CGMA MANAGEMENT CASE STUDY FEBRUARY 2019 EXAM ANSWERS

Variant 2

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SECTION 1

Acquisition

It could be argued that Crowncare has pursued a strategy of growth through acquisition, with a total of 30 practices under the parent's control. It could also be argued that the 30 practices are all relatively homogenous in that they are all focussed on private dental treatment, emphasising quality of care. Acquiring Luxedent is broadly consistent with both strategies because the company is an established dental practice within Crowncare's area of interest and it does provide high quality private dental treatment.

Luxedent's business model is not entirely consistent with those of the 30 existing Crowncare practices, which could be a distraction from the implementation of the existing strategy. It would appear that Luxedent offers an even higher standard of preventive care than Crowncare and that its patients present with very few clinical problems. The key source of revenue is from cosmetic dentistry, which is an area of interest to Crowncare, but is not necessarily within the reach of many patients at its existing practices.
It could be that the acquisition of Luxedent will introduce new skills to the Crowncare Group as a whole, improving the overall quality of its preventive dentistry. That would be consistent with Crowncare's basic business model and could maintain its competitive advantage over other dentists in Capital City. Luxedent can remain at the forefront of developments in dentistry and can pass on its experience when Crowncare's other practices start to implement them.
It would appear that Crowncare has already established a presence throughout most of Capital City and so it will prove increasingly difficult to identify potential acquisition targets in the future. Acquiring Luxedent will enable Crowncare to continue to focus on private practice. Other practices may be deemed unsuitable because they rely on VHS treatment. There may be a few other upmarket practices in other parts of Capital City that would create a further niche that falls within the overall scope of Crowncare's strategy.

Responsibility centre

Luxedent's dentists may feel threatened by this arrangement because they differentiate themselves in terms of their clinical excellence. They may resent becoming answerable to a "Clinical Director" who will oversee their practice and may not fully appreciate the approach that they take to caring for patients. Having said that, Simon Kovac will be responsible for 30 other practices in addition to Luxedent and so it is debateable whether he will be in a position to impose much in the way of detailed oversight of any given practice. Luxedent has already demonstrated that it has a successful business model, based on clinical excellence. Simon is a dentist and will understand any concerns raised by Luxedent's Head of Practice and other senior staff. Equally, as qualified professionals, Luxedent's dentists should be confident of their ability to liaise with colleagues elsewhere in the practice. Managing Luxedent as a profit centre may imply a loss of control over investment decisions, but Simon will undoubtedly be sympathetic to investments that will maintain Luxedent's position at the forefront of practice.

It could be demotivating for the other Heads of Practice if Luxedent was established as an investment centre. Many Heads of Practice will have worked for their respective practices while they were autonomous and so they will have gone through the same transition to profit centres. There is a risk that maintaining Luxedent's autonomy will cause resentment and that could undermine attempts to encourage other practices to emulate Luxedent's lead on clinical matters.

Arguably, it is important to impose some control over any newly acquired subsidiary, if only to establish the authority of the senior management team. Luxedent's founders will be stepping down after the sale and the staff will be looking for leadership. That could come from the parent company or internally from senior members of the dental practice. If Crowncare does not take charge, at least by setting some parameters for investment and other decisions, then it may prove difficult to exercise control in the future.

Section 2

Ratios

Comparing gross profit % confirms the belief that Luxedent sells a larger proportion of high-value treatments to its patients. The practice is located in a prosperous area and patients are willing and able to spend more on cosmetic treatments. It may be difficult for the rest of Crowncare to emulate that approach because the practices are located in less prosperous areas and so patients may be unable to spend as heavily on their appearance.

The property, plant and equipment turnover ratio implies that Luxedent's business model relies more heavily on investment in plant and equipment in order to generate revenue. That may be because Luxedent has to have more advanced equipment or it may be that some of its high-value services rely on additional equipment that Crowncare does not have. A heavier investment in plant and equipment is not necessarily a bad thing, although Crowncare's assets appear to be operating more efficiently in yielding revenue.

The greater efficiency in asset utilisation also appears to be reflected in a higher return on capital employed by Crowncare. The fact that Crowncare's capital employed is inflated by goodwill on consolidation suggests that the company is even more efficient in generating a return from the funds invested than Luxedent. It would clearly be undesirable to reduce group profits, so that is one aspect of the Luxedent business model that should not be emulated. Overall, the Luxedent business model appears to be well adapted to the company's environment. It sells premium dental services to wealthy clients, who expect to see attractive premises and the latest equipment. That yields high revenues, but leads to a depressed return on investment Crowncare's model is less suited to attracting and retaining this particular niche market, which is probably a good thing. It would appear that the two business models should continue because each meets the needs of its respective market.

