VALUATION

Normalizing Owner's Compensation in Business Valuations

By Stephen Kirkland, CPA, CMC, CFC, CFF

Normalizing adjustments are often the most hotly debated component of business valuations. Owner's compensation may produce large, subjective adjustments and must be handled carefully. The adjustments can dramatically impact the conclusion of value, especially when the company's value is determined in large part by using a multiple of earnings. If the value is determined to be eight times earnings, for example, adjusting owner compensation by one dollar has an eight-dollar impact on value.

To illustrate this impact, assume that a company's value is considered to be equal to eight times EBITDA. Table 1 below shows how a $200,000 downward adjustment in the owner's compensation could increase the conclusion of value by $960,000:

TABLE 1: VALUE BEFORE AND AFTER ADJUSTMENT

	BEFORE ADJUSTMENT	AFTER ADJUSTMENT
EBITDA	$1,000,000	$1,000,000
Decrease to owner pay		+200,000
Tax effect of adjustment		–80,000
EBITDA after adjustment	1,000,000	1,120,000
Multiple	x 8	x 8
Conclusion of Value	$8,000,000	$8,960,000

Owner compensation amounts are controversial, especially when hard-working business owners are questioned about their own pay. (Unfortunately, some people view their compensation as a measure of their worth as a human being.) Determining appropriate compensation amounts is also a complex process, so these adjustments must be handled carefully.

WHY NORMALIZE COMPENSATION?

Normalizing a business' financial position and results of operations as reported in the financial statements or income tax returns helps to analyze its actual financial position. So when normalizing owner compensation, the purpose is not to restate the financial statements, but to help us understand the company's operations. Then we can estimate what amount a buyer would be willing to pay.

The majority owner of a business usually has considerable opportunity to set his or her pay at whatever level they choose. However, the owner of a minority interest may not be able to influence compensation amounts, so it may not be necessary to normalize owner compensation when addressing the value of a minority interest.

Owners of controlling interests set their own pay at above-market or below-market levels for many reasons:

- Shareholders of C corporations may raise their compensation, and eliminate dividends, to avoid double taxation. S corporations may pay their shareholders below-market amounts to minimize payroll taxes.
- There may have been deferred compensation that was paid years after it was earned. Catch-up pay is especially common when start-ups cannot pay the founders the full value of their services because of limited cash flow. Yet these early years may be when the owners work the hardest.
- The owners may shift some of their pay to family members for tax avoidance. When dealing with closely held or family owned businesses, always ask early in the process for all related parties to be identified. Remember to ask about the owner's spouse and extended family members (i.e. the grandson who is thousands of miles away at college and is getting paychecks approximately equal to his college costs). Identify all those who have been receiving paychecks but would not have been paid, or would not

have been paid as much, if the company had been owned by another party. This may include a former shareholder or the owner's paramour.

- Owners can take some of their pay in different forms, such as rent or loans, for tax avoidance.
- Owners might "play with pay" because of issues related to bankruptcy, marital dissolution, ego (i.e. "my W-2 *must* be seven figures!"), social security benefits (i.e. a spouse may need credits), financial aid, or mortgage refinancing. My favorite reason for an owner being overpaid or underpaid is: "We've always paid that amount."

STANDARDS OF VALUE

Just as no one valuation method is right for every situation, there is no one-size-fits-all method of normalizing compensation. To determine the right approach, we must understand the purpose of the valuation. For example, when considering the investment value of a controlling interest, where the target will get "tucked into" the acquirer, replacement reasonable compensation could be zero. This type of cost savings may be a driving force for the buyer.

Under a value to the holder standard, there may be synergistic benefits to other entities owned by the holder, which need to be considered and quantified.

GATHERING THE FACTS

Since normalizing adjustments should reflect the reasonable compensation of replacement executives, the first step is to understand the relevant facts about the owner that will help determine what a replacement would earn. Remember that owners may have decision-making responsibilities in all areas: personnel, marketing and sales, procurement, financing, price setting, quality control, union relations, customer relations, and they may help oversee legal issues. You might have to prod them, so ask about each of these areas. Consider how you would respond to similar questions—you may simply say that you "prepare business valuations," even though you also help with your firm's business development, training, and administration.

