CHAPTER 2: HOW A FIRM ADDS VALUE

> There seems to be a deep-rooted tendency in the human mind to seek … something that persists through change … Hence the search for an *underlying* identity, a persistent stuff, a substance that is conserved in spite of qualitative changes and in terms of which these changes can be explained.
>
> L. Susan Stebbing[1]

When you make an investment in a firm you are not buying its past. You are not joining for a ride into the past. That trip has already been run and others have taken that ride. Rather, we look forward by looking for 'something that persists … an underlying identity'. This 'persistent stuff' is how a firm adds value over time in a sustainable way. In financial statement analysis this is what we are interested in engaging with and understanding. A key first step in understanding this 'persistent stuff', how a firm adds value, is to understand its strategy.

We turn up at Sydney's large, cavernous Central Railway Station and go to the Country Trains ticket counter and ask how much the train tickets are. "Well, it depends on where you are going," says the helpful railway staff employee, slightly exasperated. The destination will determine the cost of the ticket. A ticket to Brisbane in Queensland, about 1,000 kilometres north of Sydney, might cost about $150. A ticket to Kiama, 120 kilometres south of Sydney on the South Coast of New South Wales, might cost about $15. So how much we pay for a train ticket will depend on where and how far we are going.

The trains line up at the Country Platforms of Central Railway Station in Sydney. The destinations of the various trains are shown on the railway indicator boards. We can have a high level of confidence that the trains will make it to their destinations. The indicator boards usually do not say one destination and the trains go somewhere else and the trains very rarely crash on the way. Trains are generally reliable in that regard. Not so with businesses. Perceiving and understanding a firm's planned destination – its strategy – is not as easy as looking up at a train indicator board. We need to be able to discern the key aspects of a firm's strategy.

Also, getting a train to its planned destination is more reliable than getting a business to where it is planned to be. Implementing a strategy takes real skill from a firm's management and staff and is filled with dangers and risks. Many more businesses than trains fail to reach their destination as planned. The starting point for financial statement analysis is to decide what journeys we might like to go on; what business strategies we wish to back with real capital resources. A business strategy is essentially how a firm has, or intends to, add value. This involves changing the economic and business realities of a firm in some way to add value. This change in value of the firm could then be expected to be reflected in changes in a firm's financial statements.

Another way in which a firm could apparently add value as measured by its financial statements is through adopting one type of accounting treatment compared to another, without any change to its underlying economic and business reality. Clearly, a firm does not add value simply by adopting one type of accounting treatment in its accounts compared to another. The other aspect we need to consider before launching into financial statement analysis is to take a step back. We need to have a look at the train indicator board and see if we have any reason to suspect that the indicator board may be defective or inaccurate in some way. Do we have reason to suspect any aspects of a firm's financial statements may not reflect the underlying economic and business realities of the firm? Indeed, can a firm's financial statements be trusted as an aid to helping us understand how a firm adds value? Let us now consider what is a firm's strategy.

2.1 A Firm's Strategy

> One thing is sure. We have to do something. We have to do the best we know how at the moment …; if it doesn't turn out right, we can modify it as we go along.
>
> Franklin D. Roosevelt

At 104 years of age, Waldo McBurney won the "America's Oldest Worker for 2006" award.[2] He was born in 1902 and started working in 1915 at the age of 13 by guiding a team of horses pulling a wheat thresher. Until a relatively short time before his death at age 106, he worked as a beekeeper in Kansas. He wrote his autobiography in 2004, entitled *My First 100 Years: A Look Back from the Finish Line*. In investing, we are not interested in 'looking back from the finish line'. You do not make any money doing that. Indeed, the world is full of people smarter after the event. For example, not many members of the US Congress voted against commencing the Iraqi War in 2003. At that time the Iraqi War had widespread bi-partisan political support in the US. A few years later, when the war had not gone to plan, there were many US politicians ready to criticize the war with suitable moral outrage. It is much easier to look back and be wise after the event. Investing is about being wise *before* the event. This is not so easy.

A key to being wise before the event is to engage with and deeply understand a firm's strategy. A firm's strategy is the direction it is intending to take and how it is planning to get there. We have a firm's glossy annual report in our hands. We start by reading the chairman's report and the managing director's report, and other words highlighted in a firm's annual report. These can give us some qualitative clues about a firm's strategy and are often used by firms to flag some key aspects of their strategy and expected prospects. But we largely do not start financial statement analysis with the financial statements. We start financial statement analysis by considering the economics of a firm's business in a general, largely qualitative sense. We need to understand a firm's competitive environment (its industry and the broader economy) and how well positioned it is in this environment. What key risks does it face and what are the key economic factors driving its profitability? We find these things out largely using sources of information other than a firm's financial statements.

In this section, we will first see that strategy is a concept; it is not something we can pick up and see. We start financial statement analysis with an assessment of a firm's strategy, which is our guide to the future of a firm. We will see that it is this future which a firm is selling to equity investors in our capital markets. We will also see that a firm's strategy will add value to the extent it results in the firm's future earnings being greater than the cost of the capital it is using.

Concept of strategy

> True, I talk of dreams, which are the children of an idle brain,
> Begot of nothing but vain fantasy.
>
> *William Shakespeare*, Romeo and Juliet

We can view strategy as a concept; something that no-one has ever seen. It is essentially our view of the intentions (or patterns of previous actions) of a firm. We saw in Chapter 1 that we seek to form our view of the value of a firm, rather than seek to discover the one ‘true’ intrinsic value. So it is with understanding a firm’s strategy: at heart, it will be *our* view of a firm’s strategy.

