DETERMINING REASONABLE COMPENSATION

The Cost Approach

The Cost approach (AKA Many Hats Approach) takes into consideration all the tasks a business owner provides to their company. The Cost approach breaks the time spent by the owner down into the various tasks performed; wage levels are assigned for each task based on the owner's proficiency; and then added back together to obtain a hypothetical replacement cost for the owner.

Best option for determining reasonable compensation for a small business owner

Relies solely on comparability data.

The Income Approach

The Income approach (AKA Independent Investors Test) seeks to determine whether a hypothetical investor would be satisfied with their return on investment when looking at the financial performance of the business in conjunction with the compensation level of the owner.

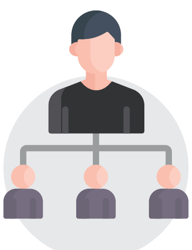
The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is examined.

The Market Approach

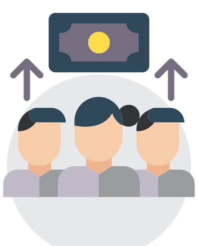
The Market approach (AKA Industry Comparison Approach) attempts to answer the question: How much compensation would be paid for the same position, held by a non-owner in an arms-length employment relationship at a similar company.

When to use the Market Approach?

The market approach focuses strongly on the owner's business type and the specific position held by the owner: typically CEO or General Manager.



The market approach works well when only one occupation, (usually upper-management), is being compared to peers in the same industry, with similar company size and geographic area.



The market approach is favored when working with medium-large companies, where the owner is wearing only one hat: that of a general manager or chief executive.

For more information about Reasonable Compensation Calculations
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