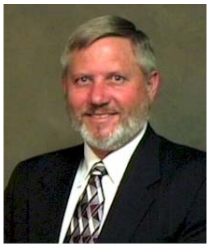

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HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

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ADJUSTING FOR OWNER'S COMPENSATION

One of the most difficult decisions to make (and support) in business valuations is whether or not to adjust the owner's compensation, owner's perquisites, excessive payments to family members, and the like, i.e. discretionary expenses not required for business operations and, if so, the magnitude of the adjustment. Many things impact this decision and arguments for opposing views often have pretty good support.

First, a decision whether or not to adjust owner's compensation should be adjusted must be made. "Conventional wisdom" holds that a non-controlling interest (also known as a "minority interest") cannot control the amount of compensation taken by the majority owner of the business. Therefore, an adjustment should not be made to owner's compensation when valuing a non-controlling interest in a business. However, this "rule" is not absolute – the appraiser must consider the facts and circumstances of each case. Also, the purpose and use of the appraisal assignment often has an impact on this decision as well.

For example, a number of years ago I valued a relatively large engineering firm for a 30% non-controlling owner. The 30% owner (the aunt & uncle of the controlling owner) had invested a substantial amount that enabled the nephew to build a large firm. After a number of years, the nephew began taking a larger and larger annual personal salary and bonuses and paying aunt (uncle had passed away) smaller and smaller distributions until the aunt became upset and threatened to sue as an oppressed shareholder. I adjusted the nephew's $3.5 million annual salary and bonus to an amount equal to that paid CEOs of similarly sized publicly traded firms as evidenced by data in those firm's annual reports. The difference dropped to the bottom line and resulted in a significant increase in the value of the firm as compared to the value using no earnings after a very large owner's compensation. Even though the interest appraised was a non-controlling (minority) interest, the majority owner's actions were so egregious as to warrant an adjustment.

Another example where an adjustment for owner's compensation was necessary involved a heating and air conditioning company that was owned two-thirds by mom and dad and one-third by the son and his wife. The son was getting divorced and the business adjusted compensation and other payments to eliminate any profits in the business in an attempt to make sure that the one-third interest owned by the son became worthless for the purpose of an advantageous divorce settlement. I made what I felt were appropriate compensation and other adjustments even though the interest was a non-controlling interest. The judge agreed that my adjustments were appropriate and ruled accordingly.

Occasionally, we see CPAs prepare a valuation report for one of their accounting and tax clients. This brings up an interesting issue – how can the CPA support a deduction for reasonable compensation on a tax return filed with the IRS and then adjust this compensation downward in an appraisal due to "reasonable compensation" in order to establish a "fair market value" indication for the business? The lack of independence becomes a big problem in these circumstances.

After having determined the need for an adjustment, the magnitude of the adjustment is the next issue to be resolved.

According to Trugman in *Understanding Business Valuation* (3rd Edition), "The officer's compensation adjustment is intended to restate the economic income statement of the company to a basis that includes the amount of salary that would be necessary to attract others that are qualified to perform the duties required by the company. I usually put myself in the position of an investor who will have to hire a replacement for current management. How much will I have to pay to replace management going forward?"

Many sources of information exist for data needed to estimate the amount of reasonable owner's compensation. For example, one of the best available sources is industry salary surveys. Other sources include salary data from various other industry sources, annual reports from publicly traded companies, published salary information, and various data sources that publish financial ratios as well as other data by industry.

Occasionally we find that a business is paying a "salary" to a spouse and/or children that are either not actually working in the business or whose contributions warrant a much smaller salary. These salaries are typically adjusted to "market".

We often only consider the cases in which ownership is taking excess compensation out of the business. However, when a business is generating insufficient income to pay the owner a "market" salary, an appropriate adjustment to increase the officer compensation may be necessary. Such an adjustment may result in an indication of no value to the business enterprise.

Adjusting for owner's compensation is not a mechanical process – it generally requires considerable thought and research in order to reach an appropriate and supportable conclusion.

Valuations play a part in strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value both real estate and businesses including machinery & equipment.**

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI
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