What Is Book Value?

This fundamental measure of a company's worth can help you decide if a stock is attractive.

IMAGE SOURCE: GETTY IMAGES.

Book value is a key measure that investors use to gauge a stock's valuation. The book value of a company is the total value of the company's assets, minus the company's outstanding liabilities. The company's balance sheet is where you'll find total asset value, and for accounting purposes, the cost of acquiring the asset is the starting point for what you'll find listed in the company's financials. The balance sheet also takes into account accumulated depreciation of those assets, and that helps bring the true value of the assets closer to the number used for book value purposes. Often, book value is expressed on a per-share basis, dividing the total shareholder equity by the number of shares of stock outstanding.

Why book value is useful

The primary advantage of using book value as a basis for a company's valuation is that there's little or no subjectivity involved in calculating the figure. When you buy an asset, its cost becomes the starting entry on the balance sheet for the value of that asset. Over time, the asset gets used up, and depreciation gradually reduces the balance-sheet value of the asset. Although depreciation methods are generally simpler than the actual drop in an asset's value over time, the approximation is close enough to give you a relatively accurate view of the current value of the asset in most cases.

Value investors like to refer to book value in searching for stocks trading at bargain prices. If a stock trades below book value, then investors typically see it as an opportunity to buy the company's assets at less than they're worth. The potential pitfall is that if the value of the assets on the balance sheet are artificially inflated, then a discount to book value is perfectly justified and doesn't represent a bargain stock price.

The shortcomings of book value

One major problem with book value is that it tends to do a bad job of valuing intangibles, such as intellectual property rights. For instance, technology companies that specialize in software are often able to develop products at relatively low cost, and so their balance sheet entries for their major assets will fall well short of their true value. It's therefore common to see tech companies trade at many times their book value, yet that doesn't mean that the stocks are overpriced.

You can solve this problem by using book value as a comparative measure within a given industry. For instance, if one tech company has a price-to-book-value ratio that's far lower than another, then it might be a relative bargain. Similarly, even though an industrial company that's highly asset-dependent might have a lower book value than the tech company, it might be overpriced if its price-to-book ratio is higher than other industrial companies in the same sector.

Book value isn't a perfect measure of valuation, but it can give you a useful measure of a stock. By comparing book value to a stock's price, you can get a sense of whether investors see its accounting statements as a fair reflection of a company's intrinsic worth.

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HOW TO INVEST IN STOCKS

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How do I Invest

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What Should I Invest In?

When's the Right Time to Invest?

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