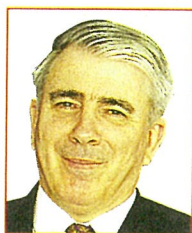


Recovery from near financial disaster: The consequence of being a dental island

By Graham Middleton, BA, MBA



"Ask yourself whether a dentist that you employ is a practice destroyer... Measure their rate of follow up appointments and personally generated referrals..."

Jon hadn't thought deeply about practice ownership. He was a competent dentist who worked in a sound practice and produced good fees. At dental school, he'd been a solid performer but had not been caught up in the hype about rushing to buy a practice. A dentist looking to choose a good graduate had been tipped off by a friend on the academic staff that Jon was one of the better performing students. His friend arranged for Jon to meet with him and Jon found himself with a job immediately after graduation, working initially for a sessional wage then graduating to commission-based remuneration.

He was not particularly financially greedy and he earned enough to pay down his HECS debt and purchase a better vehicle. In due course, Jon met and married Racheal, a primary school teacher. They purchased a home with a substantial mortgage. Although they could have afforded to accelerate the home loan repayments, they didn't and tended to spend most of what they earned. Life appeared to be comfortable.

Seven years on from graduation

The practice was steady but its owner, Hendrick, who was significantly older than Jon, gradually eased down and over several years, reduced to working two full days and two half days of clinical work per week and taking several holiday breaks per year. Patients naturally drifted to Jon's surgery and Jon was working four very full days and two half days including Saturday mornings. Patients bonded to Jon over seven years and he was now a significantly better dentist than immediately following graduation.

Hendrick also owned the premises which were in need of a face lift and most of the equipment in the practice was well used. The practice didn't set records. However, Jon's gross fees were \$750,000 per annum but Hendricks had drifted down to \$425,000 per annum. Hendrick kept an eagle eye on costs including support staff. He was diligent in his purchasing and quick to pounce on a supplier who attempted to charge more than a competitor. He trained the receptionist to manage the patient book effectively.

While staff regarded Hendrick as stingy, they knew that it was a waste of time complaining. The practice needed recarpeting, repainting and to have furnishings updated. Some equipment was approaching its use-by date. None of this had particularly interested Jon who turned up and treated patients but ignored practice administration.

Hendrick decides to retire

Hendrick had managed his finances very well over the years, enjoyed ownership of a nice family home while he and his wife had optimised their superannuation payments and had several million dollars in their fund. He owned the practice and the premises outright. He'd reached a point where dentistry no longer held much interest for him and he contemplated his exit. He considered his sale of practice options carefully and quickly realised that no corporate would buy the practice unless Jon signed a binding contract because about 64 percent of the fees were generated by Jon. The practice records showed that Jon's fees had steadily increased while Hendricks were declining. While Jon was not much interested in practice administration, he was unlikely to sign a binding contract with a corporate owner, or for that matter, a new owner.

Dentists other than corporates were unlikely to buy a practice where it was apparent that almost two thirds of the fees were generated by an employed dentist who was not contractually bound, since they would inevitably fear that Jon would set up a practice nearby, advertise his services locally and take away a huge proportion of the practice.

Hendrick considered the matter carefully and offered to sell the practice and the premises to Jon but at premium prices considering that the premises were in need of renovation and much of the equipment, which Hendrick had depreciated to zero, was in need of imminent replacement. Hendrick offered to sell the practice for \$900,000 and the premises, which he had had valued for \$800,000, were offered at \$950,000 but told Jon that the two together were worth the premium.

The Accountant

Jon, distancing himself from most financial matters, hadn't thought about the issue. Jon and Racheal had their simple tax matters done by a local small accounting practice which mainly did individual returns. Their accountant would have liked to have had a significant portfolio of business and professional practice owning clients but had had little success in building his practice beyond the individual tax returns and a few micro businesses. He would have dearly liked to have had a professional practice clientele but they all seemed to have bypassed him. He was ignorant of dental practice outcomes or the strategies which dentists like Hendrick had used to create significant personal wealth. However, he wanted Jon to buy the practice so he could acquire, he hoped, a premium practice owning client. The accountant only looked at the numbers superficially. It was apparent to him that Hendrick had done very well, but the accountant did not take into account the capital run down and the aged fitout and near worn-out equipment. He had no basis for allowing for the proper acquisition value of the practice nor did he think about the capital that Jon would need to spend after he bought it. After a superficial analysis, he told Jon that he should buy the practice and premises.