I like Professor Rumelt’s definition of strategy: “Strategy is creating situations for economic rents and finding ways to sustain them.”[3] This ties in nicely with the economic profit framework for financial statement analysis. Ryman Healthcare’s strategy could be focused on generating a strong return on its Net operating assets, most importantly on its retirement villages. It is able to do this because of strong customer demand, which is driven by positive long-term demographic trends (an increasing proportion of the population is over 75 years), increasing social acceptance of living in integrated retirement villages (resulting in an increasing proportion of the population that is over 75 years wanting to live in retirement villages) and growing residential property values (providing customers with the ability to pay for retirement village units).

Further, Ryman Healthcare has adopted a business model where it funds a substantial part of its operations by way of interest free loans from its customers (we call this operating liability leverage, to distinguish it from leverage that comes from introducing debt into a business). This helps Ryman Healthcare hold a substantial ‘land bank’ of sites for the development of future retirement villages and partly offsets its low level of asset turnover (that is, low level of sales compared to the Net operating assets employed in the firm). In this way, Ryman Healthcare has been able, and expects to continue in the future, to deliver returns to equity investors greater than its cost of capital.

Another definition of strategy I like is (in French): “un reve ou un bouquet de reves en quete de realitie.”[4] For those who prefer English, this can be translated as strategies are dreams in search of reality.[5] This can give the sense of strategy as causing our dreams, which flower in our minds, to move beyond just our minds and to impact on the real world and affect other people’s lives. Seeing our dreams gradually turn into reality is an amazing thing. Reality will always be messy, compromised and imperfect, whereas our dreams will tend to lack some degree of realism, tending to omit a lot of the inconvenient details and unpleasantness that make up our real world. Nevertheless, our dreams contain certain essences, values, feelings and ideas of what is important to us as people. Seeing our dreams emerge into the light of day and become real is great; and it usually comes only after a lot of hard work, straining and searching.

In life it is often not possible to make changes in our world that will have an impact today. We often cannot suddenly change our career one day (there may be a small issue of retraining and also of convincing others, and ourselves, about our capacities in this new untried career for us); or alleviate suffering in Africa due to the ravages of Aids (cures and treatments take time to develop, which then take further time and resources to make available to those suffering from Aids in Africa); or create a top ten listed New Zealand company specialising in the retirement and aged care industry (this took Ryman Healthcare well over 20 years to achieve). But there is one thing we can do today and that is dream about doing it and what it might take to turn those dreams into reality.

It is possible for us to have a lot of tremendous dreams and ideas and yet have no commitment to seek to turn them into reality. This is not what strategy is about. Strategy is about having dreams but also straining for ways to turn them into reality. Indeed, the strength of strategy is this: although there can often not be a lot we can do to change things in any major way *today* by doing something *today*, there is often a lot we can do today and tomorrow and the next day that can make significant changes in a few years, if we have the focus and direction that a strategy can give us. We can start to retrain today with a view to changing our careers in the future, we can save and invest today with a view to achieving a degree of financial independence in the future, we can care for young children today with a view to seeing them grow to full adulthood in the future, and so on. These strategies start with dreams. Strategies can be essentially the process to turn dreams into reality in the future. If nothing else, strategies require us to value the future and not just the present moment.

The dreams and strategies in the 1980s of Ryman Healthcare's founders, John Ryder and Kevin Hickman, are now greatly influencing the lives of thousands of residents in Ryman Healthcare's retirement villages and rest homes in New Zealand and Australia, as well as the lives of their relatives. It is also adding value to its equity investors (which includes my wife and children, as well as the investment arm of Ngai Tahu, one of the major Maori iwi or tribes, and many other investors) and to a range of other stakeholders. To engage with a firm's future, we need to engage with its strategy which is what a business is selling to its equity investors.

Selling their futures

> Change is the law of life and those who look only to the past or present are certain to miss the future.
>
> John F. Kennedy

Financial statement analysis focuses on understanding how to translate qualitative factors, such as a firm's strategy, into quantitative measures of value: to know what adds value. How to assess a firm's strategy is critical to financial statement analysis. However, how to develop winning strategies for firms is largely outside the scope of our unit. It is covered in various books and units on strategy which you can explore on your own. Although how to assess a firm's strategy is a key foundational skill in financial statement analysis, it will not be our focus. I will simply introduce some of the issues for us to think about. However, growing in our understanding of how to assess firms' strategies will greatly assist the quality of our financial statement analysis.

Fundamentally, a firm's strategy is the trip we are 'buying into' as an equity investor; it is the trip we are deciding whether or not to go on. There are only so many trips our limited capital can take. Indeed, each dollar of our capital can only go on one trip at a time. As the person selling train tickets at Central Railway Station in Sydney will tell us, how much we pay to go on a trip will depend on where and how far we are going (or, in the case of businesses, where and how far we *think* we may be going). And a firm's strategy will only add value to equity investors to the extent it is able to use the capital it has from investors to earn a return greater than the cost of that capital.

