

# Treatment of Nonoperating Assets and Nonoperating Liabilities in Private Company Business Valuations

Jason Bolt

*The treatment of nonoperating assets and nonoperating liabilities in a private company business valuation may have a material impact on the value conclusion. When considering the treatment of nonoperating assets and liabilities, there are two primary factors that the analyst may consider: (1) the standard of value and (2) the level of value (noncontrolling or controlling ownership interest). Based on the facts and circumstances of the valuation, the analyst may decide (1) whether to adjust the business income to exclude any income or expenses related to nonoperating assets and liabilities and (2) how much value to assign to the nonoperating assets and liabilities in the value reconciliation. The analyst should develop an understanding of (1) the different standards of value and (2) the differences between a noncontrolling ownership interest and a controlling ownership interest. The analyst should apply that understanding in deciding how to treat the subject company nonoperating assets and nonoperating liabilities.*

## INTRODUCTION

The existence and treatment of nonoperating assets and nonoperating liabilities may have a material impact on the concluded value in a private company business valuation. Identifying the appropriate standard of value, defining the purpose and the objective of the business valuation, and defining the subject ownership interest are important elements when the analyst considers the appropriate treatment of nonoperating assets and liabilities.

Appropriately reflecting the value of nonoperating assets and nonoperating liabilities may have a material impact on the private company value conclusion.

Nonoperating assets are “assets not necessary to ongoing operations of the business enterprise.”<sup>1</sup>

That is, any asset owned by a business enterprise that can be sold or distributed to shareholders without affecting the ongoing operating capabilities of the business enterprise is a nonoperating asset.

A nonoperating liability, on the other hand, is an amount owed by a business enterprise that is not related to the ongoing operations of the business. A nonoperating liability may also be a contingent or off-balance-sheet liability which may occur depending on the outcome of a future event.

Under U.S. generally accepted accounting principles (“GAAP”), a contingent liability is only recorded on the company’s balance sheet if the outcome is probable. However, for business valuation purposes, the analyst may decide to adjust the company’s balance sheet (or income statement) to reflect the impact of contingent liabilities.

The following are a few examples of nonoperating assets:

- Excess cash or excess net working capital
- Marketable securities such as stocks or mutual funds
- Ownership interests in other companies unrelated to the principal business

- Real estate and personal property unrelated to the current business activities
- Art collections or other collectibles
- Loans receivable from company owners
- Assets associated with any discontinued operations

The following are a few examples of nonoperating liabilities:

- Lawsuits
- Product warranties
- Dividends payable
- Liabilities associated with any discontinued operations

When considering the treatment of nonoperating assets and nonoperating liabilities, there are two principal factors that the analyst may consider:

1. The standard of value
2. The level of value (noncontrolling or controlling ownership interest)

Based on the facts and circumstances of the business valuation, the analyst may decide:

1. whether to adjust the earnings to exclude income or expenses related to nonoperating assets and liabilities and
2. how much value to assign to the nonoperating assets and liabilities in the value reconciliation.

The analyst should develop an understanding of the (1) different standards of value and (2) the differences between a noncontrolling interest and a controlling interest. This understanding may help the analyst decide how to treat any nonoperating assets and nonoperating liabilities.

There are a number of factors for the analyst to consider in this regard. A few examples may help to clarify the nuances in the appropriate treatment of nonoperating assets and nonoperating liabilities.

## STANDARD OF VALUE

The standard of value can have an impact on the valuation treatment of nonoperating assets and nonoperating liabilities. The standard of value “identifies the type of value being used in a specific engagement—for example, fair market value, fair value, or investment value.”<sup>2</sup>

Fair market value and fair value are two standards of value that are often applied for regulatory, financial accounting, and litigation purposes.

Fair market value is sometimes defined as “the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”<sup>3</sup>

Fair market value is the standard of value that is typically applied in federal tax valuation matters.

Fair value can have a different definition depending on the purpose of the valuation. For financial accounting purposes, the definition of fair value is based on Accounting Standards Codification (“ASC”) Topic 820. In ASC 820, fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

This definition of fair value is similar to (but not the same as) the definition of fair market value.

In business valuations prepared for dissenting shareholder rights litigation and shareholder oppression litigation, the definition of fair value is based on either (1) a state-specific statute in which fair value is defined or (2) state judicial precedent (often referred to as “statutory fair value”).

When performing a statutory fair value analysis in a litigation environment, the analyst should review the specific state’s definition of fair value as definitions can vary from state to state.

One difference between the statutory fair value standard among the states is the application of a discount for lack of control (“DLOC”) and a discount for lack of marketability (“DLOM”). In general, for statutory fair value purposes, most states do not accept a discount for lack of control or a discount for lack of marketability.<sup>4</sup>

## LEVELS OF VALUE

The analyst may be asked to provide an estimate of value based on one of the generally accepted levels of value. Exhibit 1 provides a simplified summary of the levels of value within a private company business valuation context.<sup>5</sup>

According to the textbook *Financial Valuation Application and Models*, Exhibit 1 is described as follows:<sup>6</sup>

Control strategic can refer to the level of value in a public or a private company.

