

Reasonable Compensation: Can Your Opinion Survive This 12-point Checklist?

Determining reasonable compensation in divorce cases is one of the “hotter topics” in the field, according to the AAML/AICPA’s most recent National Conference on Divorce. This latest annual gathering of attorneys and business appraisers was also its most successful, judging by the record number of attendees (nearly 450) who gathered in Las Vegas this past May.

How are reasonable compensation and pornography alike?

That’s not a trick question (or one inspired by the Vegas venue). Too many valuers find themselves in trouble when testifying about reasonable compensation, because they may rely too heavily on their general experience and training to support their opinions. “I know it when I see it” is their underlying rationale—which also happens to be Justice Potter Stewart’s famous definition of obscenity.

But of course, few valuers have specific training in salary determinations, vocational counseling, or professional “headhunting.” And few divorce clients can carry the expense of a compensation expert—who often earn more than the entire business appraisal will cost. (One attorney admitted that he is currently paying a compensation professional \$550 per hour, and has already racked up thousands of dollars in fees for only a few hours of input.)

As a result, “too many appraisers are still acting as compensation experts,” presenter Donald Schiller (Schiller DuCanto and Fleck, Chicago) observed. Because of the nature of the subject business—the duties of the owner/employee, the amount of money involved and other nuances, “determining reasonable or normalized compensation may be a major assignment in and of itself.” A vocational expert would perform case-specific studies instead of relying on “homogenized” databases, Schiller said. But a business appraiser, limited by time and money—may not have any other choice.

Know thy data—and its drawbacks

There are some excellent compensation sources available, and Schiller—along with copresenter Jim Hitchner, CPA/ABV, ASA (FVG, Atlanta), agreed that a target industry frequently offers the best data. “Most of them do benchmarking surveys,” Hitchner noted, which provide productivity data and more. (See the accompanying sidebar for the most current, comprehensive bibliography of compensation databases.)

But when using these surveys, “you’ve got to know the limitations of the data, and testify how you account for them,” Hitchner said.

“The worst thing for the credibility of the business valuation expert is not knowing how the databases and surveys were compiled, and what they truly represent,” Schiller seconded. To make sure your compensation calculations meet the challenges of opposing attorneys, know the following:

1. Is the data collected on a national or regional basis?
2. Does the data include owner/employees where the amount of compensation reported may also include business profits as compensation (i.e., partners in professions and businesses)?
3. Concerning data from business and professional associations, what are the sampling sizes that relate to the subject valuation?
4. When using SIC codes in identifying comparables, how do the particular characteristics of the subject company compare with the broader range of companies covered by the SIC code?
5. How does the data use/define the job titles, and are the actual duties comparable to the duties/hours of the subject owner/employee?
6. Does the data survey reflect averages? Medians? Quartiles?
7. Does the survey fairly reflect compensation for people with particular niches and sub-specialties; i.e., matrimonial attorneys, forensic accountants, lobbyists, etc.?
8. Does the valuator need to include multiple job titles from the survey data to cover the owner/employee’s duties?
9. What is the reliability of the statistics and sources that the survey uses?
10. Where applicable, are stock options, restricted stock, shadow stock compensation as well as other perks reflected in the data survey, and comparable to the owner/employee in question?
11. Were all companies in the database consistent in having/not having retirement plans separate from salary?
12. Is the owner a ‘key person’ in the business or a top performer/sales generator?

The Courts aren’t compensation experts, either

The “multifactor” test for determining reasonable compensation still finds favor in the federal Tax Court and Court of Appeals. For example, in *Haffner’s Service Station v. Commissioner* (1st Cir. 2003), the Court of Appeals discussed ten typical criteria to apply, including the employee’s qualifications and scope of work, the size and complexity of the business, general economic conditions, etc.

But ever since Judge Posner in the *Exacto Spring Corp. v. Commissioner* case (7th Cir. 1999) issued a blistering rebuke of the multifactor test (“the Judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no Judges are”), the prevailing trend has been toward the “independent investor test.” This presumes that the owner/employee’s compensation is reasonable, Schiller explained, “so long as the business owners are recovering their expected rates of return.”

The *Exacto* case recognized that managers who generate higher returns on investment can usually command higher salaries. To rebut the presumption, it’s necessary to show that the high return rates had little or nothing to do with the owner/employee’s activities; or that the company was using the compensation to conceal a dividend.

“It’s therefore important to learn what the owner/employee truly does,” Schiller said. “And don’t just ask him [or her]—ask the other employees and managers.” More often than not, when it comes to compensation, coworkers and colleagues will tell it like they see it.

Today’s Best Compensation Databases

- *America’s Career Infonet*, Employment and Training Administration, U.S. Department of Labor; www.acinet.org/acinet. Free on-line data, plus wages and trends information by occupation on a national, state, and metropolitan area basis.
- *Compdata Surveys*, Dolan Technologies Corporation; www.compdatasurveys.com. Executive and senior management base pay, annual incentives and benefits information on a national and regional basis, positions broken down by industry group, company size and revenue profile.
- *CompQuest*, Watson Wyatt Data Services; www.wwds.com A database analysis and report-writing tool that permits creation of reports by relevant positions, geographic areas, industries, and company size.
- *Executive Compensation Assessor*, Economic Research Institute; www.erieri.com. Software and report packages available for more than 271 top management positions, with data adjusted for demographics, industry, company size, and compensation valuation date.
- *Executive Compensation Database*, Aon Consulting, Inc.; www.ecomponline.com. Database covers publicly-traded companies; company data available free on-line.

- *Officer Compensation Database*, Integra Information; www.integrainfo.com/officer_compensation_database. Officer compensation expressed in dollar amounts and as percentage of sales by industry and company size for over 900 industries.
- *Officer Compensation Report*, Aspen Publishers, Inc.; www.aspenpublishers.com (search for “officer compensation”). Data on salaries, bonuses, pay increases, ownership levels, and incentives for small- to mid-sized companies in eight industry groups.
- *PayScale Salary Report*, PayScale, Inc.; www.payscale.com. Customized compensation and benefit reports for specific positions based on industry, location, company size, experience, education and certifications. Free summary reports available on-line.
- *Quick-Call Compensation Reports*, Economic Research Institute; www.erieri.com. Analysts provide “instant” compensation reports on as-needed basis, starting at \$200.

Source: *Willamette Management Associates*, “Valuing a Professional Practice,” presentation materials by Robert F. Reilly, ASA, Managing Director, for FAE Business Valuation Conference (May 15, 2006; New York).

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