Exceeding the cost of capital

The capital markets ration scarce capital to unlimited potential uses by way of a clearing price, which is the firm's cost of capital. It is set by participants in the capital markets. It is not just a 'price' paid for something in the present. The market for fish sold in the Sydney Fish Market in Blackwattle Bay on the foreshore of Sydney Harbour is based on the price paid today for fish supplied today. Typically, over 100 species of fish are sold in the Sydney Fish Market each day, fresh to consumers who consume them quickly. In capital markets, equity interests in businesses are the 'fish'; this is the commodity being sold. But the price at which it is sold is based on an expectation of 'getting our capital back plus a return' in the future. In this way, businesses are selling their futures to potential equity investors. There may be a lot of things about the future we do not know, but one thing we do know is that it is uncertain. Yet some potential futures seem more likely to us than others. The likelihood of my winning the 14 km

City2Surf Fun Run between Sydney's CBD and Bondi Beach, in which over 80,000 people run, is slight. The likelihood I will be able to catch the bus from Yeppoon to CQUniversity in Rockhampton is quite high.

So it is with business. In capital markets, businesses are selling their futures. These futures rest on their strategies: how they intend to use the resources they have to produce outcomes in their competitive environments. Participants in capital markets ask themselves how likely it is that a firm will be able to deliver the returns it expects to achieve. The cost of equity capital for a firm, its required rate of return, will be set by participants in the capital markets after a consideration of the risks or uncertainty surrounding a firm's expected future returns compared to all the other investment opportunities or trips their capital could go on. A firm 'adds value' by generating returns to shareholders greater than the return required by the capital markets, given an assessment by those markets of the risks the business is taking to generate those expected returns. Remember that capital markets – unlike, for example, the Sydney Fish Market – rely on expectations; one market sells fish each day, the other sells the futures of businesses with all the uncertainties that the future holds for us all.

We have considered strategy as a concept: creating situations for economic rents and finding ways to sustain them; or dreams straining to influence reality. We also saw that by understanding a firm's strategy we start engaging with a firm's future. We considered how firms are selling their futures in the world's capital markets – in that sense, capital markets are markets in dreams – and that our focus in assessing a firm's strategy will be the extent to which it enables a firm to add value by earning a return greater than its cost of capital. We will now consider some of the issues we need to think about when seeking to assess a firm's strategy.

2.2 Assessing Strategies

> All strategies are abstractions which exist only in the minds of interested parties. It is important to remember that no one has ever seen a strategy or tackled one; every strategy is an invention, a figment of someone's imagination, whether conceived of as *intentions* (before actions take place) or inferred as *patterns* to describe actions that have already occurred.
>
> Henry Mintzberg

In financial statement analysis we need to adopt a strategic perspective. We need to think strategically about the firm we wish to analyse. We are looking for the 'persistent stuff' of a business; how it adds value and is expected to add value in the future. We are also looking to engage meaningfully with a firm's economic and business realities today and to understand how they are likely to change in the future. Engaging with and assessing a firm's strategy is the key to doing this. To be good at financial statement analysis we need to develop our capacity for strategic insight, to be able to focus on the few things that really matter in a business. We need to do this in a careful and logical way. We need to be sensitive to the key strategic issues facing the firm we are analysing and to be able to assess the skill and adeptness of the firm's management team to address and meet these challenges. In this section, we will consider ideas about how to assess something we can never see: a firm's strategy.

Never seen a strategy

Focus is a key to success in life. I attended the final of the 4,000 metres Men's Team Pursuit in cycling at the Sydney Olympics in 2000. Sitting in the Dunc Gray Velodrome in suburban Bankstown in Sydney, we had front row seats. The German team won the Gold Medal that year and set a new world record for the event. This group of four men had become extremely good at cycling in a circular 250 metre track very, very fast. Their cycles were heavily tailored to the task at hand; for example, they had no brakes. Because of this focus, dedication, persistence and talent they were able to do a very specific task better than anyone else in the world at that time.

> The great mystery isn't that people do things badly but that they occasionally do a few things well. The only thing that is universal is incompetence. Strength is always specific! Nobody ever commented, for example, that the great violinist Jascha Heifetz probably couldn't play the trumpet very well.
>
> Peter Drucker

As with life, so in business. Successful companies will carefully focus their efforts within their competitive environment. Successful companies will be straining to achieve something that is not easy. They will be seeking to genuinely add value to real, specific, targeted customers in ways that are consistently better than the competition. A key judgement to make about a firm's strategy is to understand why different firms, facing the same environment, perform differently.

Five P's for strategy

> A desk is a dangerous place from which to view the world.
>
> John Le Carré

Henry Mintzberg, Bruce Ahlstrand and Joseph Lampel have written a classic book on strategy called *Strategy Safari: A Guided Tour Through the Wilds of Strategic Management*.[6] In their book they outline the 'Five P's for Strategy' and discuss ten schools of strategy formation. They also give a sense of the diversity that is possible in thinking about strategy. A discussion of the ten schools of strategy formation in *Strategy Safari* is included as Appendix 1. We will now discuss the 'Five 'P's' for strategy.

The first point to make is that the word strategy does not contain the letter 'P' at all, let alone five 'P's'. But alliteration (using the same first letter or sound in a series of words) can help us to remember a few points. Mintzberg suggests strategy can be seen as a Plan, Ploy, Pattern, Position or Perspective. Let us look at each 'P' in turn.

