

# HARVEST CFO CONSULTING

## Executive Compensation and Incentives

Compensation and incentive plans for executives of publicly traded companies are published in SEC filings. These documents make it relatively easy to compare the compensation structures of executives of public companies in similar industries. For privately held enterprises, public financial filings do not exist. However, compensating executives in privately held companies has similar objectives to their public counterparts. Among these is retention of valuable personnel and incentives for stated company objectives.

It is not uncommon for the senior executives of privately held companies, who are also typically substantial shareholders, to not draw their market value compensation. Instead, they either leave the earnings in the company as profit, or draw distributions on their stock or partner interests if the company is a pass-through entity.

There are inherent problems with this approach to compensation. Among these is inaccurate financial reporting of true financial results. This arises as a result of the executives not accounting for the fair market value of their services on their company's P&L. This often over-looked corporate expense impacts the accuracy of management reporting as to the true profitability of an enterprise. Another impact is an over-stated EBITDA can lead to an excessive internal valuation for shareholder buy-sell agreements.

Executives drawing a large part of their compensation in the form of S corporation or partnership distributions can result in a payout of cash that does not take into consideration the value each provides to the company. For example, a company has three shareholders, the CEO, the CFO and the lead project manager. Each receives \$100,000 in annual salary and draws their pro rate portion from \$480,000 of distributable pre-tax S corp earnings. The CEO is the primary driver of the business and his actual market value compensation is \$250,000 and he owns 45% of the stock. The CFO's market compensation for a company of this size is \$150,000 and he owns 30% of the stock. The lead project manager has a market compensation of \$80,000 and he owns 25% of the corporate stock. Under the current structure of \$100,000 equal compensation and pro rata S corp distributions, the CEO, CFO and lead project manager receive total compensation and S corp distributions of \$316,000, \$244,000 and \$220,000, respectively.

Currently the company expenses \$300,000 of executive compensation on its P&L, not the \$480,000 that would be expensed had compensation structures been set at market value (\$250,000 + \$150,000 + \$80,000). As a result, the \$480,000 of S Corp pre-tax profits is overstated by \$180,000. The company is valued at 3.5 times EBITDA for the shareholder buy-sell agreement. Therefore, \$180,000 of inflated earnings results in the company valuation being overstated by \$630,000.

Had the three executive's compensation been set at market value, S corp pre-tax earnings would be reduced to \$300,000. The total amount paid in compensation and S corp distributions would then be as follows: CEO \$385,000 (\$250,000 + \$135,000), CFO \$240,000 (\$150,000 plus \$90,000) and project manager \$155,000 (\$80,000 + \$100,000).

The market value compensation more accurately compensates the executives for their services performed. Also, the \$300,000 of distributable earnings is a more accurate reflection of the return earned by shareholders as opposed to the current \$480,000.

Whether or not a company can pay its executives market compensation is based on cash flow and the need to retain earnings for growth capital. Obviously if the company in our example is actually losing money, it would be difficult to increase executive compensation. When business uncertainty is added to the equation, then a significant portion of executive compensation should result from variable bonuses based on achieving earnings and cash flow targets.

Other awards such as restricted stock and stock options are used as incentives by publicly traded companies. For privately held companies, these incentives can also work well, especially if management believes an acquisition would be a potential exit strategy.

The use of stock options as compensation is not as prevalent as in the 1990s. In their place companies are using restricted stock to provide longer-term incentive to executives and key employees. Restricted stock awards are better than stock options for motivating employees to think and act like owners. Restricted stock awards are treated better for financial reporting than stock options. Restricted stock awards are better for the employees, management, investors, and regulators.

Market information as to compensation can be found in various published sources. [www.salary.com](http://www.salary.com) is a useful website for compensation information.

If you need assistance analyzing or creating an executive compensation structure, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail [dhillier@harvestcfo.com](mailto:dhillier@harvestcfo.com). Also, please visit our website at [www.harvestcfo.com](http://www.harvestcfo.com).

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