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Can owners compensation affect a company's value?

Owners of closely held companies have significant leeway when it comes to setting their own salaries and benefits. But how does that affect business value? Often, to obtain a more accurate valuation, it's necessary to "normalize" owners compensation. In other words, the appraiser replaces an owner's actual compensation with the amount a hypothetical "willing buyer" would pay an employee with similar duties, skills and value to the company. This results in an objective, unbiased owners compensation amount, which, in turn, contributes to a more credible business value.

Purpose of valuation

The relevance of owners compensation depends on the *purpose* of the valuation. Normalizing owners compensation is important in divorce cases when the marital estate includes a private business interest. It may also be necessary in situations calling for valuation of a company's stock, such as a merger, shareholder dispute or bankruptcy.

Typically, valuators don't normalize owners compensation when valuing a minority interest in a business, because a buyer would lack control over compensation. Also, it may be inappropriate to adjust compensation in connection with a sale or an employee stock ownership plan if it's likely that the owner will stay with the company — and continue to receive a particular level of compensation — indefinitely.

Impact on earnings

Business value is usually based on projected future economic benefits, such as earnings or cash flows. Higher owners compensation means lower economic benefits and, therefore, a lower value. Conversely, lower compensation means higher economic benefits. So, why would owners pay themselves above-market or below-market compensation? There are several possible reasons:

***Owners want to avoid double taxation*.** C corporations have an incentive to take earnings out of the business in the form of deductible compensation rather than dividends. The more they pay out in wages and benefits, the lower the company's tax bill. But dividends are taxed twice — first at the corporate level as operating income and second at the personal level as dividend income.

***Owners want to minimize compensation*.** Pass-through entities — such as S corporations, partnerships and LLCs — have an incentive to minimize owners compensation. They're not taxed at the entity level, so there's usually no danger of double taxation. But the less they pay in wages, the lower their payroll taxes will be.

***Owners want below-market salaries for nontax reasons*.** This might occur to help the company through a financial crisis, for example, or for public relations reasons.

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In some cases, owners pay themselves above-market salaries simply “because they can.” Whatever the reason, it’s important for valuators to determine whether owners compensation is in line with market norms and, if not, to adjust economic benefits accordingly.

Estimating market compensation

Determining market compensation for an individual owner can be a challenge. Be sure to include *all* owners compensation, such as benefits, stock options and personal expenses paid by the business, when normalizing the financial statements. Each business is different, so the value of a particular employee may vary depending on the employer’s particular needs and circumstances.

A valuator’s first step is to consult compensation studies for data on salaries and benefits earned by employees in comparable positions. There are many sources for this data, including the Economic Research Institute, the Bureau of Labor Statistics, Robert Half International, the Risk Management Association, various trade associations and executive recruiters *(and numerous websites including salaries.com – added by Katherine Puffer).*

Next, these benchmarks are adjusted to reflect the subject owner’s value. Factors to consider include duties, hours worked, age, health, management skills, knowledge of the market and existing relationships. Also relevant are general economic conditions and business-specific factors, such as the company’s size, financial condition, industry and geographic location.

Special circumstances may also justify higher compensation, such as an owner’s unique skills or advanced training. And an owner who assumes additional financial risk — by personally guaranteeing the company’s debts, for example — may merit a higher salary.

Ensure accurate valuations

Underpaid or overpaid owners can produce a distorted picture of a company’s future economic benefits in the hands of a willing buyer. To obtain an accurate valuation, be sure your valuator analyzes owners compensation and adjusts it if appropriate.

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