# Reasonable Com

# pensation Criteria
## for Business Valuations

*by Marshall A. Morris, CPA/ABV, CFE*

Compensation paid to a business owner-employee is a critical business valuation issue. If the owner-employee's compensation is unreasonable, the value estimate may be distorted. Reasonable in this context means fair relative to the services that the owner-employee provides to the business. Because owners typically pay themselves an excessive amount or an insufficient amount, the valuator must usually make a "normalization" adjustment to arrive at a reasonable amount of compensation.

We define compensation as total cash compensation, including base salary, commissions, bonuses and similar incentive payments for services provided.

Determining reasonable compensation generally involves identifying the subject entity's industry and researching various databases for compensation information, usually by functional title. The normalization adjustment involves adding back the reported owner-employee compensation to earnings or cash flow, and deducting an amount considered reasonable or fair. This article is concerned with the criteria and method for developing the adjustment.

### Case Law

Federal income tax case law has explored the reasonableness criteria for compensation deductions when the IRS has challenged these deductions. The following two cases, for example, delineate factors to consider when assessing the reasonableness of business owner-employee compensation:

- *Exacto Spring Corp. v. CIR* (196 F.3d 833, 7th Cir. 1999)
- *LabelGraphics, Inc. v. CIR* (221 F.3d 1091, 9th Cir. 2000)

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Although those are income tax cases, the factors discussed are applicable to the business valuation process. *Exacto Spring* considered the following seven factors in establishing reasonableness:

- Type and extent of the services provided by the owner-employee
- Scarcity of qualified replacement employees
- Qualifications and prior earnings capacity of the owner-employee
- Contributions of the owner-employee to the business venture
- Net earnings of the employer
- Prevailing compensation paid to employees with comparable jobs
- Peculiar characteristics of the employer's business

The following five factors were considered in *LabelGraphics*:

- Owner-employee's role(s) in the company
- Comparison of the owner-employee's compensation with those paid by similar companies for similar services
- Character and condition of the company
- Potential conflicts of interest
- Evidence of an internal inconsistency in a company's treatment of payments to employees

Based on my years of experience and conversations with human resources and compensation experts, I have condensed those various factors to three critical factors that are common to both *Exacto Spring* and *LabelGraphics*:

- The owner-employee's multiple roles in the company
- Comparable compensation levels within the industry
- The condition and financial performance of the company

## Multiple Roles of the Owner

Owners of closely held businesses generally provide an array of services to their companies, including chief executive officer, chief operations officer, chief marketing officer and sometimes even chief financial officer. Most owners typically perform any combination of those roles during a given workday. The result of such multiple role-playing is usually a large number of hours worked each week—typically 55 to 60 hours or more, demonstrating the overall importance of the owner-employee to the success of the business. Assessing the reasonableness of the compensation paid to them should include consideration of the multiplicity of duties and the number of hours required of them. It seems plausible that the economic compensation to a hard-working owner who must assume multiple roles, and perform them all well, should be higher than the compensation paid to an executive in a similar business who performs only one of those roles well.

For the purpose of assessing reasonableness of compensation, the valuator should quantify the time that the owner-employee spends in each of the various roles. The numbers will come primarily from an interview with the owner. In most cases we find that we can rely on the owner's estimates, but in a litigation or divorce context we may try to verify those estimates by interviewing other key employees and the non-owning spouse.

To illustrate, let's use the fictitious example of Smith, the owner-employee of ABC Corp., the subject valuation entity. We find through interviews with Smith that he wears the following hats, with percentage of his time spent in each role:

- Chief executive officer—25%
- Chief operations officer—35%
- Top sales and marketing executive—30%
- Top compensation and benefits executive—10%

ABC employs a chief financial officer, and there are 23 other employees, for a total of 25 employees. Assume that everyone in the company works a 40-hour week except the CFO who works 50 hours, and Smith who works 75 hours weekly. Smith receives $1 million annual total cash compensation.

## Industry Compensation Levels

Using industry compensation data, we can calculate comparable compensation for employees in roles similar to Smith at similar companies in the same industry. The most useful, free databases include the following:

- Salary.com, based in Needham, MA: www.salary.com, or toll-free 866-SALARY1
- The Wages, Earning & Benefits data provided by the Bureau of Labor Statistics, U.S. Department of Labor: www.stats.bls.gov/bls/wages.htm

You'll get more comprehensive data using fee-based online databases. Following are two sites that offer links to vendors of fee-based databases and surveys:

- Business & Economics Library, University of California: www.lib.berkeley.edu/BUSI/bbg 13.html
- HR-Guide.com: www.hr-guide.com/data/043.htm

Also, many trade and professional associations conduct proprietary compensation surveys for their members.

It is likely that the executives surveyed for the database work at least 50 hours, some perhaps more, or they probably would not have risen to their lofty positions. In many databases, the hours worked by these employees are not stated. Therefore, we will make an assumption to establish a standard by which we can measure the reasonableness of Smith's compensation. If we assume that the executives in the database work a *standard* 50 hours per week, then Smith's 75 hours are 150 percent of the standard.