The Bank Loans Officer

Fortunately, Jon and Racheal's home had appreciated significantly in value over the last four years, so although their 30-year mortgage had only been slightly reduced, their equity had increased substantially. The loans officer at one of the finance houses financing dentists like to lend to practice buyers who have an extensive client list within their practice as, in the bank's view, it created a low purchasing risk. The loans officer also hinted that they would like to provide additional leasing/chattel mortgage finance if Jon needed to buy new equipment. The loans officer's salary review was heavily influenced by the amount of money loaned against his name. The loans were secured by Jon and Racheal's equity in their home as well as practice premises and goodwill but their loans were badly structured leading to cash flow issues.

The buy/sell Agreement

The buy/sell agreement only specified a handover of a couple of weeks, as Hendrick argued that as Jon had been in the practice for seven years and knew most of the patients, a handover wasn't really required. In actual fact, Jon's lack of interest in practice administrative matters exposed him to a great deal more risk than he realised. He failed to take the opportunity to insist on a longer handover period and to learn from Hendrick's knowledge of practice administration.

Drudge the Practice Destroyer

Jon hired a new dentist to fit into Hendrick's surgery without taking sufficient care and unwittingly picked up a classic "practice destroyer", Drudge. Drudge was slower, used up more chairside assistant time per patient and made little effort to establish rapport with patients. Patients stopped making follow up appointments. Whereas Hendrick's personal referrals had been strong and had been used to assist Jon in building up his patient list, new client referrals to Drudge ceased. Where a new patient referred by a patient of Jon's was booked into Drudge's surgery because Jon was booked, that patient didn't come back to a follow up appointment.

The Practice Manager

Jon had naively assumed that the practice would run itself. The staff who had whinged about Hendrick's tight control over rostered hours, salaries and consumables purchasing relaxed. The receptionist who was a critical person had her job title changed to practice manager and negotiated a nice pay rise from Jon. However, there was no noticeable change in her workload or tasks she performed. Rostered hours of chairside associates were extended bit by bit to meet their requirements and to make the practice manager's job easier.

With practice destroyer Drudge in the second surgery and staff taking advantage of Jon's lax controls, the efficiency ratio of the practice took a steep dive. The practice manager took the fast and easy ways to ordering consumables and whereas Hendrick had played suppliers off against each other's prices and kept tight control

of stock on hand, the manager ordered almost solely off one company even though it meant paying extra. To make her job easier, she over-ordered so that there would rarely be a need to urgently ring up a supplier of a particular item and hence there was a build-up in the practice. Even though suppliers' bills were rising, Jon took little notice as his own book remained orderly.

The practice fitout salesperson

However, a computer summary of monthly fees drew Jon's attention to the fact that there had been a significant decline in overall fees. The practice manager, who wanted some improvements in her own work area, suggested that the practice needed a lift. While this was true, the practice fitout specialist who the manager rang, proposed a far more lavish refit than was actually needed. Nor had Jon realised or been told that a major part of his problem was that Drudge was a practice destroyer. The practice could have got by with new carpet, repainting and replacement of waiting room furniture. What it got was a report recommending expenditure of several hundred thousand dollars with a fitout specialist company helpfully putting together what it called its "business plan" and tendering it to Jon's bank lender who used the figures to sell Jon the concept of an escrow facility and a chattel mortgage repayable over six years. The bank's loans officer who saw the opportunity to boost loans against his name also suggested that it might be a good time to add some equipment into the proposal, and the chattel mortgage grew to \$600,000.

As far as refitting and re-equipping Drudge's surgery was concerned, it made no difference as he continually failed to generate follow up appointments and personal referrals to him had utterly dried up. Jon's personal referrals remained strong.

The tightening noose

Cash flow was getting tighter and despite her new title of practice manager, the receptionist was unable to curb staff excesses, nor did she speak to Jon about the assistant dentist. However, it had become difficult to pay all of the bills on time while loan and chattel mortgage repayments were automatically debited each month by the bank.

Financial realisation dawns

Jon realised suddenly that there was a real problem. The bookkeeper who Hendrick had used and who visited the practice on a fortnightly basis had noticed a fall in money at the bank but until the escrow facility for fitout and equipment had been consolidated into a chattel mortgage, had not seen the full impact. She recognised that there was a significant problem and until now, had been reluctant to speak up as Susie the practice manager seemed to be dominant.