Plan: **A strategy can be some sort of consciously intended course of action: how a firm intends to address the markets, environment and challenges it faces.**

Ryman Healthcare's strategy is to use its in-house team to identify sites, to purchase land, and to design, construct, operate and own integrated retirement villages. These retirement villages are to provide a full spectrum of services from independent townhouse living to hospital level care, typically attracting retired residents from existing communities within about a 10 km radius of each retirement village. Ryman Healthcare will not acquire existing retirement villages or rest homes, nor will it develop stand-alone life-style villages. It also does not plan to grow by acquiring other participants in the retirement sector as this sector continues to consolidate. Ryman Healthcare does not plan to diversify further geographically and plans to focus its growth in its existing markets of New Zealand and Australia.

Ploy: **A strategy can be a ploy simply designed to out manoeuvre or outsmart a competitor. It is heavily influenced by predicting the potential actions of competitors; second-guessing them and seeking to influence their actions.**

Ryman Healthcare has a strategy of actively acquiring a substantial 'land bank' of suitable sites for the development of new integrated retirement villages. It currently has a 'land bank' that should support about 3-4 years of future construction of new retirement villages. Besides providing some security for its future development plans, Ryman H ealthcare's strategy of acquiring a substantial 'land bank' also makes these potential sites unavailable for development by competitors. Ryman Healthcare has identified the key strategic importance of controlling suitable sites. It is difficult to acquire suitable sites for large-scale retirement villages in urban areas close to existing communities of its target market. Acquiring these sites well in advance not only secures its own development plans, but also, and equally importantly, makes it more difficult for competitors to develop new retirement villages in these communities.

Pattern: **A strategy can also be a consistency in a firm's behaviour, how a firm typically operates, which may emerge over time rather than result from a pre-meditated, deliberate plan.**

When Ryman Healthcare commenced its activities in 1984 it conducted all its activities in-house, including property development, construction, and the marketing and management of retirement villages and rest homes. As Ryman Healthcare grew, it further developed its in-house capacities in each aspect of its operations to accommodate this growth. Ryman Healthcare has been consistent in its behaviour of keeping virtually all its activities in-house. It is not clear to me that this was a pre-meditated plan from the outset by its founders, John Ryder and Kevin Hickman. It may have been. However, it is also possible that when Ryman Healthcare was a small business starting out, its original founders controlled in-house all its activities as many founders of small companies do as they seek to get established.

As Ryman Healthcare developed it is possible that certain consistencies or patterns in behaviours emerged in the firm, including developing a strong in-house focus on caring for individuals in retirement villages and rest homes as well as the ability to develop and construct quality new retirement villages and rest homes on a large scale. This pattern of behaviour may have developed into a strategy of seeking to preserve key capacities in-house as its operations continued to significantly expand. A successful pattern may have developed into a strategy.

Position: **A strategy can be how a firm places itself in its environment, or in other words, how it matches its activities to its environment. A strategy can be how a firm focuses its activities in a niche or place in its environment to generate abnormal returns.**

For example, key aspects of Ryman Healthcare's environment are:

- Demand in the retirement village and aged care industry is growing strongly in New Zealand and Australia (as it is in several countries). There is an increasing proportion of the total population in New Zealand and Australia in the over 75-year age group and they are enjoying longer life expectancies. Also, New Zealand and Australia has a relatively low proportion of people over 75 years of age living in retirement villages, compared to other countries such as the UK and US, and there is the potential for this proportion to grow further in the future.

- There is currently an excess of demand over supply for units in integrated retirement villages.
- The retirement village and aged care industries in both New Zealand and Australia are largely fragmented among many owners, with the five largest operators accounting for about one-half of each market. Ryman Healthcare is the largest operator in New Zealand, with about 19% of retirement village units and about 9% of rest home beds. Its market share in Australia is quite small. The industry is undergoing some consolidation.
- The government has a significant interest in the retirement village and aged care industry. The government provides substantial subsidies to people in rest homes and care subsidies for people in family homes. The government has been increasing the level of regulation of retirement villages in both New Zealand and Australia, increasing compliance costs and standards in the industry. In Australia, the Royal Commission into Aged Care Quality and Safety may lead to increased regulation in Australia.
- There are limited barriers to entry into the retirement village market, particularly the development of town houses and apartments for independent retirement living. The main barrier to entry is the ability to acquire suitable sites.
- There are more significant barriers to entry in the aged care industry for semi-dependent or dependent residents. Access to subsidised funding from the government for rest home and hospital care is limited and more likely to be allocated to existing operators with proven track records than to new entrants. Regulatory controls in this segment are also significant.
- The industry enjoys favourable taxation treatment, as income from retirement village unit sales and re-sales of occupation rights (deemed to be loans) are not taxable.

Ryman Healthcare has positioned itself within this environment by:

- Focusing on growing organically (that is, through expanding and developing the scale of its existing operations) rather than through the acquisition of competitors. It is not participating in consolidation of the industry. It is focusing on growing its existing operations strongly and preserving and developing its existing operational capacities in terms of development and construction of new retirement villages and rest homes and the care and support it provides its residents.
- Acquiring a substantial 'land bank' of suitable sites, to take advantage of the expected continued strong market demand for units in integrated retirement villages and to ensure these sites are unavailable for redevelopment by its competitors.
- Actively lobbying and engaging with government (along with other industry participants) in relation to issues relevant to the industry.

