

Bear Stearns & Co

Answer the following 10 questions, using the financial statement data from Blockbuster Entertainment Corporation. Show your work (i.e., note what numbers you're using).

On May 9, 1989, Bear Stearns & Co. issued a report on Blockbuster Entertainment Corp., which is reproduced in part below.

Blockbuster-Entertainment (Ticker symbol: **BV**, Price per share: **\$33 ½**) increased owned and franchised video stores from 19 at the end of 1986 to 415 at December 31, 1988. In the same period revenue jumped from \$7.4 million to \$136.9 million. Reported earnings also leaped; from \$.34 per share in 1986 to \$.57 per share in 1988. The stock carries an historical Price to Earnings ratio of 59, and there were 25,741,549 shares of common stock issued and outstanding as of 12/31/88.

- A) Some of Blockbuster's mergers with other video rental companies have been recorded as purchases. In a merger treated as a purchase, the price paid is first allocated to the fair values of assets that can be kicked, picked up or painted. Any excess paid for the company beyond these "fair values" becomes goodwill, which Blockbuster labels "intangible assets relating to acquired businesses." APB Opinion 17 requires that goodwill be amortized to income (expensed) over 40 years *or less*.

In the past, many companies automatically adopted 40 year amortization. Current practice (which is usually required by the SEC) is to relate the amortization period to the nature of the business acquired. Thus in a typical hi-tech acquisition the SEC requires goodwill to be amortized over 5 to 7 years; in bank purchases, over 15 to 20 years.

Other information: Eight of the eighty company-owned stores that appeared in the 1987 10-K (annual filing with the SEC) are not on the 1988 list. The maximum term of the company's franchise agreements is 25 years.

- 1) What is Blockbuster's amortization timetable? Do you think it is appropriate?
 - 2) What would be the impact on Blockbuster's 1988 earnings per share if 5 year amortization were applied to this goodwill?
- B) On April 20, Blockbuster announced an agreement to merge with its largest franchisee, Video Superstore. Video Superstore was Blockbuster's largest customer for videotapes, accounting for 10% of such sales in 1988, 21% in 1987, and 48% in 1986.

Since intra-company transactions are eliminated from the financial statements (it doesn't make sense to record sales to *yourself!*), these sales will disappear next year.

- 3) What would have been the effect on earnings per share if Video Superstore purchases were not included in 1988 revenues?
- C) BV drastically slowed its depreciation (amortization) of "hit" video tapes at the start of 1988. In 1987 BV depreciated its rental videotape "hits" over nine months, straight line. At the start of 1988, it switched to a method it called "36 month accelerated." The financial statements do not disclose how *accelerated* the curve is, but do say that the company uses 150% of straight line, computed on a monthly basis. Thus, the resulting depreciation is as follows:

First 12 months	40%
Second 12 months	30%
Third 12 months	30%

- 4) Over what period does BV depreciate its "base stock" videotapes?
 - 5) What was the effect on earnings per share of the change in depreciation method for "hit" tapes (assume that *hit* tapes made up 25% of new tape purchases, and that the average *hit* tape was owned for half the year)?
- D) BV also sells videotapes. However, most of the sales are in bulk to new franchisees, rather than to store customers. In 1988, 68% of sales were to franchisees.

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- 6) What was the effect on earnings per share of these sales to franchisees?
- E) BV charges franchisees various fees and discloses them in a somewhat confusing manner. The income statement shows, in *revenues*:

***Royalties and other fees* \$8,142,000**

However, Note 1 to the financial statements lists:

***Royalties and other fees* \$7,590,000**

***Area Development fees* 550,000**

***Initial franchise fees* 2,415,000**

The first two items total to the income statement amount, the third seems to be buried, inexplicably, in rental revenues.

- 7) What was the effect on 1988 earnings per share, of the non-recurring items: *area development fees* and *initial franchise fees*?
- 8) What would BV's 1988 earnings per share be after all of the above adjustments?
- 9) Ignoring #3 above, what would BV's 1988 earnings per share be after the above adjustments?
- 10) What would BV's Price/Earnings ratio be, given all of the above adjustments (including #3)?

