Appraising the Price of Leadership

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Valuation experts use various methods to determine the value of a business, which is inherently dependent upon its income. Some of these methods involve examining earnings that will be available to a hypothetical buyer after he or she receives a fair dollar for running the business. Earnings available beyond compensation for running the business has value and experts know how to turn that into a business value dollar figure.

Among the formulas requiring a figure for reasonable or replacement compensation are an excess earnings method, a capitalization of earnings method and industry specific rules of thumb.

REASONABLE COMPENSATION

The term "reasonable compensation" has its derivation in tax law. Business valuation experts have known for years that the figure used for reasonable compensation may have little to do with people's opinion of whether the amount is "reasonable" or not.

In tax law the term was used to describe something that was "not unreasonable." If something was not unreasonable, it would therefore be reasonable.

For example, the IRS may examine a corporation to determine if the salaries of its officers and shareholders included disguised dividends. Dividends, as you probably know, are not deductible to a corporation for income tax purposes. The "unreasonable" portion of an amount paid, as determined by the IRS, to an officer or shareholder for services rendered would be the amount the IRS would declare as a dividend.

Absent the IRS and its issues, an owner's income from his business—after expenses—is reasonable, even if it's a lot of money. Just ask the owners. They will tell you that the amount is reasonable for what they do.

Now, if you ask the same owners, "If you can hire someone to replace you, what would you pay for the right to operate as an absentee owner," they will probably give a different figure.

TERMINOLOGY

The business valuation profession has used various terms to describe the value associated with the line item "reasonable compensation" used in the valuation formula. Among them: replacement compensation, fair value of owner's services, value of owner's services, owner's replacement compensation, operator compensation and cost to replace operator.

Regardless of the terminology, the appraiser is trying to convey the same thing: the cost to replace the owner. This could be the average salaried person or a similarly situated professional. For simplicity purposes, we'll use the term "replacement compensation."

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To properly evaluate the compensation for any particular valuation, it is necessary to consider the following:

THE EMPLOYEE'S ROLE, JOB DESCRIPTION

Probably the most fundamental element—and first step—in the search for replacement compensation is to study the position's job description.

Like most job descriptions, it should include the job's responsibilities, educational requirements and work history for the person currently holding that position.

The search for replacement compensation should capture the functions at the highest level of services necessary for the position.

For example, a job description for a CEO may include the duties of customer relations, which require a degree in engineering for a highly technical area to explain the product to customers. The job responsibilities may also include purchasing office supplies.

The highest level of services—an engineering degree—is the level data should be gathered for. The lesser job functions, such as purchasing office supplies, could be performed by the new CEO or delegated by that person to someone else in the company.

THE INDUSTRY IN WHICH THE BUSINESS OPERATES

An understanding of the industry in which the business operates helps to understand the many unique characteristics associated with a particular business and how it compensates its employees. Some industries are cyclical in nature.

What may be happening within an industry, at any point in time, would be a factor in determining how much to compensate someone and how to compensate him.

Different industries—and different companies within the same industry—have different methods of compensation. Some use stock options, for example, as a major part of a compensation package, while others use bonus programs to form an incentive for productivity.

LOCATION OF THE BUSINESS

Quality of life issues and the cost of living in a particular area, coupled with geographic proximity to commerce, are factors that cause a disparity in compensation. A person located in Idyllwild, for example, performing the same function as a person running a business in Beverly Hills will probably receive a different compensation package.

Housing costs alone are a big factor in deciding how much a company has to pay to obtain its employees. Silicon Valley is a prime example of this compensation related factor.

Obtaining data for replacement compensation for the area closest to the location of the business is important. Adjustments may need to be made for data that is from areas farther away from the subject company than the appraiser would like. Such adjustments should incorporate elements the appraiser believes would bring more distant data in line with a local environment.

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THE COMPANY'S CHARACTER, CONDITION

Size, industry, location, competitive standing, operating results and history are key elements of a company's character and condition.

The size of a company, usually measured by total sales, has an effect on its ability to pay its employees. The larger the company, the greater its ability to pay.

The competitive standing of a company can have an effect on what it has to pay to get a particular job done. Generally, uniform levels of salaries tend to prevail between similar sized companies. Large market share companies, however, tend to pay higher salaries because competition enters the marketplace. Smaller companies sometimes have to pay large amounts to steal knowledgeable people, thus driving up compensation.

Operating results can affect salaries. In tough times companies tend to pay less than in highly profitable times. This factor should be integrated with an understanding of industry cycles.

EXTERNAL COMPENSATION COMPARISON

Comparing compensation of similarly positioned companies is another key factor in determining replacement compensation. For a company to be comparable, it must be meaningful and relevant. The comparable does not have to be perfect. As a matter of fact, the only true perfect comparison of a company is the company itself. Comparing a company to itself, while eliminating criticism of the limitations in a comparable, does not accomplish the task at hand.

This part of doing a compensation study has become less difficult over time. Access to studies on the Internet has made obtaining information easier. But studies are what they are: They do not represent statistical accuracy. This does not preclude reaching a conclusion on what someone should or could be paid. The compensation analysis should be coupled with an understanding of the source of information used by the study, together with the quality and the quantity of the items in the study.

Placement companies—aka "headhunters"—can serve as another useful source of information. They have experience in assisting companies in their financial affairs and can be an excellent source of meaningful relevant data, as are CPAs. CPAs counsel companies, prepare financial statements and tax returns and are usually familiar with a company, its affairs, operating characteristics and industry understanding. Often times the CPA's advice is sought by a company in setting levels of compensation.

COMPANY COMPENSATION PROGRAM

Understanding the financial arrangements between partners in a company is another key factor. Base salaries with bonuses based on profit can be an indicator that base levels are replacement levels. It depends on the facts and circumstances in each case. The program should be examined for consistency in its application.

JOB QUALIFICATIONS NECESSARY

The qualifications of the person performing the current functions need to be broken into those necessary to perform the job function and those that are unnecessary. For example, a partner running a CPA firm may have a degree in engineering. While this may be part of the person's résumé, it may not be necessary for the job. What are required are an accounting degree and a license as a certified public accountant.

Therefore, efforts should be made to encompass functions at the highest level of work necessary for the job and the qualifications necessary to do the job.

SUMMARY

An analysis of replacement compensation involves a proper understanding and consideration of not only the job functions necessary of the position, but the other characteristics associated with the company—its location, its comparability and the industry in which it operates.

The evaluator should employ techniques and methods to data obtained so that the conclusion derived represents information as close to the locale of the subject as possible. C

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