A tale of two practices: The cost of bad strategic management

By Graham Middleton, BA, MBA, AFAIM

"Many dentists conduct their practices in the dark without adequate understanding of whether they are above, below or at average practice performance standards..."

Lee and Harold graduated from dental school together. Both were rated as likely to succeed and early in their practice careers, both learnt the lesson that their clinical and chairside relationships with patients were critical to their long-term success.

Lee's early clinical career

After working for several practices offering various combinations of part-time work, Lee was eventually employed by Isabel, an efficient, hard-working dentist. Isabel ran a tight practice and had built up a second dentist caseload of patients. Her long-standing assistant dentist had moved interstate to support their spouse's corporate career. Lee inherited a well-booked surgery and was at the stage of his career where he felt comfortable offering good treatment options. Patients were pleased with the practice and prepared to support sound fee scales. Isabel, who ran an above average surgery herself, encouraged him to extend both through short in-service courses and by searching for ways to improve his dental output.

Lee could see that for the first time in his clinical career, there was a real opportunity in front of him. Isabel was still producing profitable, high quality dentistry and the practice structure was simple. Four support staff rotated through the chairside and reception positions, with one alternating between helping with infection control and relieving at the reception desk. Isabel had left the structure very flat and although one of the support staff was a natural leader, all tasks were shared. All significant practice management decisions were made by Isabel. There was no practice manager and roles in the practice ran on functional lines. Her purchasing and stock control was also simple. A part-time bookkeeper came in to do wages and prepare BASs. That left Isabel with maximum clinical time. Isabel had her interim accounts done to 31 March each year to measure that she was on track with respect to tax, cash flow and pre-30 June decision taking. Lee wasn't privy to all of the detail but could readily see that compared to several other practices in which he had worked, Isabel's was a model of simplicity and efficiency. Her business and financial advisers/accountants liked to keep things simple.

Harold's early clinical career

Harold, like many graduates, initially worked part-time in a couple of practices. After several years and various employment experiences, he gained employment in a large multi-partner practice owned by Jim, Tanya, Sally and Horst. In addition to the four owners, the practice employed several other dentists on various combinations of time, plus Harold. There were four hygienists who together made up two full-time equivalent positions.

The complex practice structure

The practice was spread over three locations. In location one, the premises were owned by Jim and Tanya, who were the senior partners in terms of ownership. Jim and Tanya had originally bought the practice from a previous owner and they had bought the premises, which they owned in a unit trust structure. In due course, they bought another practice at the second location and invited Sally to become a partner. Jim, Tanya and Sally each owned the premises at location two via a unit trust. The three in turn had purchased a practice at a third location and invited Horst to become a partner. In due course, the premises at location three had been purchased by Horst and Sally in a separate unit trust.

Jim and Tanya's accountants, who had proudly proclaimed themselves to be advisers in general business activity, had no experience of dental practices. They'd advised Jim and Tanya to own the practice via a company rather than structure it as a dental associateship. They'd heard elsewhere that dentists had service trusts, so a service trust was formed without much thought as to whether it was still useful. In actuality, most service trusts had survived from an earlier era with different tax and accounting rules. The service trust distributed its income to two family trusts, but as Jim was gay and had a partner with a good income, that structure didn't benefit him at all. Tanya's husband, a barrister, had a high income and therefore there was no benefit to him either. The amount of money that could be distributed to Tanya's children, who were both relatively young, was insignificant and the tax saving went nowhere near covering the cost of the additional structure. Each month there was a mark-up of costs and an invoice between company and trust, yet the profit created simply went round in a circle back to Jim and Tanya. In actual fact all it did was add to their costs.

When Sally joined, she was advised that this was the structure which was in place. She became a shareholder in the practice company and formed a family trust which owned units in the service trust. She also became part owner of the premises at location two.

