CGMA MANAGEMENT CASE STUDY FEBRUARY 2019 EXAM ANSWERS

Variant 5

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Section 1

Leadership challenges

The most immediate challenge is that the Board must address the loss of patients and revenue for those six practices. If the Board does not act decisively then the practices will start to lose staff and that will accelerate the loss of patients, making it inevitable that the practices will close. Crowncare's other practices may then start to feel threatened if their local economies are at risk of deteriorating and that could lead to a loss of staff from across the Group. Decisive leadership must also be provided in order to address the possibility of rumours that could undermine morale across the Group For example, the six affected practices could have senior members of staff and that could start rumours that any redundancies will not necessarily be restricted to the six practices themselves The Board must make its intentions as clear as possible and as quickly as possible, otherwise key staff might start to look elsewhere in order to protect their positions.

The prospect of changing direction and implementing a new strategy with regard to accepting VHS patients will be a test of the Board's integrity. Crowncare appears to pride itself on being a profitable private practice that competes on quality of dental care. The reversal of previous policies on publicly-funded dental care could be interpreted as a sign that the Board had made a mistake in the past and that it is becoming indecisive

There is also a challenge with respect to the Board's authority in the form of the response from the Heads of Practice. There is an implication that the Board does not understand the respective fee structures and the company's ability to maintain profits when switching to VHS. The Heads of Practice must accept that they do not have the right to question the Board or to reject the Board's decisions, even if those decisions are unwelcome.

Target costing

Target costing is about aiming for an acceptable price point and then managing costs so that the price point can be achieved. The first difficulty faced here is that the VHS has set very restrictive selling prices that are significantly lower than those charged to Crowncare's private patients. It may prove difficult for Crowncare to reduce its costs to the extent that is necessary in order to make a profit. For example, the practices may be located in expensive properties and a move to a cheaper site would be disruptive and would involve short-term outlays. Similarly, changing procedures may not necessarily save much money, if any. For example, restricting the number of dental x-rays may reduce the bill charged for a VHS patient, but the equipment will still be on site and will still be depreciating.

Target costing is also complicated by the fact that Crowncare has very little discretion when it comes to treating patients. In most businesses, if a customer is unprofitable then the problem can be resolved by refusing to do any further business with that customer. If a VHS patient who is registered with Crowncare requires extensive treatment then it would be unethical and also possibly against VHS guidelines to refuse care.

Dentists may struggle to deal with the constraints imposed by the VHS pricing structures. They have become used to using high quality treatments, such as white polymer fillings on patients' front teeth. They may find it difficult to adapt to using less expensive materials on patients who cannot afford to pay for the difference. Dentists may be forced to accept that they have to extract teeth that could have been restored using the treatments that were used on private patients.

The final constraint is that dentists are members of the medical profession and they are bound by professional ethics. Taking shortcuts to save money will endanger patients and could leave dentists exposed to the threat of disciplinary action. There are established norms for treatments such as filling teeth and every step of those norms will have to be taken.

Section 2

Competitor analysis

We might start by looking at the services listed on dentists' websites and possibly in their reception areas. It will be helpful to have an understanding of the range of services that are offered and we may consider differentiating ourselves by emphasising strength in an area of treatment that is not generally available. For example, Crowncare might be able to attract both interest and patients by advertising tooth whitening at the launch of the new practice if competitors do not generally provide that service.

Studying the potential competition will enable us to identify the practice that presents the greatest threat to Crowncare. We can focus on factors such as identifying specialisation in private treatment and an upmarket appeal That might be the most appropriate target four our acquisition in that area, partly to eliminate a competitor and partly because that will be the company that is most in tune with our approach to business.

Dental practices list the dentists whom they employ and Crowncare should analyse those lists to establish the relative sizes of the practices and also the qualifications held by their dentists. If Crowncare's staff are better qualified then that might be a further basis for differentiation. If the reverse is the case then Crowncare might recruit better-qualified staff to be ready to move to the new practice to help it become established. The key point would be counter any advantage that competing practices might be able to use again the new Crowncare practice.

Knowing the number of dentists at each competitor will enable Crowncare to estimate the capacity that exists to accept new patients in that area. The call centre will lead to an influx of new residents and Crowncare must establish the proportion of those potential patients that will have to be attracted in order to generate an acceptable profit. An external inspection of premises may also give an indication of the number of potential competitors who could expand to meet the influx by adding surgeries. Relocating a dental practice is a complex matter

Financial statements / IRR

Some figures will be fairly objective and will fit our needs directly, while others will be far more subjective. For example, we can compare the scale of the two companies in terms of their respective revenues, but not necessarily through their property, plant and equipment because of the subjective decisions linked to depreciation and fair values.

The profitability of the companies will be of some interest because it would be ideal if we could identify a company that is not making the best of its potential. For example, one that had excessive costs that Crowncare might be able to reduce. The financial statements will be unlikely to give sufficient detail to identify specific costs that might be open to reduction and management. The figures will not reveal the non-financial matters that will affect the negotiations, such as the present owners' willingness to sell. Both sides will use arguments based on the financial statements to drive the price in the direction that suits them.

The biggest problem here is that we are comparing two mutually exclusive investments that differ in terms of scale. Manner Lane is the larger business and so Crowncare will have to pay more for it. A return of 19% on a larger investment may be preferable to a 23% return on a smaller investment. Both practices look like sound investments, but the wealth of Crowncare's shareholders may be increased by more if the investment is made in Manner Lane.

