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Valuing a Law Practice

VALUING A SMALL LAW PRACTICE

Many valuation experts value law practices using an "excess earnings method" instead of using a method comparing similar business transactions, because few law practice sales are reported and compiled, thus little comparative transaction data exists.

EXCESS EARNINGS METHOD (SIMPLIFIED VERSION)

The excess earnings valuation method computes a practice's total value by combining the value of a practice's net assets and goodwill.

NET ASSETS

A practice's net assets are determined by totaling the value of the practice's assets (such as accounts receivable, work in progress, equipment and furniture) and subtracting the practice's outstanding debt. Accounts receivable should be valued at their expected collection amount.

GOODWILL

Goodwill is determined by assessing the excess earnings a practice provides to its owner. Excess earnings are computed by comparing the owner's actual earnings to the cost of replacing the owner with a professional with the same knowledge and years of experience.

The owner's actual earnings can be determined by analyzing the owner's recent tax returns. Replacement wages are estimated based on attorneys' compensation studies such as those compiled by Altman Weil Publications, Inc. A practice is said to have excess earnings if the current owner's earnings are more than the wages necessary to replace the owner.

Often goodwill is determined by multiplying these excess earnings by a multiple ranging between 1 and 3. Higher excess earnings multiples generate higher practice goodwill values.

FACTORS INCREASING GOODWILL VALUE

The following factors increase the excess earnings multiple: a good reputation in the community; a high market share of a growing market niche; a dedicated staff; a high earnings per hour worked ratio; and a recurring and stable client base. It is easier to transfer ownership of a practice with a recurring client base, such as an estate planning practice, than a practice involving mostly one-time projects.

SIMPLIFIED EXCESS EARNINGS EXAMPLE

If a practice consists of transferable assets of $25,000, debts of $10,000, an owner with actual earnings of $120,000, an owner's replacement earnings of $100,000 and a multiplier of 2, then the value of the practice would be computed as follows:

Net Asset Value		
Assets	$ 25,000	
Liabilities	$ 10,000	
Net Asset Value (A)		$15,000
Goodwill Value		
Owner's Current Earnings	$120,000	
Replacement Earnings	($100,000)	
Excess Earnings	$ 20,000	
Excess Earnings Multiplier	2	
Indicated Goodwill (B)		$40,000
Indicated Value of Practice (A + B)		$55,000

QUESTIONS OR COMMENTS

Please call me with your comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA

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