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A PRIMER TO VALUING A LAW PRACTICE

REASONS FOR VALUING A LAW PRACTICE



- **Purchase/Sale of entire or partial interest**
- **Divorce**
- **Insurance**
- **Shareholder Agreements**



CHARACTERISTICS OF LAW FIRMS

- **As a service business, does not require significant investment in equipment**
- **Financial data are generally prepared on a cash basis of accounting**

CHARACTERISTICS OF LAW FIRMS



- **Convert to accrual basis of accounting**
- **Identify non-operating expenses and perks**



CHARACTERISTICS OF LAW FIRMS

- Valuation approach is similar to other professional or service oriented businesses, but may also require analysis of
 - Contingent fees
 - Work In Progress

WORK IN PROGRESS



- Performance of substantial work on matters that have been billed
- Analysis is needed to determine if amounts computed are billable and/or collectable



CONTINGENT FEES

- **Personal injury/negligence may require a third party analysis to determine a reasonable expectation of results of case(s)**

THE PROCESS



- **Gathering data**
- **Adjusting financial information**
- **Choosing valuation methods and approaches**



DATA REQUIRED

- **General Practice Info**
- **Principal's CV**
- **Firm Brochure**
- **Firm Advertisements**
- **Billing Rate Schedules**
- **Distinguish type of work performed**
- **Firm hierarchy & structure**

GATHERING DATA



VALUATION OBJECTIVES – TO DETERMINE

- Practice's strengths and weaknesses
- Depth of management
- Dependence on key employees
- Dependence on major clients




ECONOMIC, INDUSTRY & MARKET DATA

- **Commonly used profession related economic surveys to address:**
 - **Overhead costs**
 - **Salaries**
 - **Owners compensation**
 - **Receivables and payables**
 - **Work in process**
 - **Net profit**

HISTORICAL FINANCIAL INFORMATION



- **Preferably five years Financial statements**
 - **Balance Sheet**
 - **Income Statement**
 - **Cash Flow**
 - **Income tax returns**
 - **Income projections**



ADJUSTING FINANCIAL INFORMATION

- **Determine reasonable compensation to owners and key employees**
- **Determine reasonable rent expenses by adjusting to fair market occupancy costs due to sweetheart leases &/or owner occupied premises**
- **Bartering of services**

ADJUSTING FINANCIAL INFORMATION



- Identify loan receivable or payable recorded on books of subject practice
- Loan receivable may need to be reclassified as unreported compensation to owners
- Loans payable may need to be reclassified as equity



ADJUSTING FINANCIAL INFORMATION

- **Interest income or expense may need to be recorded**
- **Examine cash Balance**
- **Does balance include excessive amounts of undistributed profits**

ADJUSTING FINANCIAL INFORMATION



- Is there a significant amount of deposits shortly after the beginning of accounting period, used to defer recognition of income
- Record accounts receivables
- Determine adjustment needed for work in process



ADJUSTING FINANCIAL INFORMATION

- **Prepayments of insurance or other expenses**
- **Identify fixed assets used in business from those assets that may be more of a personal nature**
- **Cars, furniture, stereo equipment etc.**

ADJUSTING FINANCIAL INFORMATION



- Depreciation should be reflected on an economic basis and not a tax basis
- Convert depreciation expense from accelerated method to straight-line method
- Deferred value
- Fees collected but income not earned



CHOOSING VALUATION METHODS & APPROACHES

- **Asset Approach**
 - Most appropriate for liquidation process
- **Market Approach**
 - Analyzes transactions of similar practices

CHOOSING VALUATION METHODS & APPROACHES



- Income Approach
 - Applying a multiple to normalized earnings
 - Capitalization of earnings method
- Excess Earnings Method-
 - Designed to determine value of intangibles (goodwill) separately from total value



PROFESSIONAL GOODWILL VS. PRACTICE GOODWILL

Professional Goodwill

- Also called personal goodwill
- **Associated primarily with individual practitioner**
 - It is the individual skills, knowledge, reputation and personality (of professional) that draws client/patients to the practitioner
 - Assumes that if practitioner would leave to another place, client base would follow

PROFESSIONAL GOODWILL VS. PRACTICE GOODWILL



Practice Goodwill

- Also called business goodwill
- Associated primarily with the entity
- Practice's location, staff, telephone number, facilities, and reputation that would cause clients to stay with practice upon change in ownership



THE EXCESS EARNINGS METHOD

- **Determine the fair market value of net tangible assets**
- **Determine the normalized earning stream**
- **Determine the rate of return to be applied to the net tangible assets**

THE EXCESS EARNINGS METHOD



- Apply rate to NTA and subtract result from normalized earnings
- Determine capitalization rate to be applied to earnings
- Add FMV of NTA to value of intangible asset goodwill



DIFFERENCES IN PROFFESIONAL PRACTICES & OTHER BUSINESSES

- **Reliance on individual professional practitioners, usually highly educated and licensed to practice in the profession**
- **Common use of cash basis of accounting instead of accrual**
- **Business decisions are usually influenced by income tax considerations**

DIFFERENCES IN PROFFESIONAL PRACTICES & OTHER BUSINESSES



- Purchases of professional practices are often paid out over times and may include some function of future consulting services
- Practice value is heavily dependent on intangibles
- Public market place is very limited or even not existent