When Horst joined he was faced with the dictum that this was the structure, so if he wanted to benefit through ownership, he'd have to purchase a share in the practice company and form a family trust which in turn will own units in the service trust. Horst's accountant voiced concern at a number of pitfalls in the structure, but was herself insufficiently versed in dental practice issues, nor did she understand where true dental benchmarks and efficiency lay. Jim and Tanya's accountants had triumphed again. They kept extolling the benefits of business growth and encouraged the practice's employment of additional dentists and hygienists. They sounded convincing, but in reality Jim and Tanya's profitability had struggled to match CPI growth, with overhead costs absorbing any profit from employed dentists and hygienists. The overhead costs included payroll tax.

Boadicea the practice manager

A practice manager's position had grown up inside the practice. The manager, Boadicea, known to staff behind her back as 'the Warrior Queen', or Bo for short, created a centralised administrative empire for herself. Woe betide any employee who crossed her. Even employed dentists learned to tread warily. Bo was on friendly terms with the practice accountants, who were delighted to have her as a central point of contract. A bookkeeper from the accounting practice spent many hours in the practice doing the basic bookkeeping and BASs. The four partners had largely lost sight of what was occurring. They were simply told periodically what the profit was and how much money they could draw from the practice.

Boadicea's nest

The partners, particularly the founding partners, came to believe that the practice couldn't be run without Bo. Bo for her part intended to maintain that view. In reality, she had constructed a very comfortable and expensive (to the partners) nest for herself. Not wanting to get tied up in the minutiae of bookkeeping, she had opened the gateway for the accounting practice to do the practice's bookkeeping as well as its accounts. That suited Joe Jolly, the accounting partner who looked after their returns. The Big Practice, with its array of companies, service trusts, unit trusts and supporting trusts, was his number one client group by fees. Bo and Joe found that they had parallel interests.

Bo had no taste for the work of chairside assistant or infection control and liked to spend as little time as possible at reception desks. By employing several additional staff she was able to fill temporary absences, shuffle staff between practices and have dedicated infection control nurses. In reality, the additional staff costs added 9-10% of gross fees above the average. The additional cost included her own ballooning salary package, as she'd convinced the partners that her position was akin to that of a general manager in a sizeable business. In reality, she carried much less responsibility than this comparison suggested. In most businesses, general managers have a good knowledge of the work done at the coal face, whereas in dental practices, the coal face is represented by the dentists' treatment of patients. Effectively, Bo's salary and support staff padding swallowed any profit margin gained from having employed dentists or hygienists and often intruded into the partners' margins on their own surgeries. Joe and Bo didn't realise the full extent of the feather bedding and it didn't suit either to search for the truth. Bo's nest was very comfortable. Whenever Joe spoke to either of the partners he extolled their wisdom in building up such a large group practice; yet in reality Jim, Tanya, Sally and Horst were each earning less than good solo dentist practice owners and indeed less than a significant number of employed dentists. Joe kept talking about what the practice would be worth in the future.

Lee becomes a practice owner

After employing Lee for a couple of years, Isabel had reached a situation of being financially comfortable. She was still producing good quality dentistry and her surgery remained nicely profitable, but she realised that she was at a point where she wished to take slightly longer holidays and to work an eight-day fortnight. She was astute enough to realise that the minute she began to reduce her clinical hours, this would signal that she was a bit past the zenith of her dental career. She thought it through and decided that it might be best to sell to Lee while her practice was at its peak. She would be prepared to work for Lee in a reverse arrangement, but gradually reducing her clinical time.

Lee, for his part, wanted to own the practice. It was the first practice in which he had worked which had a consistently full book in his surgery, usually several weeks in advance, and in which he had extended his clinical skills. He also realised that Isabel had run the practice much more efficiently than other practices in which he had worked. He could see the benefit of copying her simple model. Lee's adviser benchmarked and valued the practice and demonstrated that while Isabel was asking a good price, the acquisition would be earnings accretive to Lee. An important issue for Lee was the continuation of Isabel as an employee. They agreed on price and Isabel agreed to work for Lee for a minimum of three years working four days per week in the first year, then having the right to step back to three days per week for the next two years. Extension beyond the three years would be by mutual agreement. Lee paid $700,000 based on capitalisations of Earnings Before Depreciation, Interest and Taxes (DEBDIT) after allowing for the opportunity cost dental salaries on normal formula. Lee also purchased the premises which had three operatories and he used the spare capacity created by Isabel reducing her clinical time to introduce another employed dentist, initially for one day per week but gradually growing as growth in fees and Isabel's reduced clinical time permitted. Lee expected that in time he would grow that dentist into a full-time replacement for Isabel.

