Book Value and Market Value

The Book Value (BV) of an asset refers to its – heavily regulated, typically backward-looking - accounting value. An asset´s Market Value (MV), on the other hand, refers to the price an investor pays for it in the public or private capital markets.

The MV of publicly traded assets, such as shares, is constantly changing, whilst the BV is more or less frequently published in interim or audited financial statements.

Despite the fact that the ratio of the MV to the BV is a widely used valuation parameter and benchmark by analysts and investors, MV and BV have actually nothing to do with each other: Each of them is based on an entirely different concept.

On the active (left) side of a firm´s balance sheet, assets are usually accounted for at historical production cost or the price once paid when acquired. Hardly ever will the BV of an asset increase, rather more decline: Tangible assets for example decline by the speed of depreciation, inventory by redundancy over time. Also, the position of a stake acquired in another firm may have to be reduced, should its yield or performance not justify its original purchase price, a process referred to as impairment.

As far as the passive side of a firm´s balance sheet is concerned (i.e. a firm´s funding structure) both, equity and debt are disclosed at BV. The equity, for example, - composed of shareholders equity, additional paid in capital, and retained earnings – refers entirely to past, historical events. To start with, the shareholders equity is the nominal capital of the number of shares outstanding multiplied with the face value of a share, which can in essence have any nominal currency amount of choice – EUR 1, US$ 5 or 10 or SFR 0.1 or anything else. - The additional paid in capital accrues all those portions of funds raised in historical share capital increases in which shares were sold at a premium to the respective par value of the stock (as shares are in most cases issued at a MV / BV of more than 1). - And finally, the retained earnings position represents the historical accrued portion of a firm´s net income which was not paid out as dividends (with latter being cash leaving the firm, ending up directly in shareholders´ pockets).

In regards to debt, its book value equals the respective nominal, face value or the value which is owed to creditors.

The disclosure of BVs in balance sheets is strictly regulated by local or global accounting standards, whereby the most prominent of them are the International Accounting Standards (IAS) and the United States Generally Accepted Accounting Principles (USGAAP).

MV, on the other hand, reflects the trading price of an asset at a certain moment. The MV of a share is – if publicly traded - the current price on the stock market. The MV of a debt instrument is – if publicly traded, such as bonds – also the respective trading price. Thereby, investors will price an asset not only by its future value generating potential but also by non-fundamental aspects, such as the quality of management or a brand. In times of uncertainty, for example, investors may foremost look for safety and therefore seek acquiring liquid quality bonds, such as US Treasuries or German government bonds. – Therefore, the MV concept differs entirely from that of the BV, which is a historical, backward-looking representation of assets in accounting standards-driven balance sheets.

However, fundamental valuation aspects will almost certainly always play an important role in pricing an asset: In regards to shares, for example, an investor will estimate a firm´s potential of generating future net income and cash flows. In regards to fixed income instruments, such as bonds, an investor will assess whether the issuer will be able to meet its obligations and to what degree of certainty. Based on these assessments and – not least – psychological aspects as well as the actual supply and demand situation for a certain security, prices will be set.

NOTE: Within a Corporate Finance context, when analyzing balance sheet structures, calculating cost of capital, discount factors or else, it is always the MV which determines the weighting of debt and equity. Only the MV appropriately reflects an investor´s financial exposure, regardless whether this individual holds stocks, fixed income instruments or some sort of hybrid instrument.

EQUITY

BOOK VALUE		MARKET VALUE
ACCRUED NET INCOME MINUS ACCRUED DIVIDENDS →	RETAINED EARNINGS	
SHARE CAPITAL INCREASES →	ADDITIONAL PAID-IN CAPITAL	FUTURE EXPECTED CASH FLOWS
NOMINAL FACE VALUE x # SHARES OUTSTANDING →	SHAREHOLDER EQUITY	

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