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Reasonable Compensation and **Replacement** Compensation as Used in Business Valuations for Marital Dissolutions Purposes

In the world of business valuations, one of the elements in determining the value of a business is the application of a concept dealing with the compensation for the person or persons running a business. This article will discuss the terminology used in the business valuation arena and will explore the elements necessary to determine the figures which would be placed in the appropriate slot in the valuation formula for reasonable/replacement compensation.

Valuation Formulas

The value of a business is inherently dependent upon its income. Valuation experts analyze many of the aspects of a business to give their opinion and ultimate conclusion so the courts can properly charge the person who receives the business in a property division.

There are a number of methods which are used to determine the value of a business. Some of those methods involve examining earnings available to a potential hypothetical buyer after he or she receives a fair dollar for running the business. Earnings available, beyond compensation appropriate for running the business, has value and the experts know how to turn that into a business value dollar figure.

Examples of some of the formulas which require a figure for reasonable/replacement compensation are:

- An excess earnings method
- A capitalization of earnings method
- Industry specific rules of thumb
- Others

Reasonable Compensation

The term “reasonable compensation” has its derivation in tax law. Experts in business valuations have known for years that the figure used for reasonable compensation may have little to do with whether the amount is “reasonable” or not.

In tax law, the term was really used to describe something that was not “unreasonable.” If something was not unreasonable, it would therefore be reasonable. For example, a corporation may be examined by the Internal Revenue Service to determine if the salaries paid to its officer/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 Internal Revenue Service, to an officer/shareholder for the services rendered would be the amount the IRS would declare as a dividend. Absent the Internal Revenue Service and its issues, a business owner who gets paid all the income from a business, after expenses, is reasonable, even if it is a lot of money. Just ask the owner. He or she will tell you that the amount is reasonable for what they do. Now, if you ask the same owner if he could hire someone to replace himself what would he pay for the right to operate as an absentee owner, he will probably give a different figure. Now we begin knocking on the door which will reveal the artwork depicting the real issue at hand.

As discussed below, there is a trend in the industry of business valuations to use different terminology which would help clarify the actual meaning in the context of a business valuation especially as it relates to family law. What the appraiser is really after is the amount of money which would be necessary to pay to replace the owner of a business for the services they render.

Terminology

The business valuation profession has used a number of different terms to describe the value associated with the line item “reasonable compensation” used in the valuation formula. Some of the different terms are:

- Replacement compensation
- Fair value of owner's services
- Value of owner's services
- Owner's replacement compensation
- Operator compensation
- Cost to replace operator
- Others

Regardless of the terminology used, the real meaning that the appraiser is trying to convey is the cost to replace the owner. This could be the average salaried person or a similarly situated professional. For purposes of simplicity, I will use the term "replacement compensation" to convey the above concept.

Replacement Compensation Considerations

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

1. Employee's role/job description in the company
2. Industry in which the business operates
3. Location of the business
4. Company character and condition
5. External compensation comparison
6. Company compensation program
7. Qualifications necessary to perform the services of the specific job assigned.

Employee's role/job description in the company. Probably the most fundamental element in the search for replacement compensation is the job description of the position. This is the first step in the search for replacement compensation. The job description should include all of the functions necessary to perform the tasks at hand for the subject. It should also include the educational background and work history for the person currently employed.

The search for replacement compensation should capture the functions at the highest level of services necessary for the position. For example, a current job description for the position of CEO may include the duties of customer relations which require a degree in engineering for a highly technical area. The job responsibilities may also include responsibility for purchasing office supplies for the company. The highest level of services, in this case an engineering degree, is the level data should be gathered for. Lesser job functions, such as purchasing office supplies, could be performed, or could be delegated by the person at the higher level.

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 and how much a person is compensated.

Some industries have different methods of compensation. Some use stock options, for example, as a major part of a compensation package. Some use bonus programs to form an incentive for productivity.

Location of the business. Quality of life issues, cost of living in a particular area, and geographic proximity to commerce are factors causing a disparity in compensation. A person located in Idyllwild, California, for example, performing the same function as a person running a business in Beverly Hills, California, 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. The 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 which is further away from the subject company than the appraiser would like. Such adjustments should incorporate elements that the appraiser feels would bring more distant data in line with a local environment.

Company character and condition. Size, industry, location, competitive standing, and operating results and history are key elements in the make up of a company's character and condition. Industry and location have been discussed above but are clearly woven into the character of a company.

The size of a company, usually measured by a total sales yardstick, will have 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, if competition among like-sized companies exists, uniform levels of salaries tend to prevail. Large market share companies, on the other hand, tend to pay higher salaries because competition enters the marketplace. Smaller companies sometimes have to pay large amounts to steal away knowledgeable people, thus driving up prices.

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 as described above.

External Compensation Comparison. Comparing compensation of similarly positioned companies is another key factor in determining replacement compensation. In order 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 than in years gone by. Access to studies via the internet has made life easier in obtaining information. 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.

Experience in assisting companies in their financial affairs can be an excellent source of meaningful relevant data. CPAs who counsel companies and prepare financial statements and tax returns are usually familiar with a company, its affairs, operating characteristics, and industry understanding. Oftentimes, the CPA's advice is sought by a company in setting levels of compensation.

Company compensation program. Understanding what financial arrangements are between partners in a company can be yet 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.

Qualifications necessary to perform the services of the specific job assigned. The qualifications of the person performing the current functions need to be broken into those necessary to perform the job function and those which 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 resume, it may not be necessary for the job. What is required is 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 evaluated 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.

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