Perspective: **A strategy can also be something *inside* the heads of key individuals in a firm: a definite, ingrained way of perceiving the world.**

What is the 'character' or 'personality' of Ryman Healthcare? How do its key players (and its staff more generally) 'view their world'? Ryman Healthcare has many caring, conscientious staff working in its retirement villages and rest homes. There does appear to be a view of genuinely caring for the needs of the elderly and to support them as they age further. However, Ryman Healthcare is growing rapidly and has grown to 32 retirement villages (with an additional four under construction), comprising about 6,000 retirement village units as well as about 3,300 care beds. Is the perspective of key players in Ryman Healthcare changing as the firm grows and becomes more successful? Is it losing its focus on caring for the elderly in its retirement villages as it becomes one of New Zealand's top 10 listed companies and as some of its senior staff become wealthier through the firm's employee share scheme? Ryman Healthcare may be able to preserve the strengths in its culture and in the perspectives of senior management and staff; but there are on-going risks as Ryman Healthcare continues to grow rapidly.

Finally, here are some key factors to consider when assessing a firm's strategy:

- **The firm's competitive environment:** What is the nature of the industry in which the firm competes? What competition does the firm face from existing competitors? What threats does it face from the potential entry of new competitors; or from the introduction of substitute products? Who are the 'channel captains' in the value chain and what is the relative bargaining power of the firm compared with its suppliers and customers?
- **How well positioned is the firm within its competitive environment:** We need to identify the firm's core competencies and the sustainability of its competitive advantage. We need to assess the firm's ability to effectively implement and sustain its strategy in the future.

This has been a deliberately introductory look at strategy. It is designed to stimulate your interest to develop your ability to discern and connect with your firm's strategy. Financial statement analysis can give us the skills to translate a firm's strategy (expressed in qualitative terms) into a dollar value (expressed in quantitative terms). The future earnings of our firm will depend on the quality of its strategy and how well it is implemented. We engage with, and seek to understand, our firm's strategy to ensure our subsequent analysis of the financial statements is realistic. Given we will be using returns and earnings from the financial statements in our analysis, we also need to be sensitive to how well the financial statements may be capturing the economic and business realities of the firm. We need to ask ourselves whether there are any aspects to the way the accounts are put together that may be disconnecting us from, rather than connecting us to, this reality? For this reason, we need to consider the accounting treatments used.

2.3 Can the Accounts Be Trusted

> It is a matter of great moment to the analyst that the facts be fairly presented, and this means that he must be highly critical of accounting methods.
>
> Benjamin Graham and David Dodd [7]

In financial statement analysis we use the financial statements, along with other sources of information, to help us gain insights into the economic and business realities of a firm. However, before we start doing this we need to consider whether there are any aspects of a firm's financial statements that might not be helpful to us. We will consider whether there are significant aspects of a firm that its financial statements might leave out altogether. We will also consider whether there might be some significant aspects of a firm's financial statements that might be more confusing than enlightening; where management has either considerable flexibility in the accounting treatments it can use and where it has very little or none.

What the accounts leave out

The financial statements are a mixture of words and numbers. But they are mainly numbers. The financial statements are an abstraction of reality, a simplification of all the complex and varied things happening in a business. This means that the financial statements will invariably leave out a great deal.

Some of the key aspects of a business that the financial statements leave out are:

- its ability to generate positive net present value (NPV) investments in the future; and
- the opportunity cost of its activities, or in other words the cost of capital.

If you read the financial statements of Ryman Healthcare and look for these two aspects of its business, you will not find them; they are not there. The shares in Ryman Healthcare trade on the New Zealand Stock Exchange. In recent years, investors have bought and sold these shares at over three times the book value of its shareholders' equity[8]. What these investors are saying is that they think Ryman Healthcare is worth more than three times the value the company's financial statements say it is worth. Put another way, these investors are saying they think less than one-third of the value of Ryman Healthcare is included in its financial statements. These investors may or may not be right in their assessments. One thing we will learn in this book is that value depends on assessments of an uncertain future, so there is always scope for disagreement and for us to be proved wrong in our assessments by subsequent unexpected or unforeseen events. However, if these investors are correct in their assessments of the value of Ryman Healthcare, then its financial statements leave out more than two-thirds of its value.

What this would mean is that if we just look at the financial statements of Ryman Healthcare, we would leave out a lot of the value of this firm because it would simply not be included in the financial statements. Well, yes and no. Ryman Healthcare has a proven ability to consistently deliver positive NPV investments and there are substantial grounds to consider it can continue to do this for many years to come. The omission of this capability of Ryman Healthcare in its financial statements is a major reason for the difference between the book value of the equity of Ryman Healthcare in its financial statements and the views held by many investors about its value. Another major reason for this difference is that Ryman Healthcare also has the capacity to earn considerably more than its cost of capital on the shareholders' equity invested in its existing activities.

Ryman Healthcare delivered comprehensive income of $384.4 million in the year ended 31 March 2018, to provide a Return on equity (ROE) of 21.4% in 2018. If you can consistently earn a ROE of about 21.4% each year, you will become extremely wealthy. At that rate of return you will double your money every 4 years; in other words, turn $1 into about $2 every 4 years. My 25-year-old son's shares in Ryman Healthcare are currently valued at about $130,000. If he was able to consistently earn 21.4% per year on his money, in 4 years' time when he is 29 years old and perhaps buying a house and settling down, his $130,000 share portfolio would be worth about $260,000; when he is 33 years old and perhaps having a young family, his share portfolio would be worth about $520,000; at 37, $1 million; at 41, $2 million; at 44, $4 million; at 48 years of age, $8 million; and at 52 years of age, $16 million. I think you get my point. The lack of many 52-year olds with $16 million in shares is probably enough testimony to how difficult it is to consistently earn returns of 21.4% per year.