Interview the owners and see what they reveal about themselves. Ask both specific and general questions about each owner's duties, accomplishments, and compensation. Be sure to inquire about:

- Work efforts, specific responsibilities, travel requirements and challenges
- Their most significant achievements during recent years, including favorable contracts negotiated, key customers or employees attracted to the company, and any successful reorganization of the company
- Whether compensation amounts were for current or past services
- Relationships they have with customers, prospective customers, regulators, referral sources, suppliers, lenders, and employees
- Any awards or acknowledgements they have received from suppliers, customers or industry associations
- Any employment contracts, non-compete agreements, buy-sells or other agreements between the individuals and the company
- Details of corporate debts guaranteed by the owners, including interest rate differentials between guaranteed versus un-guaranteed loans[1]
- How compensation amounts were determined
- The company's organizational chart
- The company's compensation philosophy

Ask for a resume or bio for each of the owners. Also ask about unusual skills and traits. For example, being a celebrity is valuable in many businesses. One technology company was able to raise $1 billion of capital on Wall Street primarily because of the founder's name recognition and reputation. Another celebrity's name attracted valuable publicity and thousands of customers to an amusement park. Also, being technologically savvy or multi-lingual is increasingly valuable for owners in some industries.

Query the owners on how they spend their time. The owner of a construction company in the Midwest told me that he spends most of his time on business development. He chases the next project. Yet the owner of a similar construction company on the East Coast told me he spends most of his time on quality assurance. He visits job sites, inspects materials, talks to workers, and he personally walks the roof of every completed building.

Remember to include some open-ended questions such as, "What else do I need to know in order to normalize your compensation?"

Provide your questions in writing and ask that their responses be in writing. There are two advantages to having this in writing. First, you will have documentation for your files. Second, clients may think things through more carefully when they respond in writing than when they answer verbally.

It is a good idea to get these responses before your final face-to-face meeting with the client so you can ask for clarification at that time, if you need to.

COMPARABILITY DATA

The next step is to find comparability data, which is a collection of actual amounts paid by similar companies for similar services. This is a form of benchmarking. The theory is that the market establishes fair and reasonable compensation.

Although comparability data is often used to normalize compensation, getting good, reliable data may not be easy. When I receive

1 If no separate guarantor fee was paid, the wages should be increased to include an appropriate amount for this service. In some cases, the guarantor fee may be as much as 10 percent of the loan amount.

a call about new a project, the caller often says that the business he or she is calling about "is somewhat unique." This immediately raises a question in my mind: will comparability data be available? Yet the caller always expects me to find "lots" of comparability data.

One perfect comparable, such as a duplicate of your client, may not exist. Even if a perfect match did exist, how could you get reliable information from that company? You could send a questionnaire to that company, but you would be asking for some extremely sensitive information few people have access to, so you may not get a response at all. If you did get a response, you may not really know who completed the questionnaire or be able to correctly assess the reliability of the information.

Therefore, we use compensation databases and published surveys. There are many of them available from industry associations, government agencies, and publishing companies. Make the effort to find the best data available. In selecting sources for comparability data, remember that the courts are strict when determining what is really comparable. So once you have selected a survey or database, be prepared to answer some tough questions about it such as: Where do they get their information? How extensive is their data? How do they deal with duplication? How do they handle outliers? How many of their incumbents are in bankruptcy? How many are S corporations? How many are growing? [2]

Comparability data will include some individuals who have been overcompensated and some who have been undercompensated. In other words, these are raw amounts that have not been normalized. Yet by compiling a large number of samples, and then eliminating outliers, we can determine averages, medians, trends, and ranges of market levels of pay. The reliability of the data increases as the sample size increases.

Two resources that can help you with comparability data are:

- *Almanac of Business and Industrial Financial Ratios,* published annually by CCH, Inc., gives percentages. For example, they may show that companies in a certain industry and size range spent 3 percent of their gross revenue on officer compensation. But they may not say how many officers each of these companies had. Still, these ratios can be helpful in comparing your client's total officer compensation expense to industry averages.
- *Annual Statement Studies Financial Ratio Benchmarks,* published annually by The Risk Management Association, shows some databases ranges, so we can see amounts at various percentiles. For example, they may show how much an officer would be paid at the cut-off for the lower quartile or the tenth percentile of the range. This would be toward the low end. They may also show how much someone would need to earn to reach the upper quartile or ninetieth percentile. Amounts below the tenth percentile and above the ninetieth percentile are considered to be outliers and are therefore not usually used in benchmarking.

Databases may also show the mean and the median. The median may be a better guide than the mean since the median is less influenced by extreme amounts. But should we always use the median as replacement cost for a certain officer? Perhaps we should use the median only when normalizing pay for an average performer.

