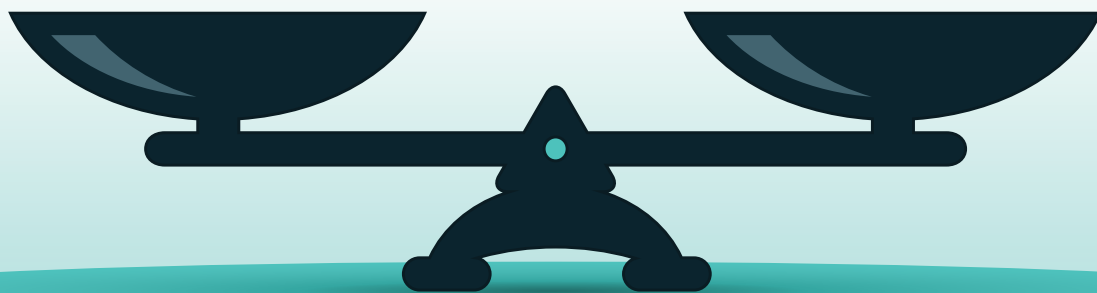


# Strike a Balance



*How practice valuations find harmony between contracts receivable and gross, net income*

**D**on't fall victim to cocktail-party chatter or false statements regarding what percentage of gross collections an orthodontic practice should sell for. Some say things like, "Of our most recent practice transitions, the average sales price was 73.8 percent of gross collections."

A statement like that doesn't have much value alone, so you must read a little closer. That statement may go on to conclude that "of those practices, the contracts receivable averaged 45–55 percent of the sales price." *Aha!*

*There* is the key piece of information that's often overlooked, but it makes sense of the initial "gross collections" statement.

## **Money math**

Gross collections and net income sit on one end of a scale that is balanced on the other end by contracts receivable; the two sides are dependent upon one another. Contracts receivable (CR) is money due in the future for work to be done in the future on all active patients. CR is, essentially, the future collections to be earned as treatment is completed. Therefore, if CR

is collected ahead of schedule (in advance of treatment), then gross collections and net income increase artificially.

Here's one example of a reasonable way to collect fees; this example is affordable for most patients, while also roughly corresponding with the active treatments performed. Take 25 percent of the total fee as a down payment, then bill out the remaining balance over a span of 24 months. When you run a spreadsheet on this—keeping patient starts, fees and collection rate static for illustration purposes—you'll discover that after the last of the 24 months, the practice reaches a point of stasis. Each month thereafter looks the same because as some patients finish payments, others are starting to make payments.

At that point, the relationship between gross collections/net income and CR (when there hasn't been any precollection or delayed collection) becomes apparent. The discovery is that when the initial payment is 25 percent and the remaining balance is billed over 24 months, the CR balance will be 70 percent of gross collections.



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Therefore, it stands to reason that in a practice that bills this way, if there's anything less than a CR 70 percent of gross, then the seller has precollected fees faster than 25 percent down and the balance over 24 months.

**Appraising mistake**

Precollecting CR means less money is available to practice buyers to pay the debt service on the acquisition loan along with the normal office overhead ... and still have enough money to live on. But it also means that the gross collections and net

income have artificially increased, which could potentially result in a falsely high purchase price—especially if the appraiser is setting the value solely as a percentage of gross and the buyer isn't aware of the relationship between gross and CR.

**True values**

Suppose the seller's usual fee is \$4,600; the usual method of collection is 25 percent down (\$1,150) with the balance billed over 24 months. In this example, the doctor starts 25 patients per month (Table 1). Gross income would be \$1.38 million

