How to Value Contingent Assets & Liabilities

To arrive at a proper valuation, business analysts gather thousands of data points about a subject company. Much of the relevant information is easy to find, but some crucial pieces are a challenge to uncover and assess. Contingent assets and liabilities fall into the latter category.

As their names imply, contingent assets and liabilities may or may not be realized, depending on the outcome of events.

For example, over the four years that NTP, Inc. was engaged in a lawsuit against BlackBerry manufacturer Research in Motion (RIM) for patent infringement, NTP had a contingent asset of hundreds of millions of dollars. Conversely, RIM had a similar contingent liability pending the outcome of the case.

In New Orleans, hundreds of companies have business interruption insurance claims pending because of Hurricane Katrina, representing millions of dollars in contingent assets. Conversely, owners of property contaminated by toxic waste have contingent liabilities, pending site cleanup.

Hard to Find, Harder to Value

Under Generally Accepted Accounting Principles (GAAP), contingencies cannot be reported on financial statements unless they are of "determinable" value. But from a valuation aspect, they must be found and considered because they can greatly impact the value of a company.

As Shannon Pratt warned his fellow valuation experts, "Don't forget about contingencies!" According to Pratt, "One of the most difficult categories of items to treat analytically for valuation purposes is contingencies. The very fact that an item is a contingency defies precise quantification. Nevertheless, the valuation analyst must try to discover contingent assets and liabilities, whether or not they are on the financial statements in some form, and deal with them within the scope of the available information."[1]

Positive or Negative?

Depending on facts and circumstances, contingencies can negatively or positively impact value. For example, Net Operating Loss (NOL) carryovers are considered assets, but because of complex GAAP rules and IRS regulations, a new owner may be limited in how he or she can use them. When valuing a company for sale with NOLs, the valuation professional must consider whether the losses will be available to a new buyer and how they can be used relative to IRS rules. The same questions surround research and experimentation (R&E) credits.

In both cases, the company needs future income with which to offset the NOLs and the R&E credits. From a fair market value perspective, NOLs or R&D credits may have limited value. Plus, if the transaction is asset-based rather than stock-based, these contingencies are worthless to the buyer. Because of the complexities surrounding contingent assets and liabilities, it is important to work with experienced valuation professionals who know what to look for.

If you would like more information about contingencies and how they might affect a valuation, please contact our firm.

[1] Source: Pratt, et. al., Valuing A Business, 4th Edition.

Which Method to Use?

Business valuation experts slice and dice data many ways to arrive at a reasonable assessment. When it comes to contingencies, experts use several common methods. In addition to the "best guesstimate" approach, analysts use probability weighting or Monte Carlo simulation, a complex mathematical technique that estimates probability.

Of course, regardless of which method is used, forecast results are only as good as the data input — another reason to make sure your valuation expert is knowledgeable regarding contingencies.