Exhibit 2

Selected Excerpts: Blockbuster Entertainment Corporation 1988 Annual Report

BLOCKBUSTER ENTERTAINMENT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations

**For the Years ended December 31,
(in thousands, except per share data)**

	1988	1987	1986
REVENUE:			
Rental revenue	\$87,299	\$19,009	\$ 2,893
Product sales	41,452	21,546	4,247
Royalties and other fees	8,142	2,673	298
	136,893	43,228	7,438
OPERATING COSTS AND EXPENSES:			
Cost of product sales	31,343	15,923	3,511
Operating expenses	63,638	16,429	5,152
Selling, general, and administrative	15,567	4,162	2,093
OPERATING INCOME (LOSS)	26,345	6,714	(3,318)
EQUITY IN LOSS OF AN AFFILIATE	—	—	(954)
INTEREST INCOME	626	456	228
INTEREST EXPENSE	(2,066)	(569)	—
OTHER INCOME, NET	92	104	—
INCOME (LOSS) BEFORE INCOME TAXES	24,997	6,705	(4,044)
PROVISION FOR (BENEFIT OF) INCOME TAXES	9,499	2,615	(823)
NET INCOME (LOSS)	\$ 15,498	\$ 4,090	\$(3,221)
NET INCOME (LOSS) PER COMMON AND COMMON SHARE EQUIVALENT	\$.58	\$.28	\$(.34)
NET INCOME (LOSS) PER COMMON AND COMMON SHARE EQUIVALENT—ASSUMING FULL DILUTION	\$.57	\$.28	\$(.34)

Exhibit 2 (Continued)

BLOCKBUSTER ENTERTAINMENT CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations
For the Years ended December 31,
(in thousands, except per share data)

ASSETS		1988	1987
CURRENT ASSETS			
Cash and short term investments		\$8,959	7,168
Accounts receivable, less allowances		5,617	2,596
Notes receivable from shareholders		—	7,919
Merchandise Inventories		17,901	8,440
Other		6,359	2,399
Total Current Assets		<u>38,836</u>	<u>28,522</u>
VIDEOCASSETTE RENTAL INVENTORY, NET		60,294	16,389
PROPERTY AND EQUIPMENT, NET		47,284	14,998
INTANGIBLE ASSETS RELATING TO ACQUIRED BUSINESS, NET		24,754	12,149
OTHER ASSETS		5,599	2,127
		<u>176,767</u>	<u>74,185</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES			
Current Portion of Long Term Debt		\$3,139	\$2,182
Accounts payable		34,131	10,587
Accrued liabilities		8,108	2,546
Current deterred income taxes		189	445
Advance payments from franchise owners		3,653	489
Total Current Liabilities		<u>49,220</u>	<u>16,879</u>
LONG TERM DEBT, LESS CURRENT PORTION		21,303	14,797
OTHER NONCURRENT LIABILITIES		1,293	451
DEFERRED INCOME TAXES		3,167	60
COMMITMENTS			
SHAREHOLDERS' EQUITY:			
Preferred Stock, \$1 par value; authorized 500,000 Shares; none outstanding		—	—
Common Stock, \$10 par value; authorized 40,000,000 and 20,000,000 shares, respectively; issued 25,741.549 and 17,995.092, respectively		2,574	1,800
Capital In excess of par value		84,806	40,572
Retained earnings (deficit)		15,124	(374)
Total Shareholders' Equity		<u>101,784</u>	<u>41,998</u>
		<u>\$176,767</u>	<u>\$74,185</u>

The accompanying notes are an Integral part of these statements.

Exhibit 2 (Continued)

BLOCKBUSTER ENTERTAINMENT CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations
For the Years ended December 31,
(in thousands, except per share data)

	1988	1987	1986
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$15,498	\$4,090	\$(3,221)
Adjustments to reconcile net income (loss) to net cash from (used in operating activities)	22,223	4,776	1,038
Depreciation and amortization	—	—	954
Equity in loss of an affiliate			
Changes in operating assets and liabilities, net of effects from purchase transactions			
Increase in accounts receivable	(3,132)	(1,211)	(1,264)
Increase in merchandise inventories	(9,309)	(5,068)	(3,153)
Increase in accounts payable and accrued liabilities	24,797	8,947	2,619
Increase (decrease) in advance payments from franchise owners	3,164	(1,511)	2,000
Increase in other working capital items, net	(3,984)	1,138	346
Other	(917)	1,378	346
NET CASH FLOW FROM (USED IN) OPERATING ACTIVITIES	48,340	10,263	(1,376)
CASH FLOWS FROM INVESTING ACTIVITIES			
Collection of notes receivable	7,919	—	—
Purchase of videocassette rental inventory, net	(51,255)	(14,281)	(3,053)
Purchases of property and equipment, net	(31,224)	(10,519)	(4,133)
Used in acquisitions	(9,843)	(2,814)	—
Other	—	(2,805)	(1,174)
NET CASH USED IN INVESTING ACTIVITIES	(84,403)	(30,449)	(8,360)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from the issuance of common stock, net	36,094	17,800	3,898
Proceeds from long term debt	39,847	9,184	1,400
Repayments of long term debt	(38,807)	(2,794)	—
Other	—	(238)	150
NET CASH PROVIDED BY FINANCING ACTIVITIES	37,854	23,952	5,448
NET INCREASE (DECREASE) IN CASH AND SHORT- TERM INVESTMENT	1,791	3,766	(4,288)
CASH AND SHORT TERM INVESIMENTS, BEGINNING OF YEAR	7,168	3,402	7,690
CASH AND SHORT-TERM INVESTMENTS, END OF YEAR	8,959	7,168	3,402