Our goal is to assess the reasonableness of Smith's million-dollar compensation. To that end, we access an online compensation database under the job category of executive management; and we request the data on a regional basis for the several positions that Smith occupies. The information returned to us describes the duties and responsibilities of those positions. For example:

The CEO "plans and directs all aspects of an organization's policies, objectives and initiatives, with responsibility for the short-term and long-term profitability and growth of the entity."

The COO "plans and directs the organization's operational policies, objectives and initiatives, and is responsible for attaining short-term and long-term financial and operational goals."

**TABLE 1**

| Position | Median compensation |
|---|---|
| Chief executive officer | $864,000 |
| Chief operating officer | $553,000 |
| Top sales and marketing executive | $300,000 |
| Top compensation and benefit executive | $188,000 |

**TABLE 2:**

| Position | Median comp. | Percent of Smith's time | Reasonable comp. for Smith |
|---|---|---|---|
| Chief executive officer | $864,000 | 25% | $216,000 |
| Chief operating officer | $553,000 | 35% | $193,550 |
| Top sales & marketing exec | $300,000 | 30% | $90,000 |
| Top compensation & benefit exec. | $188,000 | 10% | $18,800 |
| TOTAL | | 100% | $518,350 |

The top sales and marketing executive "plans and directs the entity's marketing and sales policies and objectives by identifying competitive strategies and distribution channels, while also developing and overseeing the sales function to assure the maximum attainment of sales volume."

The top compensation and benefits executive "plans and directs those human resource aspects that deal with compensation and benefit policies designed to attract and retain needed employees."

Indeed, Smith deserves to be well compensated, not just because of the long hours he works, but also because of the multiplicity of duties and responsibilities he undertakes.

The compensation data provide an indication of total cash compensation paid to executives in other companies in the same industry, for the four separate positions that Smith fills, as shown in Table 1.

To arrive at a median total cash compensation amount for Smith, we weigh the relative compensation amounts for each position. Based on the proportionate time spent in each position, we determine that an appropriate median total cash compensation for Smith as shown in Table 2.

The total reasonable comp for Smith (fourth column in Table 2) is $518,350, assuming he works the same number of hours as the executives in the database survey. But since Smith works 150 percent of the standard, we multiply $518,350 by 1.5 to get Smith's computed reasonable compensation amount: $777,525.

## Condition and Performance of the Company

That computed reasonable compensation amount is less that what Smith actually pays himself, so we should make a normalization adjustment downward. Before we determine the *final* reasonable compensation amount, however, we should consider the financial condition and performance of ABC.

Has ABC's balance sheet grown over time? Has shareholder equity increased? Have returns on equity or invested capital exceeded standard returns in the industry? In other words, has the company prospered over time under Smith's leadership? It's one thing to work hard;

it's another to prosper from the hard work. In the *Exacto Spring* case, the court applied an "independent investor's test." It said that a corporation can be viewed "…as a contract in which the owner of the assets hires a person to manage them [and] pays the manager a salary, and in exchange the manager works to increase the value of the assets that have been entrusted…." The increase in value "can be expressed as a rate of return to the owner's investment…." The higher the rate of return generated by the manager, the greater the salary that can be commanded.

How well ABC has been managed and grown, therefore, is a critical element of assessing the reasonableness of Smith's compensation. From a valuation standpoint, if ABC passes the independent investor's test magnificently, then perhaps Smith's $1 million compensation is reasonable. If ABC is floundering, then it would be hard to justify Smith's paying himself more than the computed reasonable compensation amount of $777,525.

## Conclusion

This computation of a reasonable compensation amount for the business owner-employee is significant because its deduction often has a material bearing on the economic benefits derived from business ownership. When reported compensation is not a fair or reasonable amount, large distortions of entity value can occur. The three key factors that we use in our assessment—the owner's multiple roles and effort committed, pay scales of comparable employees in other companies, and financial performance—allow us to calculate a reasonable compensation amount, and compare it with the owner's actual compensation. VE

## Additional Resources

**Articles**


- "Do CEOs Set Their Own Pay? The Ones Without Principals Do," by Marianne Bertrand and Sendhil Mullainathan, *National Bureau of Economic Research*, May 1, 2000
- "Reasonable Compensation and Excess Earnings: Hit or Myth?" by Kevin R. Yeanoplos, *National Litigation Consultants' Review*, November 1, 2003
- "Reasonable Compensation," by Gaylen R. Hansen, *National Litigation Consultants' Review*, January 1, 2004
- "How is CEO Pay Really Changing? The Answer is Surprising," *The E-Comp Report*, September 1, 2004
- "Executive Compensation and the Cost of Capital," by Marvin T. Brown, *The Value Examiner*, July/Aug 2003
- "Owner Compensation and the Value of a Closely Held Company," by Chris Hamilton, *The Value Examiner*, May/June 2003
- "How Did You Reach Your Conclusion Regarding Normalized Compensation?" by Mark DeRouen and Judith Lide, *The Value Examiner*, Oct/Nov 1998