Harold buys into Big Practice

Meanwhile Harold had been working in Big Practice on the conventional formula. His clinical skills were sound and he had the knack of establishing good relationships with patients. A good number of them referred family and friends to him. Harold lacked Lee's natural inquisitiveness. He did his dentistry, gave a cursory glance at his monthly gross fee and collection figures and was content to note the monthly bank transfer of his earnings, based on the normal commission formula. As he kept a low profile, he was regarded positively by Bo. By contrast, Derek, another employed dentist and prospective partner, had greatly offended Bo by questioning practice overhead costs at the time that his name had been put forward as a potential partner. The reaction was such that Derek had decided that practice management reform was rendered unlikely by the practice manager. Therefore he resigned and looked for opportunity elsewhere.

When Harold's name was mentioned as a potential partner, Bo was happy to endorse the choice. In reality she had progressed from practice administrator to kingmaker (or breaker). When asked for his opinion, Joe Jolly told the other partners that he thought that Harold was a sound choice.

Joe Jolly advised the price of the practice based on its gross fee turnover. Furthermore, he suggested that because of its size, a high percentage of fees was representative of its true value. This significantly overvalued the practice because its far too costly overheads diminished the partners' profit. Harold accepted at face value Joe's explanation that the benefits of ownership were long-term. It transpired that after paying interest on a loan of $600,000, Harold had less taxable income than he had experienced as a contracted employee!

For her part, Bo was skilled at lobbying among and placating the partners, particularly Jim and Tanya, the original partners, who spent most of the time at location one, where Bo herself was located. Harold worked two days per week at location two, two days at location three and one day at location one. Jim and Tanya worked three and a half days each at location one, with Jim spending a day per week at location two and Tanya spending a day per week at location three. The partners tended to take holidays at different times too. The result was that the five partners were rarely ever present together, except at an annual staff Christmas dinner. This suited Bo, who was able to effortlessly lobby. 'Leave it to Bo' was the partners' inevitable response when a difficult decision as to whether to hire or fire a staff member, or replace a significant item of equipment, arose.

Dental suppliers had long since recognised that all practice ordering crossed Bo's desk. She enjoyed numerous small gifts and theatre tickets.

Meanwhile, Big Practice had long since passed the point of efficiency gained through size. Indeed, it was doubtful that this could have ever existed. By contrast, Lee's practice had expanded its fee base and Lee's personal surgery had evolved into a very efficient unit. Isabel was quite efficient in her reduced four-day working week and a new dentist was being attuned to the practice on a very limited part-time basis. Fees were growing.

In the financial year following the purchase of Isabel's practice by Lee and the purchase by Harold of a partnership in Big Practice, the following were the respective results:

Lee's Practice

Gross fees	$1,600,000
DEBDIT	$960,000
Less salary to Isabel and part-time dentist	($300,000)
Lee's EBDIT	$660,000
Less interest and depreciation	($75,000)
Profit to Lee (pre tax)	***$585,000**

** Lee was able to pay part of this to his wife and maximise his superannuation deductions. He looked forward to further improvements in his practice.*

Big Practice's outcomes for Harold...