**Exhibit 1**  
**General Levels of Value**  
Presented in *Financial Valuation: Application and Models*

Level of Value	Type of Company	Value Characteristics
Control Strategic	Public Company Private Company	Control and/or Strategic Value
Minority/Control Standalone Liquid	Public Company	Actively Traded Minority Price per Share x Number of Shares Outstanding
Minority Liquid	Public Company	Actively Traded Minority Price per Share
Control Liquid	Private Company	Actively Traded Public Equivalent Value
Control Standalone	Private Company	Control Private Company Value
Minority Nonmarketable	Private Company	Minority Private Company Value

Note: *Financial Valuation: Application and Models*, Exhibit 103, p. 394.

An example of minority/control standalone liquid is the value resulting from the application of the guideline public company method. Some analysts consider the result a minority value. In more recent years more analysts consider the level of value from the guideline public company method as both minority and control. An example of control liquid is the value derived from the application of the income approach (with control cash flows), where the discount or cap rate is based on returns from the public marketplace. Control standalone is the value of a private company after application of the income approach with a discount to reflect the lesser liquidity of a control interest in a private company versus public stock. An income approach using a rate of return derived from public company data and adjusted for a size risk premium likely reflects a liquid value, but not as liquid as a large company stock. Many small companies are highly illiquid with large bid-ask spreads (that may contribute to the small size premia).

Publicly traded guideline company data used to calculate a subject value would indicate a marketable liquid value, but the degree of liquidity depends upon the liquidity of the guideline companies used. The guideline company transactions method presumably provides a control, illiquid but marketable conclusion of value. The asset approach would likely indicate a control marketable value, depending on the type of assets and the methods used to value the assets of the subject company.

Minority nonmarketable value is the value after the consideration of and/or application of all discounts for lack of control and lack of marketability. Some of these “levels” of value may be higher or lower than the others, depending on the circumstances. The DLOM is considered primarily with the bottom three levels for a private company.

The business valuation methods applied by the analyst may be influenced by the level of value sought.

An ownership interest in which a shareholder owns over 50 percent of the outstanding equity is known as a controlling interest. Except for certain circumstances where supermajority voting is required, a controlling interest holder can force the liquidation and distribution of nonoperating assets. Conversely, a noncontrolling interest is an ownership interest in which less than 50 percent of the outstanding equity is owned.

A noncontrolling interest holder cannot force the liquidation of nonoperating assets by themselves. Thus, the treatment of nonoperating assets in the valuation of a noncontrolling interest depends on the standard of value and the specific facts and circumstances of the valuation.

The level of value may also be affected by the standard of value. For a fair market value engagement, the standard of value will typically be based on the actual ownership interest (for example, a 1 percent interest is a noncontrolling interest). In a statutory fair value engagement, the same 1 percent interest may not necessarily be valued on a noncontrolling interest basis.

In a statutory fair value valuation, the estimated value typically excludes the application of a discount for lack of control and a discount for lack of marketability.

Thus, a 1 percent interest in a statutory fair value valuation may be assigned the pro rata value of a 100 percent business ownership interest.

## SIMPLIFIED ILLUSTRATIVE EXAMPLE

The previous discussion provided the framework for the factors that the analyst considers when deciding

how to treat nonoperating assets and liabilities. This section presents the following two examples on how to treat nonoperating assets:

1. A statutory fair value valuation
2. A minority interest fair market value valuation

In the following examples, the analyst considers (1) the treatment of the nonoperating assets and liabilities on a company's financial statements and (2) the appropriateness of making normalizing adjustments. The analyst considers the appropriateness of applying discounts to the nonoperating assets.

In the following examples, let's call our hypothetical illustrative company Subject Company. Let's assume that the valuation date is December 31, 2018. Let's assume that Subject Company owns an equity interest in an unrelated—and unconsolidated—company. Let's assume that the fair market value of that equity investment is \$4 million. In addition, the company's latest fiscal year-end earnings are assumed to represent a normalized level of earnings.

The only business valuation approach applied in this simplified example is the income approach. Summary income statement information for Subject Company is presented in Exhibit 2.

Nonoperating assets and liabilities are not necessary to the ongoing operations of a business. They may generate income for the company or cause the company to incur expenses.

When developing a business valuation, the analyst may apply a market approach wherein the analyst selects a sample of guideline companies that are sufficiently similar to the subject company. An analysis of the subject company's financial ratios is compared to the financial ratios of the guideline companies in order to facilitate the selection of a valuation pricing multiple.