The accompanying notes are an integral part of these statements

Exhibit 2 (Continued)

BLOCKBUSTER ENTERTAINMENT CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(000's omitted in all labels except per share amounts)

I. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present the consolidated financial (Million and results of operations of the Company and its subsidiaries All material intercompany accounts and transactions have been eliminated in order to maintain consistency and comparability between periods presented, certain amounts have been reclassified from the previously reported fiscal 1987 and 1986 financial statements in order to conform to fiscal 1988 presentation

The statements of changes in shareholders' equity, all per share data and number of common shares for all periods included in the financial statements and notes have been adjusted to reflect the two-for-one stock splits that occurred in both March and August, 1988, as more fully described in Note 7.

The accompanying financial statements do not include the financial condition and results operations of Major Video Corp., which was acquired in January, 1989. This transaction, which will be accounted for as a pooling of interests, is more fully described in Note 10.

Short-Term Investments

Short-term investments consist of interest bearing securities with interest rates ranging from 5.20% to 9.13% with maturities of less than ninety days.

Accounts Receivable:

Accounts receivable includes an allowance for uncollectible accounts of \$181,000 and \$155,000 as of December 31, 1988, and 1987, respectively.

Merchandise Inventories:

Merchandise inventories are stated at the lower of cost or market. Cost is determined on a moving average basis and generally includes those costs required to purchase and ready products for sale or utilization in Company-owned stores. Inventory transferred to Company-owned stores is reclassified to non-current assets and amortized in accordance with Company policy.

Videocassette Rental Inventory:

Videocassettes are recorded at cost and amortized over their estimated economic life with no provision for salvage value. Those videocassettes which are considered base stock ("non-hits") are amortized over thirty-six months on a straight-line basis. Beginning January 1, 1988, economics and the related amortization period for new release feature films, which are frequently ordered in large quantities to satisfy initial demand ("hits"), were revised to approximate 36 months on an accelerated basis.

During the six-month period ended December 31, 1987, the economic life of "hits" and related amortization period approximated nine months on a straight-line basis with no salvage value. The Company has determined that the economic useful life and related amortization for these "hits" more closely approximates 36 months on the accelerated basis with no provision for salvage value.

Videocassette rental inventory and related amortization as of December 31, is as follows:

	<u>1988</u>	<u>1987</u>
Videocassette rental inventory.....	\$76,390	\$19,600
Less: Accumulated amortization.....	(16,096)	(3,211)
	<u>\$60,294</u>	<u>\$16,389</u>

Amortization expense related to videocassette rental inventory was \$15,659,000, \$3,543,000, and \$545,000 in 1988, 1987, and 1986, respectively. As videocassette rental inventory is sold or retired, the applicable cost and accumulated amortization are eliminated from the accounts and any gain or loss is recorded.

Property and Equipment:

Property and equipment is stated at cost. Depreciation and amortization is provided over the estimated useful lives of the related assets using the straight line method. Property and equipment as of December 31, consists of the following:

Exhibit 2 (Continued)

	Life	1988	1987
Buildings	15-19 Years	\$639	\$289
Leasehold Improvement	5-10 Years	26,378	6,465
Furniture and fixtures	5-10 Years	11,141	4,482
Equipment and vehicles	3-10 Years	14,631	5,298
		52,789	16,354
Less: Accumulated depreciation and amortization		(5,505)	(1,536)
		\$47,284	\$14,938

Depreciation expense was \$3,796,000, \$993,000 and \$492,000 in 1988, 1987 and 1986, respectively. Additions to and major improvements of property and equipment are capitalized. Maintenance and repair expenditures are charged to expense as incurred and amounted to approximately \$454,000, \$191,000 and \$125,000 in 1988, 1987, and 1986, respectively. As property and equipment is sold or retired, the applicable cost and accumulated depreciation or amortization are eliminated from the accounts and any gain or loss is recorded.