Gross fees for five partners, 3.5 full-time equivalent dentists, two full-time equivalent hygienists	$5,300,000
Expenses not including depreciation, interest or dental and hygienist salaries	$3,005,000
DEBDIT (all dentists and hygienists)	$2,295,000
Less salary packages for employee dentists/hygienists	($900,000)
Partners' EBDIT	$1,200,000
Harold's partnership share based on the ratio of his fees ($650,000) to total fees of the partners ($2,950,000)	$264,407
Less interest at 9% on loan of $600,000	$54,000
Harold's net profit before tax	**$210,407**

...versus Harold's outcomes as an employee

When Harold, in the year prior to ownership when his gross fees net of lab costs had also been $650,000, he had been paid salary and superannuation benefits of 40% or $260,000.

In reality Harold had acquired a debt of $600,000 to be worse off by $59,593 before tax.

Harold meets with Lee

Harold had dinner with Lee, with whom he enjoyed a friendship at dental school. Lee told Harold how fortunate he'd been to buy Isabel's practice and how much better off he was financially. He spoke of his plans to improve the practice further. Harold decided to confide in Lee. He described the practice structure and its complications, including the size of the practice and the role of Bo and of Joe Jolly the accountant, who effectively stifled change.

Lee in turn explained how Isabel had run a simple, efficient structure. Isabel had shown Lee how a practice could be run profitably with minimum management difficulty. Isabel had also introduced Lee to her adviser, who had been able to demonstrate in simple terms how he would profit from the purchase. Importantly, this had been proven true by the actual experience. Lee asked Harold whether Joe Jolly, Big Practice's accountant, had experience of other dental practices as he had never heard of him or his practice.

Faced with this information, Harold sounded out Horst, who of the other partners seemed to be the most likely to be concerned. He found that Horst had been concerned for some time but had been unsure as to what to do. They decided to consult Lee's adviser. When they made the appointment, they were given precise instructions as to the information he needed in addition to the practice financials prepared by Joe Jolly. They were then taken through a benchmarking of Big Practice's performance compared with an Australia-wide average of practices and comparison with best practices of various sizes. The issues identified were:

1. Big Practice's percentage of fees expended on non-professional staff was vastly greater than other practices. This in turn created a significant payroll tax bill, whereas many practices were structured in such a way that they paid little if any payroll tax;
2. Purchases and laboratory costs were greater than average, suggesting that they may not have been purchasing effectively;
3. While the rents were set at arm's length at valuation, overall occupancy costs were high, reflecting the additional bodies that Bo had managed to inject into the structure;
4. The partners had lost day to day control over the running of their practice; and
5. The business structure.

The strategic question

The obvious question was why conduct one practice in three separate locations when three separate practices would clearly be more efficient and profitable overall.

Harold and Horst began to see that Bo had mastered the political art of keeping partners of the practice separate, while Joe Jolly's accounting practice, which should have been active in advising them to identify and solve issues, was closer to Bo than to the partners, who in reality paid its fees.

Armed with the facts, Harold and Horst next consulted Sally, as mostly she worked at location two, whereas Bo was located at location one. Sally's partner Fred had a good income and her needs from dentistry were modest, but Fred had at times queried whether she had sufficient understanding of the practice financials. It seemed to Fred that Big Practice produced little profit. Joe Jolly produced what appeared to be a mountainous set of accounts but gave little or no useful information. Sally sensed that Jim, Tanya, Bo and Joe Jolly were closely entwined and she had decided not to raise contentious issues. However now faced with the concerns of the two newest partners and solid evidence of a significant problem, she agreed that action had to be taken.

Jim was overseas so the three of them arranged a meeting with Tanya at location three at the end of her session on the day she worked there. Tanya attempted to defend the status quo but underneath she too had been wondering about the low profitability and had found Joe Jolly's constant assurances about the long-term tiresome. However, Tanya had a close relationship with Bo, who had always been careful to administer the personal needs of Jim and herself, sensing that as founding partners, they carried some extra weight. Indeed location one was occasionally and irreverently referred to by staff at locations two and three as the Palace of Versailles, and by other less reverent names.

Horst, Harold and Sally indicated to Tanya that they were not going to be put off. Their concerns had to be faced. Jointly they drafted an email to Jim advising him that they had major concerns over the management costs and level of profitability of Big Practice.

