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The Importance of Accurate Reasonable Compensation

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Accuracy is not just a goal in business valuation—it's a necessity. Marcum LLP performs valuations regularly and understands that precise calculations and judicious adjustments are essential for reliable valuations. One of the most critical adjustments we make is determining 'reasonable compensation' for business owners, an aspect often overlooked yet vital for presenting an authentic financial portrait. This article delves into the nuances of reasonable compensation and its profound impact on business valuation, sharing why it must be carefully assessed to reflect the true economic health of a company.

Reasonable compensation is a critical adjustment in a business valuation as it ensures that the profit/loss recorded by the business reflects the true economic picture by adjusting for the appropriate level of compensation for the business owner. If an owner is over-compensated, the business might appear less profitable than it actually is, as would under-compensation inflate its profitability. Both scenarios would lead to inaccurate valuations.

Numerous resources can be utilized to provide a guideline for reasonable compensation, as would using industry statistics of compensation within the owner's industry. However, reasonable compensation is not simply based on job title and hours worked; it must also consider the annual performance. For example, the CEO of a consulting firm whose revenue is $5,000,000, where the CEO generates a small portion of the business revenues as compared to a CEO who brings in almost all $5,000,000 in revenue. If valuation experts were to utilize statistics based solely on the industry, the revenue of the company, and hours worked, they would have arrived at the same reasonable compensation for both CEOs listed above. However, this would not portray an accurate picture as an owner who generates $5,000,000 of revenue would obviously be entitled to a much higher compensation level than that of a CEO who originates very little in revenue. In this scenario, replacement compensation should consider what benefits the CEO brings to the company instead of only focusing on their hours worked and job title.

For example, let's compare the reasonable compensation levels of professional athletes. There are thirty-two teams in the National Football League, each with a starting quarterback. Over the course of a season and career, there will be significant differences in their statistics and success despite all having the same job and working the same hours within the same industry. If an athlete were hypothetically replaced, the amount paid would vary based on their actual accomplishments. The same approach must be utilized when considering each business owner's reasonable compensation.

The art of business valuation hinges on the fine balance between numbers and judgment, and nowhere is this more evident than in establishing reasonable compensation. As we have seen, this is not a simple arithmetic or a one-size-fits-all approach but a complex consideration of individual contribution and industry standards. This is why choosing a firm with the experience of having valued thousands of businesses, such as Marcum, is paramount.

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