Intangible Assets:

Intangible assets relating to acquired businesses as of December 31, 1988, and 1987 consist primarily of the cost of purchased business in excess of market value of net assets acquired. The cost in excess of market value of net assets relating to businesses acquired is being amortized on a straight-line basis over a period of 40 years. The accumulated amortization of intangible assets amounted to \$769,000 in 1988 and \$196,000 in 1987.

Revenue Recognition:

Revenue from Company-owned stores is recognized at the time of rental or sale. Revenue from franchise owners is recognized when all material services or conditions required under the franchise agreement have been performed by the Company. The only significant commitment and obligation the Company has under its franchise agreements is to provide products to franchise owners. The Company derives substantially all of its franchise program revenue from the following sources: (1) Initial franchise fees, (2) Product sales to franchise owners, (3) Area development fees and (4) Royalties and other fees.

Franchise owners purchase their initial tape inventory, equipment and supplies from the Company at cost plus a mark-up. Revenue for these items is recognized when the products are shipped. In addition, they pay a royalty based on monthly revenue and a monthly software license fee, which are recognized as revenue when earned. Certain franchise owners pay an initial franchise fee and a non-refundable area development fee under their franchise agreement. Revenue is recognized from these fees when the store is opened.

Revenue included in the consolidated statements of operations from the Company's franchise program for the years ended December 31, is as follows:

	1988	1987	1986
Product Sales	\$28,334	\$19,163	\$3,793
Royalties and other fees	7,590	2,583	298
Area development fees	552	90	--
Initial franchise fees	2,415	270	--
	\$38,891	\$22,406	\$4,091

Approximately 10%, 21%, and 48% of total revenue in 1988, 1987, and 1986, respectively, was derived from one franchise owner: BLOCKBUSTER Midwest, L.P.

Income Taxes:

The Company has applied Statement of financial Accounting Standards (SFAS) No. 96 – Accounting for Income Taxes to all years presented.

EXHIBIT 2 (Continued)

2. SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information for the years ended December 31, is as follows:

	<u>1988</u>	<u>1987</u>	<u>1986</u>
Cash received (paid) during the year for:			
Interest income	\$578	\$486	\$268
Interest expense	(2,760)	(130)	(45)
Income taxes	(3,338)	(789)	46
Investing activities in connection with acquisitions (none in 1986):			
	<u>1988</u>	<u>1987</u>	
Videocassette rental inventory	\$8,846	\$2,575	
Property and equipment	5,090	1,316	
Other non-current assets	572	--	
Intangible assets relating to acquired businesses	13,093	11,992	
Working capital other than cash acquired	(4,037)	(384)	
Long-term debt issued and assumed	(5,527)	(10,290)	
Common stock and warrants issued	(8,194)	(2,365)	
Cash used in acquisitions	<u>\$9,843</u>	<u>\$2,844</u>	

3. BUSINESS COMBINATIONS

All businesses acquired through December 31, 1988, and accounted for as purchases are included in the financial statements from the date of acquisition. Those businesses acquired through December 31, 1988, and treated as poolings of interests have been included retroactively in the financial statements as if the companies had operated as one entity since inception.

In early 1988, the Company acquired Video Library, Inc., a 42-stor retail video chain based in San Diego, Calif., for \$6,380.861 in cash and 885,508 shares of common stock. In addition, during 1988, the Company acquired four other businesses for \$4,840.462 in cash and notes, and 449,889 shares of its common stock. The aforementioned acquisitions were accounted for under the purchase method of accounting.

The Company's consolidated results of operations on an unaudited pro forma basis, assuming these acquisitions had occurred as of January 1, 1987, are as follows:

	<u>1988</u>	<u>1987</u>
Pro forma revenue	\$144,624	\$61,936
Pro forma net income	15,532	4,216
Pro forma earnings per share	.56	.27

This pro forma information does not purport to be indicative of the results that actually would have been obtained if the operations had been combined during the periods presented and is not intended to be a projection of future results.

Effective May, 1987, the Company acquired Movies To Go, Inc., a 29-store retail video chain based in St. Louis, Mo., \$14,500,000 in cash, notes and warrants representing 880,000 shares of common stock. This acquisition was accounted for under the purchase method of accounting.