Suffice it to say, a Return of equity of 21.4% per year, which Ryman Healthcare delivered to its shareholders in 2018, is a very good rate of return and well in excess of the cost of that capital (which we later measure in Chapter 6, Section 6.2 to be 9.4% per year). If you thought Ryman Healthcare would be likely to deliver a return on its existing equity in the future greater than the cost of the capital it is using to generate this return, this would be a further reason for valuing Ryman Healthcare at greater than its book value. A large part of the value of Ryman Healthcare omitted from its financial statements is its ability to generate positive net present value (NPV) investments in the future (through developing new retirement villages and extending existing ones) and its ability in the future to generate returns significantly greater than the cost of the capital invested in its existing activities (that is, the book value of its current shareholders' equity).

The strategic choices of management greatly influence whether a firm will be able to earn a return on its capital greater than its cost of capital by making positive NPV investments into new assets and by making returns higher than its cost of capital on existing assets of its business. We need to assess a firm's strategy to help us identify the key aspects of value a firm's financial statements might leave out. Indeed, the essence of financial statement analysis is converting qualitative assessments of a firm's strategy into quantitative assessments of value. Yet we do not only need to be sensitive to what significant aspects of value a firm's financial statements might leave out. We also need to consider whether there are any significant aspects of a firm's economic and business realities that a firm's financial statements do include, but in a way which might confuse rather than enlighten us.

What the accounts confuse

> The devil can cite Scripture for his purpose.
>
> *William Shakespeare,* The Merchant of Venice

Before we start analysing a firm's financial statements we need to stand back and think about whether we have any reason to suspect some aspects of the financial statements may not accurately reflect the underlying economic and business realities of a firm. We look for aspects of the financial statements that might potentially confuse us rather than enlighten us about the realities facing a firm. What sort of things do we need to look out for? First, we need to be clear that the financial statements are constructed by intentional human beings, that is by management (and accountants), and are not themselves the firm's economic and business reality. However, management generally have a good knowledge of their businesses (and certainly better than us, as outsiders). After all, management are working full-time in the business; we are not. Management (and accountants) have the role to make judgements about how best to reflect the economic and business realities of a firm in its financial statements.

However, management do not have *carte blanche* to present the financial statements of their business anyway they like. They do not start with a 'blank sheet of paper'. There are various accounting standards and generally accepted accounting principles and conventions that place restrictions on how management can construct a firm's accounts. This is the case in Australia, New Zealand and many other countries in the world. This includes various legislation (which particularly affects firms that are companies or government bodies); the Australian Securities and Investments Commission (in Australia), the New Zealand Securities Commission (in New Zealand), the Financial Services Authority (in the UK) and the regulatory bodies in a range of other countries, which regulate various aspects of the operation of capital markets in their country; the Australian Securities Exchange, the New Zealand Stock Exchange, the London Stock Exchange and many other stock exchanges, which require certain disclosures to be made by companies listed on their exchanges; as well as accounting standards and generally accepted accounting principles.

Australia, New Zealand and many other countries have adopted International Financial Reporting Standards (IFRS) for listed companies (Australia and New Zealand have also adopted IFRS for unlisted companies). This means that the accounting standards of Australia, New Zealand and the UK will be largely consistent with each other (and with those of other countries adopting IFRS, such as the European Union, Russia, South Africa, Hong Kong and many other countries), although there can be some differences between each country. Accounting standards help to create an accounting ‘language’ as a standard way of presenting a firm’s economic and business realities in the financial statements. But businesses are all different. They each have unique economic and business realities. No two businesses are identical.

For example, Ryman Healthcare could be compared to the Zig Inge Group in Australia. Both companies develop and manage retirement villages. Yet they also have many differences. For example, they have different business models. Ryman Healthcare sells long-term occupation rights to its retirement units, which customers purchase by way of providing Ryman Healthcare with interest-free loans. In this way, Ryman Healthcare retains legal ownership of its retirement villages. Zig Inge Group sells its retirement village units to owner-occupiers. It is not possible, nor desirable, to have detailed accounting standards and rules to cover every conceivable situation that might occur in business. Considerable judgements need to be left to management (and accountants) to decide how to best reflect the economic and business realities of a firm in its financial statements.

The IFRS reflect an appreciation of the need, and desirability, for these judgements. Management (and accountants) have an ethical responsibility to ensure they exercise these judgements in a way that results in the financial statements better reflecting the economic and business realities of a firm. However, the ability of management (and accountants) to exercise judgement and discretion in choosing some of the accounting treatments does introduce a level of uncertainty for the users of financial statements. In Australia, New Zealand, UK and in many other countries, listed companies are required to have their financial statements audited. External auditing of financial statements seeks to ensure management (and accountants) use accounting standards and conventions consistently over time and that their accounting estimates are reasonable. Nevertheless, the ‘bottom-line’ is that financial statements are constructed by management (and accountants) and, particularly under IFRS, they have considerable flexibility to make their own judgements about how best to do this.

2.4 Accrual Accounting

Firms can last many years. For example, BHP Billiton has a market capitalisation of more than US$100 billion and is listed on the Australian Securities Exchange, with secondary listings in Germany (Frankfurt) and Switzerland (Zurich) and its American Depositary Receipts (ADRs) are traded on the New York Stock Exchange. It can trace its history to 1885 when BHP started a silver, lead and zinc mine in Broken Hill, New South Wales, Australia; and to 1860 when Billiton started to mine tin on an island (then called Billiton) in Indonesia near Sumatra. Firms report periodically on their performance. We do not want to wait until a firm completes its lifespan before we find out how it is performing. In the case of some firms, like BHP Billiton, that corporate lifespan might be very long indeed, longer than we as individual equity investors could expect to live.