Consider using more than one source. That way, whomever makes a challenge will have to confront multiple sources. But also be careful when using different databases for different clients, because doing so can give the appearance of cherry-picking.

Using multiple sources of comparability data and financial ratios also provides the opportunity to confirm a conclusion. At times, one source may conflict with another and it becomes necessary to determine which is more reliable under the circumstances. The more reliable one is usually the one that has the most data (drawn from the largest sample) and enables you to focus most narrowly on comparable companies and comparable positions. So whatever sources you use, try to include data that matches your client in terms of the four key data points discussed below: titles and duties performed by the owner, industry, geographic location and company size or years of experience. Also, draw data from the relevant time period or adjust the amounts for changes in pay levels over time. [3]

TIP & CONSIDERATIONS

Titles and Duties—Don't be misled by titles. As mentioned earlier, two business owners in the same industry can do very different things. Because some owners perform multiple duties, you may need to run comparables for multiple titles and blend them. Since it is common for owners to wear multiple hats, we need to give them credit for all they do, but we do not use what I call "stacking." What I mean by that is we do not determine a compensation level for a CEO and then determine a separate amount for a full-time COO, and then add those two amounts together.

One person typically does not do everything that two separate senior executives would normally do if they were each carrying a full load. So where one person has multiple

2 Remembering the answers to specific questions such as these can be difficult. Consider including the answers in footnotes or an exhibit to your report if you expect to have a copy of the report in front of you when being cross examined months later.

3 After evaluating alternatives, I decided to use primarily ERI Economic Research Institute's compensation assessors after spending a day with their analysts and reviewing their quality control procedures. ERI seems to have the most extensive compensation data available, since they purchase over 900 salary surveys, and they allow subscribers to sort that data by the four key data points discussed in this article (titles and duties, industry, geographic location, and company size or years of experience) and it adjusts for timing differences.

SOURCES OF COMPENSATION COMPARABILITY DATA

ERI Economic Research Institute	erieri.com
LOMA	loma.org
PayScale, Inc.	payscale.com
Securities and Exchange Commission (publicly-traded companies)	sec.gov
U.S. Department of Labor, Bureau of Labor Statistics	bls.gov/ocs/
GuideStar (non-profits)	guidestar.org
PAS, Inc. (construction contractors)	pas1.com

titles, you may find it appropriate to determine pay for the higher position and then increase it by some reasonable allowance. Rules of thumb can be dangerous, but perhaps a starting point would be to increase the higher amount by 10 or 25 percent, to give credit for the additional duties. Yet some workaholics deserve even more than 25 percent because it would take more than one person to replace them.

Industry—Businesses are typically categorized by NAICS code.[4] Some companies have multiple business lines and therefore use more than one code, so blending may be necessary. For example, a company may be in manufacturing *and* wholesaling.

Don't assume that the business activity code shown on your client's federal income tax return is correct. Confirm that code early in the process because the return preparer may simply have used the code that was already in the software and rolled forward. A business may have changed dramatically since someone last looked up that code.

Geographic Area—Ideally, we prefer to find data from companies located near our clients since compensation amounts vary from one region to another. If necessary, you can use data from other areas and adjust it for pay scale differences. If, for example, you are valuating a CEO, you may sometimes use nationwide data without adjusting it since searches for new CEOs are often nationwide.

Size—For licensed professionals and employees who are not senior executives with companywide responsibility, we typically draw comparability database on the individual's years of experience. Examples of this would be dentists and accountants.

For senior-level executives who have companywide responsibility, we typically want to draw comparability data based on company size rather than years of experience. For most businesses, size is measured by gross revenue. In some industries, such as banking, size may be measured by total assets. For hospitals or nursing homes, size may be based on the number of beds.

Try to draw data from companies that are no more than 50 percent larger or 50 percent smaller than your client. Then be careful in size-adjusting that data. You will notice that executive compensation amounts do not move upward or downward in the same percentages as company size. For example, when a company's revenue increases by 10 percent, the CEO's pay may rise only 2 percent.

EXAMPLE

Table 2 on page 26 below shows comparability data for the CEO of a management consulting firm with $10 million of annual revenue located in San Francisco.

To obtain data for this sample, we pulled amounts paid by companies with revenue of $15 million to $5 million. Then the software used regression analysis to adjust pay amounts from those companies to the size of our subject company. These amounts are total cash compensation, so they include base salary and cash incentive bonuses. Welfare benefits and retirement plan contributions made by the employer are not included.