Consultancy fees

The most immediate consideration is the cost of the consultancy. Crowncare must establish how much the two founders will charge for their time. This payment will be spread over six months, although that is a relatively short term and so discounting these outflows can probably be ignored.

The future cash flows that the investment will generate will be far more difficult to establish. Crowncare's Board must consider whether it is capable of appointing a suitable Head of Practice and whether that person will require the advice of the founders. It may be that Luxedent's existing staff include experienced professionals who know as much about the management of the company as its founders.

There could be further advantages to having the founders continue for an initial period. It could reassure staff that things will not change suddenly and dramatically because Crowncare is interested in what the founders have to say about the running of the company. The financial implications of that may be difficult to quantify, but it would reduce the potential costs of recruiting suitable replacements, with the associated disruption of treatment plans.

Similarly, patients may be reassured that the founders are being asked to assist with the transition. Retaining patients who might otherwise leave for different practices will protect future revenues. Continuing patients could generate cash flows for years to come.

Overall, Crowncare should estimate the future cash flows from Luxedent over the next few years, both with and without the consultancy from the founders. The horizon should probably be restricted to 3-5 years at most because it is unlikely that the benefits from the consultancy will continue indefinitely.
If there is a net future inflow then it will have to be discounted at a suitable cost of capital. Luxedent's cost of equity is probably the most appropriate rate because that will take the business risks of running Luxedent into account.

Section 3

Motivation

Luxedent’s dentists may be concerned because their practice is relatively small compared to the rest of the Crowncare Group. They could easily spend a significant proportion of their time at other practices in coming months. It would help if the schedule for these secondments could be announced well in advance and shared so that no dentist spends too long away from Luxedent.

The dentists from Luxedent could be concerned that their patients will be unhappy that they will be away from the practice for an extended period. That could interfere with long-term treatment plans and affect patient goodwill. It might be encouraging to restrict the secondment to a few days each week, so that dentists can implement any continuing treatment plans agreed with patients.

Dentists from Luxedent may be concerned that the incoming dentists from Crowncare will be less competent and could lose patients. The scheme will have to involve training and supervision so that Luxedent’s practice will not suffer as a result.

Crowncare’s dentists may view the secondment as a sign of merit, which could lead to resentment from colleagues who are not selected. Not all dentists will have the opportunity to participate. Crowncare should set out clear criteria for the selection of dentists who will be selected for secondment. If merit or seniority is to play a part then that should be acknowledged so that there are no misunderstandings.

The dentists from Crowncare may be concerned that participating in the secondment will lead to them becoming classed as experts in cosmetic dentistry on their return and could affect their career paths if they become heavily involved in that area. Ideally, Crowncare should seek volunteers who are interested in cosmetic dentistry and who are keen to investigate this further.

Crowncare’s dentists may be concerned that their colleagues at Luxedent will treat them as inferiors. Crowncare’s practices are already involved in cosmetic dentistry and its dentists are skilled professionals. The focus of the secondment should be set out in detail, stressing that its purpose is partly to familiarise Crowncare dentists with equipment and techniques that is not available across the Corwncare Group.

Cost of debt and risk

The loan has an initial fair value of V$15m. Crowncare is prepared to accept that sum in return for its commitment to make the agreed payments for interest and principal and the lender is equally willing to accept that arrangement. The nominal rates of interest stated on the contract are not particularly relevant because of the deferred nature of the payments. The most logical way to measure the gross cost of debt would be to follow the guidance in IFRS 9 *Financial Instruments* on the calculation of effective interest. That would essentially be the rate of interest that would equate the initial V$15m to the subsequent payments of low-rate interest, accrued interests and the lump-sum repayment of the V$15m principal. The interest rate so determined would be used both in accounting for the loan for financial reporting purposes and would reflect the gross cost of the debt.

The cost of debt should be reduced to reflect the tax relief on the interest payments. This will simply offset the rate of corporation tax against the effective gross rate determined. The tax relief will not actually be received until the interest is paid, but that can be reflected for accounting purposes in the provision for deferred tax.

