Insights Into Recent Data on Small Private Company Executive Comp


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Insights Into Recent Data on Small Private Company Executive Comp

By Stuart Weiss, CPA/ABV

As BV people, we’re always trying to find good compensation data so that we can properly normalize financial statements. However, most of the good data focus on companies that are too large. And even if we wanted to purchase such data, we’d spend thousands of dollars to get it. That’s why Wayne Cooper, chairman of Chief Executive Group, developed a product for our marketplace that includes salary, bonus, equity, benefits, and perk data for CEOs, presidents, COOs, CFOs, and other categories of management.

For Dan Gilbert, a valuation expert in Portland, Ore., getting good compensation data such as what’s contained in this report is critical to his analysis of companies, most of which have revenues under $10 million. “It’s really good material and fills a need for those of us who appraise small businesses,” Gilbert says.

Cooper has been in the business information industry for 20 years, and as a management consultant he saw a tremendous need for good business data. His company has published Chief Executive Magazine for the past 34 years (www.chiefexecutive.net). I sat down with him to get his insights on the compensation data source he provides.

Q. Why were they willing to do that?

A. There’s a trust factor. Unlike many journalists, we’re not out to get them, to make a sensational story. We’re on the side of CEOs, trying to help them make better decisions, so I think they trust us—and they want that benchmarking data for themselves.

Q. Do you screen the data for accuracy?

A. We do some screens and look for outliers, and we have a few tests to make sure the data are consistent. If there are outliers, they’re flagged for someone to take a look at to make sure it’s reasonable and legitimate. If it’s out of whack with the size of the company, then we’ll dig in to see whether there’s a reason for the outlier. And if it’s a questionable data point, we’ll just throw it out. We’ll throw out about 1% of the survey responses because we deem them unreliable.

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Q. Tell us about the version of your product dealing with smaller companies.

A. For Business Valuation Resources, we created a version of this compensation product for businesses of $10 million in sales and below, which is the market for most business valuation professionals. In the larger report, which has been around for three years, we break out the data by company revenue: $2 million and under, $2 million to $5 million, $5 million to $10 million, $10 million to $25 million—all the way up to $10 billion. Given that some of our customers were small companies and didn’t need the data on the bigger companies, we did a version that just focuses on under $2 million, $2 million to $5 million, and $5 million to $10 million in revenue. This version came out this past September.

Q. Can you point out any interesting trends in the report?

A. Yes, one thing to note is the variation in total CEO compensation between top quartile and bottom quartile. While the median was $225,000, the top quartile was $586,000 and the bottom quartile was $112,000. Another interesting point is how much difference the average (mean) is from the median. In this case, the top 10% skew the overall average. Some of them had very lucrative packages and may have sold the company that year and got big equity gains that one year.

Q. I notice from the data in the report that most compensation above $400,000 is in new equity and equity gains.

A. Yes, you’ll notice that the median base salary is $170,000, whereas the mean base salary is $187,280. The bonus is a bigger gap: a median of $30,000 and a mean of $94,000.

Q. It looks like salaries are significantly different for companies with revenues under $2 million versus companies with revenues between $2 million and $5 million.

A. Yes, there’s a huge step-up in compensation, with median total compensation jumping from
$175,500 to $280,000. However, the step-up to $5 million to $10 million is almost nonexistent.

Q. What about geographical differences?

A. For the small company report, we didn’t have enough data points to do a geographical breakdown. In our bigger report, we didn’t see much difference between major regions of the country, but, for specific areas such as between Silicon Valley, Calif., and Portland, Ore., there are significant differences in compensation.

Q. Your report tabulates compensation by industry. What conclusions would you draw?

A. I was a little surprised that real estate and advertising/marketing were at the high end of the range while manufacturing was at the low end. I was also surprised at the variance by type of ownership. In the report, you’ll see that the base salary is higher for private equity than any other category. On top of that, the private equity owned company offers the CEO a big chunk of new equity—$150,000—versus zero for the family business. But you have to remember that

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<th>Two Tests Courts Use to Determine Reasonable Comp</th>
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<td>Will your analysis of reasonable compensation stand up in court? Courts typically apply one of two tests to determine reasonable compensation.</td>
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<td>1. Independent investor test. Under this test, the court presumes the owner’s compensation is reasonable if the shareholders or other independent investors are receiving their expected rates of return. For example, see <em>Exacto Spring Corp. v. Commissioner</em>, 196 F.3d 833 (7th Cir. 1999) (Available at BVLaw. Subscription required). The <em>Exacto</em> case recognizes that managers who generate higher ROI 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. Alternatively, you’d have to show that the company was using the compensation to conceal a dividend.</td>
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<td>2. Multifactor test. Under this test, the court will apply multiple factors to determine whether the compensation claim or adjustment is reasonable. The key case here is <em>Trucks, Inc. v. U.S.</em>, 588 F. Supp. 638 (D. Neb. 1987), in which the federal district court listed 15 relevant factors in the determination of reasonable compensation:</td>
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<td>• Employee’s qualifications and training;</td>
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<td>• Nature, extent, and scope of his or her duties;</td>
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<td>• Responsibilities and hours involved;</td>
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<td>• Size and complexity of the business;</td>
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<td>• Results of the employee’s efforts;</td>
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<td>• Prevailing rates for comparable employees in a comparable business;</td>
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<td>• Ratio of compensation to growth and net income (before salaries and federal income tax) of the business;</td>
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<td>• Absence of the usual fringe benefits, such as pension or profit-sharing plan, stock options, etc., which are available to executives of other companies of comparable size;</td>
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<td>• Employee’s responsibility for the company’s inception and/or success;</td>
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<td>• Time of year that the compensation is determined and by whom;</td>
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<td>• Correlation between stockholder-employee’s compensation and his or her stock holdings;</td>
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<td>• Corporate dividend history;</td>
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<td>• Prevailing economic conditions;</td>
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<td>• Financial condition of the company after payment of compensation; and</td>
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<td>• Whether an independent investor would be willing to compensate the owner/employee as he or she was compensated.</td>
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In practice, one good approach is to use the multifactor test to reach your conclusions about compensation. Then, apply the independent investor test to see whether the applicable rate of return makes sense.
the private equity company is a more competitive environment with a shorter half-life than a family-owned company where tenures can last a long time.

Q. Speaking of family-owned companies, how do you distinguish between C and S corporations?

A. We do ask the controlling shareholder how much of the take-home should be allocated to salary versus ownership. Let’s say it’s a C corp that is owned by the founder. The market rate might be $200,000, and there was another $200,000 in profit, but, because it’s a C corp, it’s advantageous to take $400,000 as compensation. So we would ask: Of the $400,000, how much was truly based upon what my competitive base salary should have been?

Final point: Determining the value of reasonable compensation can be a major assignment in and of itself, depending on the nature of the subject business, the duties of the owner/employee, the amount of money involved, and other nuances. It’s crucial for the analysts who use data sources to understand the databases and surveys, how they are compiled, and what they truly represent. Also, it’s best to use several sources to do a complete analysis. This will help if you and your analysis end up in court (see sidebar).


Stuart Weiss, CPA/ABV, is a business valuation practitioner in Portland, Ore. He can be reached at stu@stuartweiss.com or 503-223-3142.
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