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Fact Sheet

Owner Remuneration and Business Valuations Explained

Topics discussed in this paper include

Owner Remuneration | Valuation Theory | Normalising

When assessing the value of a business, it is necessary to take account of variables in both a firm's accounts and it's approach to conducting business. Such reviews help to establish a credible value in the context of the broader market place. Often it is necessary to adjust the earnings of a business to take into account any abnormal or discretionary income and/or expenses. The most common, and often significant, adjustment concerns remuneration payments to business owners.

Backgrounder…

Regardless of the amount of salary a business owner has paid themselves, Business Valuers need to determine **the market rate** salary of the business owner. Factors considered in estimating the market rate salary include:

- the hours worked by the owner
- their qualifications and experience
- the level of responsibility and number of employees they manage
- the salary of other senior employees in the business and
- the size of the business.

Another way to look at it would be to ask a simple question: if the owner was leaving the business, and therefore had to employ someone to replace them, how much would they need to pay that new employee to attract a suitable candidate – at a similar level to the owner?

Subject…

A quick review of the methodology underpinning Business Valuations serves to illustrate why arriving at the appropriate market rate salary level is so important.

Most Business Valuations are calculated using an 'income approach'.

The income, or profits, of a business are reviewed to determine the business' value. Two frequently applied methods for assessing value (the Capitalisation of Earnings Method and the Discounted Cash Flow Method) rely on a careful and considered review of a business' income.

For this reason it is necessary to adjust the earnings of the business for any abnormal or discretionary expenses or income - especially remuneration payments to business owners.

Once an appropriate market rate salary of the owner has been determined, it is then a relatively simple matter of replacing the actual salary they have been paid with the market rate salary. This process is known as 'normalising' the earnings. This normalisation process is essential as it then allows businesses to be compared on a like-for-like basis.

For example; say the owner of a small manufacturing business paid himself a salary of $20,000 per year and his business returned a net profit of $150,000 (after paying himself the salary). If it were established the market rate salary for his role was actually $100,000 per year, it would be necessary to make a negative adjustment to the earnings of the business of $80,000 ($100,000 - $20,000). In this case the normalised earnings of the business would then become $70,000 ($150,000 - $80,000). We then know the true earnings of that business is $70,000 and it can then be compared to other similar businesses and industry data to determine the business' value.

In closing…

Normalising the earnings of a business is an essential part of undertaking a business valuation.

The single-most significant variable for review and adjustment is the remuneration paid to the owner.

The level of remuneration business owners pay themselves, and the way in which they do it can have a huge impact on the reported profits of the business. By replacing this discretionary expense with a realistic market rate, the business valuation can be accurately determined.

**An independent business valuation compiled by a professional can help.
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