The amount at the tenth percentile might be appropriate for a poor performer or perhaps someone who has cut back their duties. The amount at the ninetieth percentile is for top performers. Based on your understanding of the facts, you must decide which amount in that range is appropriate. This is where we carefully consider the multiple duties and demands placed on the individual and the skills required to perform the duties successfully.

OUTLIERS

You may come to the conclusion that one person's replacement compensation would be off the chart, so to speak. There are some people whose achievements are so great that they deserve compensation above that of their peers. Carefully explain why that's the case in your report and try to quantify the replacement costs of the above-normal benefits.

For example, after a company's above-normal growth rate has been compared to industry averages, the value of the excess growth may be quantified by applying the profit margin. If your client grew 30 percent and its peers grew only 10 percent, you can determine the value of the additional 20 percent. Then, the replacement cost must be determined. In other words, if that owner had not produced 30 percent growth, how would the company have generated that additional revenue and how much would it have cost to do so?

In the examples mentioned earlier, the replacement cost of the executive who raised capital on Wall Street could be

4 Most data collectors use the six-digit North American Industry Classification System (NAICS) although the U.S. Securities and Exchange Commission still uses the four-digit Standard Industrial Classification (SIC) codes.

quantified. Careful analysis would provide an estimate of how much the company would have otherwise spent to raise those funds. The amusement park could estimate the cost it would have otherwise incurred to attract the additional customers if it had not had the celebrity CEO.

In *Allen L. Davis, et al v. Commissioner,* T.C. Memo 2011-286, a shareholder who generated extraordinary growth for a payday lending company earned $37 million of compensation one year. An analysis of their financial statements and some projections would reveal what the replacement cost could have been.

One apparel retailer had an ambitious goal of increasing sales each year. Due to economic conditions, most of their competitors said they were content to "hold our own." An analyst decided to normalize the owner's total compensation based primarily on the client's growth rate. Using comparability data which included only base salaries, the analyst began by using an amount equal to the median of the range for the owner's base salary. The actual growth rate was then used to compute an appropriate incentive bonus for each year. Her bonus was computed by tripling the growth rate, and then applying that percentage to her base pay. When sales grew by 16 percent, her bonus was 48 percent of her base salary.

In another situation, a company's primary goal was to maximize return on equity. As illustrated by Table 3 on page 27, when the company's return exceeded the median return on equity for its peers by 30 percent, the analyst determined that the owner's replacement cost could be 30 percent more than the median cash compensation of his peers. In addition, that amount was further increased because the owner had personally guaranteed some of the company's debt. By having his personal guarantee, the company had gotten a much lower interest rate from the lender. Knowing how difficult it can be to get someone to personally guarantee corporate debts, the analyst increased the owner's replacement cost by $22,000, which was half the amount of interest that the company had saved by having the owner's personal guarantee.

Another owner achieved above-market results in three key areas: profitability, growth and customer satisfaction. Believing that these results were rare, the analyst determined that the best assessment of her replacement cost was the amount found at the ninetieth percentile of the comparability data range.

In *Aries Communications, Inc. & Subs v. Commissioner,* T.C. Memo 2013-97, the court recognized that the business owner had personally facilitated the sale of company assets for $6 million more than the buyers' original offers. Experts who testified in this case disagreed on how to quantity this result, and this shows that there is no one correct way to bring this into perspective. In some situations, the value of an outstanding achievement cannot readily be quantified and thoughtful judgment must be used instead. Supporting a conclusion in these situations may be very difficult. Of course, if you can quantify the cost through some understandable and logical methodology, it will be more readily acceptable than an unsubstantiated opinion.

On the other hand, there are other owners whose accomplishments are so modest that their replacement cost may be below the tenth percentile. This situation may occur when a semi-retired owner has delegated most of his or her duties to other employees.

TABLE 2: COMPARABILITY DATA

REVENUE	10TH PERCENTILE	MEDIAN	90TH PERCENTILE
$15,000,000	$151,190	$284,068	$460,254
10,000,000	138,837	260,129	421,375
5,000,000	120,667	225,571	365,189

PROFESSIONAL GOODWILL

Relationships are powerful in some industries where owners have regular contact with customers, referral sources, suppliers and employees. The owners may have many such relationships and have outstanding reputations in the industry. These intangibles are valuable and may be referred to as professional goodwill.