Meanwhile, Susie liked the supply company representative who thoughtfully provided her with a Christmas present in gratitude of the fact that she was over ordering and in reality was paying more than other dentists. He liked practices which left ordering to people like Susie.

Financial difficulty

Jon and Racheal still had a significant home mortgage. They had business related borrowings of approximately \$2 million for the purchase of practice, practice premises and stamp duty and had \$600,000 of chattel mortgage. Their overdraft was at its limit and their credit cards were maxed. Suddenly, their easy personal cash flow had vanished.

The blinding flash

Jon saw his accountant about the state of the situation and it struck him like a blinding flash that the accountant did not understand the economics of dentistry and was floundering for answers. The accountant waffled on about a couple of dissimilar small businesses and produced a cash flow forecast which indicated the obvious that the practice was in financial trouble. The accountant's answers lacked conviction and Jon and Racheal realised that they had to find a solution themselves.

The grindstone

Jon was working harder but was still unable to measure the cost effectiveness of his staff. Life had suddenly become quite grim. He was keeping his creditors at bay but only just. His enjoyment of dentistry had declined and he was discomforted by the fact that he was continually being reminded that his practice

owed money. His staff seemed oblivious to his needs and when he got home, there were overdue bills and while Racheal was concerned she was forced to remind him that school fees were imminent and that there were essential household needs.

Addressing the Issues

The bookkeeper had plucked up courage to speak to Jon and realised the signs and told him that he needed advice. Initially, Jon and Racheal went to a financial planner in a big bank. The financial plan presented to him had many pages of pre-programmed generic waffle and was aimed at signing up clients to utilisation of lots of bank products. It totally ignored their now urgent financial needs, which concerned practice operation and cash flow.

Scarcity of good advice

They then set out to find better advice and made quite a few telephone calls while searching through dental magazines and advertisements. They also began checking with dental friends and found out some of the industry names had gotten other dentists into trouble with the taxation commissioner in respect of Horticulture and Forestry Scheme deductions and sold them totally unprofitable schemes. Racheal assisted with the process and was receiving a rapid financial awakening. When an accountant or a dental consultant did not ask the right questions about the dental practice or tried to sign them up to an expensive three year practice management scheme which they could not afford, she recognised their "snake oil" pitch and moved on quickly. When accountants said that "all businesses are the same" or used similar words, she was quick to nail them with "how many dental practices do you actually do accounts for?". Eventually they reached Synstrat who quickly compared fee cost ratios in the practice against related benchmark data and indicated that support staff payments were way above average dental profession percentages. They were asked searching questions about:

1. The practice manager;
2. The employed dentist;
3. Why the ratio of practice purchases were so high;
4. The number of new patients;
5. The decline in practice appointments;

6. The basis of the advice in which they had agreed to Hendrick's sale price without realising that Jon had significant personal bargaining power because of his dominance in practice fee generation;
7. The frequency and amount of fee adjustments;
8. The structure of their borrowings; and
9. Non-clinical staff employment cost relative to fees.

The new adviser gave Jon and Racheal a realistic appraisal of where they stood financially against the financial wellbeing of practice owning dentists of similar age and experience. He also calculated their dental earnings before depreciation, interest and taxes of the practice as a percentage of fees and told them how far below the average their practice was performing at and pointed to urgent corrective actions. What they were told shocked them but it also made them realise that they were getting advice on their real issues. In reality they'd only been a hair's breath away from bankruptcy and losing practice, premises and their home.

Confronting the problem

1. The practice manager was confronted with a comparison of support staff costs compared to the average of practice expenses as a percentage of fees across dentistry and immediately realised that she'd been caught out;
2. The practice manager was also quizzed about the practice breakdown of how many patients were not taking follow up appointments with the practice destroyer and why all new referrals were referrals from Jon's own patients; and
3. Why consumable costs had blown out.

The practice manager realised that she was not managing the practice and her role reverted to that of receptionist on receptionist pay. Adjustments were made to chairside assistant's hours and staff costs reverted to the norm.

Drudge was confronted about his performance and shown the door. In the interim, individual patients were booked further ahead to Jon's own surgery while Jon and Racheal searched for another dentist with the right attributes. There was a painful interlude but Selena, a dentist with beautiful manners, was employed initially for two days per week and gradually recovered the second surgery in due course to four days per week.

Racheal spent some of her time after school hours becoming familiar with dental products and pricing lists and took responsibility for purchase orders. The nooks and the crannies in the practice had been emptied of surplus stock and due to both Racheal's activity and their urgent financial needs, the practice was operating on a just-in-time ordering basis.