Sally asked how Harold and Horst intended to proceed beyond this point. Their adviser suggested that since Bo had been drawing a fat management salary she should be confronted with the report and asked to respond as to:

1. How the support staff wages could be brought down to average practice percentage costs;
2. How the purchasing costs could be arranged to achieve average practice percentage costs; and
3. How the practice bookkeeping could be brought down to a reasonable figure.

A letter signed by Harold, Horst, Sally and Tanya was handed to Bo, whose initial reaction to Tanya was: *"Of course some costs are higher. Big Practice is different."*

Tanya's response was: *"Bo, it's out of my hands; the other partners want action."*

Bo's next action was to consult Joe Jolly along the lines of: *"Surely these other practice benchmarks can't be correct! Can they?"*

Unfortunately Joe was unable to give her the assurance she sought. He realised that he too was having his advice to the Big Practice partners questioned and he sensed that they were being advised by somebody with a great deal more knowledge of dental practices than he. He rang Tanya, who told him that:

"The other partners were questioning key elements of the practice costs, structure and business plan."

He rang Sally, who referred him to Horst and Harold. He then rang Horst and was told that:

"We'll talk to you about our plans when we're ready."

Joe realised that he was about to lose his biggest client group and he would have to explain to the other partners in his accounting practice why this had happened.

Bo grapples with the problem

Bo had a shrewd idea that she could lower purchasing costs and she was able to reduce temporary staffing costs and to juggle some rosters so as not to replace a chairside assistant who had resigned, but the unpalatable truth was that her own over-the-top salary package stood out as being the next logical area to cut. She faced the inevitable and proceeded on long service leave, having tendered her resignation effective from the conclusion of her leave. Jim and Tanya promised to be referees for her future job applications.

Separation of the practices

Meanwhile Horst and Harold proposed a separation of the practices. A valuation report was obtained, followed by further advice on separating location two and location three from location one.

Jim and Tanya took ownership of the practice at location one but changed accountants and thereafter ran a leaner practice model with one employed dentist and one hygienist.

Harold and Sally concentrated their patients at location two and practiced in associateship, with one employed dentist and one hygienist.

Horst took full ownership of location three less some patients who had shifted to other practices with partners and he employed one other dentist.

It transpired that all three practices were a lot more efficient as separate entities to that which had occurred in the aggregated model. Jim, Tanya, Sally, Horst and Harold were all more profitable in the separated practices than they had been in Big Practice.

Meanwhile Lee's practice had continued as a model of consistency and steady profitability.

Lessons learnt

1. Many dentists, particularly those who are struggling, have utterly failed to identify the vital issue affecting them or their practice.
2. Many dentists conduct their practices in the dark without adequate understanding of whether they are above, below or at average practice performance standards.
3. Small, tightly controlled practices are efficient.
4. Most efficient dentists make all of the important hire, fire, re-equip and fee setting decisions themselves. In reality, they are the practice managers, albeit that some give a courtesy title to a senior receptionist or bookkeeper.
5. Many accountants may not have many other dental clients and therefore lack a basis on which to give accurate advice as to suitability of a particular practice or dental associateship for purchase and have an inability to monitor whether costs and profitability are sound. In reality, many dentists get poor advice at this critical juncture of their careers and subsequently.
6. Despite what the management textbooks on the shelves of universities offering MBA courses say, the universal truth is that successful small businesses are run by control freaks. Dental practices are small businesses.
7. Two dental associates have one relationship, three dentists have three relationships, four dentists have six relationships, five dentists have ten relationships, etc. A way to overcome the risk of disharmony between associates in a large complex practice is to introduce another tier of management, which requires all associates to subordinate themselves to centralised direction. This is expensive and inefficient.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 23 years, the last 16 as a partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. This includes advice on the content of associate agreements and assistance in dispute resolution. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed Dealer owned by its directors who work within the Synstrat Group. Tel: (03) 9843-7777 Fax: (03) 9843-7799 Internet: www.synstrat.com.au Email: dental@synstrat.com.au