Various stakeholders want to know what is happening in a firm at regular intervals during its life. To do this, financial statements are prepared using accrual rather than cash accounting. Accrual accounting requires the matching of expected costs and benefits of economic activities in a period, regardless of whether there has been actual receipt or payment of cash. Cash is a hard concept. You either have the cash in your pocket from, or have handed over cash to, another party; or you have not. There is not too much you can argue about that. On the other hand, accrual accounting requires an assessment of the economic consequences of current business activity, which will necessarily rely on several assumptions and be subjective. Indeed, this assessment of the economic consequences may be wrong, either deliberately or unknowingly.

Reveal or disguise reality

Do financial statements, which are based on accrual accounting, reveal or disguise the economic and business realities of a firm? The answer is they can do both. Financial statements are an important means by which managers can communicate the realities of their firm to outside parties. But managers (and accountants) might be tempted to manipulate the perceptions of outside parties about the economic and business realities of their firm. They have considerable discretion in how they can use financial statements to reflect these realities. For this reason, we need to be sensitive to the accounting treatments used. The key attitude here is to be cautious and critical of the firm's significant accounting treatments.

Listed companies in Australia, New Zealand and in many other counties are required to make their financial statements widely available. We can usually obtain the financial statements of listed companies by going to their individual company websites, which will typically provide the company's financial statements. We need no 'market power' to get this information from a company, just access to a computer. Regulations in each country require listed companies to provide financial statements, and the regulations are enforced so companies generally comply.

If we have the power to require disclosure, considerable information on private firms can also be obtained. This power would typically come from the firm's interest in entering negotiations with us about us potentially making equity or debt investments in the firm. The relentless and steady growth in private equity markets in Australia, New Zealand and in many other countries has increased the extent of this activity. Also, suppliers and customers can sometimes have the power to require some disclosures from private firms. As disclosure by listed companies is driven primarily by regulation, the various rules governing this disclosure greatly influence the nature of the reporting of listed companies by way of their financial statements. As disclosure by private firms is largely driven by the market power of the users of the information and is not generally made available to the public, there are few rules governing the nature of the disclosure and the process of disclosure of financial and other information is more flexible.

Once we have obtained financial information from a firm, the second step in financial statement analysis is not to analyse what the financial statements are saying, but to step back and assess the accounting treatments that are being used. We need to ask ourselves, how appropriate are the accounting choices and estimates the company's management are using in preparing the financial statements? There are two things to look out for. Remembering that the financial statements are put together by management (and accountants), we need to consider those accounting policies and estimates of the firm where management (and accountants) have considerable flexibility under the accounting standards and conventions and where the exercise of this discretion could significantly impact the financial statements of the firm. Also, the accounting standards may in other areas give management (and accountants) little or no flexibility to adapt the accounting treatments in the financial statements to the specific economic and business realities relevant to the firm, and so for this reason the accounts may not reflect well the underlying realities of a firm.

Accounting choices of Ryman Healthcare

Let us think about areas where the management of Ryman Healthcare has some flexibility under the accounting standards and conventions and where the exercise of this discretion could significantly affect its financial statements. One area where the management of Ryman Healthcare has flexibility is in selecting the basis for revaluation of properties. A key area of judgement for Ryman Healthcare is in the valuation of properties. Management would brief its independent valuers on the criteria or assumptions the valuer is to make when valuing the properties. Management would have the ability to exercise considerable discretion and judgement in how it does this. For example, it appears the valuations of the properties are greatly influenced by the level of residential property prices in the areas surrounding each retirement village. An alternative valuation basis for Ryman Healthcare's properties could be their value as a single portfolio of properties, for example assuming they were syndicated to the institutional market and sold on yields related to commercial property. Depending on the valuation basis used, a wide range of values of Ryman Healthcare's properties would be possible.

The revaluation of Ryman Healthcare's properties typically represents a significant part of its earnings and is a key driver of its value. Its 'headline' earnings figure ('Profit for the year') in its Income Statement includes Fair-value movement of investment properties, but does not include Revaluation of property, plant and equipment (unrealised) which is included in Other comprehensive income. This affects public measures of its price-earnings (P/E) multiples published in the financial media and financial information providers. Areas where management can typically have significant flexibility in applying their judgement to a firm's accounting treatments are, in general:

- Level of bad debts provision
- Selection of depreciation rates
- Recognition of revenue
- Basis for revaluation of properties.

It is important to remember the accounting treatment used needs to potentially have a significant impact on a firm's financial statements. Otherwise, it is not worth exploring. For example, although under the accounting standards Ryman Healthcare has significant flexibility in relation to selection of its depreciation and amortisation rates, accounting treatments in respect to this item would be unlikely to have a significant impact on its financial statements as its Depreciation and amortisation expenses are relatively minor (about $20 million in 2018), mainly because it does not depreciate investment properties, the major part of its non-current assets.[9] It is wise to be sensitive to the potential impact a firm's accounting treatments could have on how well its financial statements are likely to reflect the firm's economic and business realities. We need to develop a capacity to minimise or mitigate limitations in the quality of the financial statements to clearly represent the reality we are interested in understanding.