There is likely to be a reason for the difference in IRR that means the comparison is potentially misleading. Logically, the only reason for the Grade Street owners to offer a higher rate would be because they are keener to sell. The purchase price could be lower because the company is more risky. That would not render IRR worthless, but it would complicate the comparison of the two ratios.

Section 3

Benchmarking

This is an area where benchmarking could be used, with a focus on metrics. The objective is to use performance measures to identify cases where transactions are suspiciously advantageous to Crowncare. Practices that have reported more revenue than seem realistic will be more likely to have overstated billings. The fact that the revenues have been recorded in Crowncare's records would mean that the fraud was motivated by a desire to show revenue and profit being earned and not personal fraud.

The most obvious metric would be to compare the billings from the six practices that accept VHS patients, including Dexter Avenue. Statistics relating to, say the percentage of patients receiving fillings can be compared. The figures relating to Dexter Avenue will be particularly interesting, because they reflect a pattern of excessive billing. Any other practices that have similar patterns may be overstating their charges The statistics selected for comparison should be those where there is the greatest risk, such as treatment plans that involve multiple fillings.

A similar exercise should be carried out across the Group, but private treatments should be kept separate because the norms are different from VHS. The focus should be on insured patients because uninsured patients will know what they are being billed and whether the work was carried out. This analysis should consider the Dexter Avenue practice from before the transition to VHS patients in case the dishonest dentist has been over claiming for some time.

To save time, it might be possible to identify practices where the risk of overbilling is the highest, such as the practices that have the highest average revenue per patient. Those that have high billings could then be analysed in more detail, again with a focus on the areas of greatest risk such as the incidence of extensive treatment plans. None of these results would constitute proof of dishonesty, but they would establish whether there are suspicious circumstances that require investigation.

Communication/Financial reporting

The communication issue appears to be that the fraudulent dentist has understood there to be a concern about the Dexter Avenue practice billings. He appears to have become concerned that Crowncare's Board will be dissatisfied with the practice's performance and that could have negative implications for promotions or even job security. Those concerns were strong enough for the dentist to have committed a criminal act and so the Board should have taken greater care to communicate its plans to the six practices and to reassure the staff there that it was not expected that their profits would remain at their usual levels.

There should also have been a greater emphasis on the communication of the Board's expectations concerning honest business and the need to behave with integrity. The fact that Dexter Avenue benefitted from the billings means that the dentist was not stealing for personal gain. He must have had some reason to believe that the Board would tolerate and even encourage such behaviour. The Board should issue a code of conduct or a set of corporate values as a matter of some urgency and should underpin its commitment by dismissing the fraudulent dentist.

The billings themselves should be estimated and discussed with the VHS. These calculations will be relatively easy to negotiate because it appears that only one dentist in the practice was guilty and that the nature of the fraudulent transactions makes them stand out.

The amount that will have to be repaid to the VHS should be treated as a provision in Crowncare's financial statements. The invoiced amounts can remain in revenue, but the repayment will be shown as both an expense and a liability.

There is no real need to disclose the events separately in the financial statements. There is no specific need to disclose staff fraud. The matter itself is unlikely to be material.

Section 4

Business risks

The disposal will leave Crowncare without a presence in that part of Capital City. That means that the Group will not benefit from the upside that will arise when the area returns to prosperity. It will be expensive to replace the subsidiary with another in that area and doing so will make the Group appear indecisive. The sale may attract further adverse publicity for the Group.

The disposal may be misinterpreted as an admission by the Board that it cannot control the staff at practice level. That would explain the disposal of the subsidiary even though the fraudulent accountant has left. Such a perception could undermine the Group's relationship with other stakeholders, including the VHS and the insurance company that funds its private treatments. Crowncare could unwittingly encourage intrusive audits and investigations that might delay the processing of future billings.

The staff at the subsidiary will probably keep their jobs if the subsidiary is sold as a going concern, but they are still being removed from the Crowncare Group. That could be seen as imposing blame and penalising them for the dishonesty of a fraudulent colleague. The Group's remaining staff may be concerned that they will suffer for any misbehaviour by their colleagues, which will undoubtedly pose a risk to morale and may even lead to staff loss.

This will set a very dangerous precedent for Crowncare because there can never be a guarantee that the fraud was an isolated incident. If there is a similar problem at another subsidiary then Crowncare may have to incur further loss of capacity by disposing of it. Failure to do so may risk making the disposal of the first subsidiary appear disproportionate and may also be understood to imply that there may be further cases.

Disposal

This will constitute a loss of control and so the consolidated statement of profit or loss will include only the revenues and expenses for the subsidiary from the part of the year in which control was retained. That may be done by time apportionment based on the number of months before and after the disposal. The impact on profit will depend on whether the subsidiary was profitable or loss making, but it will undoubtedly lead to a decrease in group revenues.

The disposal will require a gain or loss to be recognised, which requires a comparison of the consideration for the disposal with the subsidiaries net assets and goodwill. The subsidiary was acquired as a going concern and so there is likely to be some goodwill on consolidation. The fact that this subsidiary is effectively being sold under some duress means that the consideration may be depressed and so it is likely that there will be a loss on disposal.

Any gain or loss will appear in the consolidated statement of profit or loss. Given our expectation of a loss, this will depress profit for the year. The loss will be shown separately and readers may decide to disregard it in interpreting financial performance, but there may be readers who choose to focus on the bottom line only.

Group net assets will decline because the subsidiary will be eliminated. The Crowncare Group as a whole has no significant borrowing, but if it decides to raise any finance in the future then it will appear to be more highly geared because of this disposal. Equity will also decline because of the loss, creating the impression of a loss of shareholder wealth.