



A PRACTICAL LOOK AT REASONABLE COMPENSATION



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In the realm of business valuation in a matrimonial context, Reasonable Compensation is a significant factor to consider. Depending upon the capitalization or discount rate being used, even minor changes in the reasonable compensation number can have major implications. This article will give you some practical information about reasonable compensation which will assist you in determining the propriety of this number in the reports you use and analyze.

When valuing a business using a capitalization of earnings or discounted future earnings methodology, reasonable compensation for the business owner(s) is deducted from the income stream determined. What is reasonable compensation? In simple terms it is the amount that would have to be paid to a comparable person to do the work the business owner(s) is doing. While that may sound like a relatively easy thing to do, there are many factors which will impact this number. Among them are:

- How many hours does the owner work during the year?
- What are the owner's specific duties?
- What training, education or licensing is needed for the job?
- Are there other key personnel who perform the same job?
- What are the industry standards and parameters?
- What is the local economic situation?
- Are there bonuses involved?

All of these factors, and others, enter into the reasonable compensation number. While some of the answers can be garnered by discussions with the owner, other employees and the non-owner spouse, others require research. Most of you have heard of Internet sites such as www.salary.com or www.salaryexpert.com. Another good site for all types of employment statistics is the U.S. Bureau of Labor Statistics at www.bls.gov. That site has more employment-related statistics than you could have dreamed even existed. It is also a good site for data on the economy both nationally and regionally.

One of the best ways to get key compensation information is through the industry itself. Almost every industry has a trade or professional association that can be a wealth of information. Although you may have to be a member to access data, you can have the business owner do that or you often find someone at the office of the association who is willing to discuss the issues with you and who can get you some information or refer you to someone who can help. I once valued a rental car business and after several telephone calls I was connected to a man who was the expert in the industry and was more than happy to have a long conversation with me. The same thing happened when I was valuing a fuel oil company and a CPA in New England had literally written the book on the industry.

For information on medical practices you can contact the Medical Group Management Association at www.mgma.com. Some of the data is fee based and they also sell an annual publication with compensation and production statistics based on parameters such as size of practice, medical specialty, geographic location and experience of the doctor. You can also refer to www.medzilla.com. For law practice compensation information you can go to www.altmanweil.com to purchase their comprehensive study.

Whether you are doing the research yourself or reviewing the work of a forensic accountant, there are a few things you will need to consider and understand in order to properly evaluate reasonable compensation.

- Make sure you know the amount of hours the owner works. If you have a business with competent management other than the owner, that owner may only work part time. His reasonable compensation should be commensurate with that. By the same logic, a business owner who works an 80-hour work week may be doing the job of two people and his reasonable compensation needs to be adjusted to encompass that.
- Analyze the actual types of jobs the owner is doing. In closely-held companies the owner may be the CEO, salesman, secretary, controller and janitor all in one. Make sure the salary fits the jobs being done. Don't assume that the owner's 40 hour workweek is spent solely on executive functions.
- If the business owner gets bonuses, you must determine not only if these bonuses are recurring and normal for the industry, but also if they are based on job performance or are simply a tax-saving device. Small businesses often try to "bonus out" the year end profit in order to reduce corporate taxes. This bonus might truly be part of the earnings stream that should be capitalized.
- Always consider the economic outlook of the industry and the local economy. Several years ago computer technicians were in demand and salaries rose accordingly. In more recent years the available positions in the industry have lessened, causing salaries to drop. It is a matter of supply and demand, and knowledge of the industry is necessary.
- Location, location, location. As with real estate, location can have a significant impact on reasonable compensation. A lawyer working in New York City may command a higher salary than that same lawyer working in Nebraska.
- Know what is included in the reasonable compensation number. Is it strictly salary or does it include payroll taxes, fringe benefits and pension? Make sure you compare apples to apples when the actual compensation paid is replaced by the reasonable compensation.

For an excellent discussion on the many factors that influence the determination of reasonable compensation, you can read the case of *Mad Auto Wrecking, Inc. v. Commissioner*, Docket No. 1959-94., TC Memo. 1995-153, 69 TCM 2330, Filed April 5, 1995. Remember, a \$20,000 change in reasonable compensation in a valuation using a 20% capitalization rate will change the value of the business by approximately \$100,000. The proper evaluation of Reasonable Compensation takes research, analysis and some common sense. It is a key component of the value of a business and should be closely scrutinized in order to assure the proper amount is being used. For more information on determining Reasonable Compensation contact Lynne Broza, CPA, ABV, CFF, Director at 732-676-4100 or lbroza@cowangunteski.com.

About the Author

Lynne Broza, CPA, ABV, CFF, Director is an expert in the financial aspects of matrimonial litigation and the valuation of closely-held businesses. With 30 years of experience in public accounting, Ms. Broza has been retained as an expert witness in litigation matters including divorce proceedings, personal injury claims, shareholder disputes and estate valuations. She has testified in cases in both New Jersey and New York.