In order to facilitate comparability between the subject company and the guideline companies, income or expenses related to nonoperating assets may be removed from both the subject company's earnings and the guideline companies' earnings. In addition, if sufficient information is available, the balance sheets of the subject company and the guideline companies may be adjusted as well.

In the application of the market approach, the analyst may remove the impact of nonoperating assets and liabilities from the subject company's earnings. To conclude a value indication, the analyst will apply a market-based multiple to a measure of the subject company's earnings.

## Exhibit 2 Subject Company Treatment of Nonoperating Assets Income Statement Summary and Fair Market Value of the Equity Investment As of December 31, 2018

	Year Ended 12/31/2018
Income Statement Summary	\$000
Operating Income	2,000
Earnings from Equity Investment	<u>500</u>
Pretax Income	2,500
Less: Income Taxes @ 20%	<u>500</u>
Net Income	<u>2,000</u>
Assumed Fair Market Value of the Equity Investment	<u>4,000</u>

The selected market-based pricing multiple considers the risks inherent in the industry and the growth prospects in the industry. Including income or expenses from nonoperating assets or liabilities may overstate—or understate—the business value of the subject company.

The nonoperating assets or liabilities may not be subject the same risks or growth opportunities as the industry represented by the guideline companies.

In the application of the income approach, the analyst may determine the value of the company by applying either (1) a direct capitalization method or (2) a discounted cash flow (“DCF”) method.

In the direct capitalization method, the analyst may consider the company's historical earnings as one of many factors to determine normalized cash flow. Since historical earnings may form a part of the analyst's determination of normalized cash flow, earnings or expenses related to nonoperating assets or liabilities may be adjusted to remove their impact from pretax and after-tax earnings.

Similarly, when the analyst applies the DCF method, if the projected financial information contains income or expense from nonoperating assets, the projected cash flow may be adjusted to remove the impact of such nonoperating assets.

### Example 1: Statutory Fair Value Case

Statutory fair value valuations typically exclude consideration of a DLOM and a DLOC. That is, in a statutory fair value valuation, the ownership interest value is estimated based on the pro rata value of 100 percent of the subject company value.

In this example, let's assume the facts as presented in Exhibit 1. The valuation subject in a hypothetical shareholder oppression claim is a 25 percent ownership interest in Subject Company.

To account for nonoperating assets or liabilities in the statutory fair value valuation, the analyst may adjust the earnings for the income or expense related to the nonoperating assets or liabilities. The analyst may add the fair market value of the nonoperating assets or deduct the full amount of nonoperating liabilities from the value of the private company operations.

Following the facts presented, the analyst may remove from pretax income the earnings associated with the equity investment. As presented in Exhibit 3, the earnings from the equity investment are removed from pretax income. Adjusted pretax income is then tax affected to arrive at adjusted net income.

In this simplified example, it is assumed that adjusted net income represented a normalized level of income on a controlling ownership interest basis and the equity direct capitalization rate is 10 percent.

Based on these valuation variables, the estimated value of the ongoing operations of the business is \$16 million. To this, the analyst adds the fair market value of the equity interest of \$4 million to arrive at a value of 100 percent of the equity of the company of \$20 million, presented in Exhibit 3.

Since the standard of value is statutory fair value, no valuation discounts are applied to the 100 percent equity interest to arrive at a noncontrolling interest value.

## Example 2: Minority Interest Fair Market Value Case

In family law matters, the jurisdiction-specific standard of value may be fair market value. One difference between fair market value and statutory fair value is the application of valuation discounts in the fair market value case. To illustrate the impact of discounts, let's assume the same facts and circumstances as in Example 1.

Another factor to be considered is whether the income is projected on a controlling ownership interest basis or a noncontrolling ownership interest basis. Finally, the analyst needs to understand whether the nonoperating assets are expected to be liquidated in the near-term and the proceeds distributed<sup>7</sup> to the shareholders.

Let's first consider the case where income is projected on a controlling ownership interest basis and the equity is expected to be retained. In this case, the conclusion of value of a 100 percent equity interest is similar to that presented in Example 1.

The main difference is the application of the DLOC and the DLOM. Let's assume a discount for lack of control of 25 percent and a discount for lack of marketability of 30 percent. The estimated noncontrolling, nonmarketable value of a 25 percent interest is \$2.6 million, 48 percent lower than the concluded statutory fair value. Exhibit 4 summarizes the fair market value indication in this case.

Now, let's assume that the Subject Company nonoperating assets are expected to be sold and the cash proceeds will be immediately distributed to the shareholders. Therefore, the conclusion of the fair market value may change somewhat. In this instance, the DLOC and the DLOM are applied only to the operating business value, as presented in Exhibit 5.

The pro rata amount of the expected cash proceeds from the immediate sale of the nonoperating assets are added directly to the concluded noncontrolling, nonmarketable value.