Fee review

Jon had ignored fees yet his patients accepted an immediate fee rise and he realised that he had been too soft for too long. Discounting became a dirty word. Selena's chairside manner was so good that it encouraged Jon to further improve his own chairside manners and his fee base continued to grow with some of his personal referrals overflowing to Selena's surgery. With each tiny improvement Jon's own morale improved and he found his enjoyment in dentistry was returning.

Meanwhile he approached the bank on his new adviser's prompting and negotiated a restructure of the duration of the chattel mortgage and acquisition loans. That improved their immediate cash flow.

Racheal had recognised that they had come dangerously close to bankruptcy and losing all of their assets but her involvement in the turnaround had been hugely supportive of Jon.

The turnaround - 12 years after dental school

While Jon and Racheal were still in a tight financial squeeze, the fact that they had confronted the problem and were gaining knowledge as to where they were at made them a lot more competent in dealing with their situation. As Jon's enjoyment of dentistry returned, he began to feel more in control of his practice and its financial future. His improved demeanor and confidence reflected throughout the practice and outwards through his patients. They couldn't put their finger on it precisely but the fact was that more patients were referring their friends to Jon and any overflow into Selena's surgery were treated effectively and retained long term. Within a couple of years, Jon's fees had passed \$1 million per annum. Selena's four days were producing \$750,000 p.a. A recent revaluation of the premises for bank purposes indicated that

there had been a satisfying lift in value. Their home too had appreciated. Jon and Racheal were able to make modest superannuation contributions for tax purposes and it was clear that the dental practice and premises had comfortably surpassed their purchase price. The chattel mortgage although extended, was reducing.

The next five years

It's likely that over the next five years, Racheal and Jon's declining home mortgage together with a steady appreciation in home value, ability to steadily address their superannuation funding plus the improving practice performance and value will see an accelerating improvement in their overall financial situation. Core debt related to the practice and premises will be held on an interest only basis while they accelerate the reduction in their home loan. Their large chattel mortgage will be paid out but there will be a follow on smaller financial contract to replace some items of equipment. Selena's performance has been so good that it is likely that in due course they will sell her half of the practice and form an associateship. She is now working four and a half days per week and is well booked. Fortunately Jon and Racheal acted just in time.

The lessons

1. Many accountants give incompetent practice acquisition and practice business advice;
2. Big bank financial planners are not equipped to deal with dentists' real financial needs;
3. Many practice managers cannot control costs and simply don't pay their way;
4. Ask yourself whether a dentist that you employ is a practice builder or a practice destroyer. Measure their rate of follow up appointments and personally generated referrals. A practice owner cannot afford to carry a practice destroyer;
5. Profits occur at the margin. A successfully implemented fee rise will be largely profit restoring other than a percentage paid to employed dentists as additional commission while one extra procedure squeezed into a session before knock off has a higher marginal profit content because the cost of the equipment, rent/interest cost and chairside assistant has already been met;

6. Dentists need to ask themselves whether they have any meaningful measure of performance against other practices and whether their accountant is capable of giving them informed advice or indeed has any valuable input into the running of the practice to share with them;
7. Pay fairly but don't pay staff above what the profession as a whole pays them;
8. Don't overstaff. Beware of practice managers who push for more staff or extended staff hours to make their own job too cushy;
9. Ask yourself whether you are getting a good suppliers deal and review whether you carry too much stock. Be wary of the person doing the ordering becoming too easy on suppliers;
10. Some fitout specialists unnecessarily gold-plate practices for their own purposes. The most successful dentists I know have attractive premises but they are far from lavish; and
11. Be wary of advice from practice bank lending staff whose remuneration is determined by the amount of the loans attributed to them.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 31 years, the last 24 as a founding 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 Management, of the 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. He is the author of Synstrat Dental Stories, the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. 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 financial services company. Both Synstrat companies are owned by the same directors who work within the Synstrat Group. For more information, call (03) 9843-7777 Fax: (03) 9843-7799 Email: dental@synstrat.com.au or visit www.synstrat.com.au.

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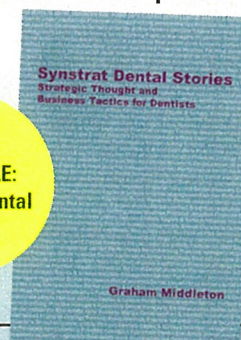
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