Table 1

Month	Patient Starts Per Month	Total Active Patients	Individual Patient Fee	Individual Down Payment	Down Payments Collected	Individual Monthly Payments	Monthly Payments Collected	Total Monthly Income	Contracts Receivable
1	25	25	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$3,593.75	\$32,343.75	\$82,656.25
2	25	50	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$7,187.50	\$35,937.50	\$161,718.75
3	25	75	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$10,781.25	\$39,531.25	\$237,187.50
4	25	100	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$14,375.00	\$43,125.00	\$309,062.50
5	25	125	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$17,968.75	\$46,718.75	\$377,343.75
6	25	150	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$21,562.50	\$50,312.50	\$442,031.25
7	25	175	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$25,156.25	\$53,906.25	\$503,125.00
8	25	200	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$28,750.00	\$57,500.00	\$560,625.00
9	25	225	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$32,343.75	\$61,093.75	\$614,531.25
10	25	250	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$35,937.50	\$64,687.50	\$664,843.75
11	25	275	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$39,531.25	\$68,281.25	\$711,562.50
12	25	300	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$43,125.00	\$71,875.00	\$754,687.50
13	25	325	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$46,718.75	\$75,468.75	\$794,218.75
14	25	350	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$50,312.50	\$79,062.50	\$830,156.25
15	25	375	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$53,906.25	\$82,656.25	\$862,500.00
16	25	400	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$57,500.00	\$86,250.00	\$891,250.00
17	25	425	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$61,093.75	\$89,843.75	\$916,406.25
18	25	450	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$64,687.50	\$93,437.50	\$937,968.75
19	25	475	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$68,281.25	\$97,031.25	\$955,937.50
20	25	500	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$71,875.00	\$100,625.00	\$970,312.50
21	25	525	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$75,468.75	\$104,218.75	\$981,093.75
22	25	550	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$79,062.50	\$107,812.50	\$988,281.25
23	25	575	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$82,656.25	\$111,406.25	\$991,875.00
24	25	600	\$4,600.00	\$1,150.00	\$28,750.00	\$143.75	\$86,250.00	\$115,000.00	\$991,875.00

All months after this point will look like Month 24.

Table 2

Month	Patient Starts Per Month	Total Active Patients	Individual Patient Fee	Individual Down Payment	Down Payments Collected	Individual Monthly Payments	Monthly Payments Collected	Total Monthly Income	Contracts Receivable
1	25	25	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$4,259.26	\$42,592.59	\$72,407.41
2	25	50	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$8,518.52	\$46,851.85	\$140,555.56
3	25	75	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$12,777.78	\$51,111.11	\$204,444.44
4	25	100	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$17,037.04	\$55,370.37	\$264,074.07
5	25	125	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$21,296.30	\$59,629.63	\$319,444.44
6	25	150	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$25,555.56	\$63,888.89	\$370,555.56
7	25	175	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$29,814.81	\$68,148.15	\$417,407.41
8	25	200	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$34,074.07	\$72,407.41	\$460,000.00
9	25	225	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$38,333.33	\$76,666.67	\$498,333.33
10	25	250	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$42,592.59	\$80,925.93	\$532,407.41
11	25	275	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$46,851.85	\$85,185.19	\$562,222.22
12	25	300	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$51,111.11	\$89,444.44	\$587,777.78
13	25	325	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$55,370.37	\$93,703.70	\$609,074.07
14	25	350	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$59,629.63	\$97,962.96	\$626,111.11
15	25	375	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$63,888.89	\$102,222.22	\$638,888.89
16	25	400	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$68,148.15	\$106,481.48	\$647,407.41
17	25	425	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$72,407.41	\$110,740.74	\$651,666.67
18	25	450	\$4,600.00	\$1,533.33	\$38,333.33	\$170.37	\$76,666.67	\$115,000.00	\$651,666.67

All Months after this point will look like Month 18

and CR would be \$991,875. Similarly, the seller’s competitor also charges the same fee of \$4,600 and also starts 25 patients per month, but instead of taking a down payment of 25 percent, he requires one of 33 percent and the balance is billed over 18 months, not 24 (Table 2).

The result of the competitor’s billing schedule on the same fees and same patient

The entire purpose of examining a practice’s CR compared to its gross income is to verify that there hasn’t been significant precollection of fees, which artificially raises the gross income and the fair market value.

starts is the same gross income of the seller (\$1.38 million), but the competitor has a much lower CR balance at \$651,666.

If an orthodontic practice appraiser suggested or implied that a fair market value was 73.8 percent of gross and that the CR should be 70 percent of it (without looking at the practice’s usual billing schedule), then the competitor’s practice is improperly valued. The entire purpose of examining a practice’s CR compared to its gross income is to verify that there hasn’t been significant precollection of fees, which artificially raises the gross income and the fair market value.

But an appraiser cannot tell if there has been precollection if they don’t understand the usual and historic billing schedule for that specific practice. Gross income and CR are related to one another by the billing schedule. An appraiser must analyze a practice’s billing schedule in order to know if the CR present are expected, given the practice’s gross income. ■