Chapter 4: Business Valuation (Adjusted Book Value or Cost Approach)

In adjusting the balance sheet, the most difficult task is to "mark to market" (substitute market values for book values) the assets and liabilities. This section focuses on the adjustments and nuances of making these adjustments.

Overview

One of the shortcomings of the historical-cost balance sheet is that it is unlikely to reflect intangible assets. The adjusted-balance-sheet (or cost) approach to value involves a determination of the going-concern fair market value of all assets and liabilities of a theater. After calculating the value of the theater via an income approach, many buyers will only pay for the fair market value of the assets less liabilities, *plus* some intangible value (e.g. from zero to two times annual pretax income). When a business such as an exhibition theater is more of a commodity business with low margins, then this approach is most relevant. Visually, the determination of a going concern can be seen in Figure 4-1 on page 98.

"Adjusted" means that the book value of assets and liabilities are adjusted to their fair market values, or *marked to market*. The difference between the adjusted assets less the adjusted liabilities is the assumed market value of the stockholder equity.

One problem with this approach is that much of a business' worth may be derived from its cash flows and working capital and not from fixed or intangible assets. When this is the case, then the adjusted book value of a company's equity may be worth *less* than the book value.

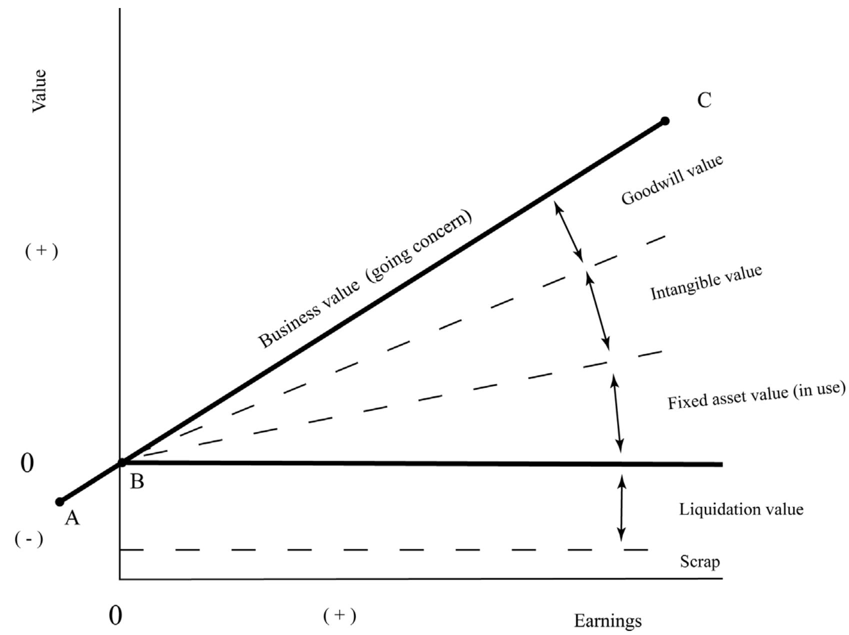
Assets

The adjustments to each of the assets of a balance sheet are described below.

Cash

Cash is almost always treated as cash, without adjustments made to this value.

Figure 4-1: Business Value of Assets Relative to a Going Concern



Accounts Receivable

Accounts receivables are generally reflected at their face value. However, it is important to determine whether the accounts receivable are net of questionable receivables which will not be collected. Note that if a company is in financial distress, then the ability to collect these accounts is called into question, as well as all other current assets. For example, if a company is about to declare bankruptcy, then the value of these receivables may only be a fraction of their face values since the company might have extended credit to questionable customers as they attempted to increase sales. When applicable to a theater's operation, the majority of accounts receivables are from credit card and debit card transactions. Almost all transactions are secure valid credit sales, with the majority of collection risks diverted to credit card companies.

Inventories

Inventories need to be adjusted to some degree. Most adjustments are made pursuant to IRS Revenue Procedure 77-12, which governs the treatment of manufacturing and retail inventories. Raw materials are valued at their most recent cost. If the inventory is a commodity such as concessions inventory, then it may be valued at its purchase cost. The "finished-goods" inventory is typically valued by determining the amount that will be received from its sale in the ordinary course of business, less any normal discounts and allowances, less the cost that the new owner incurs in holding, transporting, and making the sale of the inventoried products, less any returns. Finally, the buyer's share of the anticipated profit should be adjusted.

Other Current Assets

Most other current assets are held at their book value. However, items such as notes from shareholders may need to be adjusted if there is no intention of ever repaying these notes. Furthermore, if the minority interest is being valued, then it is important to recognize that the minority interest shareholder cannot influence its repayment.

Fixed Tangible Assets

The largest adjustments are usually made to the land, building and improvements, as well as machinery and equipment, as the largest investments made by many companies are in these assets.

Land and improvements should be valued at their highest and best use. It is important to start with assessor information, but comparable sales for a true market value should be found and used. Sometimes if there are no comparables available, then a recent insurance appraisal can be used instead.

With respect to the machinery and equipment, the cost approach is typically used as a proxy for their fair market value, valued in a continued-use or going-concern valuation. However, it is critical to adjust these values due to potential obsolescence, or on the other hand, possible inflation since the original date of purchase. It must be noted that values may need to be concluded at orderly liquidation rates or at rates which a dealer would pay. The differences in these values can have an enormous affect upon the value of the adjusted equity.

Nonoperating Assets

Nonoperating assets are those assets that are not critical to the operating needs of a business. For example, excess land, a vacation home, a company plane or a motor boat would meet this definition.

These values would also be different if there were a minority valuation or a control valuation. If the company was valued on a control basis, then these assets would be *marked to market*. The rationale is that a new owner could utilize these assets. On the other hand, a minority interest valuation would either simply utilize the book value or provide some discount to its fair market value. The reason for the difference is that the minority shareholder cannot influence the accumulation or liquidation of company assets.

Intangible Assets

These assets should be identified and appraised but are often overlooked in a business valuation. Sellers always want “blue sky,” but if they are not making a profit, then there is no “blue sky.” Generally the cost and income approaches are most often used. Adjustments are typically made for items such as those shown in Table 4-1.