200	
One-off: reception refurbishment (included in repairs)	8,500	
LESS:		
Rent	(10,000)	1
Notional market rate salary for owner	(27,500)	2
Adjusted EBITDA	110,118	
Multiple, say 4	4	
EBITDA valuation	440,472	
Notes		
1	Market rate Rent per Profit & Loss Account re practice property	60,000 (50,000)
	EBITDA adjustment	10,000
2	Market rate salary + employer's National Insurance	55,000
	Full-Time Equivalent number of owner(s)	0.5
	27,500	

In this example, no goodwill is recognised on the balance sheet prior to the revaluation. It may be that, in practice, goodwill is included on the balance sheet at an earlier historic value. This should not prevent it being revalued to its appropriate level in a similar way.

What is the company worth?

If your practice trades as a limited company, your 'interest' in the company will be the value of your shares together with the value of any director's loan account that you may have. (This is generally included within current liabilities).

Using the same £440,000 EBITDA valuation for goodwill as shown in Fig. 3, this practice has a total share value of £600,000 (excluding property) as shown on the shadow balance sheet.

Remember that your 'interest' in the company will also include the value of your director's loan account on top of this share value. The value of your 'interest' will be increased if the company owes you money or reduced if you owe the company money.

Understanding the differences above is critical to establishing the correct valuations.

Summary

Goodwill is one asset of the business. Other assets and liabilities combined with goodwill reflect the total value. As can be seen, goodwill might be valued for many different reasons and it is critical that this is fully understood. Whether the goodwill valuation is for internal (e.g. a partnership change) or external (e.g. a sale to a third party) purposes needs to be taken into account. The structure of the business, whether unincorporated or incorporated, is also an important consideration. These factors, together with many others, will influence the valuation, so it is essential that you understand them all.



Fig. 2 Sole Trader or Partnership

	Existing balance sheet	Revalued balance sheet
	£000	£000
Tangible fixed assets	200	200
Goodwill	-	440
	200	640
Current assets	80	80
Current liabilities	(75)	(75)
	5	5
Long-term liabilities	(45)	(45)
Net assets	160	600
Capital account	100	540
Current account	60	60
Net assets	160	600

Fig. 3 Company

	Balance sheet	Shadow balance sheet
	£000	£000
Tangible fixed assets	200	200
Goodwill	100	440
	300	640
Current assets	80	80
Current liabilities	(75)	(75)
	5	5
Long term liabilities	(45)	(45)
Net assets	260	600
Issued share capital	1	
Profit and loss reserve	259	
	260	600



Mark Beaney

t: 01242 680000
e: mark.beaney@hazlewoods.co.uk



Phil Swan

t: 01242 680000
e: phil.swan@hazlewoods.co.uk



Mark Harwood

t: 01242 680000
e: mark.harwood@hazlewoods.co.uk

Our Veterinary Team is happy to discuss matters arising from this newsletter, as well as any other issues relating to your business or personal financial affairs.

The services we provide include:

- Accounting and bookkeeping
- Management accounts
- Business planning and practice reviews
- Tax planning advice and compliance services
- Goodwill and business valuations
- Benchmarking and profitability advice
- Advice on buying or selling a practice
- Incorporation
- Partnership changes
- Payroll
- Sage software advice

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Our Veterinary Team is based at our Staverton Office:

Hazlewoods Veterinary Team

Staverton Court, Staverton, Cheltenham, GL51 0UX

Tel: 01242 680000 Fax: 01242 680857

www.hazlewoods.co.uk

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