Based on this set of hypothetical circumstances, the calculation of the noncontrolling, nonmarketable value of a 25 percent interest in Subject Company is presented in Exhibit 5.

### Exhibit 3 Subject Company Statutory Fair Value Valuation Adjustments to Pretax Income and Estimated Fair Value As of December 31, 2018

	Year Ended 12/31/2018
Normalization Adjustments to Pretax Income	\$000
Pretax Income, as Reported	2,500
Less: Earnings from Equity Investment	<u>500</u>
Adjusted Pretax Income	2,000
Less: Income Taxes @ 20%	<u>400</u>
Net Income	<u>1,600</u>
Income-Based Direct Capitalization Rate	10%
Conclusion of Fair Value	\$000
Estimated Fair Value of Business Operations on a Controlling Ownership Interest Basis	16,000
Plus: Fair Market Value of Equity Investment	<u>4,000</u>
Fair Value of Total Equity	<u>20,000</u>
Statutory Fair Value of a 25% Equity Interest in Subject Company on a Controlling, Marketable Ownership Interest Basis	<u>5,000</u>

**Exhibit 4**  
**Subject Company**  
**Estimated Fair Market Value**  
**Nonoperating Assets Retained in the Business**  
**Noncontrolling Ownership Interest Fair Market Value Case**  
**As of December 31, 2018**

	As of 12/31/2018
Conclusion of Fair Market Value	\$000
Estimated Value of Business Operations on a Controlling Ownership Interest Basis	16,000
Plus: Fair Market Value of Equity Investment	<u>4,000</u>
Fair Market Value of Total Equity	20,000
Less: Discount for Lack of Control	25%
Less: Discount for Lack of Marketability	<u>30%</u>
Less: Combined Valuation Discounts <sup>8</sup>	48% <u>(9,600)</u>
Fair Market Value of Total Equity on a Nonmarketable, Noncontrolling Ownership Interest Basis	<u>10,400</u>
Fair Market Value of a 25% Equity Interest in Subject Company on a Nonmarketable, Noncontrolling Ownership Interest Basis	<u>2,600</u>

**Exhibit 5**  
**Subject Company**  
**Estimated Fair Market Value**  
**Nonoperating Assets Will Be Liquidated**  
**Noncontrolling Ownership Interest Fair Market Value Case**  
**As of December 31, 2018**

	As of 12/31/2018
Conclusion of Fair Market Value	\$000
Estimated Value of Business Operations on a Controlling Ownership Interest Basis	<u>16,000</u>
Fair Market Value of Business Operations Equity	16,000
Less: Discount for Lack of Control	25%
Less: Discount for Lack of Marketability	<u>30%</u>
Less: Combined Valuation Discounts <sup>8</sup>	48% <u>(7,680)</u>
Estimated Nonmarketable, Noncontrolling Interest Value of Business Operations	8,320
Plus: Fair Market Value of Equity Investment—Assumed to Be Liquidated	<u>4,000</u>
Fair Market Value of Total Equity on a Nonmarketable, Noncontrolling Ownership Interest Basis	<u>12,320</u>
Fair Market Value of a 25% Equity Interest in Subject Company on a Nonmarketable, Noncontrolling Ownership Interest Basis	<u>3,080</u>

**SUMMARY AND CONCLUSION**

The standard of value and the level of value may have a material impact on the valuation of the private company business or business ownership interest. The analyst typically specifies in the engagement letter which standard of value is to be applied in the subject valuation assignment.

If the standard of value is statutory fair value, the analyst should also consider the definition of fair value provided by the statutory authority or judicial precedent.

Statutory fair value is not always formally defined in each state. In such instances, the analyst may seek legal instructions from the client's counsel as to the appropriate interpretation of fair value.

**Notes:**

1. "International Glossary of Business Valuation Terms." National Association of Certified Valuators and Analysts, 8 June 2001, www.nacva.com.
2. Ibid.
3. Ibid.
4. For a detailed discussion of the standards of value for litigation purposes, the reader can refer to Jay E. Fishman, Shannon P. Pratt, and William J. Morrison, *Standards of Value: Theory and Applications*, 2d ed. (Hoboken, NJ: John Wiley & Sons, 2013).
5. James Hitchner, *Financial Valuation: Applications and Models*, 4th ed. (Hoboken, NJ: John Wiley & Sons, 2017).
6. Ibid.
7. Even if the nonoperating assets are expected to be liquidated but the proceeds will not be distributed, the nonoperating asset will still exist, only as a different asset (cash instead of an equity investment in this example).
8. Calculated as  $1 - [(1 - DLOC) \times (1 - DLOM)]$

Jason Bolt is a manager in our Portland, Oregon, office. Jason can be reached at (503) 243-7533 or jmbolt@willamette.com.