When determining the value of a business, it is common to distinguish between professional goodwill, which is an asset of the owners, and enterprise goodwill, which is an asset of the business. It is wise to also consider professional goodwill when determining the value of the owners' services, and that may be a reason why normalized pay for one person is toward the high end of the range. This may effectively reduce or eliminate any professional goodwill from the valuation outcome, indicating any intangible value is enterprise intangible value.

CAN YOU CONFIRM YOUR OPINION?

The hypothetical investor test is a method of assessing a business owners' compensation level. You would not use this method often to normalize compensation in a business valuation; however, you might use it as a sanity check.

The hypothetical investor test looks at historical financial statements and uses the net income and the shareholders' equity to determine the return on equity.[5] If that return is high enough to satisfy a hypothetical investor or shareholder, then that may suggest that the owner earned all of his or her pay. In other words, to oversimplify it a little bit, if the company paid and deducted a certain amount of compensation and the company was still profitable enough, then it may be presumed that the people running the

5 The courts have often used net book value in computing return on equity, although an argument could be made for using fair market value instead, if fair market value is known.

TABLE 3: RETURN ON EQUITY

	PEER GROUP	CLIENT
Return on equity	10%	13%
CEO Compensation	$300,000	$390,000
50% of interest saved	–	$22,000
Total compensation	$300,000	$412,000

company were not overpaid. Again this may not be the methodology you would typically use to normalize the owner's compensation, but it is an interesting approach to consider for confirming your opinion.

COLLATERAL DAMAGE

As professionals, we always regard our work as highly confidential, and we expect our reports to be used only for their stated purposes. Yet somehow, our reports may eventually be seen by those we least expect. Although we cannot control these situations, it may be of great value to remind clients about the sensitivity of this information. Consider these examples:

- If your work product is somehow seen by tax authorities, they may propose tax assessments for unreasonable compensation based on your adjustments and explanations.
- Other shareholders may object when they see that another co-owner was "overpaid" and thereby received disguised dividends. It may not be an issue immediately, but in a few years, the relationship among the shareholders may turn ugly. You could be deposed in a shareholder dispute years after your report was issued.
- Lenders, such as banks, could claim that they had been given misleading or inaccurate financial statements. Be especially careful with catchup pay owed to a shareholder, which is not reflected as a liability on the balance sheet.
- Be mindful of prospective buyers. We hope they sign nondisclosure agreements and then honor those agreements. But one business owner near the West Coast learned a valuable lesson the hard way. The owner showed a prospective buyer a report stating that he and his wife had been receiving large paychecks from the company, but not really having to do much work. Rather than making an offer to buy the business, the prospect returned to his office and contacted the IRS in hopes of receiving a cash reward under the IRS' whistleblower statute.
- Some e-mails get forwarded and forwarded again. For example, I recently e-mailed a draft of a report to a doctor so he could confirm the facts. The next day, I began getting calls from attorneys and bankers saying, "I read your report." The doctor had forwarded the e-mail to one person, who promptly forwarded it to at least three others and on it went. (By the way, it was noteworthy that each of the callers said they had read my "report" even though it was clearly marked as a draft.)

CAUTION ABOUT CATCH-UP PAY

It has long been common for owners to get catch-up pay for earlier years.[6] For non-qualified deferred compensation (NQDC), beware of Internal Revenue Code Section 409A. The effects of Section 409A are far-reaching, because of its broad definition of "deferral of compensation" and the severe tax consequences of non-compliance. If you have a large normalizing adjustment for NQDC, consider sending the client a letter suggesting that they call this to the attention of their tax advisor. It may not be your role to provide tax advice, but do your clients a big favor and suggest that they tell their tax advisors the same facts they tell you.

If the NQDC has been accrued on the books each year as it was earned, remember to consider that expense accrual when computing your adjustments.

FINAL WORDS

Be sure your facts, methods and conclusions are well documented and explained. Before finalizing your report, ask yourself the questions you might be asked if you and the report ended up in court. Examples of such questions:

- Were you provided accurate information? Remember that the parties you talk to may have biases.
- Did you use reliable sources for comparability data?
- Did you use accepted methodology? And again, using comparability data is the most commonly-accepted methodology for normalizing compensation amounts.
- Could you confirm your conclusions with respect to adjusting the owners' compensation?

Your analysis and conclusions will be clear to you when you finalize your report. Be sure they are clear and make sense to others who read the report, even if they do not understand the client's business, and you will be less likely to end up in court. VE

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6 See *Choate Construction Company*, T.C. Memo 1997-495.