Conclusion

We have seen in this chapter that a firm adds value by taking capital from investors and using it to earn a return greater than the cost of the capital it uses. To do this, a firm needs to generate returns to equity investors greater than the return required by capital markets generally in making equity investments, given an assessment by those markets of the risks the business is taking to generate those returns. We also saw that we are interested in a firm's future earnings because that is the journey we would be taken on by investing in shares in a firm. And a firm's future earnings will depend on the quality of its strategy and how well it is implemented. For this reason, we start financial statement analysis with a qualitative assessment of a firm's strategy.

As we will be using earnings and other elements from the financial statements to capture in numbers (that is, quantify) the strategy of a firm, we need to be sensitive to how well the financial statements may be capturing the economic and business realities of a firm. We need to understand what is left out of the accounts and what may be confused in the accounts. Indeed, are there aspects to the way the accounts are put together that may be disconnecting us from reality? Once we have first considered the firm's strategy and its accounting treatments, we are ready to consider how to assess the value of a firm using its financial statements. In the next chapter, we will see there are a range of methods and approaches analysts can use to assess the value of firms, some involving the need to make explicit forecasts about the uncertain future and others that do not. They can all have a place in helping us use accounting numbers to engage with the economic and business realities of a firm.

FOOTNOTES

1. Stebbing, L.S., *A Modern Introduction to Logic*, Methuen 1930: 404; author's own emphasis.
2. The 'America's Oldest Worker' award is awarded by Experience Works, a national US group that provides training and employment for seniors. Source: *The Dominion Post* Tues 5 December 2006, page B2.
3. Quoted in Mintzberg, H., "The Strategy Concept I: Five P's for Strategy", *California Management Review*, Fall 1987: 15.
4. Lapierre, L., "Le changement strategique: Un reve en quete de reel," PhD Management course paper, McGill University, Canada, 1980. Quoted in Mintzberg, H., "The Strategy Concept I: Five P's for Strategy", *California Management Review*, Fall 1987: 17 and footnote 36.
5. Mintzberg, H., "The Strategy Concept I: Five P's for Strategy", *California Management Review*, Fall 1987: 17.
6. Mintzberg, H., Ahlstrand, B., Lampel, J. *Strategy Safari: A Guided Tour Through the Wilds of Strategic Management*, Free Press, New York, 1998.
7. Graham, B. and Dodd, D.L., *Security Analysis: Principles and Techniques*, McGraw-Hill Book Company, Inc. New York & London. Second Edition. 1940. The first edition of this book was published in 1934 and it has reached a sixth edition (which has a foreword by Warren Buffett). The second edition was a comprehensive revision of the first edition and is considered by many to be significantly superior to the first edition and to be the 'classic' edition of this book. Reprints of this second edition are often available in libraries and can be bought online. Another excellent book written by Benjamin Graham is *The Intelligent Investor*, 4^{th} rev.ed. New York: Harper and Row, 1973. This book is more readable than *Security Analysis* and is highly recommended.
8. In November 2018, the Ryman Healthcare share price was about 3.25 times book value.
9. See Ryman Healthcare's 2018 Accounts Note 2 Depreciation and amortisation; and its 2018 Statement of Financial Performance.

QUESTIONS

2-1. Henry Mintzberg has noted that nobody has ever seen a firm's strategy. He describes a firm's strategy as 'a figment of someone's imagination' (See Section 2.2). How can we base our analysis of financial statements on figments of imagination, on insubstantial dreams of people? Is all our detailed analysis of a firm's financial statements simply built on sand; susceptible to well-marketed strategies from the management of firms? Tell me what you think about this issue. Does it worry you? Why or why not?

2-2. In using financial statements to help us understand and value firms we need to be wise before the event. A key to being able to do this is to understand a firm's strategy. What does this mean exactly? Are not the financial statements of a firm backward looking, that is they tell us about the past of firms rather than their future? Discuss, particularly telling me how you think analysing financial statements is, or is not, a *'Look Back from the Finish Line'*.

2-3. In 2018, Ryman Healthcare's shares have traded at prices representing over three times the book value of its shareholders' equity. Assuming Ryman Healthcare's share price reflected a reasonable estimate of its value, what possible use can its financial statements be to help us understand Ryman Healthcare's economic and business realities? Do we not need to look at other sources of information to understand most of the sources, or reasons, for its value to equity investors? Comment.

2-4. Benjamin Graham and David Dodd, in their classic and highly regarded book *Security Analysis*, suggest we need to be "highly critical of accounting methods". Do you agree? Why or why not? Do we not need to 'trust' a firm's financial statements and its underlying accounting methods if we are to act on the results of our financial statement analysis?

2-5. Do you think management (and accountants) of listed companies in Australia, New Zealand, UK and other countries in the world are generally honest, usually act in the best interests of a range of stakeholders including equity investors, and genuinely seek to ensure a firm's financial statements provide useful insights into a firm's economic and business realities? Why or why not? If you were a chief financial officer of a listed company could the capital markets rely on you to ensure the firm's financial statements provide useful insights into a firm's economic and business realities? Why or why not?

2-6. Given your answer to Question 2-5, how does this make you feel about the task of financial statement analysis? What attitude do you think you need to adopt in respect to assessing a firm's accounting treatments?

2-7 Warren Buffett advises people to take as many accounting courses as you can, to become very conversant about accounting, which is the 'language of business'. Why might Warren Buffett recommend this?