The business and financial risks are effectively linked to the future demand for the laser whitening service. The principal upside risk is that the machines will be fully occupied throughout their useful lives and will generate significant cash inflows. In the first instance, such a scenario would interact with the nature of the loan because the finance has been provided entirely by the bank and there are no outflows for first two years and only reduced payments for the next three. Such an arrangement will enable Crowncare to generate a substantial cash surplus that will, hopefully, be sufficient to repay the loan and accrued interest at the end of year five.

The downside risk is that the anticipated demand for tooth whitening does not materialise, or that technology will change and create cheaper or superior systems for competitors. In that case, the loan will still have to be repaid in accordance with the contract and so Crowncare's future cash flows will be disrupted. If Crowncare cannot raise the full amount in time then it may be forced out of business. If this venture does prove to be loss-making then Crowncare may be unable to make full use of the tax relief on the debt and so the effective rate will increase.

Section 4

Impairment of goodwill and retention of professional staff

Goodwill on acquisition is essentially the difference between the fair value of the purchase consideration and the fair values of the separable net assets acquired. Goodwill would arise in the acquisition of a dental practice because it had a body of patients who were expected to continue with the practice, yielding revenue in the process. The departure of Luxedent's dentists could lead to the loss of patients, which could reduce the value of goodwill and so create the possibility that an impairment adjustment will have to be made.

The question of whether an adjustment is needed really depends on the impact that the departure of these staff members will have on patient numbers. Crowncare should ensure that these posts are filled as a matter of urgency. The easiest way to establish whether there would be an impact on goodwill would be to contact the departing dentist's patients directly in order to introduce the replacement. Patient responses to such a call should give an impression of whether they are likely to leave the practice. Dental practices will gain and lose patients as a matter of routine. There would only be a need for an impairment adjustment if the loss of patients who were with Luxedent at the time of acquisition is sufficient to reduce the value of goodwill below the price paid.

Someone senior, such as the Clinical Director, should conduct an exit interview with the dentist and dental nurse who are leaving. Ideally, the interview should focus on their reasons for leaving Luxedent, although they may not be totally candid about that. If they respond then they may reveal an underlying problem that needs to be rectified in order to retain the remaining dentists. It would be worth asking what, if anything, Luxedent could do to persuade them to remain with the company. Any positive response to that question could give a more realistic insight into their reasons for departure. The interviewer should attempt to establish where the dentist and her nurse are going to. The fact that they are leaving together raises the possibility that they have been recruited by a competitor or that they plan to establish their own practice.

The concerns about the pressure to sell cosmetic treatments should be investigated and discussed with Luxedent's dentists. This practice is still a new member of the group and so Crowncare's Board will not necessarily understand all of the issues associated with its management. A frank discussion will demonstrate that the Board takes the dentists' concerns seriously, even if they do not feel pressured in that way. That discussion could prompt the staff to raise the issues that actually matter to them if, indeed, there is a problem. An open meeting of practice staff would create an environment in which such a discussion could be had without making anybody feel pressured

Target costing

The whole point of target costing is to create a product that can be sold at a price that customers will pay. It is reasonable to assume that there is a potential demand for cosmetic dentistry because consumers are prepared to spend money on improving their appearance though fashion, grooming and so on

Crowncare's dentists are also in a position to gauge demand by offering patients suitable treatments. They may have significant anecdotal evidence that prices are too high.

The suitability of cosmetic dentistry for target costing is complicated by the fact that designing out costs must allow for the clinical issues raised. Cheaper materials, say, could lead to weaker teeth or increased risk of infection. Most surgical techniques will be automatically be designed to eliminate any potentially unnecessary steps in order to limit the risk of harming the patient, as well as enhancing efficiency. There are, therefore, unlikely to be many redundant processes that might be designed out of treatments for the sake of reducing selling prices.

The application of target costing should start by establishing which procedures patients wish to have, along with an idea of their acceptable price point. Crowncare can then identify the treatments that are worth considering in more detail. Ideally, there will be some potentially popular treatments that are not so expensive that they could not be made commercially viable.

The treatments that have been identified as potentially viable should then be studied with a view to establishing whether there are any efficiencies that might be introduced. For example, it may be possible to create a "clinic" system whereby an expensive piece of equipment is acquired to treat patients from several practices. Keeping the machine busy will reduce time and cost for setting up and could make it affordable for patients, even if the location is slightly less convenient.

Crowncare could also consider different strategies, such as working with dental insurers to create a policy that is more expensive, but that gives a discount on a limited range of cosmetic treatments. Patients will not necessarily save any money, but they may be willing to pay slightly more in month insurance premiums and take advantage of cosmetic treatments as they can afford them.