In March, 1987, the Company acquired the net assets of Southern Video in exchange for 321,840 shares of common stock of the Company. The transaction was accounted for under the pooling of interests method of accounting.

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EXHIBIT 2 (Continued)

4. LONG TERM DEBT

The details relating to long term debt as of December 31 are as follows:

	1988	1987
Notes Payable:		
Payable to banks under an unsecured revolving credit agreement, interest at prime plus $\frac{1}{4}\%$ (10.50% as of December 31, 1988), due 1992, interest payable quarterly with principal due at maturity.	\$15,000	\$ —
Payable to former shareholders of Movies to Go, interest rates escalating annually from 6% to prime plus 2% due 1992. Periodic annual principal payments ranging from \$427,000 to \$2,570,000 plus interest.	6,905	9,121
Payable to a bank under an unsecured revolving credit agreement, interest at prime (8.75% at December 31, 1987), due 1989. Interest payable quarterly with principal due at maturity. --	—	7,500
Payable to others, interest at various rates ranging from 6% to 14% due at various times through 1992. Monthly principal payments of approximately \$89,000 plus interest. Secured by certain inventories and real estate.	928	988
Capitalized lease obligations secured by furniture and fixtures, computer equipment and vehicles	1,609	—
Total long-term debt	24,442	17,609
Less: Current Portion	(3,139)	(2,812)
Long term debt, less current portion	\$21,303	\$14,797

The long term debt as of December 31, 1988, is due as follows:

1989	\$3,319
1990	2,670
1991	3,003
1992 and thereafter	15,630

In June, 1988, the Company entered into a revolving credit agreement with Security Pacific National Bank, for itself and as agent and Southeast Bank, N.A., for itself, pursuant to which the banks have agreed to loan the Company an aggregate of \$50,000,000 on an unsecured basis. No principal payments are required until the maturity date in 1992. Interest on current loans is the lower of the prime rate in effect of the agent plus $\frac{3}{4}$ of one percent, depending on the aggregate principal amount of the advances outstanding of the London Interbank offered rate plus 1 and $\frac{3}{4}$ percent or two percent, depending upon the aggregate principal amount of advances outstanding. There is a commitment fee of $\frac{1}{2}$ percent per annum on the average unused portion of the available commitment plus $\frac{1}{4}$ percent per annum on a portion of the banks' average daily inactive commitments and $\frac{1}{2}$ percent on such part of the inactivated commitment when activated. There are no compensating balance requirements in connection with the revolving credit agreement. The agreement requires the Company to maintain certain financial ratios and imposes certain restrictions on, among other things, additional debt, payment of cash dividends and capital expenditures in excess of specified amounts.

5. INCOME TAXES

The income tax provision (benefit) for the years ended December 31, consists of the following components:

	1988	1987	1986
Current:			
Federal	\$4390	\$1,925	\$(790)
State	373	80	--
Total Current	4,763	2005	(790)
Deferred:			
Federal	4,323	582	(33)
State	413	28	---
Total Deferred	4,736	610	(33)
	\$9,499	\$2,615	\$(823)

A reconciliation of the expected income tax provision at the U.S. federal income tax rate (34% in 1988), 40% in 1987, and 46% in 1986) to the Company effective income tax provision for the years ended December 31, is as follows.

	1988	1987	1986
Income tax provision (benefit) at statutory rate	\$8,499	\$2,682	\$(1,860)
Amortization expense not deductible for tax	157	78	--
Tax benefits of temporary differences not recognized for financial reporting	--	--	800
Effect of future lower tax rate on temporary differences, net	--	(137)	--
State income taxes, net of federal income tax benefit	786	108	--
Intercompany profit eliminations of pooled entity	--	--	160
Other, net	57	(116)	77
Total	\$9,499	\$2,615	\$(823)

Deferred taxes reflect the impact of "temporary differences" between the amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations.

Report of Independent Public Accountants

To BLOCKBUSTER Entertainment Corporation:

We have audited the accompanying consolidated balance sheets of BLOCKBUSTER Entertainment Corporation (a Delaware corporation) and subsidiaries as of December 31, 1986 and 1987, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly. In all material respects, the financial position of BLOCKBUSTER Entertainment Corporation and subsidiaries as of December 31, 1988 and 1987, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

ARTHUR ANDERSON AND COMPANY

Ft. Lauderdale, Florida, Feb. 17, 1989